FIELD COURT TAX CHAMBERS

FCTC DIGEST

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Producer: Imran S Afzal

MEMBERS OF CHAMBERS

Patrick C Soares

Patrick Way QC

Philip Baker QC

Imran S Afzal

Peter Vaines

Philip Goeth

Katherine Bullock

Dilpreet K Dhanoa

David Bloom QC (Door Tenant, Australia)

Porus F Kaka (Door Tenant, India)

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Dilpreet K Dhanoa

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EDITORIAL

Imran S Afzal

Welcome to the fifth edition of the *FCTC Digest*.

Partitions Of Investment Properties Among The Joint Owners Can Resolve Family Problems But Note The Inheritance Tax Wrinkle – as you can see from the title of **Patrick Soares'** article, partitions of investment properties can be helpful but there is a wrinkle to be aware of! The article contains a helpful overview of the position.

Sticking with the topic of land, **Patrick Soares'** second article discusses *The New SDLT Regime Which Applies To Non-Residents Who Purchase UK Properties*.

Patrick Way QC's article *Boston Tea Party Part Two – Not Tea This Time, But DST! – (The New Digital Services Tax)* is a must read for its detailed introduction to the digital services tax and for its (albeit shorter!) discussion of the Tea Act 1773.

Tax law is full of conundrums and **Peter Vaines** identifies an interesting one in his article *Omitting*

To Exercise A Right – A Feline Conundrum. Read Peter's article for an interesting discussion of the inheritance tax position in relation to omissions to exercise rights.

At Field Court Tax Chambers we like to cover all angles, and a good example of that is **Katherine Bullock's** article *Pooling Land To Sell To Developers*. Above I mentioned Patrick's article about partitioning properties, and Katherine has discussed in detail the other side of the coin.

And finally for this edition of the FCTC Digest **Dilpreet K Dhanoa's** article *IHT And Interest Free Loans Repayable On Demand – Wherein Lies The Gift?* contains an interesting discussion with a focus on the position when a beneficiary lends monies interest free and repayable on demand to a trust to pay inheritance tax.

Happy reading!

PARTITIONS OF INVESTMENT PROPERTIES AMONG THE JOINT OWNERS CAN RESOLVE FAMILY PROBLEMS BUT NOTE THE INHERITANCE TAX WRINKLE

Patrick C Soares

A brother and his two sisters own three investment properties, as tenants in common, a third each.

They fall out and want to swap their interests so they own one property each.

This will be a partition.

Are there any tax problems?

WHAT IS A PARTITION?

Halsbury's Laws of England defines in para 223 a land partition thus:

> The legal term 'partition' is applied to the division of land, tenements and hereditaments belonging to co-owners and the allotment among them of the parts so as to

> put an end to community of ownership between some or all of them.

In the footnotes the following points are made.

> If three persons are co-owners, tenants in fee simple, of Blackacre, Whiteacre and Greenacre, the transaction by which one of them becomes sole owner in fee simple of Blackacre, another of Whiteacre and the third of Greenacre is a partition.
>
> A transaction by which one person becomes sole owner of Blackacre, while the other two remain co-owners of Whiteacre and Greenacre, is a good partition. This can only be by agreement of those persons between whom a community of ownership is left subsisting.

CAPITAL GAINS TAX (CGT)

Introduction

There is no CGT disposal under general principles on a partition.

If there is such a disposal the specific relief in TCGA 1992 s248A-s248C will apply in the normal case.

General Principles

In *Booth v Ellard* 53 TC 393 shares were pooled and Oliver LJ at 417 said there were no CGT disposal (it follows if the correct proportionate number of shares were taken out of the pool no disposals would result);

> **Where several separate owners of property pool their property through the medium of a trust in such a way that their respective beneficial proprietary interests under the trust reflect precisely the individual property interests which they separately had before the creation of the trust, nobody would say, I think, using language in its ordinary sense, that they had disposed of their property** except in the purely technical sense that the legal ownership has been transferred to the trustees. To tax such a technical disposition as one producing a capital gain would be capricious.........(my emphasis)

In *Jenkins v Brown* (1989) STC 577 *land* parcels were pooled and the Judge at 595 stated:

> ....one looks at the mass and not at the individual case in transactions such as the present**, where property was put into a pool, and where that result is reached (that the interests in the mass precisely reflect the individual interests before the deed was entered into) there is for capital gains tax purposes no disposal.** This seems to me inconsistent with the analysis that counsel for the Crown skilfully advocated of comparing the individual interests of the beneficiaries before and after. It is not for me to speculate whether the Court of Appeal might perhaps have reached a similar or even presumably a different result by any such approach; it simply is not the approach that was adopted by them. (the writer's emphasis)

There is no reason to restrict this approach to one land parcel. Thus, under general principles there is

no CGT disposals on partitions relating to a number of properties.

The express statutory reliefs are superfluous but it is prudent to satisfy them never the less.

The Express Statutory Relief for Partitions in TCGA 1992 ss248A-248C

The legislation reads thus:

> **248A Roll-over relief on disposal of joint interests in land: conditions**
>
> (1) Section 248B applies where conditions A to E are met.
>
> (2) Condition A is that a person ("the landowner") and one or more other persons jointly hold—
>
> (a) ....
>
> (b) two or more separate holdings of land.
>
> (3) Condition B is that the landowner disposes of an interest ("the relinquished interest") in—

(a) the holding, or

(b) one or more of the holdings,

to the co-owner or to one or more of the co-owners.

(4) Condition C is that the consideration for the disposal is or includes an interest ("the acquired interest") in a holding of land held jointly by the landowner and one or more of the co-owners.

(5) Condition D is that as a consequence of the disposal (taken together with any related disposals) the landowner and each of the co-owners become—

(a) ....

(b) ...... the sole owner of one or more of the holdings.

(6) Condition E is that the acquired interest is not an interest in excluded land (see section 248C: - this relates to cases where the principal private residence exemption may be in issue and is not relevant).

The effect of the above is thus: s248A applies to the partition between the 3 parties and any gains are rolled over under s248B.

STAMP DUTY LAND TAX AND PARTITIONS

Land exchanges under general principles bear SDLT (FA 2003 s47).

However, there is an exemption if the exchange in question amounts to a partition.

The relevant relief is in FA 2003 Sch 4 para 6 which reads thus:-

> Partition etc: disregard of existing interest
>
> In the case of a land transaction giving effect to a partition or division of a chargeable interest to which persons are jointly entitled, the share of the interest held by the purchaser immediately before the partition or division does not count as chargeable consideration.

The relevant HMRC guidance reads thus:-

SDLTM04030 - Scope: How much is chargeable: Non-cash consideration: Land partitioned FA03/SCH4/PARA6

Where two or more people are jointly entitled to land (whether a single chargeable interest **or more than one chargeable interest**) and there is a partition or division of the land this is not treated as an exchange. The giving up of a share in one part of the land is not treated as chargeable consideration for the acquisition of a share in another part…….(the writer's emphasis)

SDLTM04030a - Scope: How much is chargeable: Non-cash consideration: Land partitioned FA03/SCH4/PARA6:

Example

A and B own a farm jointly in equal shares.

They decide to partition the farm and it is agreed that A will take 50% of the land and B will take 50% of the land.

The total market value of the land is £2m.

> If each half of the land is of equal value then no Stamp Duty Land Tax (SDLT) is chargeable.
>
> However the land taken by A may include the farmhouse and farm buildings.
>
> The land retained by A has a value of £300,000 greater than the land that is to be retained by B.
>
> A's share is worth £1,150,000 and B's share is worth £850,000 and A might compensate B by paying £150,000 to equalise the partition.

This £150,000 would be subject to a charge to SDLT.

The point may be raised as to whether one can partition more than one property. The above extract refers to “more than one chargeable interest” so there is no limitation on the relief. If needs be the Interpretation Act 1978 s6 can be called in aid. It reads thus:-

> In any Act, unless the contrary intention appears,—
>
> …………

(c) words in the singular include the plural and words in the plural include the singular.

Thus with regards to the partition no SDLT is payable.

INHERITANCE TAX

The key IHT issue is what discount can be obtained for the 1/3rd interests in the triple owned properties. *This valuable discount is lost if the properties are no longer jointly owned.*

These discounts could be between 15%-30% and the adviser must take these into account.

Example

A, B and C own one third each in 3 investment properties each worth £1m pounds each. If A left her one third shares to her children in her will and died IHT would be paid on £1m less a discount of say 20% i.e. on £.8m. If the partition had taken place IHT will have been paid on £1m.

CONCLUSION

Partitions can be tax free events. Maybe when the properties were bought the brothers and sisters got on well. They may fall out and want to go their own ways.

Joint ownership is an automatic IHT savings device and clients must be warned that that savings is lost on a partition as seen in the above example. It may be in some cases a partition produces an attractive CGT position: if the partitioned property is left to a surviving spouse there is a CGT uplift without an IHT charge and the partition will have been a good idea as there will have been no discount on the uplift.

THE NEW SDLT REGIME WHICH APPLIES TO NON-RESIDENTS WHO PURCHASE UK PROPERTIES

Patrick C Soares

Introduction

The government announced in the Budget of 2018 that it intended to increase the amount of SDLT payable by non-UK residents when purchasing residential property in England and Northern Ireland.

On 11 February 2019, the government commenced a consultation on its proposals and published its "Stamp Duty Land Tax: non-UK resident surcharge consultation", which explored options for implementing a surcharge on non-UK resident purchasers. The consultation ran until 6 May 2019.

On 21 July 2020, the government published a response to its consultation "Non-UK Resident Stamp Duty Land Tax Surcharge: Summary of Responses", confirming its proposals in respect of

the surcharge. The provisions below give effect to those proposals.

The new provisions are contained in the Finance (2) Bill 2021 (Ordered 9/3/21) clause 88 and Schedule 16 will be found in FA 2003 s75ZA and Schedule 9A.

Residential transactions are dealt with in a number of provisions in FA 2003 and s75ZA simply increases the rates across the board by 2% (s75ZA(2)) if the transaction is a "non-resident transaction." The top rate can thus be 17% which is an astounding rate for UK stamp taxes.

UK practitioners use to look on with disbelief at the high rates of Irish stamp duties, but no more.

Meaning of "non-resident" transaction

A non-resident transaction is the purchase of a dwelling by a non-UK resident person. There are certain de minimis exemptions and there is an exemption where leases have not over 7 years left to run (Sched 9A para 2(1)).

The new legislation applies even if one of a number of purchasers are non-resident: the whole purchase consideration bears the extra 2% even that part which relates to the share taken by resident persons (Sch 9A para 2(1)(a)). There is a relief for spousal and civil partners who buy jointly (see below) and crown employees.

Example

Mr X and his brother Y by a London flat for £10m. Mr X is UK resident and buys a 90% share. Y is non-UK resident. The 2% surcharge is paid on the full purchase price.

When is an individual non-resident for these purposes? (Backwards and forwards test)

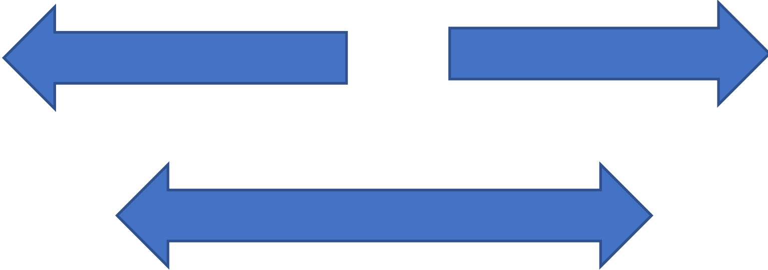
Special rules apply to determine residence and one does not look to the statutory residence rules or nationality or the like.

An individual is non-resident unless he is UK resident (Sched 9A para 3).

An individual is UK resident if he is present in the UK on at least 183 days during a continuous period of 365 day that fall within the relevant period. The relevant period begins 364 days before the effective date (normally legal completion of the purchase) and ends with the day 365 after the effective date (Sched 9A(4(2)).

THE GENERAL RULE – LOOK BACKWARDS AND FORWARDS

364 DAYS BEFORE......ED......365 DAYS AFTER



Find continuous 365 days

++++++++++++++++++++++++++

Find 183 days

This general rule is extraordinary as one needs a crystal ball to determine the residence position of the purchaser in the future. Sch 9A para 18 states the return must be done on the basis the individual will be resident outside the UK for these purposes if the test applied at the effective date does not treat him as resident. The return must then be amended if the individual is found as matters turn out to be resident (Sch 9A para 19). Buyers will need evidence of their presence in the UK. HMRC have indicated that a "pragmatic approach" will be taken. Evidence can include a person’s digital footprint; credit card and bank statements; work diaries, planners, timesheets / rosters; mobile phone usage and bills; utility bills; membership and usage of clubs. What an extra-ordinary state of affairs.

Exception to the general rules found in Sched 9A para 5 (1) and referred to in para 4 (3) (backward test only).

An individual is UK resident (so the 2% increase does not apply) if the individual is present in the UK for 183 days during the period that begins with the day

364 before the effective date and ends with the effective date and any one of Conditions A, B or C are satisfied.

Condition A is the purchaser is a trustee of a unit trust scheme or the individual makes the purchase with a company.

Condition B concerns certain partnership purchases.

Condition C covers purchases by trustees of certain settlements where no beneficiary is entitled to occupy the property for life or to the income from the property.

When is a company non-resident for these purposes?

Non-UK resident company.

A company is not UK resident if that is its treatment for corporation tax purposes on the effective date (Sched 9A para 7(2)).

UK resident company controlled by non-residents

In addition a company which is UK resident for corporation tax is deemed to be non-resident if it is a close company and is non-UK controlled and is not an excluded company (Sched 9A(para 7(3)).

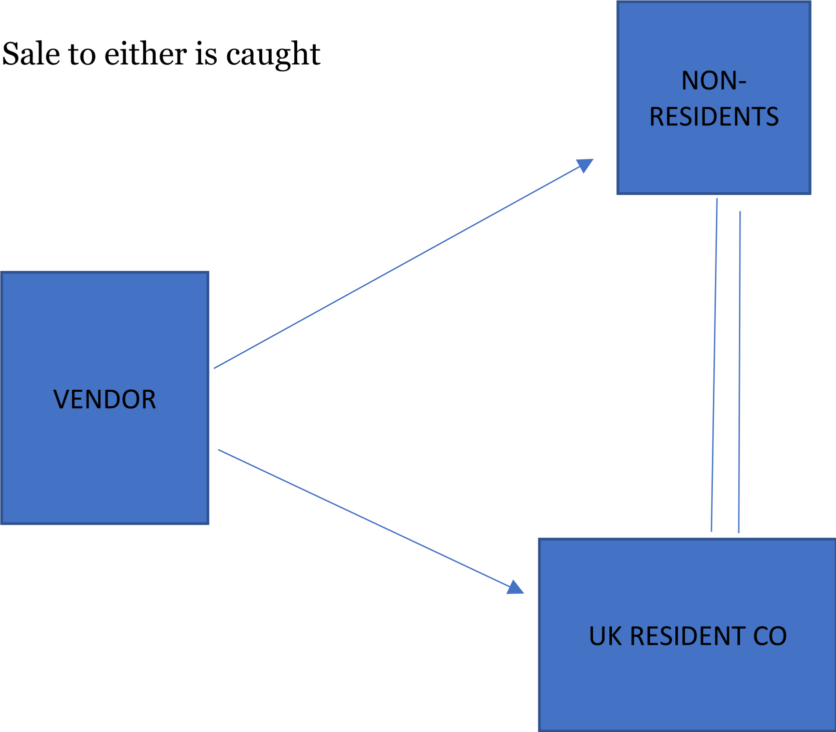
The company will be controlled by non-residents if non-residents would be entitled to the greater part of the company's assets on a liquidation disregarding any loan creditor rights. The rules are based on the close company participator rules and these are substantially adapted and practitioner must refer to these.

Pity the solicitors at the coal face.

Excluded companies are PAIFs and REITs.

UK COMPANY CONTROLLED BY NON-RESIDENTS

Sale to either is caught



Special rules for particular purchasers and transactions

Spouses and civil partners of UK residents

If say spouses living together are joint purchasers and one is non-resident and the other resident, Sch 9A para 12 treats the non-resident spouse as UK resident so the 2% does not apply.

Purchase by settlement if beneficiary entitled to occupy , or to the income from, dwelling.(Sch 9A para 14)

This relief applies if the purchaser or one of them is a settlement trustee and under its terms a beneficiary can occupy the dwelling for life or to income earned from the dwelling (the provision does not add "for life" as far as the income is concerned).

In such a situation one looks to the residence of the beneficiary and not the trustees to determine if the 2% charge applies.

Supplementary provisions

Dwelling has the normal definition (Sch 9A Para 20).

Reliefs – some good news

Reliefs such as the six or more dwellings relief are unaffected by this surcharge as a purchase of six or more separate dwelling are deemed to be a commercial purchase and the maximum SDLT charge is 5%.

Commencement (F(2)B 2021 Sch 16 para 6)

The key date is 1 April 2021.

The new provisions only apply if the effective date is on or after 1 April 2021.

Also if a contract is entered into and substantially performed before 1 April 2021 the new provisions do

not apply even though legal completion takes place on or after 1 April 2021.

There are also special rules which apply if the contracts were entered into before 11 March 2020.

BOSTON TEA PARTY PART TWO

NOT TEA THIS TIME, BUT DST!

(THE NEW DIGITAL SERVICES TAX)

Patrick Way QC

The Tea Act 1773 was passed into law on 10th May 1773 and, soon after, on 16th December 1776, American patriots reacted by throwing into Boston Harbour an entire shipment of tea sent by the East India Company. This in turn caused the British Government to respond and the resulting hostilities escalated into the American War of Independence which began on 19th April 1775 and culminated with the Declaration of Independence itself in July 1776.

As is well known the locals objected to the Tea Act because they considered it violated their rights as Englishmen to “no taxation without representation” but they also objected to the fact that the East India Company had been granted competitive advantages over colonial tea importers.

Well, now we have a new tax introduced into UK legislation, namely, Digital Services Tax (“DST”)

and although Boston Harbour cannot expect any new “dunkings” nevertheless the Americans are very unhappy about the new tax.

Specifically, the United States Government have objected strongly to the tax and in a paper produced by the Office of the United States Trade Representative (Executive Office of the President) on 13th January 2021 they described their objections as follows:-

(a) DST by its structure and operation discriminates against US digital companies when one takes account of the particular activities to which the DST applies and also the very high thresholds;

(b) DST is unreasonable because it is inconsistent with the principles of international tax as DST is by reference to gross revenues and another objection is that DST operates on an extra-territorial basis and with an element of retroactivity; and

(c) DST burdens or restricts US commerce.

In particular, they draw attention to the fact that all the companies which have been identified as being the subject of DST are American. These include the following:-

- Amazon;
- Apple;
- eBay;
- Facebook; and
- Google.

So what is the DST?

The starting point is that it is a 2% tax on the VAT-exclusive revenues derived from UK users. It is to be imposed on large businesses who are engaged in digital service activities meaning:-

(a) a social media service;

(b) an internet search engine; or

(c) an online marketplace.

It should be noted that there is an exemption from the online marketplace definition in respect of financial service providers.

DST applies in relation to an entity (including a group) when:-

(a) annual worldwide revenues arising from those digital services activity exceeds £500m.; and

(b) more than £25m. of these annual digital services revenues are attributable to UK users.

The legislation is intended to be temporary and will be repealed if and when the various attempts by international authorities to introduce a tax on a worldwide basis are finally implemented by, for example, the BEPS regime. Indeed, the Government have specifically stated that it considers the most sustainable long term solution to the tax challenges in point will be reform of international corporate tax rules and the Government also states that it strongly supports G7, G20 and OECD discussions on long term reform.

Although the legislation is relatively short (running to approximately eleven pages in relation to its main thrust) it is a sad comment on the wording of the DST that the new HMRC manual describing how DST operates runs to 118 pages.

Given that the threshold is so high (£500m. of which £25m. must be in relation to UK users) it might be thought that the legislation will have an impact *exclusively* on large US companies such as Amazon and Google. In fact, in the writer's experience it is already having an impact on businesses that would not be expecting to suffer the tax.

The key definitions are as follows:-

> "social media service" means an online service that meets the following conditions:-
>
> (a) the main purpose, or one of the main purposes, of the service is to promote interaction (between users including interaction between users and user-generated content); and
>
> (b) making content generated by users available to other users is a significant feature of the service.
>
> "internet search engine" does not include a facility on a website that merely enables a person to search:-
>
> (a) the material on that website, or

(b) the material on that website and on closely related websites.

"online marketplace" means an online service that meets the following conditions:-

(a) the main purpose, or one of the main purposes, of the service is to facilitate the sale by users of particular things, and

(b) the service enables users to sell particular things to other users, or to advertise or otherwise offer particular things for sale to other users.

"thing" means any service, goods or other property.

Any reference to a "user" in relation to a digital service activity of a person (the "provider") does not include –

(a) the provider, or a member of the same group as the provider, or

(b) an employee of such a person acting in the course of that person's business.

As mentioned, there is an exclusion for online financial marketplaces and an online marketplace is

an online financial marketplace for a relevant accounting period if more than half of the revenues arising to the provider in the accounting period in connection with the online marketplace arise in connection with the provider's facilitation of the trading of financial instruments or commodities or foreign exchange. The reference to the trading of commodities is to the kind of commodities and the kind of trading occurring on a commodities exchange.

Entities that are providing a social media service or an internet search engine or an online marketplace will need to consider the legislation carefully. The key to this is that these services are caught in circumstances principally where those activities are not an adjunct to the specific business of the taxpayer. For example, a business whose website has an internet search engine so that customers can consider better what goods to buy from that business will not have a relevant internet search engine. Equally, an online marketplace will not extend to a situation (for DST purposes) where customers are buying exclusively from that principal provider rather than being introduced to separate sellers.

Where there is a charge to DST then most unfortunately it does not operate as a credit against corporation tax but merely as a deduction. The ability to deduct does not specifically appear within the legislation but according to HMRC is simply available under normal "wholly and exclusively" principles.

By not having the DST as a credit against corporation tax there is a manifest unfairness. This is because UK companies that are already within the charge to corporation tax on these activities will effectively suffer an increase in tax by reference to the additional DST charge which is unnecessary. The legislation should have made the DST a credit against corporation tax.

As to the reaction from the US Government it will not involve, this time, jettisoning tea into Boston Harbour but the Biden Administration has nevertheless threatened tariffs on UK exports as a result. Consequently, it is expected that the price of clothing and footwear together with ceramics, beauty products and furniture will be hit.

More particularly, it is expected that these tariffs will raise the $325m. which (unsurprisingly) is

equal to the estimate of how much Britain is expected to raise from taxing the UK sales of Amazon, Google, Facebook, eBay and other tech companies which, as mentioned, are based in the US.

OMITTING TO EXERCISE A RIGHT

A Feline Conundrum

Peter Vaines

The charge to inheritance tax arises from section 1 IHTA 1984 on the value transferred by a chargeable transfer – that is a transfer of value made by an individual which is not an exempt transfer: section 2 IHTA 1984.

Section 3 defines a transfer of value as a disposition as a result of which the estate of the transferor is less than it would be but for the disposition.

This gives rise to the general principle that the charge to inheritance tax is not on the value of the subject matter of the gift, but on the value by which the transferor's estate is diminished. The example often quoted is the gift of a 2% shareholding which takes the donors shareholding from 51% to 49%. The 2% is worth very little but the difference in value between a controlling 51% shareholding and a minority 49% holding could be colossal – and it is that diminution of

the transferor's estate which represents the transfer of value.

Things can get more subtle, and section 3(3) IHTA 1984 covers the situation where somebody omits to exercise a right. Section 3(3) provides that:

> "Where the value of a person's estate is diminished, and the value—
>
> a) of another person's estate, or
> b) of any settled property, other than settled property treated by section 49(1) below as property to which a person is beneficially entitled,
>
> is increased by the first-mentioned person's omission to exercise a right, he shall be treated for the purposes of this section as having made a disposition at the time (or latest time) when he could have exercised the right, unless it is shown that the omission was not deliberate."

So if you do something, like not taking up a rights issue, allowing somebody else to take advantage of that opportunity with a result that the value of your shares goes down and the value of their shares goes up, you are treated as having made a transfer of value by section 3(3).

This issue became important in connection with pension schemes because many people do not take their pension benefits as soon as they arise. Why do that when you do not need the income – especially if you would have to pay tax at (maybe) 45% on it. The money can stay in the pension scheme and be invested free of tax - and be exempt from inheritance tax as well.

This sounds like good thinking - except that HMRC took the view that because you could have drawn your pension before you died, omitting to do so was a transfer of value under section 3(3) so it was not free of inheritance tax after all. Did we all know that the inheritance tax exemption for pension schemes only really applied to those who died before reaching pension age? Of course we didn't – and section 151 IHTA 1984 which provides an apparently unrestricted

exemption from inheritance tax does not say so either.

This obvious unfairness was eventually corrected by the Finance Act 2011 to the effect that the omission to exercise rights under a registered pension scheme or a QNUPS is specifically outside the scope of section 3(3).

Unfortunately, this was not soon enough for Mrs Staveley whose case found its way to the Supreme Court last year: *HMRC v Parry and others [2020] UKSC 35*

Mrs Staveley was gravely ill and in the knowledge that she did not have long to live she arranged a transfer from one life policy to another which provided better death benefits. She did not draw her pension (which she could have done – but why would she do that when she had only a short time to live; she clearly did not need the money) and when she died the value went to her sons, free of inheritance tax. Or so she thought.

Unfortunately not. HMRC said that she deliberately omitted to exercise a right to take her pension with the intention that her sons would benefit. So under Section 3(3) the transfer of value took place at the last time that she could have exercised her right which was the moment immediately before her death.

This case had a checkered history through the courts. There were two essential points. The first was whether the transfer into the new pension fund was exempt under Section 10 as a disposition not intended to confer a gratuitous benefit on any person. The second was that she omitted to exercise a right by failing to draw her pension during her lifetime.

The First Tier Tribunal said that the transfer of the pension fund was not a transfer value because it was protected by Section 10. It was merely moving her pension entitlement to another pension fund in which she was equally entitled. However, they found that her omission to exercise the right to take her pension was a transfer value and therefore chargeable.

The Upper Tribunal agreed that there was no transfer of value because of Section 10 but they also decided that here was no omission to exercise a right either.

The Court of Appeal then decided exactly the opposite; both the transfer and the omission gave rise to a charge to tax.

This judicial ping pong is enough to make you dizzy.

However, the Supreme Court has determined these

issues definitively, concluding that the FTT was right after all. The transfer into the new pension fund was not a transfer of value by reason of Section 10 but the omission to exercise her right was a transfer of value - and that is where the tax arose.

That is the end of the matter as far as the case is concerned and although it is no longer a trap for pensions, the implications of omitting to exercise a right has been confirmed to be worryingly wide. The Supreme Court explained that the omission by Mrs Staveley to exercise her right to her pension benefits meant that her sons' estates were increased. Section 3(3) does not require any particular person to benefit, merely that the value of another person's estate is increased by the omission.

This highlights a real problem with this provision. If I decline to accept a lucrative piece of new work simply because I cannot be bothered to do it, knowing that another barrister will do it instead and receive the substantial fee, I tick all the boxes for this to be a chargeable transfer. There are many other examples. This surely cannot be right and although this issue was not specifically determined by the Supreme Court, it may take a considerable effort for this proposition to

be overcome.

The test is that "the value of a person's estate is diminished" by the omission – and it could be argued that Mrs Staveley's estate was not diminished by her omission. Her omission merely failed to increase her estate which is not the same thing at all. But this is to overlook that she had a right to take the pension benefits and receive the money. The value of that right formed part of her estate and that right ceased to exist on her death. So her estate was therefore diminished by her omission.

However this gives rise to a philosophical point because section 3(3) provides that the value of a person's estate for the purposes of inheritance tax is "*the value of his estate immediately before his death*". But immediately before the death the rights still existed. So could the rights both exist, and have ceased to exist at the same time? I did not expect to find Schrodinger's Cat in the IHTA 1984.

POOLING LAND TO SELL TO DEVELOPERS

Katherine Bullock

INTRODUCTION

In his article in this edition of the FCTC Digest, Patrick Soares has addressed the complexities of partitions. In this article I cover the other side of that coin, pooling and in particular the pooling of land.

Also known as Land Collaboration Arrangements, there are various methods whereby multiple landowners can agree to combine their land to optimise its position on sale, either to make it more desirable, more valuable, or both. The landowners will generally each get a share of the profits, pool costs, and if correctly done the tax burden will be equitably split to match the economic return.

STRUCTURING THE ARRANGEMENT

The main goal when creating a land pooling arrangement as far as tax is concerned will quite simply be to avoid paying tax twice. After that, it is

generally preferable for proceeds to be taxed as capital gains rather than income, maintaining access to reliefs such as Business Asset Disposal Relief (BADR). Last but not least "dry" tax charges need to be mitigated.

Equalisation Arrangements

The most straightforward means of achieving the goal of selling combined properties as a single piece of land is through an Equalisation Agreement. Under such an agreement the parties will agree to promote the combined site together, and then when each sells their individual land, the costs and profits will be split in agreed proportions amongst all the parties. To achieve the agreed split of proceeds, the equalisation agreement provides for the landowners to make equalisation payments from the proceeds they receive to each other.

This arrangement has a considerable downside, however, in that the landowners may be taxed twice on the equalisation payments. Firstly, the owner making the disposal of his land will suffer CGT on the full amount paid by the buyer in respect of their land, despite the fact that they will be keeping only a

portion of the proceeds. There is no deduction under TCGA 1992 s.38 for the equalisation payments paid to the other landowners (*Burca v Parkinson [2001] STC 1298).* In addition, promotion costs that do not relate directly to the land disposed of do not qualify for deduction (although HMRC may be pragmatic if these are a pre-condition of planning permission). Each other party to the agreement will be charged CGT on their equalisation payment, as the disposal of a chose in action (ie the right to receive a share of the proceeds). The base cost of the chose in action is £nil and the full amount is therefore subject to tax. In addition, BADR and protective IHT reliefs will not be available in respect of the equalisation payments. Finally whilst the double charge to CGT might be avoided if the developer enters into the equalisation agreement directly with the landowners rather than these payments being made between the landowners, this risks the equalisation element falling subject to the higher rate of income tax under the Transactions in UK Land regime on the basis that the right to the equalisation payment is a slice of the developer's trading profits.

In terms of VAT, if the property is commercial, the owner is VAT registered and has opted to tax, VAT should be recoverable, albeit with some potential difficulty as HMRC may seek additional evidence that the owner has borne the cost and benefited from the services where a different owner is invoiced. Any parts of the owner's land which are residential land are VAT-exempt and VAT on costs attributable to that land will be irrecoverable. The buyer will pay SDLT as normal. However, care is required to avoid an SDLT charge on the landowners where they have a contractual right to force the other landowners to sell to a buyer. Here an SDLT charge might arise under Finance Act s.44A where the agreement is "substantial performed" by a party to the contract (not a third party) taking possession of the land (eg to carry out infrastructure works) prior to the transfer to the buyer.

An Equalisation Vehicle (Companies and Partnerships)

A method of avoiding the double CGT charge inherent in the method above is to transfer each landowners' land into a single equalisation vehicle beforehand (ie a company or partnership). This will

trigger a dry tax charge on the transfer into the vehicle. Where the transfer is to a company, whether by way of gift or in consideration for shares in proportion to the land introduced, a chargeable gain will arise on 100% of the market value of the land (subject to any reliefs available). Suitable valuations will be key. A company adds another layer of taxation increasing the effective rate of tax. The company will be charged corporation tax on the sale of the combined plots as a trading profit and the distribution of the net profit by way of dividend will be subject to income tax. Alternatively, if the landowners liquidate the company or dispose of their shares, a charge to CGT will arise. SDLT will also arise on the transfer to the company regardless of whether any profit is ever made on the sale, or if a sale ever occurs at all.

Where the equalisation vehicle is a partnership, CGT will only be suffered on the percentage of the partnership that the transferring landowner does not own. Whilst a partnership also avoids a double layer of taxation, it is likely be taxed on the sale as trading income rather than capital gains, with the accompanying higher rates of tax. SDLT on the

transfer may also be lower where the partnership provisions apply.

Finally, bear in mind that if the sale does not take place and the assets are transferred back to their original owners, this will attract another round of corporation tax, SDLT and VAT charges.

However, there is a benefit to the use of an equalisation vehicle, and that is the simplification of recovering VAT costs on commercial land where the vehicle would register and opt to tax. There is a similar commercial benefit in that a potential buyer would deal with a single entity.

Land Pooling Trust (Bare Trusts, aka. Jenkins v Brown Structures)

Collaboration without the landowners being taxed twice can be achieved through the use of a bare trust. Typically the landowners transfer their land to two individuals who hold the entire land as bare trustees for the landowners, with each landowner having an undivided interest in the overall land in proportion to the value they contributed and their agreed share

of the profits on sale. If the creation of the trust were to give rise to an exchange of an interest in land for a share of the whole, CGT, SDLT and VAT liabilities could arise. However, provided the contributions exactly reflect the beneficial interests of the participants, *Jenkins (Inspector of Taxes) v Brown [1989] 1 W.L.R. 1163* and *Booth v Ellard [1980] 1WLR 1443* established that this transfer into a bare trust will not be deemed a disposal and that the base cost on sale is the original base cost of the landowner.

Any transfer back out of the bare trust where a landowner has second thoughts, or a sale is aborted is similarly not treated as a disposal. The position may be more complex if a part disposal has taken place.

This treatment depends heavily on the drafting of the documentation (in particular to avoid the creation of a partnership), HMRC's acceptance of the case law as at CG3441 ("The documentation needs to be carefully considered before it is accepted that the decision in Warrington (or Jenkins) v Brown applies") and valuations that support the transfers

into trust. The CGT position is therefore not certain. When a tranche of land is sold, the trustees hold the proceeds for all of the landowners in their respective shares. Equalisation payments are avoided, and each landowner is liable to CGT on the gain arising on their respective share, avoiding the double charge to CGT.

This arrangement also minimises the risk that the whole arrangement will be considered trading, and thus treated as income, rather than capital gains, since no disposal to an equalisation vehicle takes place. There remains a risk of proceeds being taxed as income if substantial development takes place.

HMRC's approach to the SDLT position is also uncertain. The argument is that the trust arrangement does not attract SDLT on creation on the basis that no disposal has taken place. Although HMRC has indicated that this may be reviewed and that SDLT may be charged (as an exchange of land interests giving rise to SDLT on the market value), as it stands this is not their approach. Note, however, that if SDLT were to arise, there would be no proceeds to meet the liability. Nevertheless, when

pooling and depooling care should be taken to avoid exchange language in the documentation. Any distribution of land from the pool to an original landowner should qualify for partition treatment, but alterations in the landowners' shares (not becoming entitled to a particular piece of land outright) for consideration will enjoy no relief from SDLT and will be chargeable transactions.

Exchanges of land interests are taxable supplies for VAT but HMRC appear to accept that this is not the case. There is no change in the beneficial interests and legal ownership is ignored for these purposes. Typically, the owners would jointly register for VAT and opt to tax on commercial land, enabling recovery of input VAT incurred on the costs provided that the invoices are addressed to the owners as a group.

The major downside of a land pooling trust is that Entrepreneur's/Business Asset Relief may not be available to the landowners on the sale since their interest is in the entire site and not simply their own land. Parts of the land may therefore not have been owned or used by the landowner and therefore fail to meet the criteria for an associated disposal. There

may also be other impediments. The landowners may also lose IHT reliefs if they pre-decease the completion of the development, although it may be possible to preserve these if rent/licence fee is paid for the part occupied. There should be no IHT on contributions to the trust as there is no transfer of value and it is a bargain at arm's length. Given HMRC's ambivalent position it is wise to seek clearance in advance, if possible.

Options

An alternative for pooling the land where the sale is to a developer is to use options, whereby each landowner grants the developer an option to purchase their land, to be either used or assigned to a prospective buyer. The consideration for the grant equals the equalisation payment the landowner is entitled to receive, the exercise price being the market value of the landowner's land at date of exercise less the equalisation payments due to the other landowners.

Each landowner is therefore only taxed on their share of the profits. However, there is an acceleration of that part of the tax charge on the

grant of the option since the grant qualifies as a disposal for CGT purposes. This gain arises on the value of the right to the equalisation payment; thus, the more uncertain the grant of planning permission and the sale the lower the tax paid.

This structure should also allow for BADR provided the landowners meet the conditions for that relief in relation to their own land. However, note that this relief would only cover gains from the disposal triggered by the grant or exercise of the options over a landowner's property, and not the gains from the share of the other landowners' proceeds, being a chose in action under the principle in *Marren v Ingles [1980] 1 WLR 983*.

In terms of SDLT, the grant of options is a chargeable transaction and SDLT must be paid by the developer when they acquire the option. Since the eventual proceeds of sale are not yet known, the SDLT will be paid on a "just and reasonable" estimate with an adjustment made when the sale is finally made. SDLT will also arise on exercise of the options and based on the exercise price. The developer has two options at this point. They can assign the option to

the purchaser paying SDLT on the assignment fee. Alternatively they could contract to sell the land, exercise the options and direct the transfer of the land to the purchaser and claim sub-sale relief such that only the buyer is subject to SDLT on the amount paid to the developer.

As with equalisation payments, if the property is commercial, the owner is VAT registered and has opted to tax, VAT should be recoverable, albeit with some potential difficulty as HMRC may seek additional evidence that the owner has borne the cost and benefited from the services where a different owner is invoiced.

However, as the options structure does not require any taxable supply by the developer (since the developer's share of the profit is received by way of a reduction in the option exercise/assignment price) no VAT is due on the developer's share of the profits. This can be a significant benefit to landowners of residential land.

Options and Equalisation vehicles

By combining the option route with a company, the dry tax charge that arises under either scenario may be avoided by granting the option to the equalisation vehicle. At this point, the value of the option at grant will be low. Exercise will take place when a buyer is found and the company can direct the landowners to transfer the land directly to the buyer, with the company paying the land value at grant to each owner and any excess profit being shared as a distribution. Since the value of the options at grant equals the value of the land at the grant the CGT and SDLT payable will be low. BADR will also be available to those who qualify for it on the exercise price although not on the distribution from the company on which income tax will be due. As this structure should be able to benefit from sub-sale relief, SDLT should be reduced. However, there will be an additional taxation on the extraction of profits from the company.

Restrictive Covenants

One solution to the double taxation issue is an arrangement whereby each landowner grants the others a restrictive covenant over their land, to be lifted in exchange for payment when the land is sold.

Since these payments are a cost of sale, they qualify for deduction under s.38 TCGA 1992. However, granting a restrictive covenant is a part disposal for CGT purposes based on the value of the restrictive covenants granted in return, giving rise to a dry tax charge. Again, this value will be low where the prospects of success are very unsure. Significant projected value will drastically increase the tax charge on these covenant disposals.

BADR will not be available against receipts from other landowners on the release of the restrictive covenants, since the covenant is not an asset used in business, although the relief may be available on the grant. SDLT should also not apply on the grant (as there is no exchange of a major interest), but the payment made in consideration for lifting a restrictive covenant will be subject to SDLT (effectively creating a double charge). Furthermore, each landowner must register and opt to tax and invoices should be issued to all owners, increasing the compliance required to recover VAT.

Concerns about enforceability of the covenants may make this option a non-starter in many cases.

POTENTIAL TAX ISSUES

There are some issues to consider which may affect any and all of these structures and should be checked before a choice is made as to what type of land pooling should be used.

Trading or investment

All of the above structures assume that the landowners are holding their property as investments, so as to be charged CGT on their gains, rather than as trading stock which would attract income tax instead. Trading stock would avoid double taxation entirely and would allow a deduction for equalisation payments, but it would attract income tax which, at rates which can be as much as double that of CGT, may be bad or worse.

The mark of a trading asset in respect of land is that it typically carries two “badges of trade” as set out by a Royal Commission in 1955 - the owner’s intention on acquiring the asset, and the amount of work done on it. It is important to note that even if the intention on acquisition was to hold the asset as an investment, if a significant amount of work is done

on the asset, this can indicate a supervening intention to trade. Note that if an equalisation vehicle is used, the intention of the vehicle is what matters, not the original owners.

A full redevelopment such as the construction of housing estates on a plot of land will generally be taken as a change of intention, even where the land has been held as an investment for a long time (but see the recent decision of the UTT in *Hopscotch*). However, merely getting planning permission for development and starting preliminary work should not generally tip an investment over into the territory of being a trading asset. The dividing line is indistinct and must be judged on a case by case basis, with any profit before the change in intention attracting CGT, and any after being taxed as trading income.

Transactions in UK Land (TUKL) regime

The TUKL rules apply if land is acquired or developed with the main purpose to realise a profit on disposal. If these rules apply, the gain is taxed as income and not as capital gains. However, these rules are unlikely to apply in the vast majority of

collaboration cases, where the general principles apply. They are also unlikely to apply to the sale of an equalisation company where the land is held as trading stock.

The exception is where the land was held as an investment but then sold on to a developer who has agreed to pay the landowner additional amounts contingent upon the development of the land (overage). Although the TUKL rules apply only to land acquired or developed with the main purpose of realising a profit on disposal, which does not cover the landowner, they do apply to any profits realised by a person who is a party to or concerned in an arrangement enabling a profit to be realised from the land. In HMRC's view, additional profit dependant on the development of the land falls within these provisions (BIM 60645). This is not the case where a fixed sum is paid to the landowner regardless of the success of the development process, or where the payment has been deferred but the amount paid will not vary based on the development of the land. In that case, the payments will be treated as capital gains.

Entrepreneur's/Business Asset Disposal Relief

Entrepreneur's relief, or as of 11 March 2020, Business Asset Disposal Relief, has of course reduced lifetime limit of £1 million. The availability of the relief, where land pooling is undertaken, requires careful consideration. The land being sold may not constitute all or part of a business; a property letting business will not count as a business for these purposes.

The relief can also apply to shares, thus potentially applying to a vehicle structure where the company is used to acquire the site and then the company itself is sold. However, it is only available where the shares have been held for 24 months as of 6 April 2019, so significant forward planning may be required. Furthermore, only the gain realised on the shares is relieved, and relief on the initial disposal to the company is dependent on whether there has been a disposal of business assets.

OTHER PITFALLS

There are also a number of issues to consider which are not directly tax related but may still throw a

significant spanner in the works if they crop up unexpectedly.

Collective investment scheme

The landowners must take care that their arrangement, however it is structured, does not fall within the definition of a collective investment scheme as per s.235 of the FSMA 2000, or else they will require a FA-registered operator to manage the scheme for them. Companies and LLP are exempt from this requirement as are structures where the owners share day-to-day control. If neither of these exceptions apply, it may be possible to structure the arrangement in such a way as to be excluded as a scheme not operated by way of business.

Partnership

Care must also be taken to avoid accidentally creating a partnership at law. If business is carried out with a common view to profit, this can give rise to partnership and unlimited liability for the partners, with the obvious risks that carries with it. Carrying out significant works and sharing the costs and losses is likely to give rise to a partnership, and

in such cases the landowners may wish to employ a company or LLP to avoid the risk of unlimited liability. Just as one cannot create a partnership where none exists through a Partnership Agreement, one also cannot simply agree that no partnership exists when the evidence shows that one does.

Valuation

Valuation of respective areas can give rise to particular issues. Acreage may not reflect the value; areas of woodland, ponds, nature reserves are unlikely to be developed and may skew the profit shares. Valuation issues arise on areas such as infrastructure, amenity and SANG (suitable alternative natural green space) land, which whilst not valuable, is required for planning consent. In addition, there are more traditional areas of difficulty such as ransom strips.

CONCLUSION

In summary, land pooling is less a single way for multiple landowners to efficiently transfer land and split the costs between them, but rather is a selection of methods by which this goal can be achieved, with

having pros and cons which make them more or less suitable for any given parcel of land or group of landowners. As always, great care should be taken to ensure that the most suitable option is selected for an individual's circumstances, as the consequences for choosing the wrong method or applying the right method incorrectly can result in more tax rather than less, and the tax burden being split even more unevenly than might otherwise have been the case. But when done right, the commercial benefits of land pooling are significant, and well worth the care required to establish.

IHT AND INTEREST FREE LOANS REPAYABLE ON DEMAND – WHEREIN LIES the GIFT?

Dilpreet K. Dhanoa

"Inheritance tax is a voluntary levy paid by those who distrust their heirs more than they dislike the Inland Revenue."

PETs & GROBs

This often-misquoted line from the former Chancellor, Roy Jenkins, tends to be simplified when repeated with respect to context. Jenkins originally made the statement in 1986 when the predecessor to Inheritance Tax, the Capital Transfer Tax, was repealed. The new Inheritance Tax Act brought in provisions concerning potentially exempt transfers and gifts with reservations of benefit (PETs & GROBs), which in essence provided that gifts of any amount could be made provided such gifts were outright with no strings attached, and provided the person who made the gift survived for seven years.

In theory, one could argue that in order to avoid an inheritance tax liability one could give away everything they own today to their beneficiaries – provided they survived seven years IHT would not be in point. An issue arises when that individual needs money to live on, and Jenkins' statement went to this point: how much could one trust people to give that money back versus how much an individual might dislike paying tax in the first place.

It is axiomatic in the legislation that under the Finance Act 1986 (section 102(3)), a settlor on his or her death is generally treated as beneficially entitled to the settlement assets if a benefit has been reserved. In other words, for inheritance tax purposes, the trust assets formed part of the settlor's estate (*per* section 5(1) of the Inheritance Tax Act 1984) and there will have been a deemed inheritance tax transfer of value on the death of the settlor. Unless the settlement comprised excluded property, this will be a chargeable transfer.

The trustees are usually liable to pay the tax (*per* section 200(1)(b) of the Inheritance Tax Act 1984), and they have the responsibility to deliver up the inheritance tax account.

Loans - gift of the interest forgone?

A question which arises periodically, and which is the focus of this article is: what if a beneficiary lends monies interest free repayable on demand to a trust to pay inheritance tax (this may have arisen on the death of the settlor who reserved a benefit in the settlement) – does this make the lender a part settlor of the settlement such that on the beneficiary's death inheritance tax on the trust assets will be an issue? Assume the lender is not domiciled in the UK and the loan is not situate in the UK. Assume the trust assets are not excluded property and the trust is not located in the UK ; this may be an Isle of Man trust created by a non-UK domiciled settlor which owns shares in an Isle of Man company which owns UK residential property (the shares are not excluded property: Inheritance Tax Act 1984 Schedule A1).

Breaking down the transaction into its constituent parts and analysing the purpose of each is critical. The money being loaned to the trust is interest free, but it is a loan. The purpose and function of a loan is to give money to another for a period of time, with the intention that that sum will be repaid. Looked at in another way, there is no transfer of value as the

intention is for it to be repaid (albeit on demand) and not retained. As a result, there is no reduction in the value of the beneficiary's estate.

A loan is not a gift as the intention is it will be repaid. Thus the gift with reservation of benefit provisions cannot apply to the loan itself.

One might argue that the interest forgone is a form of a gift. Again, breaking down the constituent parts of the transaction and looking at their function and purpose, the interest was never in place to have been forgone. The sum was loaned without the expectation of any interest being part of the repayment sum. Therefore, any such argument – that there is a gift of the interest forgone – is not very impressive.

HMRC Guidance and interest free loans repayable on demand

HMRC's guidance on the matter is that such a grant of an interest free loan repayable on demand is that it is not a transfer of value, *"because the value of the right to repayment of the loan is equal to the amount of it"* (HMRC Manual IHTM14317). However, HMRC adopt the view that there is an element of gift *"because there is a clear intention to confer bounty:*

the property disposed of is the interest foregone." However, HMRC makes clear that the grant of such a loan in itself is not a gift with reservation.

From an inheritance tax perspective, if the loan is not a gift with reservation of benefits and the loaning party is excluded from all benefit (save for their right to have their loaned sums returned), then the logical outcome must be that there is no charge to inheritance tax on the death of the lender on any part of the trust fund (which is located in the UK for IHT purposes in the situation envisaged).

HMRC's statement in relation to the loan being a gift might be a practical approach to the problem, but it opens a veritable Pandora's box. Academic commentators are generally of the view that a loan is not a gift (see, for example, Clarke's Offshore Tax Planning, para. 108.9). The point made is that whilst HMRC may argue that the failure to charge interest on a loan is a gift which triggers the gift with reservation rules with regards to the interest forgone, the critical question is: are those rules even engaged in the first place? Whilst a failure to charge interest may be bounteous, this author agrees with Clarke's position that, *"it is difficult to see how interest*

forgone can be subject to a reservation”. Furthermore, there is no property which has been gifted onto which the tracing rules can be attached.

Home loan schemes

HMRC’s guidance has doubtless been impacted by, and is the result of the home loan schemes. These schemes largely came to an end towards the end of 2003, but the pre-owned assets income tax charge announced in the Budget that year was targeted at the schemes (in part). The result was legislation which stated that the loan was an excluded liability that affected the value of the house (*per* Finance Act 2004, Schedule 15, paras 11(6)-(7)). HMRC’s guidance at the time stated that it was of the view that loans repayable on demand could not be called gifts and that such schemes would not be caught as gifts with reservation.

Swynson’s case

In the recent Supreme Court case of *Swynson Ltd and another v Lowick Rose LLP (in liquidation)* [2017] UKSC 32, their Lordships held that a short-term repayable loan carrying no interest was not a gift. Citing Lord Reid in the case of *Parry*, the Court said that the ‘intrinsic nature’ of such transactions

should be looked at (as opposed to the source of the payment) – in other words, the substance should be considered over the form. Simply because the lender has chosen not to charge interest does not mean that the loan is a gift. Substantively, the lender requires repayment and that is the condition on which the monies have been loaned.

Conclusion

The conclusion is interest free loans repayable on demand do not engage the reservation of benefit provisions with regards to the loan itself.

HMRC argue the interest forgone is a gift of the notional interest but that is an arguable point and the author feels HMRC are wrong on that point.