Points of View

by Patrick Soares

VAT and Landlord Inducements to Tenants to Enter Into Leases

The results of the European Court decision of C&E Commrs. v. Mirror *[2001] STC 1453 and the subsequent High Court decision in* Trinity Mirror plc (formerly Mirror Group plc) v. C&E Commrs. *[2003] STC 518 made it clear that, except in extraordinary circumstances, if a landlord paid a tenant an inducement sum to take on a lease the payment was outside the scope of VAT.*

The tax editor had some doubts as to whether the analysis of the courts in this area was correct: surely the tenant gave a vatable service, of taking on the lease, to the landlord? Nevertheless, the law is the law. HMRC sought to give the decisions a highly restricted interpretation in Business Brief 4/03, holding that there was still a VAT charge where the tenant, for example, not only agreed to pay rent but also agreed to redecorate the demised premises from time to time. However, in Business Brief 12/05 (15 June 2003) HMRC have now given a view which will hopefully settle some of the difficult areas.

HMRC accept that lease obligations to which tenants are normally bound do not constitute supplies for which inducement payments on entering into leases are consideration. There may, however, be exceptional circumstances where the tenant does make a supply to the landlord and the inducement payments become vatable. This could be if the tenant agrees to carry out:-

1. building works to improve the property by undertaking necessary repairs or upgrading the property, or

2. fitting out or refurbishment works for which the landlord has responsibility and is paying the tenant to undertake.

Also, if the tenant is acting as an anchor tenant, and is paid on inducement for this, the payment may be vatable. HMRC will not assume that a tenant is an anchor tenant just because there is publicity indicating that a particular tenant has taken a lease. HMRC also confirm that undertaking to use improved materials as part of continuous repairs under a tenant repairing lease would not constitute a taxable benefit to the landlord.

This change of practice may mean that some taxpayers have been wrongly taxed over the past few years and Business Brief 12/05 sets out how they should approach their local office to deal with the past. Although the Business Brief shows that HMRC accepts the implications of the European Court decision and the High Court decision, there will clearly be borderline cases. However, inducement payments to tenants to take on normal leases with the normal repairing clauses and rent obligations, unless exceptionally the tenants are to be an anchor tenants, and are to be paid for this, should not present problems: the inducement payments will be outside the scope of VAT.

Major Restriction on SDLT Relief for Intra-Group Land Transactions

There is a major restriction on the ability to obtain SDLT group relief in the Finance (No. 2) Act 2005 now found as FA 2003 Sched 7 para Z(4A)).

It is provided that group relief is not available if the intra-group transaction is not effected for bona fide commercial reasons. If the taxpayer overcomes that restriction it is further provided that the relief is still not available if the land transfer forms part of arrangements of which the main purpose or one of the main purposes is the avoidance of liability to "tax". The critical point here is that "tax" means stamp duty, income tax, corporation tax, capital gains tax and SDLT.

One would expect to find more and more provisions such as these – mini-GAARS as they are called – finding their way into the tax code following the House of Lords' recent retreat from the *Ramsay* approach to tax avoidance (*MacNiven v. Westmoreland Investments* 73 TC 1, *Barclays v. Mawson* [2005] STC 1 and *IRC v. Scottish Provident Institution* [2005] STC 50). It is difficult to know how the new restriction on group relief will operate. The House of Lords in *IRC v. Willoughby* 70 TC 57 at 117A indicated that tax avoidance "is a course of action designed to conflict with or defeat the evident intention of Parliament". It may be in many cases where intra-group transactions have been carried out there is no avoidance of tax within that definition. For example, if one non-UK-resident group member sells property at market value to another group member in order (amongst other reasons) to increase the amount of interest relief available for offset against rents from the property it could be argued that obtaining the relief for the interest in these circumstances does not conflict with or defeat the evident intention of Parliament.

The critical thing is practitioners should not assume that just because the technical requirements in FA 2003 Schedule 7 Part 1 are satisfied that the relief is available – they must also take into account the effect of this new anti-avoidance provision.

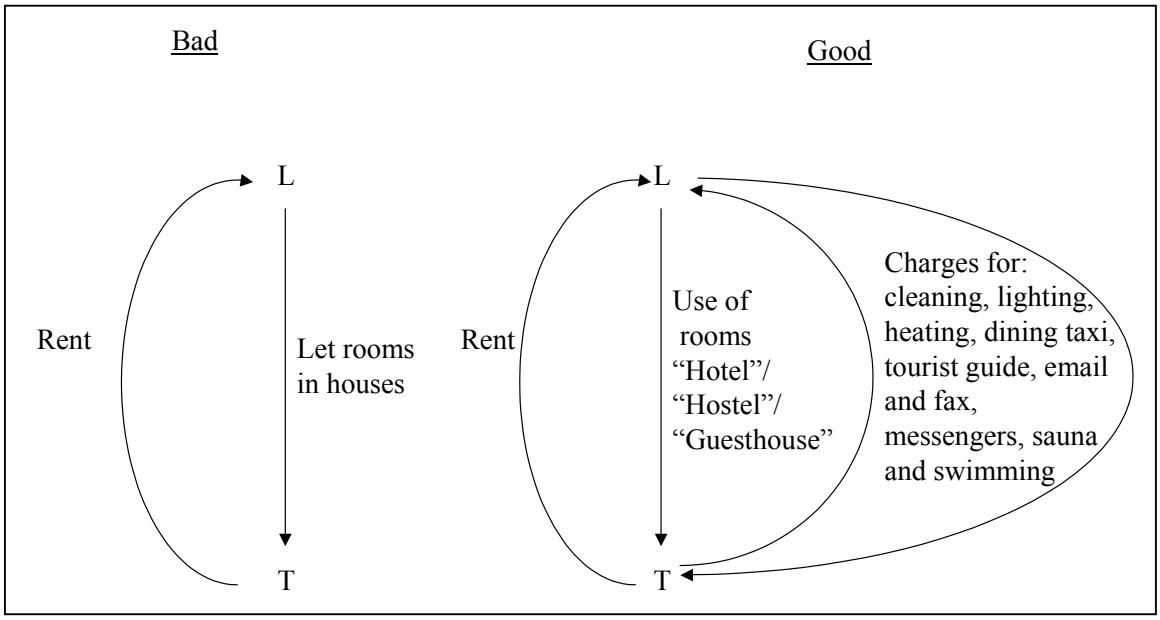
Inheritance Tax – Get Active: Business Property Relief is Everything!

There can be very few doubts that the obtaining of the 100% exemption from inheritance tax for assets which qualify for business asset property relief under IHTA 1984 s.104 is a great area of focus for inheritance tax planners.

All businesses qualify for the relief unless they consist (with some exceptions) wholly or mainly of one or more of the following, that is to say, dealing in securities, stocks or shares, land or buildings or making or holding investments. A simple land dealing business will not qualify and nor will a simple property investment business. However, one should be able to ensure that property developers and builders qualify for the relief. In *IRC v George* (2004) STC 147, Carnwath LJ (at [23] and [27]) commented on property letting businesses. The key thing is to determine whether the business consisted mainly of the holding of property as an investment. The property investment activity would require one to look at activities such as arranging for leases or licences and the maintaining of the property as an investment. However, activities relating to cleaning, lighting and heating would not be property investment activities. If a landlord took the opportunity of having a captive audience – its tenants – make use of other services - on top of cleaning, lighting and heating – then it may be his

business is not one of mainly holding property as an investment. The landlord may be able to change its business name to include "hotelier" or "guesthouse" and supply additional services to its captive audience making as much profit as possible – dining facilities, laundering facilities, tourist guide and email and fax facilities, theatre booking services and taxi services for example.

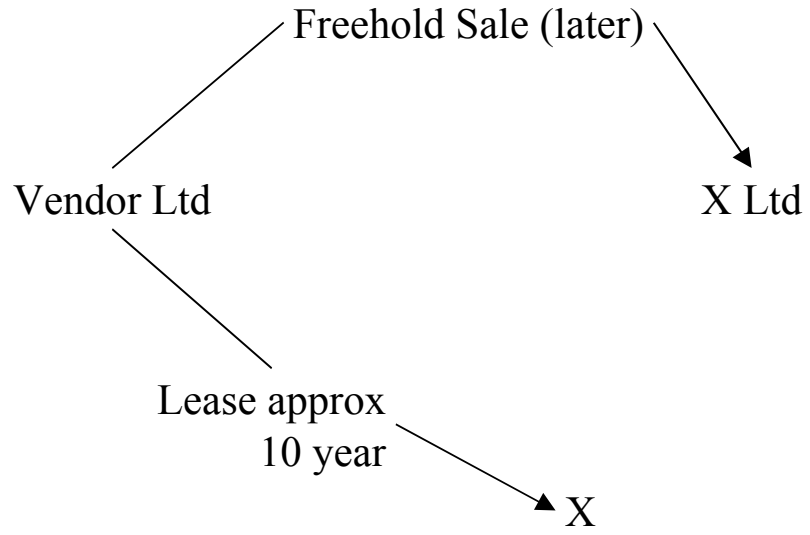
Practitioners should clearly be looking at property businesses which are activity intensive as far as the landlord and its agents are concerned to see whether there is any scope for demonstrating that the business does not comprise mainly (this may mean something significantly over 50%: see *re Hatschek's Patents* (1902) 2 Ch 69) of holding property as an investment. On the border line a small amount of extra activity may result in a 100% tax relief. It is an "all or nothing" test.



Premium Stripping - Free It Relief – Grant Lease, Don't Sell

It may be that a taxpayer intends to acquire a new freehold property for the purpose of carrying out his business, eg., X is an accountant and wishes to acquire new freehold premises.

On the acquisition of the property the individual would not obtain any income tax relief except to the extent that he may obtain plant and machinery allowances at 25% per annum for any machinery in the building (see CAA 1990 s.24 and s.150). If the individual on the other hand took a lease of the premises for about 10 years and paid a premium (and a nominal rent) he may obtain income tax relief on some 80% of the premium (spread over some ten years) under the lease premium provisions (TA 1988 s.87). It may be the freehold can subsequently be purchased by a company (X Ltd) owned by him (X). This of course may cause tax problems for the lessor/vendor (TA 1988 s.34) but it may be that it has reliefs available as a trading company or it may be a tax exempt body.



Business Property Relief: That Contract May Lose You the 100% Business Property Relief/Agricultural Property Relief

Farmers and businessmen who may be entitled to the 100% inheritance tax business property relief or agricultural property relief (under IHTA 1984 s.103 or s.115) will instantly lose that relief if they enter into a binding contract for sale of the property. The question is what sorts of contracts cause the relief (and the tax haven status) to be immediately lost.

The relevant sections in IHTA 1984 ss.113 and 124 provide the relief is lost if there is a binding contract for the sale of the farmland or other business land in existence at the time of, for example, the death of the farmer or businessman. The following points can be made:-

Contracts With Conditions

1. Clearly if there is an unconditional contract under which the developer is to buy the land with completion taking place three years hence, the relief will not be available (see *Eastham v Leigh* 46 TC 687). Even if completion is stated to be conditional of the payment of the consideration moneys by the developer the relief will be lost (see Simon's Direct Tax Service I7.118).

Options

2. If the developer has an option to buy the property if planning permission is obtained, for example, then the relief would not be lost. One may be able to effectively treat the exercise of the option as comprising a new contract and in any event the Capital Taxes Offices have accepted the point (see The Law Society's Gazette 6th May 1991, Vol 78 No 17, page 480 and SP 12/80 and also guidance note

TR557 published September 1984 ICAEW and also The Law Society's Gazette of 4th November 1992 Vol 89, No 40, page 30).

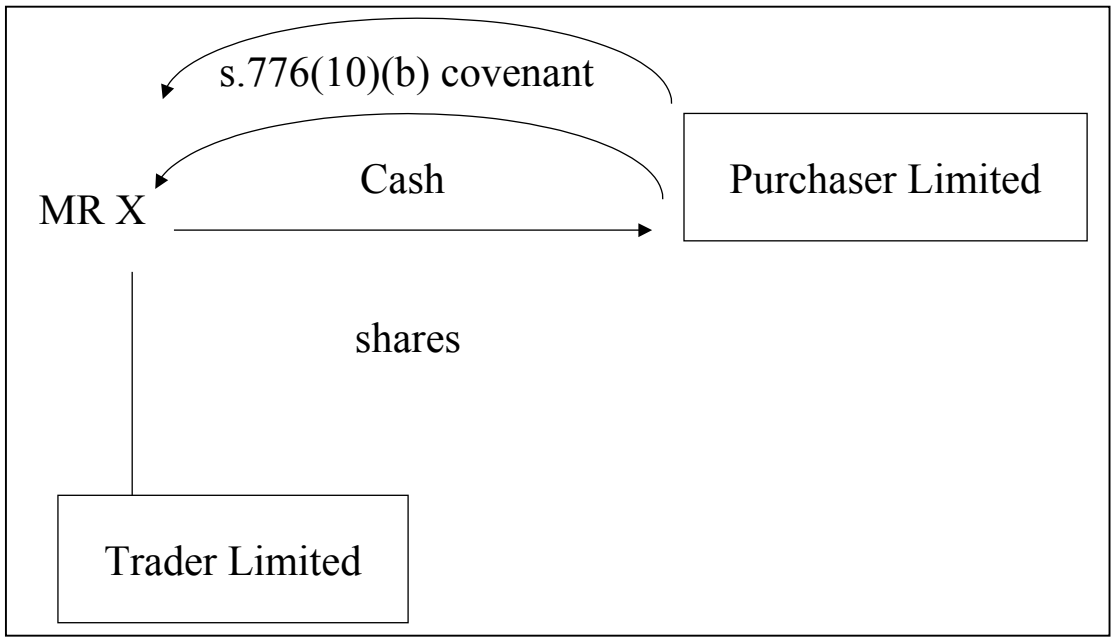
Conditional Contracts

3. What is the position if a conditional contract was entered into subject, for example, to a condition precedent that planning permission first be obtained? Is this a binding contact which would cause the relief to be lost? The implication from the capitals gains tax case of *Thompson v Salah* 47 TC 559 is that the reference to "binding" simply means enforceable: there may be an enforceable contract in existence, but is it enforceable with respect to the sale of the land? Presumably not. The implications from the equivalent capital gains tax provisions dealing with contracts (TCGA 1992 s28) and the now abolished Development Land Tax provisions (DLTA 1976 s45) is that any reference to a contract means a contract whether or not conditional. If the condition, however, is such that one cannot enforce the sale of the land at the relevant time there is no binding contract in existence within the IHT provisions. Thus in the example given above of a sale subject to the condition precedent of obtaining planning permission the relief is not lost until the condition precedent is satisfied.

Selling Shares in Property Trading Companies

An individual (Mr X) may have held shares in a property trading company for some years. If he sells the shares he may expect, after capital gains tax taper relief, only to pay tax at the rate of 10%. What must he do to avoid a tax charge on the share gain at the rate of 40% under TA 1988 s.776?

TA 1988 s.776 applies if a company holds land as trading stock and the taxpayer (Mr X) indirectly disposes of that stock by selling shares in the company which owns the trading stock and obtains a gain of a capital nature.



The Transaction would Clearly Fall Within the Ambit of s.776

Under s.776 that capital gain can be assessed to income tax and the taper relief provisions found in TCGA 1992 s.2A have no relevance to income tax.

However, there is a relieving provision in s.776(10), which states that where a taxpayer disposes of shares in a company which holds land as trading stock, then (assuming no scheme or arrangement has been entered into) TA 1988 s.776 does not apply to the gain made on the share sale, provided the trading stock is disposed of by the company in the normal course of its trade and in such a way as to procure that all opportunity of profit in respect of the land sale arises to the company. Thus, if Mr X sells his property trading company (Trader Limited) to Purchaser Limited and Trader Limited disposes of its land in the normal course of its trade, ensuring that all the profit also goes to Trader Limited, then the pernicious s.776 – provided there is no scheme or arrangement in existence – will not have application. It is normal for the vendor – Mr X – to take a covenant from Purchaser Limited to ensure that the conditions in s.776(10)(b) are satisfied. The form which such a covenant can take is set out below.

It should be noted that s.776 can still apply if a "scheme or arrangement" has been effected as respects the land which enables the gain to be realised by any indirect method, or by any series of transactions, by any person who is a party to, or concerned in, the arrangement or scheme. Arrangement or scheme has a wide meaning (*Page v Lowther* (1983) STC 799). There should be no problems if one has a long-established property dealing company. However, if it is arranged that land is to be put into a particular company with a view to making a share sale it may be (depending on the facts) that there is a scheme or arrangement within the section so that instead of a 10% charge there will be a 40% charge under TA 1988 s.776.

Precedent (TA 1988 S.776(10)(b) covenant)

Covenant to be given by Purchaser Limited to Mr X on the acquisition of Trader Limited:-

> "Purchaser Limited hereby covenants with Mr X that Trader Limited will dispose of the land which it holds at the date hereof in the normal course of its trade and in such a way as to procure that all opportunity of profit in respect of that land arises to Trader Limited."

NB: This covenant does not protect Mr X from s.776 if "a scheme or arrangement" as discussed above is found to exist.