

Overage Agreements and Related SDLT Issues in Property Transactions¹

By Michael Thomas

Introduction

This article is concerned with the tax treatment of deferred consideration payable on land sales. Such consideration is typically contingent, for example on the grant of planning permission, and is commonly referred to as overage. Overage is generally payable where land is sold to a developer so that the vendor receives additional consideration dependent upon the success of the development. However, it is increasingly common for vendors to negotiate overage or “clawback” arrangements to share in any profits when land is sold to a person other than a developer.

The most important taxes to consider with regard to overage payments in a development transaction are:

- (i) income or corporation tax;
- (ii) capital gains tax (or, if the vendor is a company, the corporation tax charge on capital gains) (“CGT”), and
- (iii) stamp duty land tax (“SDLT”)

In addition the special time of supply rules for VAT contained in regs. 84(2) and 85 of the VAT Regulations 1995, the effect of which is broadly that a VAT tax point arises each time that either a payment is made or an invoice issued, should not be overlooked. But I am not concerned with VAT in this article, as whether or not overage is payable does not generally affect the nature of the supply².

Direct Tax Issues

Developer Issues

If, as would be usual where overage is payable, the developer is trading, then it simply obtains a deduction for the purchase price, including overage, against trading profits. Where the developer is an individual or a small company it may perhaps improve its tax position by ensuring that sales fall to be taxed in different years (to take advantage of the lower tax rates or small companies rate).

Vendor Issues

Direct tax treatment is more of an issue for vendors. The starting point is whether the vendor has been holding the land as a capital asset or as trading stock. If the vendor is a trader, the entire sale proceeds constitute of course a trading receipt. Issues tend to arise where the vendor wants capital treatment so that the sale proceeds are within the capital gains regime. Typically, capital treatment will result in a lower tax charge, owing to the availability of indexation and, for individuals, taper relief, which reduces the effective rate of tax to a minimum 10% if the asset is a business asset and held for more than 2 years: see further on taper relief Schedule A1 Taxation of Chargeable Gains Act 1992 (“TCGA 1992”). If the

vendor wants CGT roll-over relief (on replacement business assets) then an income tax charge might be disastrous.

There are two ways in which land which was formerly a capital asset is brought within the income tax regime. First, if the vendor appropriates the land to trading stock, a deemed market value disposal takes place for CGT purposes at that time (under s.161 TCGA 1992), and disposal proceeds in excess of that market value are chargeable to income tax. Whether an asset has been appropriated to trading stock is a question of fact, but can be hard for the HM Revenue and Customs (“the Revenue”) to prove.

Secondly, s.776 ICTA 1988 applies where either:

- (a) land is acquired with the sole or main object of realising a gain; or
- (b) land is held as trading stock; or
- (c) land is developed with the sole or main object of realising a gain from disposing of the land when developed.

and a gain of a capital nature is realised. The application of s.776(2)(c) includes a deemed appropriation to trading stock: see s.776(7). When the vendor takes a “slice of the action” then the Revenue may argue that s.776 applies. The result of s.776 applying is that profits in excess of the market value of the land at the date the intention to develop it was formed will be chargeable to income tax.

The Revenue’s view is that s.776(2)(c) applies in situations where the vendor receives a share of the sale proceeds from the development. The Inland Revenue’s Manual at para 60350 gives the following guidance:-

60350.

Common situations: 'Slice of the action' contracts

'Slice of the action' contracts are so called because they confer upon a landowner (who holds the land as an investment) the right to share in the proceeds of any subsequent development by the purchaser. In these cases the contract for sale of the land to a builder or developer provides for consideration that is, in whole or in part, contingent upon the successful development of the land.

A common arrangement is for the landowner to receive a fixed sum at the time of the disposal, plus a percentage of the sale proceeds of each building subsequently constructed by the purchaser on the land.

Such 'slice of the action' contracts fall within Section 776 ICTA 1988. The activity carried on by the purchaser, who acquires, develops and sells the land, is a trading activity. The vendor, in entering into the slice of the action contract, is able to share in the proceeds of that trading activity. However he cannot be assessed under Schedule D Case I because the vendor is not a builder, the contingent consideration is a capital receipt on the disposal of a capital asset. This constitutes the avoidance, which may be unwitting, that Section 776 ICTA 1988 targets.

We accept that the fixed initial payment is not caught by Section 776(2)(c) ICTA 1988, since it is not contingent upon the development. We argue that the contingent part is within Section 776 ICTA 1988 and Page v Lowther [1983] 57 TC 199 provides the authority for applying Section 776 in these circumstances.

An element of the contingent payment may not arise as result of the development and therefore remains within the charge to capital gains tax (see BIM60360).

Only gains which arise after the intention to develop the land is formed are chargeable to income tax. It is the vendor's intention which is relevant, and there must be a disposal. Not all overages which realise a gain from a disposal of the developed land will be caught by s.776. A planning permission overage or final market value overage should not be caught by s.776, because there is no intention to realise a gain from sale. The distinction is between sharing in the profits of the development as against obtaining a high sale price for the land. However, s.776(2)(ii) covers any indirect arrangement to participate in the profits. If capital treatment is important it may be prudent to obtain a clearance under s.776(11).

Capital Gains Tax Treatment of Deferred Consideration

An important rule for vendors to be aware of is that the right to receive future unascertainable consideration, such as sales overage payable under a formula, is a separate asset for CGT purposes, the value of which is included as sale proceeds on the initial disposal: see *Marren v Ingles* 54 TC 476. This has tax consequences, so that for example, business assets taper relief is not transferred to the right to deferred consideration. When the overage is paid, the allowable base cost on the disposal of that asset will be the value brought into charge on the original disposal. Accordingly, where, for example the original asset qualifies for business assets taper relief, putting a value on the earn out right when calculating the chargeable gain on the first disposal can be a crucial issue.

A key distinction is drawn between unascertainable consideration, as discussed above, and contingent but ascertainable consideration, such as a fixed sum payable in the event of planning permission being obtained. If the consideration is ascertainable but contingent then the starting point is that the whole amount will be brought into charge at the outset under s.48 TCGA 1992. If the consideration is calculated according to a formula it will normally be unascertainable even if it has a maximum amount stipulated. Section 48 would apply in the event that a fixed sum were payable on the obtaining of planning. Accordingly, most overage payments will not fall within s.48. However, if s.48 does apply then if the payment turns out not to be made then the tax can be reclaimed. Consideration payable by instalments may also be deferred under s.280 TCGA 1992.

SDLT Issues

Developer Issues

SDLT is a tax on acquisitions of land and is primarily the concern of the developer. The starting point is s.51 FA 2003, which provides that where any consideration is contingent then the chargeable consideration is calculated on the basis that the outcome of the contingency is that the maximum amount is payable. If the consideration is uncertain or unascertainable then a "reasonable estimate" is used.

First, it is useful to define terms for SDLT purposes:

- (i) *Contingent consideration* means consideration dependent upon a future event – e.g., an additional payment of £5 million if planning permission is granted.
- (ii) *Uncertain consideration* means consideration whose value depends on future events. Sales overage as a percentage of profits of the future development is a classic example of this.
- (iii) *Unascertained consideration* means consideration which is ascertainable but which has not yet been calculated – e.g. where the consideration is dependent on last year’s profits for which accounts have not yet been drawn up.

Typically, overage will be both uncertain and contingent. In that case, the proper approach is to determine its value according to a reasonable estimate. If the overage formula contains a cap, this does not override the need to make a reasonable estimate. (Section 51 is not a re-enactment of the stamp duty “contingency principle” under which either a maximum or a minimum figure might be taken as the correct amount.)

Having made a reasonable estimate as to the likely overage, the developer has a choice. It can either pay the tax or apply to defer payment of the tax in accordance with s.90 FA 2003 and Part 4 of the SDLT (Administration) Regulations 2003/2837. An application must be made within 30 days – the same period as that allowed for the delivery of the land transaction return. The tenor of the Regulations is that deferral applications will not normally be refused unless the deferral provisions are being exploited for tax avoidance purposes. Deferral is only possible where at least part of the overage is or may be payable 6 months after the effective date.

When the consideration becomes known (e.g. because the overage is paid), a further return is required under the Regulations within 30 days together with the tax payable: see Regulations 12 and 24. Time runs from when the amount is ascertained, not when it is paid, so it is important that developers have the necessary cash available. If the developer does not defer payment of the tax and the overage turns out not to be payable then he may apply for a refund under s.80 FA 2003. Alternatively, if the overage payable exceeds his original estimate then he must pay the additional tax again under s.80.

Vendor Issues

The possibility of an SDLT charge on the vendor should not be overlooked. The retention by the vendor of easements and covenants over the property does not amount to the acquisition of a chargeable interest, because the rights are not acquired but retained (notwithstanding that s.43(3)(c) provides that the creation of a chargeable interest amounts to an acquisition). A charge to secure payment of an overage is an exempt security interest: see s.48(2)(a) FA 2003. However, there are cases where a vendor might be chargeable to SDLT. One instance is where a vendor and a developer each provide land towards a development and agree to share the profits: here, arguably, the developer has obtained rights over the vendor’s land, or a partnership may have unwittingly been created giving rise to an occasion of charge. The second instance is where a vendor might become chargeable to SDLT is where it obtains a re-transfer of part of the property in a mixed use development. Mixed use developments present problems for both developers and vendors so I shall deal with them together.

Mixed Use Developments: Consideration Given to Vendor in Form of New Unit or Works³

The situation envisaged is where land is sold to a developer who will construct both a residential development and a commercial unit, which is to be given back to the vendor under a long lease.

First, the vendor will be chargeable on the market value of the lease under the provisions dealing with exchanges in s.47 para 5 Sch 4 FA 2003. This charge might be avoided if the vendor is first able to grant a lease of the part of the site to be retained to a nominee (although where the development involves flats this may be difficult) and further difficulties may arise following the amendments to para.3 Sch.16 FA 2003 which ignore bare trusteeship on the grant of a lease. No charge will arise on the vendor if land is transferred to a public authority in pursuance of an s.106 agreement or other planning obligation: see s.61 FA 2003.

Secondly, if the transaction is chargeable as an exchange, the developer is also chargeable on the market value of what he receives. This raises the possibility that the developer may lose the benefit of the building works exemption in para 10 Sch 4 FA 2003 and the ability to defer payment of the deferred overage payments under s.90 FA 2003. The better view is that the ability to defer payment is lost but that the benefit of the building works exemption continues to apply to reduce the amount of chargeable consideration. Nevertheless, developers have an interest in s.47 FA 2003 not applying.

The other key issue for the developer is the amount of chargeable consideration where s.47 does not apply. Infrastructure etc works undertaken for the benefit of both parties are partly consideration and partly not because they are partly for the benefit of the developer. Accordingly, a reasonable proportion of the joint infrastructure works will count as chargeable consideration: see para 4 Sch 4 FA 2003. Building works carried on land to be acquired by the developer will not count as chargeable consideration owing to para 10 Sch 4 FA 2003. All the conditions of para 10 must be met. Relief remains available if the works are done on land to be handed back to the vendor but not if works are done on land retained by the vendor.

The above is a summary and the complexity of SDLT issues which can arise from mixed use developments should not be underestimated.

Reducing the SDLT Charge for Developers

Following the abolition of stamp duty sub-sale relief saving SDLT for developers is extremely difficult unless the land is already in a special purpose company. The key problem is that the developer will want in practice to have a right over land which amounts to a chargeable interest e.g. the right to compel the vendor to sell completed units. Nevertheless, it may be worth considering further whether SDLT can be saved on the particular facts.

One idea is that, if the developer is required to provide social housing, it could sub-sell to the social housing provider and save having to pay SDLT on that element of the purchase price.

Another point to have in mind is the ability to follow **Prudential Assurance Co v IRC** [1992] STC 86) and have separate building and land sale contracts. This is especially useful to developers of large commercial units who have purchasers in place before building commences.

Another idea, which is particularly relevant where large overage is expected is to use a joint venture structure whereby the developer acquires an undivided share in the land in consideration of supplying building works to the vendor, plus a small amount of cash. The building works do not count as chargeable consideration, owing to the exemption in para.10 Sch.4 FA 2003. Accordingly, this minimises the SDLT charge on the developer. However, it will cause direct tax complications for the vendor, who will make income profits when the units are sold. Nevertheless, in appropriate cases it may be effective to save SDLT.

¹ This is based on a lecture I gave for CLT Conferences.

² See in this regard *Customs & Excise Commrs. v. Latchmere Properties* [2005] STC 731 which is authority for the proposition that a right to receive overage payments is deferred consideration for the land sale and does not involve a separate supply of construction services to the vendor by the developer.

³ Consideration in this form is not overage in the usual sense. However, it is a form of deferred consideration, so it is thought appropriate to discuss it here. Mixed use developments also raise issues for other taxes. However, as the SDLT issues are relatively new and topical, mixed use developments are only discussed in relation to SDLT. The issues raised by mixed use developments for other taxes are outside the scope of this article.