Minimising mineral taxes!

Those who are lucky enough to have acquired property estates containing minerals of interest to industry will probably find that they are sitting on the UK equivalent of a gold mine. Very substantial sums are paid these days for the extraction of minerals from the ground and it is quite easy to overlook some tax planning opportunities in this area.

In tax terms, mineral deposits include any natural deposits capable of being lifted or extracted from the earth and also geothermal energy which, in this context, is treated as a natural deposit. Some of the most common minerals which landowners may be able to sell are gravel and other materials of use to the construction industry, but all other materials which can be taken from the land are equally classed as minerals for tax purposes. There is a special tax regime for the relevant agreements, which is provided for in the tax legislation. This requires that the rent receivable under the lease is to be divided between the proportion which relates to the winning and working of the minerals and the proportion which relates to the occupation of the land. The latter is fully chargeable to income tax, but the former is chargeable only as a one half share to income tax, the other half share being liable to capital gains tax without any deduction for the base cost of the land. Landowners will find this to be a helpful regime to reduce tax liabilities but, even so, having one half of the receipts charged for income tax may still appear to be a heavy burden.

They will therefore be looking for ways to transfer all, or nearly all, of the prospective receipts into the capital gains tax regime. This can be achieved, but care must be taken and the wrong sort of agreement could quite easily make matters very much worse. For example, the landowner might consider it better to sell the whole site outright to the purchaser of the minerals with the option to buy the land back at a later time. This he might hope would count as a disposal of the land for capital gains tax purposes and all the profit would then fall within the capital gains tax regime. Unfortunately, this would not be the case. The rules relating to the tax treatment of lease premiums extends to the sale of land with an option to buy it back and most of the sale proceeds would fall within the income tax regime. The capital proportion is 2% of the profit to the landowner from the transaction for each year of the life of the bargain, but leaving out of account the first year. The "profit" is calculated as the sale proceeds less the buyback price under the option and the life of the bargain is the time from commencement until the earliest date on which the option can be exercised. So, for example, if the sale is for £6m and there is an option to repurchase the land after ten years for, say, £500k, the difference is £5.5m and only 18% of this would fall within the capital gains tax regime. That would be a much worse result than the basic tax treatment of mineral royalties.

The sale and subsequent buyback of the land can be structured as a wholly capital transaction if the terms of the sale do not include the option to repurchase. Instead, the option would be negotiated as a separate transaction at a later time. In that event, no part of the funds received from the sale is chargeable for income tax and the whole transaction falls within the capital gains regime of the vendor. However, in a commercial situation, legal advisors will undoubtedly have great difficulty with this type of transaction since, once the sale has taken place, there

is no protection for either the vendor or the purchaser. The vendor's position can be assisted if the site can only be accessed across other land owned by the vendor which is not included in the sale, and the access rights given to the purchaser are for a limited period of time only. Once the access rights have expired, there will then be no reason for the purchaser to hold onto the mineral site. However, one can expect this type of arrangement to be viewed unfavourably at the offices of the solicitors for each party.

A better method of securing capital treatment is under what is known as "the treasury route" and this is tried and tested, with even a mention briefly in the manuals of HM Revenue & Customs. The treasury route involves outright sale of the minerals to the purchaser coupled with a lease at minimal rent in order to allow the purchaser to collect what it has purchased. Only the rent is chargeable to income tax and the outright sale falls within the capital gains tax regime.

This is, of course, a different bargain from the purchaser's point of view but there are capital allowances given to those who conduct a business of mineral extraction and these allowances should broadly permit a full deduction for the cost incurred by the operator over the life of the bargain. The sale of the minerals themselves is unlikely to fall within the 10% capital gains tax rate under entrepreneurs' relief, even if the vendor otherwise qualifies for the relief by virtue of having ceased business prior to the sale, since the minerals themselves will not normally have been used in a business of the vendor. However it may be possible to sell the land into trust in the first place, leaving the trustees to enter into the agreements with the mineral extraction business with little or no tax being incurred by the trust, and with the 10% rate applying on the sale to the trust.

The arrangements described in the foregoing require careful advice and should not be attempted by those unfamiliar with this type of business.

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