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Too Hot to Burn?

Julie Butler FCA examines the tax treatment of farmers growing energy crops and bio-fuels

IN recent months the increasing emphasis on energy crops has raised some interesting arguments as to whether their production counts as 'farming' for tax purposes. It was generally agreed that, where the crops grown by a farmer and sold for energy use constituted a relatively small proportion of the total farm income, the overall enterprise was still one of 'farming'. However, there was more doubt about the position where energy crops were undertaken as a large-scale operation, as some said that, to qualify as 'farming', an enterprise had to be principally concerned with the production of food for human consumption.

Why the debate as to whether the activity was farming or non-farming? Clearly, if the activity is not 'farming' for tax purposes, there will be a loss of the specialist agricultural tax reliefs, such as agricultural property relief for inheritance tax, farmers' averaging for income tax, agricultural buildings allowances and tax-free job-related accommodation for farmworkers. On the other hand, farming is specifically excluded from relief under the Enterprise Investment Scheme – and outside investment could obviously be important for diversification into energy crop development.

At the time of writing, the United Kingdom generates around 2.5% of its electricity needs from renewable sources such as energy crops. Apparently the target is to increase this to 10% by 2010. The Government is supporting the sector through 'non-fossil obligation contracts'. These pay an enhanced price for electricity for 15 years, over which time it is hoped that the capital cost of the generating plant will have been re-

covered. Energy crops are sometimes known as 'biomass'. Seven 'green' power stations are currently in differing stages of development, with the potential to use biomass from approximately 20,000 hectares (49,000 acres) of land.

Waste straw is being used as an energy crop, with an approximate £20 to £25 per tonne ex-farm price. There is also potential for reed canary grasses as well as wood from short rotation coppices and miscanthus (elephant grass to all you townees).

Is bio-fuel production farming?

Bio-fuels are transport fuels produced from plant material. They can also be made from organic waste such as used cooking oil and paper. Their production could help British farming by providing new markets for current crops such as cereals and sugar beet, and for oil seed rape. But the same questions as regards tax treatment have arisen as for other energy crops.

Bio-fuels could promote production of new biomass crops and provide an environmentally-friendly use for certain waste products. The production of bio-fuels is supported by the National Farmers' Union, the Country Land & Business Association (CLA), British Sugar, the Institute for Food Research (attached to the University of East Anglia), Friends of the Earth and many others. The Curry Report (the Government-acclaimed report on the future of farming and foods published in 2002) stated that: 'England needs a long-term strategy for creating and exploiting non-food crops. This area should be a high priority.'

Bio-ethanol, which is made from starch and sugar crops, can be used to run

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petrol engines. Bio-diesel, made from plant oils, is used in diesel engines. The fuels can be either partly or wholly substituted for petrol and diesel. Up to 5% of the volume of petrol or diesel can be replaced with bio-fuel without any modifications to the vehicle being necessary. Petrol engines apparently require only minor adjustments to run when up to 10% of the fuel volume is replaced by ethanol, which should present no problems for motor manufacturers. Greater promotion of bio-fuel is strongly supported by the CBI and the British Chamber of Commerce.

What about the environment? Government Ministers repeat their 'commitment' to the reduction of greenhouse gases and carbon dioxide emissions. How would the production of more bio-fuel contribute to this commitment? Will there be tax-driven reliefs?

At the time of writing, clearly the bio-fuel question is wrapped in political debate, which needs to be resolved before markets are identified and separate operations undertaken. The NFU has warned that Britain could lose out unless more encouragement is given to the country's bio-fuels industry. DEFRA have said that support will be given for bio-fuel production where it is most effective and affordable. What about help to make it cost-effective? More tax reliefs?

Half an answer to the tax question

In correspondence with the CLA, the Inland Revenue have confirmed that 'normal crops grown with fuel production as the objective still constitute husbandry' for income tax purposes – and section 832(1), *Income and Corporation Taxes Act 1988* defines 'farm land' as 'land in the United Kingdom wholly or mainly occupied for the purposes of husbandry'. 'Normal crops' include oil seed rape, beet, cereals and miscanthus and the Revenue will consider others on a case-by-case basis. Accordingly, it is now clear that the production of such crops will be accepted as 'farming' for income tax purposes, even if most or all of the farmer's land is devoted to them, but the CLA is still seeking an assurance that this activity will also constitute 'agriculture' for inheritance tax purposes.

Whilst the income tax treatment of farming is generally favourable, it would seem to follow that EIS relief is not available for investment in companies engaged in growing 'normal crops' for fuel production. However, farming companies may qualify for R&D Tax Credits.

Potential tax advantages of R&D

Traditionally, diversification for many farmers has been just a simple move towards supporting farm income with some non-farming income, such as letting cottages or redundant farm buildings. But moving in the direction of bold diversification projects such as energy crops and bio-fuels, it is considered that some of the expenses will qualify as 'research and development' and qualify for the appropriate Tax Credits. This is recognised by the *Finance Act 2004*.

The previous R&D changes, which were included in the *Finance Act 2003*, have received clearance from the European Commission and apply with effect from 27 September 2003. These reduce the annual threshold for qualifying R&D expenditure from £25,000 to £10,000. As a result, more and more smaller companies will be able to claim the Credit.

Other measures, also brought into force from 27 September 2003, include the ability to claim for the cost of agency workers undertaking R&D work on behalf of companies and

improvements to the rules for those who spend only part of their time on R&D work.

The definitions are contained in a DTI paper called *Guidance on the Meaning of Research and Development for Tax Purposes*, which was announced on 5 March 2004 (www.dti.gov.uk/rd-guide/rd-guidelines-2004.pdf). The definition of R&D is being simplified. The Government's consultation document *Defining Innovation*, published in Summer 2003, can be found on the Revenue's website at www.inlandrevenue.gov.uk/consult_new/defining_innovation.pdf.

Some work carried out in the production of energy crops could be considered to qualify for tax relief under R&D.

Energy Crops Scheme

Energy crops are those used to produce heat and / or electricity. The two most popular forms in the United Kingdom are short rotation coppices (SRC) and miscanthus. They are carbon-neutral and therefore, as a substitute for fossil fuels, can help reduce greenhouse gas emissions and increase renewable energy generation. They are a new opportunity for rural areas. So what of the available grants? In England, support is by way of the Energy Crops Scheme, which offers the following.

There are establishment grants of £1,000 per hectare for short rotation coppice (willow or poplar) and £920 per hectare for miscanthus. (The enhanced rate of £1,600 per hectare for short rotation coppice on ex-livestock land is under review following CAP reform.)

Applicants for the grants need to demonstrate that they have, or will have, an energy end-use for their crops. This could be:

- A biomass power plant;
- A community energy scheme using heat or combined heat and power (CHP); or
- Heat for a small business or home (including own use).

The end-use(s) must be within a reasonable distance of the crops (generally 10 miles for small installations, 25 miles for power plants). Applications must be for at least three hectares and are subject to environmental checks.

There are also grants available for setting up producer groups. Producer groups must be legally formed by and consist of members who are growing short rotation coppice for an energy end-use. (Grant aid for miscanthus producer groups may be available under the forthcoming Bio-energy Infrastructure Scheme – see the contact below.) Up to 50% of the costs of setting up the group are available (to a maximum of £200,000 per group). Eligible expenditure includes:

- Purchase of specialist equipment
- Staff costs
- Specialist fees
- Office accommodation
- Publicity and promotion

Further information on the scheme is available from www.defra.gov.uk/erdp/schemes/energy/default.htm. Useful contacts are the Organic and Energy Crops National Implementation Team at organic-energy@defra.gsi.gov.uk and (for producer groups and the Bio-energy Infrastructure Scheme) the Agricultural Materials Branch: industrialcrops@defra.gsi.gov.uk.

Tax treatment of woodlands and coppices

Energy crop production brings into the tax planning equation the tax treatment of woodlands. Long-term woodlands – where trees are grown for their value as timber – are exempt from income tax under section 53(4), *Income and Corporation Taxes Act 1988* and are eligible for inheritance tax deferral under sections 125 to 130, *Inheritance Tax Act 1984*.

'Short rotation coppices' are defined by section 154(3), *Finance Act 1995* as:

'a perennial crop of tree species planted at high density, the stems of which are harvested above the ground level at intervals of less than ten years'

– and are taxable as farming income under Schedule D, Case I. For inheritance tax, the energy crop land should qualify for 100% business property relief under section 105(1)(a), as part of the energy crop trade, or for agricultural property relief under sections 115ff. It is essential that this is a part of the tax planning surrounding the future use of SRCs.

Under section 250(4) to (6), *Taxation of Chargeable Gains Act 1992*, that part of the cost and sale proceeds of woodlands in the United Kingdom, which is attributed to trees or underwood growing or felled on the land, is disregarded for capital gains tax. Under section 250(1) and (2), where woodlands are managed on a commercial basis with a view to the realisation of profits, the proceeds from disposals of timber are also disregarded. The proceeds could be for the right to fell standing timber, the proceeds of felled timber or the insurance proceeds from their destruction. These two provisions, in principle, ensure that where the woodland is exempt from income tax, then it is also exempt from capital gains tax.

The problem arises on the disposal of the land, as the sale and purchase prices need to be apportioned between the land and the growing timber. The former is taxable, the latter is not. Although the occupation of woodlands on a commercial basis is exempt from income tax, it is still a business for CGT purposes. There is still the ability to roll over for CGT purposes with the sale of business assets.

During the Standing Committee debates on the Finance Act 2003 taper relief changes, the Paymaster-General said that the lack of Business Asset Taper Relief (BATR) for woodlands would 'receive serious consideration from Government in due course'. As far as is known, they are still thinking about it.

From 6 April 2004, following section 160, *Finance Act 2003*, nearly all tenanted land and buildings used in a trade, profession or vocation are 'business assets' for taper relief purposes. Land used for commercial forestry is not a 'business asset' although it can qualify for rollover relief and for gifts hold-over relief under section 165, *Taxation of Chargeable Gains Act 1992*.

Trading as a limited company

Traditionally, the farming community has avoided the limited company for tax reasons – for example, the lack of 'sideways' loss relief, the absence of Business Asset Taper Relief (especially for development gains) and tax problems with the farmhouse and with benefits-in-kind.

So what of energy crops and bio-fuel development projects? The limited company is needed to protect against risk and to qualify for R&D Tax Credits. With energy crops there could be a need to trade as a limited company. So what of agricultural and business property relief for the land? If it is not agricultural land, the Farm Business Tenancy will not give 100% inheritance tax relief between landowner and company. Will the landowner have to settle for 50% business property relief?

So all things considered, where does that leave the development of energy crops – supported or hindered by the tax system?

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Single Farm Payment Scheme: Application Deadline

As readers in rural areas will be well aware, from 1 January 2005 subsidies for agricultural production (such as arable area payments and suckler cow premium) are replaced by the new Single Farm Payment (SFP), which requires the farmer or landowner only to keep his land in 'good agricultural and environmental condition' (GAEC).

In England, the Single Payment Scheme (SPS) will be administered by the Rural Payments Agency (RPA), an executive agency of DEFRA (the Department for the Environment, Food and Rural Affairs). Last month (February) the Agency sent a preview of the SPS application form to 180,000 farmers and landowners, to allow them to see what information will be required and so to begin work on their applications. The definitive application forms will be issued in late March or early April.

The deadline for applications will be **Monday, 16 May 2005**. Applications not received by that day will be subject to financial penalties and any not received by Friday, 10 June 2005 will be rejected altogether. Eligible applicants will be given an estimate of their entitlement in Autumn 2005, with payment being made between 1 December 2005 and 30 June 2006.

It is very important to note that a successful application for 2005 will be a precondition of claiming a Single Farm Payment for 2006 or any future year. The deadline for 2005 is therefore effectively also the deadline for claims for all future years.

DEFRA have already produced a range of explanatory publications, which may be accessed from www.defra.gov.uk/farm/caprefom/pubs/index.htm or from the Rural Payments Agency website www.rpa.gov.uk. The Agency is operating a helpline for general SPS enquiries on 0845 603 7777, or e-mail customer.servicecentre@rpa.gsi.gov.uk.

Farmers and landowners in Wales, Scotland and Northern Ireland – in each of which different rules apply – should contact their own agriculture departments.