Back to base

Ascertaining the correct capital gains tax base cost for farming assets is always important, emphasises **JULIE BUTLER**.

Many landowners and farmers change the structure of their farms and it is important to ensure that the base cost for capital gains tax moves with these developments. Common events that may affect the base cost are farm improvements, death, passing the business to the next generation during life, part disposals, inter-spousal transfers, development gains and rolled-over gains. They tend to be quirky, but fairly frequent transactions. The propensity for farmers to change advisers can also have an effect and adequate records must be kept.

Improvements to the farm

Recording farm improvements might seem a simple case of good bookkeeping, but the property that has been upgraded must be identified clearly. Some farms have many property units and types and it is important to understand exactly when and where the expenditure has been incurred. For example, improvements to residential farm cottages rather than farm buildings will be subject to different treatment for the various capital gains tax reliefs.

HMRC may also enquire into whether the cost has been incurred on repairs or improvements (see *Pratt v HMRC* (TC1269) and *Cairnsmill Caravan Park v HMRC* (TC2580).

In *Pratt*, a farming partnership claimed a deduction for the cost of resurfacing the driveway at its farm. HMRC rejected the claim on the basis that this was capital expenditure, but the First-tier Tribunal allowed the partnership's appeal, holding that it was revenue rather than capital expenditure.

Similarly, in *Cairnsmill*, a partnership operated a caravan park. It claimed a deduction for the cost of resurfacing part of the park. The previous grass surface was replaced by a hardcore surface.

KEY POINTS

- The need for accurate recording and understanding of the importance of base cost.
- The valuable role of the detail of the probate valuation.
- The impact of the history of the farm on current capital gains tax calculations and planning.
- The consideration of lifetime transfers reporting and the interaction of all capital gains and inheritance tax planning.
- The complex role of the executor and the responsibility involved with any family farm.

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The First-tier Tribunal allowed the partnership's appeal against HMRC's claim that the expenditure was capital.

As a further complication in cases such as this, such matters may be finalised some years after the event. Advisers should remember that business accounts' working papers and personal capital gains tax base cost schedules may require adjustment after the conclusion of an HMRC enquiry.

Death and the farm

Passing the farm to the next generation as a gift on death will produce a capital gains "tax free" uplift because the uplifted probate value (IHTA 1984, s 160) will replace the historic base cost. Again, business accounts and personal capital asset registers must be updated. This may seem straightforward, but complexities can arise. For example, there might be delays reaching an agreement on the probate valuation with the District Valuer. Further, the quality of the probate valuation might be "light" on detail depending on the instructions of the executors. How that valuation has been split between, for example, business and non-business assets, cottages and the like could be crucial. This is important if, say, the farm is left to the spouse and some element of the inheritance tax spouse exemption (IHTA 1984, s 18) is involved. Also, if the claims for agricultural property relief and business property relief are strong, so that no liability is likely, there may be a temptation for the probate valuation to be a best approximation with very little detail. Although the immediate requirement for a more accurate valuation may not be pressing, full details should be provided because these will make future calculations more accurate and robust.

Lifetime transfers

Some farmers and landowners take advantage of lifetime transfers for various personal and tax reasons, often with a focus on

inheritance tax. The minimisation of immediate capital gains tax liability in a lifetime transfer can often be achieved by a holdover election under TCGA 1992, s 165 where the transferee takes on the transferor's base cost. If the farm was bought in, say, the 1970s a March 1982 value is used as the base cost.

There are arguments to say that the correct valuation in the accounts is the market value at the date of transfer. The accounts and the base cost control will have to be updated for the change. The control is simply a way of recording how an asset's base costs develops over time through death, improvements, lifetime transfers and the like. This will need to be reconciled with business accounts as applicable and a careful review of the relevant allocation of improvements will be essential as mentioned above.

Inter-spousal transfers

Farms have often been passed down the male line through the generations. In today's world, with an emphasis on equality, farming wives will often have part of the farm passed to them. This could be the farmhouse alone or the whole farm. The spouse will take on the husband's base cost for capital gains tax purposes.

Again, there will have to be checks on the costs of improvements to ensure that the correct base costs of the individual property assets and types is understood. As an example, a half-share of a farm might be transferred to a wife during the transferor's lifetime and she may inherit the other half or farmhouse when her husband dies. In such a case, the wife's base cost of the whole property will comprise two elements:

- half the husband's "inherited" base cost from when he purchased or acquired the farm; and
- the probate valuation of his remaining half share.

So far we have focused on the need to control and record the correct base cost but tax planning considerations, such as determining when transfers can be made tax efficiently during lifetime or on death, will come into play when restructuring is being considered. These factors should be linked to the future plans for the farm. Such tax planning will be eased by robust and well-recorded capital gains tax base costs, which will help to identify the potential tax liabilities that could arise on any transactions. Once transactions have taken place, updated valuations and costs can be carried forward in readiness for future planning opportunities.

Development gains

The property development potential for landowners and farmers is very positive. The current aims of farmers owning potential development land are generally to maximise the use of entrepreneurs' relief. Careful structuring with this in mind can reduce the tax payable to 10% or that gains can be rolled over into other business assets so that all potential capital gains tax liability is deferred. Because death is not a chargeable event, it is possible to erase potential capital gains tax liabilities at that point.

In practice, the capital gains tax mitigation strategy is often a mix of these two reliefs. For example, part of the gain may be subject to a claim to entrepreneurs' relief while the balance might be rolled over into new property or into improvements to those parts of the farm that remain after the development. Identification of the base cost for the disposal of development land can be a very complex matter. Spreadsheets showing the interaction of entrepreneurs' and rollover reliefs, together with the use of the part disposal rule, can be part of the required tax planning tool. Remember that rollover relief can be achieved on acquisitions 12 months before and 36 months after the date of the disposal. Time delays may affect valuations and these will need to be updated and incorporated within the base cost control.

It is easy to see that a well-thought-through base cost spreadsheet with complex workings is integral to all capital gains tax planning, understanding and compliance.

Transfers on death

The transfer of assets on death combines favourable inheritance tax reliefs with increased capital gains tax base costs providing the tax free uplift to probate value. This simplifies the capital gains tax base cost register.

If there is development potential, this could be extremely useful because the probate value would include hope value. If business property relief can be obtained, the future base cost is the very tax efficient probate value.

Change of advisers

A problem can arise when previous advisers fail to provide full and complete details of base costs. Answers to requests such as "not applicable", "to follow", "held by client", or "see accounts workings" can be frustrating. Hopefully, this shows the need for diligence in obtaining and retaining transfer figures. Solicitors, accountants and tax planners should work closely on these issues. If the information is missing from the accountant, the trail must be followed through the legal papers – dates of acquisition, transfer, disposals and so on.

Conclusion

The need for accurate, detailed probate valuations with well-researched allocations between the various elements of freehold property is essential, as is the need for executors to provide professional instructions on all areas of legal ownership, legal agreements, basic payment entitlements, and partnership agreements. There is no doubt that a "red book" valuation is needed by valuers. This is a formal – and possibly costly – valuation for probate or capital gains purposes, mortgage applications and so on rather than a simple marketing valuation which tends to be free. However, executors must understand the importance of valuations, not just for the distribution of the estate but for future planning. Ideally, the accountant's working papers together with the base cost control should form part of the documents supporting the instructions. ■

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