Earl of Balfour

Julie Butler considers why the assessment 'Overall, mainly a trading activity' shows the greater need for IHT protection, not less on a mixed estate

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Does the *Balfour* case direct more protection with regard to IHT relief for the mixed estate, or less? The judgement of the *Earl of Balfour* case was delivered on 14 May 2009. The case recorded a successful business property relief (BPR) claim for a mixed agricultural estate in Scotland. The First Tier Tax Tribunal (Special Commissioners) ruled that the business in question was not 'wholly or mainly making or holding investments' under the interpretation of IHTA 1984 s.105 (3). This is seen as great news for the farming world and it is considered that the case strengthens the decisions of *Farmer* and *George*. However, does it create an overly optimistic approach?

The basic facts

The Scottish estate in question, Whittingehame, was owned by a trust founded by the 1st Earl. The 4th Earl had the liferent – a term of Scottish trust law that gave him the right to the income of the estate and the power, within limits, to manage it (for example he could grant short leases but not long ones). The estate was a typical one for Scotland, including farms (both managed by the estate and leased), woodland, shooting and 28 leased cottages. In November 2002 the Earl succeeded in having the trust wound up, the property becoming his absolutely. He then put it into a partnership that he ran jointly with his heir, his nephew. In June 2003 the Earl died. His executors claimed BPR on the Earl's share in the partnership, to considerably reduce the taxable value of the Estate. HMRC denied the relief.

The direction of this case *Brander (Representative of Fourth Earl of Balfour)* v *HMRC Comms (2009) UK FTT 101* was that in order to see if a business was in fact an 'investment business' there was a need to establish where the 'preponderance of the business activity' lies (Para 42).

Relevant factors, including time spent

The case states that the relevant factors that have to be looked at are 'turnover, profit, expenditure and time spent by everyone in carrying on the various business activities.' With incomplete evidence as we have here, and probably in most cases, it is a matter of more general assessment as to where the preponderance of business activity lies. This involves reviewing the activities being carried on at the estate 'in the round' (an approach emphasised by the Court of Appeal in *IRC* v *George 2003* at 152c). The time spent question continues to recur.

> "In order to see if a business was in fact an 'investment business' there was a need to establish where the 'preponderance of the business activity' lies"

The agricultural activities occupied a greater area of the estate

The case is seen as a victory for the mixed estates and endorsement of the ability to claim BPR on non-qualifying activities integrated into the main business. Para 42 goes on to say:

'Most estates of the type under discussion are heavily based on farming and to some extent on forestry and woodland management and related shooting interests. The letting side was ancillary to the farming, forestry, woodland and sporting activities. The farming activities, albeit they include agricultural tenancies, occupied by far the greater area of the estate (see for example *Farmer* v *IRC* 1999 STC (SCD) 321 especially at paragraphs 6, 22, 40, 41, 43, 47, 52-4).

HMRC put forward a number of alternative arguments to deny BPR. The Tribunal judge did refer to the HMRC arguments as follows: 'I regret that I did not fully follow the purpose of these submissions.' However, he did address the two main arguments.

Firstly, that overall the estate was concerned mainly in 'making or holding investments', and so under s105(3) did not qualify for BPR. Secondly, that in the period before 2002, while the trust still existed, the operations of the estate had to be looked at in two parts:

a) the farming business that was carried on by the Earl (despite using the land and other assets of the trust), and
b) the property rental business that was carried on by the trust (despite with the Earl involved, with the agents, in the management).

If so, HMRC contended that only the farming business would qualify for BPR, the property rental business being concerned mainly in 'making or holding investments', and so disqualified under s105(3). Therefore, even though the combined business after the trust was wound up might all qualify, only part of the operation qualified for the necessary two years.

It might be argued that the important point of this case is that HMRC is appealing.

The clarity given by the case was a surprise to some commentators and the fact of the HMRC appeal is based on unresolved areas of law and practice.

Failure to achieve BPR is absolute – so what protection is there?

For all those advisors of mixed agricultural estates who are taking comfort from this case,

there are arguments to support the argument that they should consider actually taking more protective action around IHT safeguards now than before. The only time the 'investment business' question is actually tested is death. Failure to achieve BPR is therefore absolute.

This case shows that the land owner can shelter a lot of what might be considered to be non-qualifying business activity within a qualifying business, and claim BPR on the whole business. By integrating the property business within the overall estate, everything qualified for BPR.

Integration of non-qualifying activity

How far can this integration go in order to protect the non-qualifying elements, and how much non-qualifying activity can be included? The property letting side was a major part of the estate, bringing in nearly half of its total turnover and (it appears, although it was not specifically stated) the great majority of the profits. But how far can this integration extend?

Strength of involvement by the deceased

Another key point arising from the case is the strength of involvement of the deceased in managing the business. In this case there are complexities around trusts and partnership, which are not looked at in this article.

It is important to integrate the non-qualifying operations into the ethos and high level of management of the business, even if the day to day management is separate. Although it does appear that the Earl had significant involvement across the whole range of operations in the day to day activities as well, the importance is involvement in the overall operation.

If the guidance of *Farmer* and *Balfour* encourages greater diversification into the investment business, as opposed to the farming and trading activity, are there risks of s.105 (3) becoming engaged and the estates being determined to be a business activity?

Greater clarity on APR via Chapter 24

Chapter 24 of the IHTM manual, which was published in February 2009, now gives much greater clarity over which activities HMRC considers to qualify as agriculture and therefore qualify for Agricultural Property Relief (APR), and which activities do not qualify. Consequenlty there is improved understanding of what activities will be accepted as qualifying for APR and so do not necessarily need BPR.

Is the result of the good news of *Balfour* actually a trigger to reduce some of the excessive or 'surplus to requirements' activities from the main trade? The question is: does the investment business test the remaining business BPR by making the remaining business not mainly one of the holding investments? Does the amount of let property tilt the balance by making the whole estate vulnerable to s.105 (3)?

The joint impact of Balfour and Dance

Passing to the next generation to remove the surplus investment assets has been considered by many to be 'franked' by the 2009 *Nelson Dance* case. *HMRC* v *Trustees of Nelson Dance Family settlement (2008) spc682*, where the taxpayer's appeal was successful in CH/2008/APP/0434 and endorsed by the Court of Appeal.

The Special Commissioner held that what mattered was the loss in value to the transferor's estate and that the loss to the estate was attributable to what left the estate, not what the transferee received.

Paragraph 30 of the *Balfour* case provides help in understanding the factors to take into account. The case applies to both Scotland and England, 'the traditional mix of a traditional Scottish landed estate and consisted of a blend of agriculture.' The letting of some of the cottages provides a good illustration of the fact that the management of the various activities on the estate was integrated and strategically prudent. For example, 'the provision of accommodation at reasonable or low rent to attract good workers or occupants who had skills which might one day be displayed on the estate…'

Removing assets surplus to requirement

On the basis that the Balfour case gives hope for the mixed estate, is the answer to remove the surplus non-trading assets following the ruling in Dance and then create a robust 'overall, mainly a trading activity?'

The summary has to be to look at all the recent guidance given by chapter 24 on the definition of agriculture, identify what activities need BPR and not APR, consider the ruling in *Dance* to help with the understanding of gifts from a business and await the judgement of the Appeal with interest.

Grazing

This case perhaps gave guidance on grazing. This should be considered in light of the fact that the further appeal re *McCall* v *HMRC [2009] NICA 12* has been declined by the House of Lords. In Balfour grazing rents were regarded as investment activity, as opposed to trading turnover. Paragraph 19 of the judgement in *McCall* helps explain the importance of cultivating the grass as a crop and not merely maintaining the land as a landlord. There is a difference between landlord and trader activities.

Summary of action plan

The Tribunal judge said that the estate had always been managed by the deceased as a single business, despite operating under two names prior to the partnership. He took de facto responsibility for the running of the whole estate, making business decisions himself. As a 'liferenter', the Earl had to be treated as beneficially entitled to the property, basically the whole estate, in which the liferent interest subsisted. The assets of the estate were used in the business, which was exactly the same before the limited partnership as after.

Consequently, it satisfied the replacement property provisions of IHTA 1984, s 107 and qualified for BPR under IHTA 1984, s 105 subject to the business not consisting of making or holding investments. It was essential to establish what the 'preponderance of business activity was.' 'A variety of relevant factors' need to be looked at 'in an attempt to create an overall picture.'

There is a risk of actively sheltering too many non-qualifying businesses within a qualifying business and claiming BPR thereon and then experiencing 'absolute' failure. Is there an opportunity to use the ruling in Dance to remove non-qualifying assets as a lifetime gift to take pressure away from the whole operation? ■