Field of dreams

With agricultural land values and food prices high, and still rising, it has never been more important for tax and estate planners to understand how their clients can qualify for agricultural property relief. **Julie Butler** explains

The world of agricultural property is going through major changes. At the time of writing, corn prices are high. The world population is increasing, and diet in the developing world is becoming more sophisticated, leading to shortages in the supply of food, and consequent large increases in food prices. Agricultural land values continue to rise. Reform of the Common Agricultural Policy (CAP) is due in 2013.

In the context of all this, estate and tax planners increasingly need to turn to agricultural property relief (APR) to try to protect large agricultural values from inheritance tax (IHT).

Agricultural property is defined in section 115(2) of the Inheritance Tax Act 1984 (IHTA 1984), as quoted by the HM Revenue and Customs (HMRC) Inheritance Tax Manual (IHTM):

"Agricultural land or pasture (IHTM 24031), which includes woodland (IHTM 24032) and any building used in connection with the intensive rearing of livestock or fish (IHTM 24033), if the woodland or building:

- is occupied with agricultural land or pasture (IHTM 24111); and
- the occupation is ancillary to that of the agricultural land or pasture.

It also includes such cottages (IHTM 24034), farm buildings (IHTM 24035) and farmhouses (IHTM 24036) together with the land occupied with them, if they are of a character appropriate (IHTM 24031) to the agricultural land or pasture."

DIVERSIFICATION

Diversification is the alternative use of land – that is, using the land for a purpose that is not agriculture (farming), such as sporting rights, horse livery, or developing agricultural land and buildings into residential dwellings, offices or workshops. Most landowners have to diversify to survive and to make full use of out-of-date or redundant buildings including cottages.

There are complex rules around which diversified activities qualify for APR and which do not. It is therefore imperative to understand the definition of farming for income tax purposes.

Under section 996(1) of the Income Tax Act 2007 (ITA 2007), "farming" means "the occupation of land wholly or mainly for the purpose of husbandry". For corporate taxpayers, the definition is somewhat more circuitous, as stated in section 832(1) of the Income and Corporation Taxes Act 1988 (ICTA 1988), where "farm land" is defined as "land in the United Kingdom wholly or mainly occupied for the purposes of husbandry … and 'farming' shall be construed accordingly".

To be classified as a farmer for tax purposes, a taxpayer must satisfy two tests: he or she must be in occupation of land, and the purpose of the occupation must be, at least mainly, for husbandry. The actual use of the land will normally be indicative of the purpose of occupation, but is not necessarily conclusive. Nor does the occupation need to be to the exclusion of others. Share-farming is an example in which two persons may occupy land and each be farmers. "Husbandry" is specifically said to include hop-growing, the breeding and rearing of horses, and the grazing of horses in connection with those activities (section 996(2) of the ITA 2007), together with short rotation coppices and energy crops.

EQUINE DIVERSIFICATION

Stud farming is, for tax purposes, farming, where there is occupation of land; however, general equine diversification – such as the activities of horse liveries, horse racing, eventing and so on – is not considered as farming.

For the breeding operation to be counted as agriculture, the stud must be carried out in conjunction with the occupying of land. This can either be through owning the land or having a tenancy. Where the mares are boarded at stud in return for a keep fee, the mare owner is not carrying out an agricultural activity, as he or she is not occupying land.

Many owners of equine businesses question whether or not APR will apply to the stud farm, and what the concerns are. HMRC has, at last, produced greater guidance on the stud farm and the qualification thereof for APR. Paragraph IHTM24068 of the IHTM sets out the taxman's understanding of the stud for agriculture: "it is considered that an essential requirement is for an element of horse breeding carried on in a systematic manner, with proper record keeping".

The paragraph continues:

"You should usually decide whether a stud farm qualifies for agricultural relief by reference to

- the information on the file,
- supplemented as necessary from other HMRC sources, such as the tax papers for the business or SAV (livestock),
- business accounts for the 5 years preceding death.

In arriving at your decision you should consider aspects such as:

- the age of the deceased both at death and at the acquisition of the farm;
- the length of the period of ownership;
- the number of horses held at the date of death and the breeding record in recent years;
- details of advertising and publicity for the stud, plus full particulars of sales;
- accounts of the enterprise, and details of the precise nature of the trading activity, including purchases and sales of horses."

This paragraph also states that, if the business has any horses not connected

with the stud farm, they will need to have a link with agricultural use. For instance, the grazing of horses used as draught animals on a working farm or declared to be part of the food chain under the 'horse passport scheme' would qualify, but the grazing of horses used for leisure pursuits would not. Where horses are grazed in connection with, for example, a livery business, business property relief (BPR) may apply instead.

Paragraph BIM55701 of the HMRC Business Income Manual, sets out the overview as follows:

"Stud farming, which in these paragraphs is taken to mean the occupation of land for the purpose of breeding thoroughbred horses, is a very expensive and high-risk activity. In some cases it may be carried on by wealthy individuals essentially as an adjunct to their racing activities. Nevertheless, for tax purposes it is treated as farming and thus – by virtue of ITTOIA/S9 and ICTA88/S53 (1) for companies – as the carrying on of a trade regardless of its commercial viability…".

Non-stud activities, such as riding schools, livery yards and sporting competitions are not agriculture.

ACTIVITIES WHICH ARE NOT FARMING

These include:

- the letting of cottages;
- the letting of farm buildings;
- equine activities that are not the breeding of horses;
- music concerts, raves and so on;
- market gardening and growing Christmas trees; and
- commercial woodland.

However, in relation to the last two items, note that, if the woodland or Christmas trees are ancillary to the main activity of farming, they do qualify for APR.

BUSINESS PROPERTY RELIEF

If APR fails, the landowner has to turn to the protection of BPR. There are those who consider that all agricultural property should have the back-up of BPR.

Under section 105(3) of the IHTA 1984, "relevant business property" does not include business or interest in a business, or shares in or securities of a company, if the business consists "wholly or mainly" of dealing in securities, stocks or shares, or land or buildings, or making or holding

investments. HMRC has made a number of well documented attempts to disallow BPR on the basis of this "wholly or mainly" requirement – that is, where more than 50% of the turnover or profit is from trading, more than 50% of the capital is used for trading and / or more than 50% of the work done is trading.

The case of *HMRC v Brander* [2010] UKUT300 (TC) considered entitlement to BPR of a mixed agricultural estate in Scotland. The question was whether, having decided that the estate was operated as a single composite business, the business operated – a combination of agricultural activity and let property – was "mainly" investment activity. Various factors were taken into account: the overall context; turnover and net profit; time spent on the various activities; and capital value. Although the capital value of the let properties (£4.3m) exceeded the value of the other properties (£2.3m), the judge confirmed that this was generally immaterial, and would only be relevant if the business were to be sold, which was not the case here. BPR was therefore allowed on the estate, including the let property. The decision extends the decision in *Farmer (Farmer's Executors) v IRC* [1999] STC (SCD) 321. In practice, the key item that HMRC generally asks for is a business plan for the stud that shows commerciality, and the ability to make a profit.

FARMHOUSES

One of the unique points of APR is the ability to claim IHT relief on farmhouses. Farmhouses are entitled to APR if they are: used for agricultural purposes; and of a character appropriate to the holding of which it forms part.

APR is limited to agricultural value: "the agricultural property shall be taken to be the value which would be the value of the property if the property were subject to a perpetual covenant prohibiting its use otherwise than as agricultural property" (section115(3) of the IHTA 1984).

This principle was tested in the case of *Antrobus (2)* in front of the Lands Tribunal. In this case, 70% of market value of the farmhouse achieved APR. The agricultural value of 70% of the farmhouse was established in the case but, as stated, Mrs Antrobus died in 2001, and the 30% discount is deemed to be lazy. Some district valuers (DVs) hold firm to 30%, others will settle on the facts – some taxpayers with rather grand houses are happy with the 30%.

It is important to note that there are a number of character-appropriate points in

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this case, and that, since 2001, the understanding of the tax position is developing.

Considerations are:

- the appropriateness of the house in reference to size and area being farmed;
- the 'elephant test' – "one knows a farmhouse when one sees one";
- how long it has been a farmhouse (*Rachel Jane Dixon v CIR* [2002] STC (SCD) 53);
- whether land predominates, so that the farmhouse is ancillary;
- whether the deceased is a "farmer" (in *Arnander and others (executors of McKenna, deceased) v HMRC Commissioners* [2006] STC (SCD) 800, there was no mention of farmer in the obituary);
- whether the deceased was involved in "active husbandry";
- whether it is a house with land or land with a house;
- whether an educated rural layman would regard the property as "a home with land" or "a farm";
- the relationship between the value of the land and the commerciality of the land – that is, whether the farm can support the farmhouse (*McKenna*).

Section 117 of the IHTA 1984 – that is, the qualification for APR – does not apply to agricultural property unless:

a) the property was occupied by the transferor for the purposes of agriculture throughout the period of two years ending with the date of the transfer; or

b) the property was owned by him throughout the period of seven years ending with that date and was throughout that period occupied (by him or another) for the purposes of agriculture.

Put at its simplest, this means that it does not apply to agricultural property unless it was occupied for two years, if it is the farming business of the owner; or for seven years if it is the farming business of a third party.

Atkinson and another (executors of Atkinson, deceased) (TC420) looked at the question of agricultural occupancy of the farmhouse. Mr Atkinson was a partner in a farming business until he died in 2006. Until four years before his death, he lived in a bungalow on the farm. The question was whether the bungalow was occupied for the purposes of agriculture in the seven years before his death. No one else occupied the property during the last four years of his life, and his partners regularly visited the property to collect post and deal with any other matters requiring attention there. Mr Atkinson remained a partner, and took part in discussions relating to the business. The test in section 117(b) of the IHTA 1984 that the property was occupied "by him or another" (in this case, the partnership) was held to be satisfied. The decision is subject to appeal.

This will obviously not be of help to the sole trader farmer, and in some circumstances, it might be beneficial to take a partner into the business to preserve APR – however, this must be considered as part of a full tax planning strategy.

Is now the time, given the strong tax reliefs in place, to consider passing estate to the next generation?

HOPE VALUE

Hope value is the difference between market value and agricultural value – APR only applies to agricultural value.

Section 160 of the IHTA 1984 dictates that probate assets – that is, assets held at death – are valued at market value – that is, the price that would be achieved between a willing buyer and a willing seller. When looking at what is the market value, it can be argued that not many lenders would be prepared to lend monies to purchase speculative blocks of potential development land, as they can be difficult to resell, thus pushing development land values down.

Due to this uncertainty around the value of development land, many personal representatives (PRs) with hope value in the estate have perhaps relied on the fact that the DV will question the value, and have therefore decided to submit a reasonable estimate, and finalise the matter by negotiating with the DV.

There are tax planning issues around the variance of probate values of potential development land. On the assumption that the beneficiaries will want to sell the land for development, the high probate value creates the 'base cost' for capital gains tax (CGT). Again, on the assumption that 100% BPR for IHT purposes will be obtained on the death value, the beneficiaries will want as high a value as possible to obtain as high a CGT base cost as possible. However, what happens if the BPR claim fails? In addition, IHT could be paid at 40% on hope value.

THE OFFICE OF TAX SIMPLIFICATION

The Office of Tax Simplification (OTS) was set up as an independent office within HM Treasury on 20 July 2010 "...to advise the chancellor on delivering a simpler tax system, providing independent advice on options for addressing existing complexity in the tax system...'.

On 3 March 2011, in its final report, it recommended a "complete review" of IHT, which it says would "enable the policy rationale for various provisions to be analysed, reliefs to be reviewed and, where necessary, either repealed, simplified or increased in line with inflation, and a simpler system overall to be considered".

Watch this space – if APR disappears and BPR stays, it would be so needed by the whole of the business community that it would surely lead to IHT relief on the farmhouse being scrapped.

ACTION POINTS

Within the current format of APR, it can be argued that every claim for APR should have the support of BPR, to prevent attacks on areas of a mixed estate that do not qualify for APR. Should APR be 'simplified' or disappear, this protection should be considered in advance of any change. In the meantime, there are arguments to say that every farm and / or mixed estate should consider a 'BPR audit', with emphasis on commerciality, trading and 'active husbandry'.

The other clear action point or consideration is whether now is the time, given the strong (some would say generous) tax reliefs currently in place but at potential risk, to consider passing estates to the next generation. Does the recent pre-nuptial case possibly present greater confidence to the farming community to review this course of action?

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