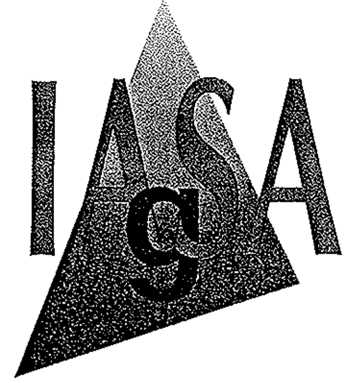

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Hobby Farming Rules – Avoiding the Traps and the Loss of Future IHT and CGT Reliefs

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With the recent history of declining farm incomes, an article which looks at the use of farm losses, their computation, the risk associated therewith and the future of agriculture would seem appropriate.

It may seem obvious to state, but It is essential to establish the amount of the loss before considering the alternatives of how to deal with it, such as which reliefs to seek and so on. Consideration should be made, amongst other things, of the hobby farming rules and how these could affect, at some time in the future, or even now, a history of farming losses.

The starting point is identifying the extent of the loss. It is imperative that the tax computation is clearly sorted out between farming and non-farming profitability with possible apportionments of overheads etc. The question of what is Schedule A (rental)and what is Schedule D Case 1 (trading) income is important when looking at agricultural property relief (APR), business property relief (BPR) and the potential to claim capital gains tax (CGT) reliefs. A large number of farming tax computations are now including a significant amount of diversification income which should, strictly speaking, be extracted from the tax computation, thus possibly increasing the farming loss and increasing the profit from other activities.

Hobby And Recreational Farming – The Facts

Farming has its own set of hobby farming rules which historically have stated that a profit must be made every six years. This again can be seen as an over-simplification and must be looked at carefully.

The hobby farming rules were introduced in 1960 due to concerns by the Inland Revenue over taxpayers farming for recreational purposes and not for commercial reasons. The original intention was to restrict loss relief in 'extreme cases' where the trading activities bore no relationship to the criteria of a commercial trade. The so-called five year rule was introduced as an extension of the original rules, i.e. as a further test it must be shown that the business is capable of making a profit [Income and Corporation Taxes Act 1988 (ICTA 1988) s 397]. Similar provisions for the restriction of corporation tax relief are included in ICTA 1988 s 393A(3). There are provisions introduced to prevent a formation of a company or a change of partnership breaking the five year rule, i.e. changing the nature of the business to stop the hobby farming rules being evoked. In the latter case example, husband and wife are treated as the same person.

The Inspector's Manual at IM2340a states the position is as follows:

"ICTA 1988 s 397 denies relief against general income etc in respect of a farming or market gardening loss where a loss computed without regard to capital allowances was also incurred in each of the five years of assessment preceding that in which the claimed loss was incurred."

The section only applies to losses sustained in trades of farming or market gardening, but for this purpose the definitions of those trades are extended, by subsection (5), to include activities carried on outside the UK.

It is worth referring direct to the Inspector's Manual at IM2336a.

Claims for tax relief in respect of farming losses can present particular difficulty because:

- Farming is regarded by many people as an attractive activity in its own right. Taxpayers with substantial income from other sources may take up farming for the sake of recreation or the lifestyle or status which it offers rather than for genuinely commercial reasons; and yet

- All UK farming is treated as the carrying on of a trade by virtue of ICTA 1988 s 53(1) – and is thus eligible for the loss relief provisions applying to trades – whether or not it meets the normal commercial criteria of trading (see Inspector's Manual at IM2262).

Special legislation therefore exists to prevent losses from farming activities which lack commercial inspiration being relieved against non-farming income.

Where losses are sustained in farming activities of an essentially non-commercial nature, relief under ICTA 1988 s 380 may fall to be restricted under either:

- ICTA 1988 s 384 – which restricts relief where the trade was not run on a commercial basis and with a view to the realisation of profits, or
- ICTA 1988 s 397 – which restricts relief where losses were incurred in each of the five previous years

Section 397 of ICTA 1988 is generally more straightforward to use as it involves an objective test. It should be applied in all cases where the conditions are satisfied. Cases where ICTA 1988 s 397 does not apply, but where the activities appear clearly non-commercial, should be considered for challenge under ICTA 1988 s 384.

Where relief by way of carry back in respect of losses sustained in the commencing years of a trade is claimed under ICTA 1988 s381 the test of commerciality is provided by s 381 (4) and is stricter than that of s 384.

Outsiders looking at the tax position of a farm or estate held as a pleasure activity rather than a genuine working farm would say that all that has to be achieved is a profit every six years and there is great scope for claiming what could only be termed as 'quasi business expenses', to subsidise an enjoyable country life.

However, anybody contemplating undertaking the purchase of a country estate or following in the steps of the TV comedy "The Good Life" must embrace the hobby farming rules with eyes wide open. With the move to diversification they must also look at standard commerciality rules.

Tax planners must be aware of what would happen if a farm or holding were deemed to be trading as a hobby. Not only would income tax losses no longer be available under ICTA 1988 s 380 but it could lead to a large potential denial of other tax reliefs. If the farm is deemed to be a hobby then the assets used therein would not have business status which could put in jeopardy future claims for CGT and inheritance tax (IHT) relief. The loss of BPR for IHT where income tax loss relief has been denied under the hobby farming rules is a matter on which opinions differ.

A large number of enterprises have had to look seriously at diversification in order to ensure that there is a profit. Some of these activities do not come under the farming definition. As a result the Inland Revenue have a right to apply to some or the whole of the trade not just the hobby farming rules but the normal commerciality rules. In the current climate those involved with the farming industry are painfully aware that it is very difficult to make a profit from pure farming and it has been difficult for a number of years. Strictly the tax computation of the business should be separated between farming and non-farming and the tax implications of the hobby farming/ commerciality rules dealt with accordingly.

It is vital, therefore, that anyone contemplating entering into such a venture or advising clients about entering into such a venture should look carefully at the definition of what is and what is not farming.

Anybody contemplating the purchase of a farm should do everything in their power to ensure that the hobby farming rules will not apply. Review of farming methods such as the choices between share farming, contract farming and farm business tenancies is a prime example: whereas the FBT does not qualify for business reliefs for CGT, it can result in a higher return. It is a question of personal choice.

Hobby And Recreational Farming – The Good Life Or A Nightmare?
The desire for many people to return to 'the country' has over the years been given much media publicity. The recent re-runs of the TV comedy "The Good Life" set a picture of one end of the scale whereas stars of the music and TV industries buying very expensive estates in beautiful parts of the West Country presents a picture at the

other. Likewise, with the recent fashion for tracing family roots back several generations via the internet, people are more aware than ever of the UK's strong agricultural history. Prior to the Industrial Revolution, which in the grand scheme of things is not that long ago, over 70% of the UK population earned their living from the land. Hence the desire to own a small farm or estate is a dream of many hardworking town and country dwellers alike.

The above factors could link quite closely to the interesting current position in the UK whereby, despite falling farm incomes, and the farming industry very much in decline, land prices are still maintaining their high levels and in some instances still increasing in value. To an "outsider" this might appear an anomaly rather like houses in mining villages going up in price at the time of the collapse of the mining industry. However, there are a large number of other factors which underpin the current strong land prices.

In the Home Counties where a large percentage of the workforce is based in the City or the prosperous large towns surrounding London, the increase in land prices is not that surprising. There are the underlying factors of "hope value" for development, the laws of supply and demand (there is an undeniable shortage of houses as borne out by documents such as the Hampshire Structure Plan) and the desire to enjoy the pleasures of a shooting estate, of being surrounded by your own land and the tax advantages that can be linked with 'the good life'.

A summary of the tax advantages are set out below:

- The ability to rollover gains from business assets into another business asset, and the potential for business asset taper relief for CGT should part of the land be sold or developed within the allowed timescale. This is even more attractive post Finance Act 2002.

- Business and agricultural property relief for IHT.

- The allowability to claim income tax relief where losses are sustained.

- The ability to repair and improve the property whilst claiming maximum allowable input VAT and where possible maximum income tax relief.

All reliefs must be carefully scrutinised and it is essential that all the relevant conditions are met so as to take full advantage of each and every one of them.

As with any business all the expense claims must be wholly, necessarily and exclusively for the purpose of the farming trade or estate enterprise and the operation must be commercial and must be shown to be commercial.

The terms of any contract farming agreement must be carefully reviewed. Some agreements are no more than tenancies "dressed up" as farming arrangements. Some arrangements are fragile and could fail Inland Revenue scrutiny. It is imperative to have a well drafted agreement.

Another area of concern is where "recreational activities" are blatantly incorporated in the farming activities and subjective decisions have to be made between the allocation of expenses between business and private. Clear examples are shooting estates and farms that incorporate the stabling of private horses.

There can be examples where the owners/taxpayers can be greedy in their claim for business expenses, such as those creating large losses for income tax purposes but jeopardising the five year rule and capital gains and IHT reliefs. The expenditure and income of recreational activities should be excluded except for the element of control of vermin. Professionals must not only warn their clients of the potential problems of trying to claim such expenses but evidence it in writing.

The Need To Review The Tax Computation

With the farming industry moving towards greater diversification there is a need to consider carefully how business tax computations are prepared and to plan for future reliefs.

It is interesting to note that the Country Land and Business Association (CLA) document *A Tax Framework for Jobs and Enterprise in the Rural Economy*, published prior to the Finance Act 2002, included the request for one set of tax rules to all rural activities managed as one business which they consider would be a useful tool for diversification. The CLA follow-up document *Reform to Perform* suggests that income from diversification such as let office space in farm buildings should be taxed as farming income.

When practitioners prepare the farm tax computation, the correct procedure is to remove non-farming income items and also to match the non-farming expenses to the income. In practice a lot of accountancy and tax practitioners are just preparing a computation which arrives at an accurate schedule D case 1 net profit or loss and which has little regard for the allocation of expenses and income. It could be that income from items such as quota leasing and grazing by horses are inflating the profit to assist with the avoidance of the hobby farming rules.

Stanley, *Taxation of Farmers and Landowners* (LexisNexis Butterworths Tolley), states of the hobby farming rules:

"To state the rule cynically, a profit once every six years is sufficient to avoid the effect of the section. This can sometimes be secured by correct apportionment of expenditure amongst the years in question."

Nevertheless, abuse of the 'hobby farming' provisions is foolhardy in the extreme, partly in view of the current high values of the farmland and, above all, farmhouses and their associated IHT reliefs.

As a practical tax planning point, the affairs of all clients who are associated with farming should be reviewed to ensure the correct treatment of income and expenses. It will also be essential to review what future reliefs the client may need to claim, e.g. Is there a question of the 'commerciality' of the farm or the business? It is also useful to ask such questions as does the client intend to claim APR for IHT purposes? If APR is lost will BPR still be available?

Farming Losses - Test Of Commerciality

The tests for commerciality are very well set out in the Inspector's Manual at IM2338.

'ICTA 1988 s 384 denies relief against general income etc unless the taxpayer can show that, during the period when the loss was sustained, the trade was being carried on on a commercial basis with a view to the realisation of profit. The fact that a trade was being carried on so as to afford a reasonable expectation of profit is taken as conclusive evidence that it was being carried on with a view to the realisation of profit.'

The provision was first introduced in 1960. The Chancellor of the day stated in the course of a Parliamentary debate on the section:

'We are after the extreme cases... in which expenditure very greatly exceeds income or any possible income which can ever be made and in which, however long the period, no degree of profitability can ever be reached.'

These words should be borne in mind when considering the application of the section to farming cases. The small farmer and the farmer with marginal land who are genuinely trying to make a living from their farms in difficult circumstances are not caught.

Nor should the section be used to deny the relief to a farmer who incurs temporary losses while establishing an enterprise, for instance by building up a production herd or bringing land back into fertility, provided the enterprise in which he is engaged is likely in due course to become an economic undertaking. For example, it may take a farmer five years to clear and work land infested with bracken before there can be an expectation of profit. Relief under ICTA 1988 s 380 should not be refused on the initial losses in such a case.

General guidance on ICTA 1988 s 384 may be found in the Inspector's Manual at IM3375 onwards. Where the application of the section is contested in a case involving

a farming loss, the Inland Revenue should make a report to the Business Profits Division (Farming) before listing the claim for hearing by the Commissioners.

There is a let-out where farming is part of a large undertaking. This is set out in IM2341b as follows:

'Section 397 (4) provides that relief is not to be denied where the loss-making farm or market garden is part of, and ancillary to, a larger trading undertaking. The subsection is designed to meet cases such as that of a butcher who makes a practice of fattening bullocks for his business, or a manufacturer who grows his own raw materials, or a seedsman or chemical manufacturer who runs a farm for testing or improving his products.'

The phrase, 'part of, and ancillary to' should be interpreted strictly. 'Ancillary' means 'subservient and annexed to' (see Croom-Johnson J in Cross v Emery at 31 TC 198). It implies a close operating link with and contribution to the larger undertaking.

The Inspector's Manual also sets out the principle on how the Revenue look for avoidance with regard to tax losses. This is set out at IM2342 as follows:

'Taxpayers may attempt to avoid the operation of Section 397 by ensuring that the farming enterprise periodically makes an isolated profit. The most obvious year to pick for this purpose would be the sixth year, and then every sixth year thereafter.'

Obviously there is nothing to say that a farm which has been unprofitable for five years could not make a profit in the sixth year. Furthermore, it may be possible for a taxpayer to arrange his or her affairs in a way that leads to the making of a genuine one-off profit. The Inland Revenue will check to ensure that the profit has not been manufactured by means of artificial transactions or devices, particularly in a case where substantial farming losses have been relieved against the income of an otherwise wealthy taxpayer. The Inland Revenue will look for the following examples:

- Charging business expenses (especially interest paid) to the farmer's capital account or not including them in the accounts at all.

- Recognising sales and/or expenses in the wrong year.

- Manipulating opening of closing stock valuations.

The Revenue naturally consider these and similar methods as unacceptable and enquiries could be made, in worthwhile cases, to ensure that the accounts include all the business income and expenses for the period concerned but only the business income and expenses for the period.

Agriculture – More Than Just A Profit
It has been said by Elliot Morley that tourism was more important to the countryside than farming. In response to this Willy Poole MBE of the CLA quotes "It is this countryside that brings in the tourists. Tourism may be a larger industry than farming but it rides on the farmer's back. A well farmed countryside that maintains its ancient traditions and people who make it work are, or should be, treasured national assets".

The Deputy President of the CLA, Mark Hudson, has equally strong views on future conservation policy being underpinned by profitability. In a speech given to a public policy seminar he stressed the need to reform current measures, many of which prevent good conversation management. Mr Hudson gave full backing to the Curry Report's recommendations on profitability and warned that for farmers to deliver the countryside that the public wants on a sustainable basis, they must be able to derive profit from conservation activities.

He said: "Land managers and woodland owners need to make a profit for the same reasons as companies that sell medical equipment to the NHS. Nobody would ever suggest that medical companies should supply the NHS at their own cost, so it is equally unreasonable to ask farmers and land managers to undertake conservation at their own cost."

Whilst reviewing the profitability of diversification, the profitability of pure agriculture must not be overlooked. All those involved in farming and land ownership need to keep updated with what farming policy is together with the outcome of CLA and National Farmers' Union (NFU) lobbying. If profit is to be achieved action has to be taken and the farming accountants have to act promptly on that action.

It seem ironic to long-time farmers that they could be caught under the hobby farming rules purely due to the farming crisis.

How to prevent a real farmer being classified as a hobby farmer
There is no doubt that in the current economic climate it is difficult to make a profit from true farming after all overheads have been correctly allocated. This is particularly so if a farming unit has borrowings, staff commitments or rent to pay. Unless the word agriculture is broadened it could be that a lot of farming units will be showing profits from diversification such as let property and losses on the actual farming activities. If these losses continue on the farming activity then the hobby farming rules might have to come into play.

It is imperative that costs are allocated correctly and that non-farming income such as let property does have its full share of overheads allocated to it. This could cause arbitrary calculation and some negotiation with the Inland Revenue. The CLA are lobbying for a broadening of the definition of agriculture to prevent this, but in the meantime the tax planner must take care when reviewing tax computations.

At the other end of the scale, is the recreational landowner who enjoys the lifestyle and would like to embrace the tax reliefs as a side issue. The tax planner must point out all the benefits but at every stage warn of commerciality.

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Editor's note: I can highly recommend Julie's book on Tax planning for farm and land diversification, which is a regular source of information for me personally. This book is to be updated shortly, so watch out for it!