Protecting goals

Land values, potential development value and the current tax regime have a major impact on the choice of agricultural tenancy, explains **Julie Butler**

Recently, a flurry of legal cases emphasised enthusiasm for landowners and landlords to escape from Agricultural Holdings Act 1986 tenancies. The objective of this Act was to give tenants security of tenure virtually for life, underpinned by the Agricultural (Miscellaneous Provisions) Act 1976, which introduced a rights of succession scheme to farm tenancies by members of the tenant's family.

The preferred farming opportunities for landowners include farming "in-hand" or a farm business tenancy (FBT) or contract farming. The desire for landowners to be free of the "succession" tenancy and achieve 100 per cent inheritance tax (IHT) relief can seriously drive change. Most landowners consider FBTs the answer. However, FBTs come with hidden tax problems, such as no business property relief (BPR) or IHT relief on the farmhouse; likewise, contract farming arrangements can be fragile and come under attack from HM Revenue and Customs (HMRC).

The FBT means that farm assets only qualify for agricultural property relief (APR) and do not achieve BPR on land with development potential (hope value).

Despite the fact that since September 1995 no new "1986 Act tenancies" can be created (except for those arising on a statutory succession and some additional rare exceptions), the Agricultural Land Tribunals still, broadly speaking, receive as many applications from tenants for a direction entitling then to succeed tenancy as ever they did.

Agricultural arbitrations continue to abound because tenant farmers generally do not want to give up their tenanted farms, and the total rent can be very cost-effective in terms of farmhouses and cottages.

The continuing rise in land price encourages landlords to challenge succession applications or otherwise seek vacant possession via the "seven deadly sins". Development land potential also seems to be a focus of landlords' and landowners' attention to "reclaim" farmland as "in-hand" farming.

In sharp contrast to the 1986 Act, the new FBT regime is simpler and almost wholly devoid of the statutory labyrinth surrounding 1986 Act tenancies.

What are these cases?

• **Atrocious husbandry:** The Tribunal found that fields had been abandoned or used for dumping rubbish, scrap metal, tyres and plastic, and long-term poor management would adversely affect production for several years. The tenant lost on a certificate of bad husbandry. The case is *Phillips v Davies*. However, such cases of neglect are rare.

• **Notice to remedy, equitable set off and notice to pay:** In *National Trust v Rose*, notices to quit had been served on behalf of the National Trust following the tenant's failure to comply with two notices to remedy and a notice to pay. The tenant argued that, by reason of the landlord's failure to undertake certain repairs, there was a defence to the arrears of rent claimed, and the arbitrator should, therefore, not uphold the notices to quit. The argument was that of equitable setoff. In this case, the discussions between landlord and tenant about repairs to be undertaken by the landlord had occurred six years prior to the service of the notice to pay. The notices to quit were held to be valid.

• **Succession – tenant's livelihood from agricultural work on the holding:** In *Thomson v Church Commissioners for England*, the Agricultural Land Tribunal refused a succession tenancy when the requirements of the Agricultural Holdings Act 1986 section 36(3)(a) were not fulfilled, meaning that the tenant's livelihood was derived from agricultural work on the holding for a continuous period and had not been satisfied to a "material extent" pursuant to section 41(1)(b) of the Act.

The claimant's hard work on the farm was acknowledged, but in seven years, the percentage of livelihood derived from the holding ranged between 36 per cent and 39 per cent, and she had reached an average of 75 per cent in terms of her time, which was insufficient to meet the conditions of the Act.

• **Retirement – livelihood test:** *Crabtree v Shirley* was a retirement case between retiring father and an applicant daughter. The legal issue concerned the principle livelihood test (that the applicant's only or principal source of livelihood was derived from his agricultural work) set out in section 50(2) of the 1986 Act viz.

What are the "eligible person" rules of succession? The 1986 Act states: "(2) For the purposes of sections 49 to 58 of this Act, 'eligible person' means (subject to the provisions of Part I of

schedule 6 to this act a applied by subsection (4) below) a close relative of the retiring tenant in whose case the following conditions are satisfied–

(a) in the past seven years his only or principle source of livelihood throughout a continuous period of not less than five years, derived from his agricultural work on the holding or on an agricultural unit of which the holding forms part; and

(b) he is not the occupier of a commercial unit of agricultural land."

What period must the livelihood test be demonstrated? In the case of succession on death, the relevant provision refers to the past seven years ending with the date of death; but in the case of a retirement, no specified date is given.

Action plan for landowners and tenants

When landowner and tenant share an amicable relationship, they should be encouraged to discuss the whole area of succession, retirement and possible replacement of the AHA 1986 tenancy – but what of the tax consequences?

• **Landlord – at risk of a large IHT bill if tenancy stays:** The IHT relief is restricted to 50 per cent IHT relief via APR. IHT 1984 section 116(2)a allows 100 per cent relief with vacant possession. ESC F17 extends this when there is a right to obtain vacant possession with 24 months. With the current property values, very few farms and landed estates are restricted to agricultural value. There is an important need for landlords to be able to enjoy BPR on "hope" (potential development value) and "special value" (premium above agricultural value, such as valuable sporting location, close to road and train links for "lifestylers").

If the landlord makes a payment to the tenant, he or she will be doing so to secure vacant possession by way of surrender of the lease, so enhancing the value of his or her reversion. The payment will normally, therefore, augment the landlord's cost base for capital gains tax (CGT) purposes and relief will be secured if and when the freehold is sold for an ultimate capital gain. For the tax position of the tenant, see below.

If the landlord pays nothing, no tax considerations arise unless the market value rule operates, for example, because the landlord and the tenant are connected persons.

• **Landlord with development value:** The most intense action by the landlord to remove the tenant could arise when potential development value exists on the land he or she owns.

Where vacant possession is acquired and there is a disposal of the whole interest at a later date, liability could, in certain circumstances, arise on trading income as an adventure in the nature of trade, but HMRC have indicated that they would not mount an attack under TA 1988 section 776.

• **The tenant accepts payment for surrender – what is the tax position?:** If the landlord makes a capital payment to the tenant, the latter will be liable to CGT. In computing the tax, deductions will be due for expenditure by the tenant on improvements, such as the land and any buildings surrendered with the tenancy.

If the landlord pays nothing for the surrender, the whole of the tenant's assets will have been lost or destroyed in the act of surrender, and it may be that a loss will arise, for capital gains purposes, on the principles described. On the other hand, if the landlord and tenant are connected persons, HMRC may seek to infer or substitute an "arm's length" price as consideration for the surrender with consequential effects on the CGT computation (TCGA 1992 section 17), but holdover relief may be claimed. If the tenant pays the landlord, the payment arguably falls to be treated as expenditure incurred in the disposal of an asset, therefore producing a loss, although it is unclear whether section 38 TCGA 1992 supports this deduction.

• **The tenant accepts compensation:** The tenant's position will differ if what he or she receives is not a payment for the surrender of the tenancy, but compensation in respect of disturbance under the Agricultural Holdings Act 1986 sections 60 and 63. Such payments are intended to reimburse the tenant for the loss or expense suffered in having to quit. Up to one year's rent can be claimed with proof of loss and up to two years' rent if particular proof can be provided. These receipts are not derived from an asset; therefore, no liability arises. Similar treatment is accorded to comparable payments of up to four years' rent made under the Agricultural (Miscellaneous Provisions) Act 1968, as compensation for surrendering the tenancy on a notice to quit from the landlord or on a notice of entry served by local authority.

Payments of this class are made when land is required for private or public development or for other non-agricultural purposes, and the tenant would be entitled to compensation under the Agricultural Holdings Act 1986 sections 60 and 63. This receipt is wholly exempt from income taxation and CGT (*Davis v Powell*).

The question arises as to taxation when a tenant does not serve out a period of notice following the receipt of a notice to quit, but instead enters in to a surrender agreement with his or her landlord.

Compensation to tenants for milk quota on the termination of a tenancy is now regarded as within the scope of CGT. The Agricultural Act 1986 schedule 1 paragraphs 1–4 impose liability on landlords to pay compensation to tenants for milk quota on the termination of a tenancy.

• **The CGT position of the tenant:** The surrender of an existing tenancy for consideration is the disposal of a capital asset for CGT purposes. The tenant could, therefore, become liable to CGT when he or she surrenders the old tenancy, if connected to the landlord or because the bargain with the landlord is not considered to be a bargain at arm's length. In either case, the tenant will be deemed to receive the open market value of the tenancy as consideration (see TCGA 1992 sections 17, 18).

The CGT reliefs available to the tenant range from principal private residence relief on the element of the farmhouse to rollover relief into another asset.

• **Surrender of the family farming tenancy:** The question remains as to whether an existing family farming tenancy should, in light of existing reliefs, be brought to an end.

Put simply, every landlord and every tenant should review their current commercial and tax position and take action to protect their goals.

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