

# Strictly business

The recent *Agnew* case has a number of implications for inheritance tax relief claims for businesses where commerciality may be called into question, such as bloodstock stud-farming. **Julie Butler** explains

Evidence of the commerciality of a business is a major issue in terms of both income tax losses (under sections 64 and 72 of the Income Tax Act 2007 (ITA 2007)) and claims for business property relief (BPR) for inheritance tax (IHT). A recent case, *John Agnew* (TC 566), raised two important points: who is actually trading; and is the business structured in a way that it would ever be profitable (that is, ever possible to make a profit)? It can be argued that *Agnew* highlights the need for the trader to produce a business plan. If the taxpayer has to show to HM Revenue and Customs (HMRC) that a business would be profitable, then they have to show that, from the outset of the business, there was commercial intent – the business plan must show a potential profit, and one that can be sustained. HMRC will check the validity of the business plan during an enquiry. The plan should be convincing enough that a bank would lend money on the strength of it, and there should be evidence to support its details.

## HMRC's focus on commerciality can be exceptionally expensive in terms of the potential loss of tax relief

The case of a livestock farming partnership in *Walsh v Taylor* [2004] STC SCD 48 brought into question the commercial trading basis throughout the relevant period of the partnership. Questions were raised as to whether the business was conducted in such a way that profits could be reasonably expected to be realised in that period and in a reasonable time thereafter – in other words, was the business of commercial design?

The question of commerciality is currently being asked by HMRC of income tax loss claims contained within tax returns. Likewise, IHT400 forms are being questioned for IHT relief allowability. HMRC is approaching both of these aggressively, and the result can be exceptionally expensive in terms of the potential loss of tax relief.

The position of commerciality was considered in *Walls v Livesey* [1995] (SpC 4). The Special Commissioner recognised that there were two separate tests. The first was subjective, as to whether the taxpayer had neither purpose nor interest to follow a course other than the realisation of profit. The second was objective, taking account of the fact that he had been “blown off course” by unexpected circumstances.

Taking the example of a bloodstock stud, what would happen if the owner were to die before initial losses were turned into a

profit? HMRC would not question that there was a business, provided the basic criteria were there, but there would still be a question as to whether it were a business carried on for gain, and which would therefore qualify for BPR.

The position concerning agricultural property relief (APR) and studs is different to BPR with regards to commerciality. HMRC Manual BIM 55701 states that it is treated as farming “and thus, by virtue of ITTOIA/s9 and ITCA 88/s53 for companies, as the carrying on of a trade regardless of its commercial viability”. It can be argued that there is a contradiction between IHT and income tax guidance. BIM 55725 refers to the guidance that the income tax loss relief can be achieved provided “that a stud farming business is potentially profit making”.

There is a difference between a stud which has recently become unprofitable due to the current problems in the marketplace, and a stud which has never produced a profit – the first situation should not be a bar to a BPR claim, but the second could be, even if an APR claim is achieved.

Can *Agnew* provide guidance? Can it be proved by HMRC that a bloodstock stud is structured in such a way that it can never make a profit?

### THE FACTS OF THE AGNEW CASE

Mrs Agnew worked part-time, about 10 hours a week, as a manicurist, pedicurist and beautician from her home. Her husband claimed that he owned the business, and that she was employed by him, although, in fact, Mrs Agnew effectively ran the business on her own. Mr Agnew claimed losses from the trade against his income. HMRC began an enquiry, questioning whether or not Mr Agnew was trading with a view to profit. HMRC decided that the wages paid to Mrs Agnew were a transfer of income rather than expenses of the trade.

The First-tier Tribunal found that there was a trade, but that it was undertaken by Mrs Agnew, rather than Mr Agnew. Mrs Agnew carried out all the treatments, dealt with all the bookings and bought most supplies, and the insurance was in her name. There was nothing to show that Mr Agnew was involved in the business. The business was not being carried on a commercial basis, as it was not structured in such a way that it would ever be profitable. Mr Agnew's appeal was dismissed by the Tribunal.

### THE IMPORTANCE OF COMMERCIAL DESIGN

The *Agnew* case emphasises the importance of the business being of commercial design and structured to be able to make a profit in order to achieve income tax relief. It must be “potentially profit making”. There are points raised in this case that apply to many equine and farming operations which make large and / or

persistent income tax losses, or which have never made a profit, which can happen in the case of a bloodstock stud. The same questions have to be asked: who is undertaking the trade; and is it structured to produce a profit? The emphasis in order to prove commerciality is on the original structure, so again, there is a need for a business plan to show that the proposed structure can produce a profit and ideally does make a profit, in accordance with the plan. For IHT planning, the business matrix must be reviewed – try and look through the eyes of HMRC and visualise the aggressive correspondence.

### INCOME TAX PLANNING POINTS

Whenever an income tax loss claim is made, the question of commerciality must be considered. If no business plan has been prepared, then it is essential that the whole question of commerciality is reviewed, and business plans and budgets prepared. Ideally, there should be evidence that the taxpayer has responded to the problems shown by both the results and projections, and taken positive action to rectify problem areas. It must be proved that a profit can be achieved in the existing structure. Likewise, the two tests in *Walls v Livesey* must be capable of being proved to HMRC – that the only purpose of the business and course the taxpayer wanted to follow was to achieve a profit, and that the taxpayer has been “blown off course” by, taking the example of the bloodstock stud, the downturn in the bloodstock breeding and racing industries.

*Agnew and Walls v Livesey* help clarify what the tests are that have to be passed to prove commerciality – a structure capable of making profit, and proof that the only goal is profit (nothing else), and that if there is a delay in profitability, it is due to being “blown off course”.

### INHERITANCE TAX PLANNING POINTS

First, analyse the property in terms of agricultural activity and business activity, to see what will qualify for APR (such as breeding or a farmhouse) and what will qualify for BPR or will need the additional protection of BPR (and must therefore be shown to be carried on for gain). Remember that any elements of the business that will need the protection of BPR (such as development value, boarding mares and livery) do not actually come within the definition of agriculture. Stallions do not count as trading or agriculture, unless they are integrated into a stud and cover the mares belonging to the stud.

One of the key points from *RCC v Brander (as Executor of the Will of the Late Fourth Earl of Balfour)* [2010] UK UK300 (TCC) was the active involvement of Lord Balfour. In this respect, the income tax rules give guidance that goes hand-in-hand with IHT planning, in the form of the ‘10-hour rule’ to ensure the income tax loss claim is not restricted to £25,000. Obviously, to work much more than 10 hours is ideal for the income tax loss relief claim, as it proves

dedicated active involvement. Where the potential to make profit has been “blown off course”, then keep evidence to support this – in the case of bloodstock, evidence of the collapse of the Irish economy and Irish bloodstock market. However, this development also means that there has been a drop in foal numbers, which

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gives an opportunity for greater profitability for stud farms which have survived.

Many might argue that *Golding v HM Revenue & Customs* [2011] UK TC1211, which HMRC is not appealing, contradicts the points raised on commerciality in the light of the low income in later years. However, many of the important points of *Golding* concerned the history of trading, and a continued business matrix that supported Mr Golding’s executors’ case for APR.

### A STEP-BY-STEP GUIDE

1. Review the structure of the business – can a profit ever be achieved?
2. Rectify problems found from this review (for instance, reduce expenditure through repaying borrowings to reduce finance costs or sharing costs with other studs).
3. Scrutinise unprofitable areas of the business and make commercial decisions (for instance, retire unprofitable mares).
4. Produce a business plan and take action upon the findings of that plan, no matter how painful. Include evidence of working with professionals to try to resolve problems.
5. Consider increasing profitability through adding income streams like diversification or grants (such as renewable energy projects) or increasing marketing (after considering the cost / reward balance).
6. Produce management accounts.
7. Produce prompt historical accounts (don’t deliver the books to the accountants’ office in December for the 31 January tax return deadline!).

It is not enough that some or all of the above have been carried out casually – there must be evidence and a documentary trail that could, if necessary, survive the scrutiny of a First-tier Tribunal. ■

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