Beware of tax traps in the countryside

***Julie Butler* highlights aspects of capital taxes and VAT that are coming under increasing scrutiny from HMRC**

HM Revenue & Customs have stated that they will be looking closely at the tax treatment of all land and property and that this will include rural locations and activities. This article aims to set out the areas that are coming under attack and to suggest practical solutions.

Game shooting

HMRC's Shoot Project Team from Norwich is on the road and carrying out their 'programme of visits to shoots across the UK' as promised in their April 2006 missive, which said: 'You may get a visit in the coming year and some of these visits may be made without an appointment.' This attack on the VAT treatment of shooting was taken one step further when it was featured on the front page of 'oneHMRC', the department's in-house journal, in November 2006. It emerged that:

- this is proving to be a very, very successful campaign for HMRC – most shoots visited are having to pay some extra VAT or direct taxes;
- 'oneHMRC' claims that the 'average extra tax take' is £19,000 a visit; and
- it is likely that some actual or potential VAT irregularities will be identified.

Advisers need to look now at historic damage limitation and commercial restructuring to minimise the future VAT.

One of the key areas of the VAT debate (and the possible collection of extra VAT by HMRC) is over the granting of the shooting rights by the landowner. On the assumption that the landowner is VAT registered, output VAT at the standard rate of 17.5% will have to be charged on the granting of the right to shoot. Historically, the grant of sporting rights has been mis-described as the zero-rated letting of land.

What are HMRC looking for?

- **Shoots which escape the HMRC 'net'**: Commercial shooting which has been variously mis-described, in HMRC's view, as private shooting, a non profit-making club activity, or the zero-rated supply of birds.
- **The Wicked Barter**: Exchanging supplies of VATable shooting for zero-rated or other supplies, by way of barter, with neither transaction entered in business records.
- **Not Registering**: Failure to register for VAT if the turnover of the shoot is over £61,000 (with effect from 1 April 2006).
- **Dividing to Escape**: Artificial separation of business activities to stay below VAT registration limits.
- **What is everything really worth?** Under-recording of sales values.
- **Paying VAT and tax on Private Enjoyment**: VAT and income tax irregularities on claims for private expenditure.

'Agricultural value' disregards any value which may be attributable to the hope or prospect of obtaining planning permission.

The barter trap

In order to claim 100% inheritance tax (IHT) relief, it is essential for the landowner to show that the farm is a business, trading as a farm, and that the farm accounts show that the activity is sufficient to support the claim for IHT relief on the farmhouse and the land.

It is not uncommon that perhaps due to age, the principal farmer has let neighbours keep cattle on his land in return for mowing, hedging, fertilising, topping etc and other maintenance activities on the farm. In such a case, the main activity will not show up in the accounts. Part of the remedy would be a properly worded grazing agreement for the neighbour's stock, which would be seen by HMRC as farming for tax purposes and should help ensure that IHT relief could be achievable.

In order to claim capital gains tax rollover relief or business asset taper relief (BATR) (which can lead to an effective CGT rate of 10 per cent, ie. 40 per cent tax less 75 per cent BATR) it is essential to show that the farming assets are business assets, which means broadly that they must be used in the business.

If all the trading activities are sheltered (and ultimately not recorded) via barter it is difficult to prove that the land is actually a business asset and so these reliefs may be at risk. For example, if an area of the land were to become available for development it could be very tempting for HMRC to challenge whether this is actually a business asset used in the business, where that use is not supported by the business accounts. Ironically, the use of barter could lead to the loss of valuable IHT and CGT reliefs.

Agricultural property relief: 'hope' value

The 'special value', eg. potential development value of a farm or landed estate over and above its agricultural value – as defined in *Inheritance Tax Act (IHTA) 1984, s115(3)* – is known as the 'hope' value.

IHT is a tax on values, specifically on the diminution in value caused by a transfer of value in the transferor's estate. The distinction is crucial to how various reliefs and exemptions are statutorily expressed. It explains, for example, why the spouse / civil partner exemption in *IHTA 1984, s 18* is expressed to be limited to what the transferee gains in terms of assets or value. HMRC have always proved to be very keen on drawing the distinction between the business and the assets.

The first question is whether the land with 'hope value' qualifies as 'agricultural property' as defined in *IHTA 1984, s 115(2)*. The problem here is that 'agricultural value' is to be calculated on the value of the land as agricultural land only. Agricultural value disregards any value which may be

attributable to the hope or prospect of obtaining planning permission – still less any value attributable to the actual grant of planning permission. *IHTA 1984, s 115(3)* provides that the agricultural value of any 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'.

Business property relief

The second question is this – does the property qualify for IHT business property relief (BPR)? BPR is not available on the agricultural value of land where that value qualifies for APR (see above). What is needed to achieve BPR? The farmland must be part of a trading activity, by definition part of a genuine business – defined in *IHTA 1984, s 105*. 'Business' is liberally defined. However, the business which qualifies for these purposes does not include a business consisting wholly or mainly of 'making or holding investments' [*IHTA 1984, s 105(3)*].

If BPR could be made available, it does not matter that a major part of the market value of the farmland may reflect the hope or prospect of obtaining planning permission. In order for that hope or market value to be eligible for BPR the land with hope value must be farmed in exactly the same way as land without any hope value. Some farmers do not farm the land that has potential development value with the same commitment (eg. it is left fallow or it is removed from the main farm strategy) and this could jeopardize the potential BPR relief.

Business property relief will not be available if the farmland is in truth an investment.

BPR will not be available if the farmland is in truth an investment, ie. it is tenanted farmland. It matters not for these purposes that the landowner may indeed be carrying on some form of trade elsewhere, since *IHTA 1984, s 112* would operate to exclude the land held as investment (eg. under a tenancy agreement) from relief on the grounds that it is an 'excepted asset' for these purposes.

So under what circumstances would HMRC not be stopped from contending that the hope element in the value of farmland was not eligible for BPR? Well, we have already looked at *ss 105(3)* and *112*. What if the farming business has been overtaken by an investment business? What about a non-commercial farm?

Does 'Farmer' still apply in 2007?

One case on this subject of BPR is that of *Farmer and Another (Executors of Farmer Deceased) v IRC*, [1999] STC SCD 321 SpC 216. The Special Commissioner held that the decision has to be made looking at all relevant factors including profits, turnover, the time spent and the value of the assets concerned. These all help to establish the fundamental nature of the business, which in *Farmer* was 'farming'.

HMRC are likely to review the balance sheet for assets which can be excluded from BPR.

The ability to claim BPR on hope value depends on *IHTA 1984, s 110*, which sets out the value of a business as follows:
(a) the value of a business or of an interest in a business shall be taken to be its net value;
(b) the net value of a business is the value of the assets used in the business (including goodwill) reduced by the aggregate amount of any liabilities incurred for the purposes of the business;
(c) in ascertaining the net value of an interest in a business, no regard shall be had to assets or liabilities other than those by reference to which the net value of the entire business would fall to be ascertained.

In *Farmer*, the farm trade activity exceeded the non-trading activity, eg. let cottages. What happens if the criteria of trading profits, turnover and time spend are not met? Will the BPR be denied?

Rural property – the non-commercial business

Help with the definition of a non-commercial business is found in HMRC's Inheritance Tax Manual at IHTM 25153: 'Meaning of a business'.

This states that many stud farms are carried on otherwise than for gain and that the inspector should refer cases of doubt via Technical Group TG (IHTM 1081) to Shares Valuation (SV) (IHTM 1110) (Livestock) for advice.

In the VAT case *Commissioners of Customs & Excise v Lord Fisher* [1981] STC 238, Gibson J identified at p245 six indicators, some or all of which should be satisfied to identify an activity or activities as a business. HMRC regard these indicators as equally applicable as a test for IHT purposes (IHTM 25152):

Gibson J referred to six aspects of an activity that are to be considered in determining whether the activity is a business. Those aspects, as listed by counsel for the Crown, were whether:

- the activity is 'a serious undertaking earnestly pursued' or 'a serious occupation, not necessarily confined to commercial or profit-making undertakings';
- the activity is 'an occupation or function actively pursued with reasonable or recognisable continuity';
- the activity has 'a certain measure of substance as measured by the quarterly or annual value of ... supplies made';
- the activity was 'conducted in a regular manner and on sound and recognised business principles';
- the activity is 'predominantly concerned with the making of ... supplies to consumers for a consideration'; and
- the supplies made 'are of kind which subject to differences in detail, are commonly made by those who seek to profit by them'.

Taxing development gains as income

HMRC do try to assess gains on the sale of development land to income tax and corporation tax under *ICTA 1988, s 776*. Clearly this will remove the CGT advantage of BATR which, as already mentioned, can reduce the effective rate of tax payable by the landowner to 10 per cent.

Income tax (or corporation tax) can only be charged on development gains on farmland if the land is (i) held as the 'trading stock' of a land dealer or developer, or (ii) acquired (or developed) with the sole or main object of realising a gain on the disposal of the land (or the disposal of the land when

CGT and incorporation: there was no 'loan' within TCGA 1992, s 253

The appellants had transferred their partnership business to a limited company in 1999. In June 2005 a Special Commissioner had denied them hold-over relief under *TCGA 1992, s 165* in respect of the transfer of goodwill valued at £250,000 (see SpC 483 [2005] STC (SCD) 633 and TPT 26.18, 26 August 2005). The appellants contended at that earlier appeal that the goodwill was gifted to the company for no consideration, but the sum of £250,000 had been credited to the directors' loan accounts and the Special Commissioner found as a fact that the goodwill was transferred for consideration.

Based on their interpretation of that decision, the appellants then claimed loss relief under *TCGA 1992, s 253* on an irrecoverable loan. They contended that the consideration created a debt to them from the company, that the debt was a qualifying loan within *s 253*, and that the loan became irrecoverable when the company started trading. HMRC contended that the appellants had not been able to produce evidence of the loan's existence.

The point at issue

Whether there was sufficient evidence of a loan to support a claim to loss relief under *TCGA 1992, s 253*.

The decision

The Special Commissioner dismissed the appeal. The appellants had produced no evidence to substantiate the creation of a loan between them and the company arising from the transfer of goodwill. There was no evidence in the earlier appeal that a loan existed, and the appellants had failed to adduce sufficient evidence on the balance of probabilities that it existed.

Colley and another v HMRC SpC 585

Profit-sharing arrangement: double taxation relief denied

The appellant ran an accountancy training consultancy in Eastern Europe. He entered into an oral agreement with the director of X International Ltd in Slovakia. Each party to the agreement would provide tutors who were to be charged out at a profit, and they would share the residual profit. The Slovak operation, which was terminated in March 2005, had paid Slovakian tax as a branch of X under the name 'X International Ltd Oz'. Management accounts included a calculation of the appellant's 'profit share' after various adjustments. HMRC issued an assessment for 2001/02 and made amendments to the appellant's 2002/03 and 2003/04 self assessments.

The point at issue

The availability of double taxation credit relief would be determined by the legal nature of the Slovak operation. The appellant contended that it was something akin to an English partnership, in which he and X were carrying on business jointly, so that he was entitled to credit relief for Slovakian tax. HMRC regarded the operation as something akin to a silent partnership under which X carried on the whole business but paid the appellant 50 per cent of the adjusted profits. On this basis no credit relief would be due.

The decision

The Special Commissioner considered that there were some factors in favour of the operation being akin to an English partnership. Many decisions were taken jointly, and the appellant was consulted throughout. However, there were many more factors in favour of it being akin to a silent partnership. The operation was carried on as a branch of X which was registered as such in the commercial register and with the Slovak tax authorities. X employed and paid the staff, paid for the premises and provided all the capital for the operation. The appellant took no part in the financial transactions and was not a signatory to the bank account, and in the later years his involvement was small.

The Special Commissioner concluded that the operation was conducted as a branch of X and the appellant had a contractual profit share. The adjustments to the management accounts reflected the reality of the situation, namely that X carried on the whole business and paid a profit share to the appellant. The operation was, therefore, akin to a silent partnership and the appellant was not entitled to credit relief.

Training Consultant v HMRC SpC 584

developed) and the remaining conditions set out in *ICTA 1988, s 776* are met.

Decisions such as that in *Tempest Estates Ltd v Walmsley* [1976] STC 10 and *Page v. Lowther* [1983] STC 61 suggest that, in making any arrangements for the sale of the land to developers, caution will be needed in ensuring that what is received is received as capital rather than as the receipts of a land dealer or developer or someone who has participated in developing with a view to sharing the profit on the disposal after development. In such a case the profit is taxed at the highest income tax rate (potentially 40 per cent).

IHT: replacement property

Agricultural property or the landed estate can provide practical choices for replacement property relief. There are real-life situations which can benefit from the practical use of agricultural property or landed estate, eg:

- sheltering development profits in farming/the landed estate;
- sheltering business gains in farming/the landed estate; and
- sheltering wealth from IHT.

The classic 'hope value' shelter is where farmland is sold for development and the gain is rolled over into an eligible business asset for CGT (thus sheltering the CGT liability) and potentially sheltering the asset for IHT via the replacement asset rules – but will agricultural property/the landed estate qualify as replacement property?

It is quite normal for a successful entrepreneur to turn to agriculture late in life. The fondness of the English for farming as a pastime is well documented. Whilst the assets of the entrepreneur remain within his business he may pass them to the next generation with the benefit of substantial tax relief. On a successful sale of the entrepreneur's business he now faces a new problem. The substantial value which has been protected by BPR is represented by cash which, unless invested in qualifying property, will be taxed very heavily should he die before

having distributed it among his family and survived seven years.

An attractive option for the retired entrepreneur might seem the purchase of a landed estate including, typically, a home farm in hand, some let farms, and local facilities such as part of a village. The estate will be run as a composite whole. The question arises as to how far the entrepreneur has succeeded in reinvesting into favoured property.

Generally, APR will be allowable but problems will arise in relation to those who let properties which are not occupied for the purpose of agriculture. Depending on the location of the estate such properties might command a premium value because of their setting. BPR will not be available on such properties if, taking the estate as a whole, *IHTA 1984, s 105(3)* applies to treat it as consisting wholly or mainly of making or holding investments. BPR could apply to these cottages under *IHTA 1984, s110* and principles established in the *Farmer* case as set out previously.

What guidance can be obtained to help explain the problems of the movement of replacement assets between BPR and APR? To quote IHTM25303:

'... For the purposes of the ownership test ... the nature of the business carried on by (or on) the business property need not be the same throughout the two year period. But there must have been a business throughout that period'.

IHTM 25312 provides a very useful flow chart for replacement property, and IHTM 25313 sets out a limitation on the relief. There is an anti-avoidance provision which prevents a business owner from buying a much more expensive property shortly before death or transfer. Clearly it can be quite special tax planning to predict the exact date of death. However, IHTM 25313 says:

'When the replacement property (IHTM 25311) provisions apply, *IHTA 1984 s 107(2)* restricts business relief by providing that the relief shall not exceed what it would have been had the replacement or any one or more of the replacements not been made. For this purpose a replacement resulting from the formation, alteration or dissolution of a partnership, or from the acquisition of a business by a company controlled by the former owner of the business, is to be disregarded, *IHTA 1984 s 107(3).*

'IHTA 1984 s 107(2) is an anti-avoidance provision and its purpose is to prevent a person who has qualified for relief from purchasing a much more expensive property shortly before death or making a transfer.

'Your approach to *IHTA 1984 s 107(2)* should be practical. If there is any indication that the deceased's/transferor's resources were being rearranged into considerably more extensive business property to obtain increased relief on the death/transfer, you should refer the case to Technical Group (IHTM 1081). Otherwise you should adopt a reasonable approach aimed at quantifying and agreeing the restricted relief in a practical way. The approach you should adopt is illustrated by two examples: one of which deals with the equivalent provisions for replacement property in an agricultural relief case (IHTM 24136), and another which involves agricultural and business relief (IHTM 24137).'

Careful planning is essential when switching replacement assets between those qualifying for BPR and those qualifying for APR.

The 'excepted assets' – future use

HMRC Inheritance Tax (previously Capital Taxes, see www.hmrc.gov.uk/cto/iht.htm)) are likely to review the balance sheet for assets which can be excluded from BPR because they are caught under *IHTA 1984, s112* which begins as follows:

'(1) In determining for the purposes of this Chapter what part of the value transferred by a transfer of value is attributed to the value of any relevant business property so much of the last-mentioned value as is attributed to any excepted assets within the meaning of subsection (2) below shall be left out of account.

(2) An asset is an excepted asset in relation to any relevant business property if it was neither:

(a) used wholly or mainly for the purposes of the business concerned throughout the whole or the last two years of the relevant period [defined in subsection (5)], nor

(b) required at the time of the transfer for future use for those purposes ...'

Historic examples of assets caught under *s 112* are 'cash mountains' and investment assets which do not appear to have a 'future use' in the business. The keys to protection are the business minutes showing future use and contemporaneous evidence that such assets will not fail to be eligible for relief due to the provisions of *s 112*.

Action plan

It is considered that the way forward is a Rural Property Tax Audit to prepare to deal with the HMRC scrutiny. For example:

- analyse the rural property, farm or estate within its current structure and business management arrangements;
- produce a report as to the expected taxation outcome in the event of an immediate death of various parties involved, or a potential sale if appropriate;
- make suggestions and give reasons for changes intended to maximise the potential to qualify for APR or, where appropriate, BPR; and
- woodlands must be reported in detail as the tax treatment is complex.

The report should include a full history of the rural property with maps, areas of potential development, and CGT base costs, highlighting any areas that might be used for recreational purposes or otherwise vulnerable to attack, eg. shooting, private home etc.

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