Stud losses

Julie Butler and Lucy Knighton analyse the changes to the rules concerning stud losses as they appeared in the recently updated BIM 55725.

The guidance in HMRC's *Business Income Manual* at BIM 55725 'Farming: stud farms: losses in stud farms' covers allowability of losses in the breeding of horses. With regard to the application of the hobby farming loss restriction rule to stud farming, a concession was confirmed in a letter sent in 1982 to the Thoroughbred Breeders' Association (TBA) which has always previously been included under BIM 55725. This stated the following:

> 'It has always been recognised that some ventures are by their nature unlikely to show a profit by the sixth year of trading and section 397(3) [now either s 68(3) ITA 2007 or s 49(3) CTA 2010] provides for loss relief to be continued after the fifth year where the claimant is engaged in a particular farming activity of an intrinsically long term profit making nature we have long accepted that the breeding of thoroughbred horses is such a long term venture, and provided that a stud farming business is potentially profit making, we would not normally seek to invoke section 397(1) [now either s 67(2) ITA 2007 or s 48(2) CTA 2010] until after 11 years from the start of the business.' [BIM 55725]

It has therefore been on this basis that accountants and tax advisers had considered stud losses, and this date had been the key point for discussions with HMRC.

Stud farming is specifically treated as agriculture for the purposes of inheritance tax agricultural property relief per IHTA 1984, s 115(4). The losses are therefore subject to the 'hobby farming' rules as is farming. To quote the updated BIM 55725:

> 'The guidance on farming losses at BIM 85600 onwards applies equally to stud farming and other long-term ventures. Under self assessment for the 6th plus (ie 6th, 7th, etc) consecutive year of losses, farmers should assess the reasonable expectation of profit test as set out at BIM 85640 and BIM 85645.'

Key points

- The application of the hobby farming loss restriction rule to stud farming a concession – previously included under BIM 55725.
- BIM 55725C has been updated and puts evidence on commerciality – HMRC no longer accepts the 'long-term' nature of stud farming.

Following the recent update, BIM 55725 no longer includes the TBA agreement. The manual puts evidence on commerciality. To quote again from the updated section:

> 'The requirement that the business should be potentially profitable (in other words, the question of whether s 68(3) ITA 2007 or s 49(3) CTA 2010 is satisfied) is important and should be checked in all cases.'

This would suggest that HMRC no longer accepts the 'long-term' nature of stud farming and arguing the ability to claim losses for 11 years from the start of the business becomes even harder work for both tax advisers and stud farms. It is suggested that the 1982 agreement, now 40 years old, must not be forgotten and argued with determination when in discussions with HMRC. While all advisers understood that the 11-year rule could never just be simply accepted by HMRC and the stud was not free to make losses as it wished up to that point, this does put more pressure on the stud farms to show that a profit can be achieved from an earlier stage.

This therefore means that stud farms will largely be considered like any other farm and come under the reasonable expectation of profit test. The aim of this test is to deny relief for businesses where HMRC deems that the business could never make a profit.

We have been in contact with the TBA and it is our understanding that it is investigating this change to the BIM and it will issue further guidance to its members in due course.

So what should stud farms be doing in light of this change?

- A strong business plan should always be put in place at the start of trade, and this should be updated as the business goes on. The updated business plan needs to reflect updated profit and loss projections, explain hurdles that may have stopped the previous business plan coming to fruition, and how the business is overcoming them now. The business plan should also be the opportunity to sell the owner of the business as the 'competent farmer' and to highlight their strengths and knowledge in the trade. The business plan should be reviewed by the accountant to ensure that it covers everything necessary to satisfy HMRC.

- Assessing the business model is important for any business. Are there any potential diversified income steams for the stud that can help with costs? Are there any elements of the business that are not working? While it is important that the core trade does not change, tweaks to the model and plan to ensure profitability are always sensible.
- Strong evidence to show that this is a commercial undertaking includes a good business website and advertising channels for the horses. How will the stud reach its market?
- It is important that studs (along with any business) can show to HMRC how they have responded to potential challenges along the way to help ensure that future profit. Identifying things that might cause a profit to not be achieved and to be managing them, an example here may be getting the young stock x-rayed at an early stage to try and avoid a failed vet assessment in the future.
- It is also beneficial for a stud to have a depth of stock, and not to base the business plan all on one sale of one good horse as this is a high-risk strategy. HMRC will want to see that there is a continuing business that is viable going forward.
- Be prepared for an HMRC enquiry. Have good quality books and records. Take advice from a specialist accountant if not done so already. The onus is on the farmer (or stud farmer in this case) to produce hard evidence to justify the claim of a reasonable expectation of future profits.

It is also important that the accountant is ensuring that a stud farming loss summary is in place so that they can keep track of the losses. As with farming the accountant needs to be looking at the pure trading profit so that the tests can be satisfied.

Quite often there is valuable tax relief at stake, and therefore it is important that stud farm businesses offsetting losses understand the risks and are well prepared so that an HMRC enquiry can be readily defended.

Author details

Lucy Knighton ACA is managing director of Butler & Co. She can be contacted by email: lucy@butler-co.co.uk.

Julie Butler FCA is the author of *Tax Planning for Farm and Land Diversification* (Bloomsbury Professional), *Equine Tax Planning* ISBN: 0406966540, *Butler's Equine Tax Planning (3rd Edition)* (Law Brief Publishing) and *Stanley: Taxation of Farmers and Landowners* (LexisNexis), and editor of *Farm Tax Brief*. She can be contacted by email: julie@butler-co.co.uk.

FIND OUT MORE
On Taxation.co.uk

- Put out to stud: tinyurl.com/ycku6u9t
- Animal valuations for tax purposes: tinyurl.com/c76pnd6u