Cutting losses

Julie Butler and Fred Butler examine the recent Court of Appeal judgment in *Naghshineh* and its importance to farmers making continued losses from the farming operation.

A recent Court of Appeal judgment, *Ardeshir Naghshineh v CRC* [2022] EWCA Civ 19, is of huge importance for the farming industry and those farmers making continued losses from the actual farming operation. The judgment on 13 January 2022 comes at a time when the farming industry is going through significant change and is faced with much uncertainty. It is ironic that the findings of the case are published in the same month as the House of Commons' Committee of Public Accounts report on the environmental land management scheme (ELMS). The report is damning about the work by the Department for Environment, Food and Rural Affairs (DEFRA) so far, stating: 'The department has not established metrics or clear objectives which would allow it to measure the success of the scheme.'

The history of the case starts with the First-tier Tribunal (FTT) allowing sideways loss relief claims for a farming business where losses were made for 17 years in *Naghshineh* (TC6631). The success of the decision caused some surprise among professional advisers and indeed it was overturned in the Upper Tribunal (UT). The Court of Appeal has now upheld the UT judgment.

History of the farming operation

Against this background let's consider the case in detail. In 1995 Mr Naghshineh bought a conventional working agricultural farm of about 75 acres. Over the years he acquired more land until, by 2007, the farm extended to 438 acres. Mr Naghshineh was a businessman and he had no experience of running a farm. Mr Naghshineh had never lived in the farmhouse and, in 2007, he employed a general manager but had to make him redundant in 2010.

Key points

- The First-tier Tribunal allowed sideways loss relief claims for a farming business making losses for 17 years – overturned in the Upper Tribunal.
- The Court of Appeal considered the overriding issue to be the proper construction of ITA 2007, s 68(3)(b).
- It upheld the Upper Tribunal's decision saying the First-tier Tribunal misinterpreted the test in s 68(3)(b).
- HMRC needs to create guidance on taxing the environmental land management scheme and how it will affect claims for sideways loss relief.

The farm was run on an organic basis until 2009-10 when Mr Naghshineh reverted to conventional farming methods. Some commentators on the case imply that Mr Naghshineh switching between different types of farming was a negative. However, organic and bio-diverse farming can have very high infrastructure costs and business analysis show changes must sometimes be made to return to profit.

Mr Naghshineh carried on other activities on the farm including holiday lets, a farm shop, a micro-brewery, toymaking and a mustard business. Overall, the operation was very entrepreneurial. However, the farm made losses from the year Mr Naghshineh bought it until 2012-13, which in total was 17 years. Since 2012-13 the farming has been profitable. Mr Naghshineh claimed sideways loss relief for the five-year period 2007-08 to 2011-12 in the sum of £1,464,324 with tax at stake of £587,140.

The Court of Appeal considered the overriding issue to be the proper construction of ITA 2007, s 68(3)(b) with regard to sideways loss claims. The complex wording of the section caused much debate, particularly over the phrase 'the activities at the beginning period of the loss'.

The plethora of recent tribunals on farm and equine losses (see 'Handle with care', *Taxation,* 12 February 2015, page 14) indicate both the lossmaking problems but also HMRC's appetite to challenge sideways loss claims. With farms failing to make money under the area-based subsidy regime, the future under ELMS looks bleak (see 'All change', *Taxation*, 25 February 2021, page 24).

Under the 'hobby farming' rules where a farming business makes losses for five years in a row, loss relief is not available in the sixth and subsequent year unless the reasonable expectation of profits test is met and demonstrated to HMRC. The test requires that a competent person carrying on the activities in the tax year in question meets a further two tests:

- test one – they would reasonably expect future profits; but
- test two – they could not, at the start of the loss-making period, have reasonably expected the activities to become profitable until after the end of the current period.

Test one

In order to understand the latest Court of Appeal judgment it is necessary to understand the FTT decision. The test in ITA 2007, s 68(3)(a) requires consideration of whether or not the hypothetical competent farmer had, in the year under consideration, a reasonable expectation of profits in the future. Such a test has confused many farm tax advisers over the years and makes loss planning very complex. HMRC held that in the three years from 2007-08 to 2009-10, prior to making the general manager redundant, costs had been allowed to spiral out of control and there was too much diversity with regard to the activities of the farm. HMRC therefore argued that this high-cost structure meant that a competent farmer could never have expected to make profits in the future. However, the report by the farming and profitability expert at the tribunal disagreed with HMRC and stated that for each of the years under consideration, a competent farmer would have had a reasonable expectation of future profits.

The FTT therefore rejected HMRC's argument that a competent person would still have been unable to make a profit due to the high level of costs incurred at that point. A competent person is defined as a competent farmer or market gardener. The FTT also dismissed the 'illogical' idea that in order to examine the position of the hypothetical competent farmer we must assume that he could not make any changes at all in the way in which the farm was being run. The FTT's final view was that even if it was agreed that the high level of overheads meant the farm could never be profitable, the hypothetical farmer could reduce his costs later, just as Mr Naghshineh had done, such that he would have had a reasonable expectation of future profit. For those reasons, the tribunal accepted that the first test was met by Mr Naghshineh.

Test two

The second test in ITA 2007, s 68(3)(b) requires consideration of whether a competent farmer could not, at the beginning of the prior period of loss, reasonably have expected the activities undertaken to become profitable until after the end of the year under consideration. Any subsequent unforeseen or unforeseeable events, such as the 2007-08 financial crisis, were not to be taken into account, following the decision of the Upper Tribunal in *Scambler v CRC* [2017] STC 2108. However, they did find it reasonable that a competent farmer would allow a contingency for any such events and that this contingency would inevitably have the effect of prolonging the time by which the farming venture became profitable.

Naghshineh meeting the second test

To confirm the second test, the FTT applied the expert's timescales (assuming any contingency for unforeseen events to have been built into these) to the activities carried out in the years under consideration. The time it would have taken the hypothetical competent farmer to do these was concluded to be as follows:

1) finding and acquiring the necessary land – three to five years;
2) conversion of the land to organic status – four years;
3) producing a wide range of farming produce – four to ten years;
4) selling farm produce directly to the consumer – four to ten years, and
5) achieving profitability – ten years after the land had been converted to organic status.

Profits would therefore not have been expected until after the end of 2012 and so the FTT considered that Mr Naghshineh had met the second test.

Upper Tribunal's view

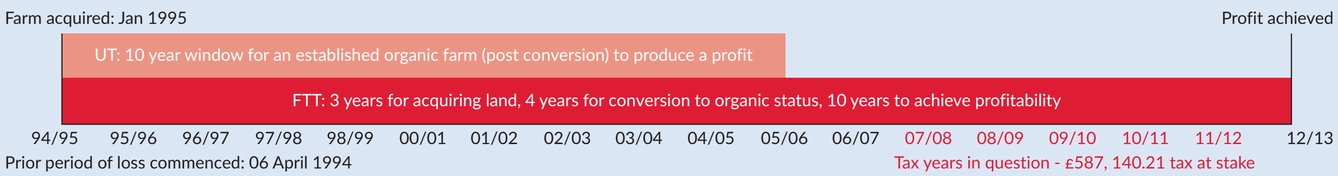
HMRC appealed to the UT which set aside the FTT decision, concluding that the FTT decision contained material errors in law in applying the test in s 68(3)(b). The expert opinion was that it would have taken Mr Naghshineh four years to convert the farm to organic farming then another ten years for the organic farm to become profitable. In the first tax year in question, 2007-08, the activities consisted of mixed-use organic farming with the conversion to organic farming having already been completed. It is the activities in this year that are important and therefore the preparatory years for conversion, acquisition of land etc should be ignored. As such, if organic farming had been taking place at the beginning of the prior period of loss on 6 April 1994, (with the conversion to organic farming having been completed some years prior), then a profit would have reasonably been expected by 2005 at the latest. Therefore, relief was disallowed for this year and the subsequent years. It was noted that for the last two tax years in question (2010-11 and 2011-12), when they had reverted to conventional farming, there was no evidence at all as to timescales for a competent farmer to expect a profit and this had not been considered by the FTT either.

In the opinion of the UT, Mr Naghshineh did not meet the 'reasonable expectation of profit' test. The UT remade the lower tribunal's decision and disallowed Mr Naghshineh's appeal. To quote from the UT judgment:

> '39. In our opinion, the test operates as follows. First, the activities actually carried on in each year of loss – in this appeal each of the five tax years from 2007-08 to 2011-12 inclusive – must be determined. Second, one must then assume that those activities were being carried on at the beginning of the loss period (discussed below but found by the FTT to be 31 March 1995). Having made that assumption, one must ask how long a competent farmer at 31 March 1995 would have expected it would take for those activities to become profitable. In answering that question, the competent farmer must "have regard to" the factors mentioned in s68(4). Only if the competent farmer can say "it would have taken until after the end of the relevant loss year", and only if he could not reasonably have reached a contrary view, is the test in s68(3)(b) satisfied. While applying the test of expectation as at 1995 may seem harsh, we note that s68(3) refers specifically not to a competent person at that time but to "a competent person *carrying on the activities at the beginning of the prior period of loss*" (our emphasis).'

We note the UT later determined the beginning of the prior period of loss to be 6 April 1994, not 31 March 1995, to reflect the fact that it must refer to a tax year. The 'prior period of loss' is defined as the five tax years before the current tax year. If losses, excluding capital allowances, were also made in successive tax years before those five tax years, the period comprising both those successive tax years and the five tax

Comparison



years before the current tax year, are included in the period calculation. See the graph ***Comparison***.

Organic and bio-diverse farming

Farming has suffered from lack of profitability over a number of decades with rising costs and competition from cheap imported products where the cost burdens of health and safety are much reduced. An area of farming that has suffered commercially has been the bio-diverse and organic markets. While saving the planet and responsible farming are currently on-trend, the commercial reality of the high costs of organic farming production does not translate into sales demand from the buying public. There has always been a lot of hype, publicity and apparent enthusiasm but the true cost of production with an appropriate markup sees it dwindle. Where farmers switch back to traditional farming from organic the costs of the transition can also be high. Some argue they are 'damned if they do' (switch) and damned if they stick to the organic/bio-diverse ideal.

Court of Appeal's decision

The Court of Appeal dismissed Mr Naghshineh's sideways loss relief claims, agreeing with the Upper Tribunal. To quote from the judgment:

> '81. The UT was correct in its construction of ITA 2007, s 68(3)(b). The FTT had misconstrued that test. Section 68(3)(b) does not test the competence of the individual farmer, but rather it tests the reasonable expectation of the length of time for farming activities, as they are carried on in the year of loss, to come into profit, taken from the beginning of the prior period of loss. The purpose of that test is to cap the length of time, beyond the five-year rule, that sideways relief is available for loss-making farming or market gardening activities which may otherwise be commercial (by reference to s 66) and may otherwise be likely to make a profit in time (s 68(3)(a)). The cap will vary in each case and will depend on evidence, that evidence focusing on the amount of time reasonably expected for those activities, ie the ones which are being carried on in the current year, to come to profit, taking their hypothetical start date at the beginning of the prior period of loss.'
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> '82. Applying the test in that way, Mr Naghshineh was not entitled to sideways relief for any of the five years of claimed losses.'

Planning ahead and business plans

As soon as losses look like they will exceed five years (this could be from the original business plan or ongoing financial detail), the 'cap', ie the length of time beyond the five year rule must be calculated case by case and with supporting evidence and reasonable evidence. With the report on the ELMS showing DEFRA conceding 'its confidence in the scheme looks like blind optimism', Sir Geoffrey Clifton-Brown, deputy chair of the Public Accounts Committee states: 'Farmers, especially the next generation of farmers who we will depend on to achieve our combined food production and environmental goals, have been left in the dark and it is simply wrong that DEFRA's own failures of business planning should knock on to undermine the certainty crucial to a critical national sector.'

The impact that this will have on future sideways loss claims, especially the proper construction of ITA 2007, s 68(3)(b), is significant. It would seem that farmers and tax advisers urgently need guidance from HMRC, not just on how ELMs will be taxed but also on how they will affect the claims for sideways loss relief.

Against this background it is surprising to understand that the value of farms and the demand for farms, especially from lifestyle farmers, is high. Part of the strategy for the new breed of farmers embracing the changes and the technical demands of the tax relief could be a greater move to contract farming arrangements (see 'Farming arrangements', *Taxation,* 1 July 2021, page 14).

It can be argued that some farmers really are faced with insurmountable problems. Not just HMRC's appetite to fight their loss claims but in order to achieve sideways loss relief they must have collected the necessary contemporaneous evidence from the outset. There is a current emphasis on using making tax digital to keep on top of profitability and cost analysis but it is also important to use the software for management accounts to tie into original business plans and budgets together with financial road maps. ●

Author details

Julie Butler FCA is founding director of Butler & Co Alresford Limited. She is the author of *Tax Planning for Farm and Land Diversification* (Bloomsbury Professional), *Equine Tax Planning* (ISBN 0406966540), *Butler's Equine Tax Planning* (third edition) (Law Brief Publishing) and *Stanley: Taxation of Farmers and Landowners* (LexisNexis), and editor of *Farm Tax Brief*. She can be contacted by email: j.butler@butler-co.co.uk or by phone: 01962 735544.

Fred Butler MSc ATT is tax manager in the farm and equine department at Butler & Co. He can be contacted on 01962 735544 or email: fred@butler-co.co.uk.

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