Farming peculiarities

Julie Butler and Lucy Knighton consider the impact of basis period reform for farmers.

There has been much discussion and debate with regard to the proposed basis period reform as part of making tax digital for income tax self assessment (MTD ITSA), in particular for those in seasonal industries who deliberately have non coterminous year ends and for whom the proposed changes are expected to affect their tax position the most. With the announcement that MTD ITSA has been delayed until 2024, so have the proposals for the changing of basis periods. Considering that there still appears to be many finer details to be ironed out this is a sensible move. However, while 2024 now seems a long way in the future, extra time does mean that accountants and their clients still need to consider the position if their year end is not coterminous with the tax year and to start factoring the impact into any decision making. It is now planned that the reform will take effect for the 2024-25 tax year with a transition year in the 2023-24 tax year.

See 'Shaking the foundations' by Emma Rawson (*Taxation*, 2 December 2021, page 12) for analysis of the impact of these changes for businesses in general; in this article we focus on the effect of the changes on the farming industry. First, we set the scene with a synopsis of the measure.

This reform changes the taxation of profits to a 'tax year basis' with effect from the tax year 2024-25, so that a business's profit or loss for a tax year is the profit or loss arising in the tax year itself, regardless of the business's accounting date. Such changes remove the basis period rules and inhibit the creation of further overlap relief. On transition to the tax year basis in 2023-24, all businesses' basis periods will be aligned to the tax year. Therefore in this transitional year, some businesses will experience double taxation because they will be taxed not only on 12 months' worth of profits from the end of the basis period for 2022-23, but there will also be transitional profit subject to tax based on the period from the end of those 12 months to 5 April 2024.

For example, in the transition year the basis period for a business with a 30 June year end would be determined by adding together two components:

- taxable profit for the year ended 30 June 2023 – the standard component; plus
- taxable profit from 1 July 2023 to 5 April 2024 (9/12ths of the profit to 30 June 2024 – the transition component.

Consequently, this brings the profits taxed into line with the tax year basis to 5 April 2024 but results in 21 months' worth of profit being taxed in the transitional 2023-24 tax year. This would mean preparing the accounts to 30 June 2024 before the 2023-24 tax return could be filed in order to obtain this 9/12ths figure or using an estimate for this period.

For businesses which have profits in the transition tax year that are higher than if calculated under the current basis of assessment because of the changes to basis periods, the government proposes an election to spread any 'excess profits' in the transition year over up to five years. There is an option to elect out of this. Due to concerns raised during consultation on the impacts on allowances and means-tested benefits the government has proposed to treat any excess profits arising during the transition year as a one-off separate item of taxable income, rather than as part of a business's normal trading income. The scope to focus on business decisions that work to the tax advantage of the client are obvious.

Impact on farming clients

Farming will be especially adversely hit. This is because advisers already have to cope with the anomalies of farmers' averaging and hobby farming rules, together with the fact that the industry is facing large changes with greater moves to diversification and the need for full succession planning which could in itself result in adjustments to accounting periods. Where possible these factors could be used to the client's advantage by the proactive tax adviser.

Overlap profits

Farm accountants will need to identify if there are overlap profits brought forward as these will be able to be used to reduce the taxable profit in the transition year. A forward planning point would be to identify these sooner rather than

Key points

- Basis period reform will affect farmers averaging and hobby farming rules.
- It may not be helpful for farmers with production cycles to align accounts with the tax year.
- Changes to farming subsidies are another area of concern.

later to ensure that overlap profits are correctly recorded on files. With many farming businesses having been in existence pre-self assessment, determining the correct overlap position brought forward may not be straightforward if records are unavailable, perhaps lost on a move of accountant or due to possible previous incorrect recording on the tax return.

Overlap profits from the early years of trade must be deducted from the profits of the transitional year. If there is excess overlap relief arising in the transition year, the time period for the resulting loss to be carried back will be extended from one to three years. This treatment mirrors the current rules for loss relief when a business ceases and therefore gives greater flexibility on the use of excess overlap relief.

Cessation of business or retirement of partner

If a business ceases or a partner retires before the whole of the transition period profits have been charged to tax, the balance will be immediately brought into charge in the tax year of cessation. It is therefore important to ensure that the possibility of such events is included in the five-year business plan, especially with farmers looking to pass the farming business down the generations or sell the farm due to the current high land values, and to look at the impacts of such proposals and the best timing for such events.

Change year end?

For farmers, annual accounts are not prepared solely for tax purposes. For businesses with a production cycle which does not align to the tax year, an accounting period based on this cycle is valuable to the business. By having this year end, it can provide important information on the business and allow for decisions to be made. These benefits would be lost if a change to the accounting year end was made and far greater emphasis on management accounts would be needed.

There are also obstacles for aligning an accounting period to the tax year. These include the inconvenience in arriving at stock valuations and ensuring that these follow HS232, as well as for famers where their very busy periods affect their availability to deliver their books and records to their accountant and have time to go through their accounts. Another aspect farmers enjoy from a non-coterminous year end is having time for post year-end tax planning – for example, if the profit of the accounts is known to for example 30 September they can use this knowledge to decide whether to then make a pension payment before 5 April or consider some kit purchases in the next accounting period.

It could, however, be complicated for farmers to understand fully the impact of accruing profits on their tax position if their current year end is retained. For those businesses unable, or for which it would be inconvenient or undesirable, to adopt a tax year accounting period end, this would just replace the complexities of the existing regime with different (and potentially greater) complexities of apportioning profits, and potentially making estimates in ITSA returns. Such unchanged accounting periods would mean that the bookkeeping system would show their accounts based on current year end expectations, but when working out their tax bills for cash flow purposes, they would need to be considering proportions of different periods. Juggling these complications

could be messy. It is important to remember that many farms are small, and this would be a lot for them to manage.

If the decision is made to adjust the year end to be coterminous, ie in line with the tax year end, it could be beneficial for farmers to consider whether it is beneficial to change their year end ahead of the proposed reform. Although such action would not be the case where the farmer wants, or indeed needs, to make use of the option to spread the excess profit, if a farmer knew they had some big equipment purchases planned, an extended trading period would not result in too much additional tax. So, there would be an argument in favour of extending the year end sooner in order to take control of the financial impact in their own time, particularly with the extension of the limit for annual investment allowance (AIA) at £1m to 31 March 2023.

The timing of the acquisition of plant and machinery will be poignant especially in the light of the extension. With the grain silo case of *May* (TC6928) and the potato storage case of *JRO Griffiths Ltd* (TC8203) highlighting the potential for high AIA claims, the timing of assets eligible for AIA should be incorporated into the forward planning calculations to achieve the maximum benefit of the timing of expenditure.

Farmers will also need to consider that some types of accounting software do not take an extension to an accounting period very well, only allowing a 12-month period so will need to consider the impact on their bookkeeping arrangements.

It will also be necessary for farmers to liaise with their contractors or farmers with whom they are in a share farming arrangement as they will also need to consider the effect of changing the year end on these arrangements and the joint management accounts prepared as part of this. This is because it makes it more difficult for the main farm accounts if the management accounts are not produced to the same year end.

For farm accountants, if it is decided not to change the year end, they will need to factor the timings into workloads as preparation of accounts may need to be brought forward from the normal timeline and consideration given to staff availability.

Incorporation

Many businesses are considering incorporation as some of the benefits of operating as a partnership will be diminished when this rule comes into place. There are also the tax advantages of the super-deduction plus research and development restricted to the limited company. However, for farmers a limited company structure is often not advisable because of the complications that arise due to the land being traded either held outside the company and therefore only attracting 50% business property relief or the cost – such as professional fees and stamp duty land tax – of transferring the land into the company.

Farmers' averaging

It has not yet been announced as to how these new rules will affect farmers' averaging, indeed it is still under consultation.

If a farmer decides to adjust their year end ahead of the reform, they would still be able to average their profits under these rules with an extended trading period. As an example, extending a 30 September year end to 31 March will in effect mean that they will all be taxed in the tax year – as the 31 March year end falls in the tax year – and farmers' averaging will apply to the full 18 month profits as against the 12 month profits for the previous year or years.

Hobby farming rules

Farming has its own set of 'hobby farming rules', which historically have stated that a profit must be made every six years. This is known as 'the five-year rule', in that there can be five years of losses but there must be a profit in the sixth year for losses to be used against other income. The profit considered must be the pure farm profit.

Many farms have been surviving on the basic payment subsidy (BPS) which is being replaced with the environmental land management scheme (ELMS) as part of farming for the environment. As a result, tax definition between farming and non-farming activities will need to continue to be forensically analysed. A change of year end may make it simpler for the farm accountants for calculating the hobby farming rules, which have to be calculated in accordance with the tax year which requires apportioning year ends to determine whether a fiscal year basis farm profit has been achieved. This is an element of the rules which is often forgotten. A coterminous year end will make it much clearer as to which year's profits need to be made to not fall foul of the loss restriction rules.

Enterprise accounts will become even more important. For farmers facing such change and complexity the tax planning could be described as a house of cards – if accounting and tax decisions are made without looking at all the tax considerations in the round, parts of the house could collapse.

It should be noted that general partnerships will not be required to join MTD ITSA until April 2025, with limited liability partnerships and partnerships with corporate members not expected to join until a year or more after that, although this is yet to be confirmed. This therefore does give farming partnerships a little more time to consider how best to deal with this. However, we would recommend decisions are made before the AIA advantage is lost.

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 at j.butler@butler-co.co.uk or by phone: 01962 735544.

Lucy Knighton ACA is managing director of Butler & Co Alresford Limited. She can be contacted by email at lucy@butler-co.co.uk or by phone: 01962 735544.

Parts of this article refer to recent Taxation articles including 'Farming Arrangements' and 'All Change'.

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