Farming property transformation

Julie Butler and Lucy Knighton discuss the decision in *E Balnakeil* in relation to repurposing farm buildings into holiday accommodation.

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With the Agriculture Act 2020 orchestrating the move towards farming for the environment and a commercial need for diversification to fill the 'subsidy gap' following the loss of farm subsidies, there has been a push for farmers to look at projects that will increase profits in the future.

Furnished holiday accommodation

Furnished holiday accommodation is currently a positive direction for farmers to pursue, especially with the Covid-19 lockdown aftermath increasing the demand for UK farm holidays, staycations and camping.

Repairs and renovation to farm property will be needed to provide suitable farm accommodation. A recent case *E Balnakeil* (TC8143) (tinyurl.com/TX-BuildRen) gives guidance on the importance of tax planning. It concerned a farming partnership denied relief on the costs of altering run-down farm buildings to convert to holiday accommodation. The costs were found to be capital in nature rather than revenue, and not wholly and exclusively for the purposes of the trade. This provides a timely reminder for farm accountants and tax advisers to forensically examine the true nature of 'repairs' recorded in the farm records so as to establish the correct position and whether the valuable tax relief is available.

The facts

A farming partnership in the Scottish highlands owned several farm buildings, the largest of which was a nine-bedroomed farmhouse, historically used as accommodation for the farm manager until he died in 1992. It was then used by a shepherd during the lambing season each year and sporadically by other casual workers. However, it was in a poor state of repair and, because it was a listed building, the partnership was compelled to carry out repairs to preserve it.

To secure various grants to fund these works, it was agreed that the house should be used for five years as a furnished holiday let along with the conversion of the Beach Bothy (previously a shepherd's cottage but more recently used for storage due to disrepair).

The renovation works began in 2010 and were mostly complete by late 2012. However, during this time it was apparent that the partnership would dissolve as the partners went their separate ways and split the partnership assets up accordingly. The dissolution agreement took effect from October 2014, but it was, in fact, an entirely new partnership formed on 1 January 2012 between one of the partners and his wife that marketed the newly renovated properties and received the first letting income.

As mentioned, such diversification is currently of significant interest to farmers facing a commercial need for change. Maximising the tax relief on the associated costs of such changes is therefore a key challenge for farm tax advisers to help assist with cashflow and this case provides good guidance for this.

Key points

- Importance of tax planning when renovating farm accommodation into holiday homes.
- The First-tier Tribunal in *Balnakeil* determined the entire cost of works to buildings was capital in nature.
- The expenditure was incurred for the new income operation of furnished holiday accommodation.
- Advisers should encourage farm clients to involve them before work begins.

Capital versus revenue

The First-tier Tribunal dismissed the appellant's arguments and found that the entire cost of the works was capital in nature rather than revenue. It first looked at the appellant's means of apportioning the revenue expenditure from the capital expenditure, based primarily on the VAT treatment. It was pointed out that there is no legislative provision, nor any noted authority to support this.

The extent of the works carried out were then reviewed. The tribunal referred to Buckley LJ in *Lurcott v Wakely* [1911] 1 KB 905 who said: 'Renewal as distinguished from repair, is reconstruction of the entirety'. It deemed the nature of the costs allocated to repairs on both the farmhouse and Bothy were of the nature of 'replacement of substantially the whole', given, for example, the roof was completely overhauled and replaced and therefore were not repairs. While some of these costs may have been genuine repairs and eligible revenue expenditure if done as necessary over the past few decades, doing it all at once meant it had become a renewal. Having determined this, the whole sum must therefore be treated as capital as in *William P Lawrie v CIR* [1952] 34 TC 20.

Further, although much of the works was necessary, the result was to change two barely habitable farm properties into luxury holiday homes, changing the overall character and therefore impacting on the available tax relief.

Finally, it was submitted that the expenditure incurred did not relate to an income receipt of the farming partnership, rather 'the expenditure was incurred for a new income earning operation of furnishing holiday letting, which had never been, and never was, and never became, a part of the appellant's "produce or fruit"'.

As the expenditure was capital in nature by virtue of ITTOIA 2005, s 33 it was not necessary to consider whether it was wholly and exclusively incurred for the purposes of the trade under s 34. However, the tribunal found for completeness that as the decision had already been made before the completion of the work that the properties would be used in a new trade, the expenses could not have been allowed as wholly and exclusively for the trade, even if found to be revenue.

Restructuring and planning ahead

This decision shows that in future it will be important to encourage farm clients to let their farm tax advisers be involved in the tax planning before work begins. It would be useful for evidence purposes to have photographs before, after and during the works and farm clients must be trained to help their advisers with the detailed understanding to enable them to provide best advice.

The *Balnakeil* case highlights to all farmers and their tax advisers that timing the start of the new diversification must be planned in advance to be able to gain tax relief. If any restructuring of the business is planned in conjunction with projects which involve high levels of expenditure, this needs to be discussed with an accountant to ensure that the correct entity and trade are carrying out the works. In this instance, if the farming partnership had started the trade of holiday accommodation before the partnership ended and a new business undertaken, there would have been greater chance that these significant costs could have been allowable for tax if the work had been of a revenue nature. Indeed, the tribunal judge stated (at para 72(4)): 'Instead, the expenditure was incurred to convert the redundant farm buildings to be used as assets in a different partnership of Andrew Elliot and his wife, which received the first income from the new trade. The trade of furnished holiday lets had never been part of the trade of Messrs Elliot Balnakeil. It follows that the expenditure could not have been incurred for the trade of the appellant, which had no component of furnished holiday letting.'

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With all farmers having to both increase and start new diversification projects, they must undertake tax planning in advance. These are difficult times for farmers and with the subsidy gap looming, farmers cannot afford to pay extra tax that could be avoided with timely advice. Now is the time for farm tax advisers to meet farmer clients to discuss future changes, not just diversification projects but all the changes to the basic farm trade that will evolve from a more environmentally responsible method of farming in future. ●

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