

Focus on tenancies

Julie Butler and **Libby James** discuss the intricacies of the tax treatment of farm tenancies.

Various statistics show that just under one-third of the farmland in the UK is farmed under a tenancy of over a year. Those tenancies are split fairly equally between farm business tenancies (FBTs) and Agricultural Holdings Act 1986 tenancies (AHAs). Given every tenancy has two sides to the arrangement – the landlord and the tenant – this affects a lot of taxpayers and tax advisers. With all the changes under way – a theme running throughout our *Taxation* articles (for example, see ‘All change’, 25 February 2021) – everyone involved needs to be aware of the importance of the accounts and tax treatment moving forward.

Given all the developments that are happening in the farming industry with lack of profitability and the move to ‘farming for the environment’, along with the Rock Review, more farm tenancies are changing (see ‘Under pressure’, *Taxation*, 9 November 2023 and also ‘Farming arrangements’, *Taxation*, 1 July 2021). There has also been the announcement by the prime minister on 20 February about increased subsidies for food production. The end result is that some existing tenancies and arrangements will cease, and new ones will emerge. It is therefore essential that all the areas of tax impacted need to be reviewed now.

Dilapidations are repairs that can be required at the end of a tenancy if a tenant has not upheld their maintenance and repairing obligations or has simply caused some damage. For example, ditches may need to be cleared out, damaged fencing replaced and dilapidated buildings repaired. Such costs can be expensive and must be understood for tax purposes by all parties well in advance. The detail and quantum can vary with the conditions of each lease and each situation. The type of tenancy can impact on the cost and obligations and it is therefore essential to read every agreement.

The 1995 Agricultural Tenancies Act makes no specific provision for dilapidations so it is down to the respective

Key points

- The type of tenancy can affect the cost and obligations, so it is essential to read every agreement.
- The tenant will be entitled to compensation where a valid notice has been served.
- If the terms of the lease require the tenant to make good any dilapidations, the payment is deductible against income profits.
- The landlord and tenant must record all items of expenditure and understand the tax treatment from their respective viewpoints.



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parties to include their own clauses specifying how repair disputes etc should be resolved with regards to FBTs. Conversely, the process of dealing with dilapidations within an AHA tenancy is relatively straightforward because there is a set mechanism for a landlord to make a claim. However, there is still a lot for the tax adviser to consider.

AHA tenancies

Many landlords want to terminate AHA tenancies so as to move from the 50% agricultural property relief (APR) of the AHA tenancy to the 100% APR of the FBT. Taken a stage further, some landlords are considering moving to farming in hand to try to achieve the 100% business property relief (BPR). With this increased incentive for an AHA landlord to give a notice to quit, it is key for tax advisers to be aware of the lease termination process.

A landlord can serve a notice to quit under AHA 1986, s 25 (length of notice to quit) and the tenant will be entitled to compensation where a valid notice has been served. Section 60 of the AHA 1986 (rights to and measure of compensation for disturbance) outlines the tax-free compensation which is made up of both basic and additional compensation elements. This could provide for six years’ rent capital gains tax free, to be paid to the tenant. The tax can depend on the assets, eg the farmhouse element could qualify for principal private residence relief for CGT. Likewise, cottages could be at 28% CGT whereas land and buildings at 20% and business asset disposal relief (BADR) should apply. Rollover relief can also apply to the business assets. A FBT attracts 100% APR while farming in hand attracts 100% APR and BPR so there are greater advantages of change.

AHA tenancies and dilapidations

The 1986 Act specifies that a landlord must provide the tenant with a written notice under s 83 (settlement of claims on termination of tenancy) within two months after the end of the tenancy agreement. This notice must specify the nature of the dilapidations claim. Claims need to be settled within eight months of the termination of the tenancy or the case must

go to arbitration. Some landlords may also file a s 72 notice (compensation for general deterioration of holding) if they are concerned that the value of their reversionary interest has been damaged by the outgoing tenant.

As indicated above, the tenant may need to be paid compensation for giving up an AHA tenancy. This is subject to tax so they must be made aware of the net payment. The tax position of all such arrangements must be reviewed with tax planning incorporated into the exit strategy from the start (see 'Starting well', *Taxation*, 16 March 2023). Here, it is essential for tax advisers to work with good land agents.

Where a tenant is considering surrendering a tenancy early, then part of the negotiation could be that the landlord agrees not to make claims for dilapidations. Tenants often need to argue their case, as landlords can push for repairs that are not the tenant's responsibility, but they should also be mindful that a settlement is likely to be a much cheaper option than going to arbitration. If a matter is referred to arbitration, then both parties will need to have either a land agent or solicitor acting on their behalf to argue their case, so costs can escalate but often such advisers can be involved from the start especially where the settlement is clearly in dispute from the outset.

The surrender payment is treated as a premium for CGT purposes. However, the landlord is treated as having made a disposal of their interest in the land itself. If the terms of the lease require the tenant to make good any dilapidations, the payment is deductible against income profits to the extent that it represents the cost of repair. Therefore, where the settlement contains 'offset' or 'barter' it is essential to analyse the components for both tax planning and tax compliance.

Buildings put up by AHA tenant

It could be a tenant put up some buildings for which they did not ask the landlord's consent. Can the tenant leave them behind when they leave? If the building was put up without written consent, it would be considered a tenant's fixture, rather than a tenant's improvement. If the building was still in usable condition, as a tenant's fixture it could be offered to the landlord for purchase. However, the landlord has no legal obligation to buy and if it is a very old building, they may try to claim dilapidations against the tenant on the basis that it is causing a reduction in the value of the property on reversion because of the money required to repair it or pull it down. The tenant may therefore need to remove the building and make good the area on which it was located to avoid dilapidations.

The complexities that can be involved here highlight how easily problems may arise when non-agricultural accounts and tax advisers produce working papers, accounts and tax computations with no experience of the tax significance of the arrangement. The accounts recording and tax treatment are important to understand at every level and a copy of the AHA tenancy, indeed all tenancies, should be contained in the permanent file.

History of the lease

It is necessary that the landlord and tenant meticulously record all items of expenditure and understand the tax treatment from their respective viewpoints. For landlords, rental profits are subject to income tax at their marginal tax rate. Except for capital expenditure, most rental-related

expenses are deductible against income. Capital allowances may be available on qualifying capital expenditures and can be offset against taxable profits. The structures and buildings allowance (SBA) gives relief at a rate of 3% a year for the cost of a new structure (such as a tool shed) or non-residential building (such as a new barn). Integral features of a building, such as lifts and electrical and water systems, may qualify for plant and machinery capital allowances and it is common practice to remain mindful of the terms of the lease.

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Plant and machinery allowances give relief for qualifying expenditures, such as a fire alarm system. These include the annual investment allowance, which provides 100% relief for the expenditure of up to £1m a year, after which the writing down allowances apply.

The distinction between capital and revenue expenses is not always clear cut, so experienced tax advisers need to be involved from an early stage. That in itself presents a problem with the marginal nature of successful capital allowance cases going to tribunal, eg a grain store in *May (S May and others (TC6928))* and a potato store in *JRO Griffiths Ltd (TC8203)*. The Upper Tribunal decision in *Gunfleet Sands Ltd and others v CRC [2024] STC 177* highlights the debatable nature of the tax treatment of projects and again any large projects on tenanted land must not just be planned ahead but tied into negotiations and agreement with the landlord. All these considerations make the potential for lease termination even more complicated. ●

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