Partnership issues: How to avoid accounting errors

Accounting errors are coming to light as farming partnerships undergo reviews and restructuring. Suzie Horne asked for advice on the issue

Many farming partnership accounts contain errors which cause complications, cost and stress when there is a change, such as a death or retirement from the business, or a dispute.

As farm businesses evolve and review their structures in the light of the loss from April 2026 of agricultural and business property reliefs (APR and BPR) from inheritance tax (IHT), the tax implications of incorrect accounting are being uncovered.

Even when a new partner joins, or a new partnership is formed, historic errors can continue in the accounts, often concerning previous assumptions about what is partnership property and what is owned personally.

This can lead to assets and values moving inadvertently into the wrong hands and/or causing disputes, legal battles or just unnecessary arguing, says accountant Julie Butler of Butler & Co. "Assumptions about ownership are dangerous – a forensic approach should be taken to detailing how property assets are held," says Julie.

This can be rectified by the creation of land capital accounts to clearly show who owns the land, splitting this out from current accounts and general capital accounts (see Need for land capital accounts). Other common errors and omissions include:

Asset ownership is often unclear, causing complications, cost and sometimes conflict

- Farming and non-farming income and their associated costs not being correctly identified. This means farmers averaging claims and those for hobby farming losses can be incorrect, which can have a negative effect for APR claims.
- Incorrect treatment in the accounts of bank loans – for example, not showing the term of the loan nor the security involved. This can make the accounts misleading in terms of solvency and future cashflow.
- Lack of clarity in family and farm partnership paperwork as to what is a gift to a family member and what is a loan, potentially leading to misunderstandings and disputes.
- Incorrect allocation of personal drawings. Send details to the accountant so they don't have to rely on assumptions.
- Incorrect recording of tenant's improvements, failure to understand dilapidations and to record expenses to clarify these (see "End of tenancy considerations").
- Repairs versus improvements – misunderstandings as to what constitutes a repair and what an improvement from a tax and accounting perspective. This can lead to profits being overstated and a higher income or corporation tax bill.
- Failure to correctly claim and account for capital allowances and grants.
- VAT errors in farm returns and accounts. Farm VAT is complicated, especially with regard to property. A VAT audit is suggested for protection.

The issues above highlight the importance of having professional advisers who are experienced and specialist in farming accounts.

End of tenancy considerations

There are tax reliefs on some end of tenancy compensation payments, but these are not always claimed, says Julie. Agricultural Holdings Act tenants are entitled to the equivalent of six years rent as compensation for giving up land.

The cash compensation is subject to capital gains tax (CGT), but there are allowances for the farmhouse element through a principal private residence claim, for which there is tax relief. Any element of compensation reflecting the value of farm cottages in the tenancy will also be subject to CGT, but business asset disposal relief will be available on this element where the business is ceasing.

The cost to the tenant of dilapidations should be treated as a repair in the accounts, so allowable against income. However, if there is a barter arrangement – for example, the landlord makes no dilapidations claim – then the tax treatment is different.

Diversification capital and revenue expenses

Whether an expense is treated as a repair or rebuilding has important tax implications, as does the timing of expenditure. A tax case involving a Scottish farming business which renovated two houses for high-end holiday letting illustrates that if holiday accommodation letting had begun before forming a new partnership and before starting renovation work, the tax treatment of the cost would have been far more favourable.

"This applies not just for holiday accommodation but other diversification cost and investments too, so take advice on the tax implications and best timings of all the major items of expenditure before you commence work on the project – it could save you thousands," Julie advises.

Further tips

Record all "farm junk" – for example, vintage kit and memorabilia around the yard but not used in the business.

Correctly record barter items in accordance with accounting standards, with the effective income forsaken shown clearly in the trading account and the effective matching cost of the transaction shown as expenditure. For example, hay and straw bartered with a neighbour in exchange for grazing should be

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ACCOUNTS NOTES AND MEETINGS

"More notes to the accounts are needed in many cases to help to make sure everyone is clear about how matters are being treated," says Julie Butler.

"Farm accounts meetings should involve all farm partners so everyone knows the correct accounts position. The balance sheet and trading positions should be explained to the partners, including how the freehold property is held and what is in the land capital account.

"This gives the opportunity for any ownership misunderstandings to be considered at this meeting stage and ideally kept out of the courts."

shown as the sale of hay and straw of the farm, with the equivalent cost of the grazing as a cost of the farm.

Capital allowance claims

Capital grants towards the costs of slurry storage, silage clamps and other farm equipment and infrastructure should be deducted from the cost of the capital asset and the annual investment allowance (AIA) then claimed on the net amount.

However, grants are sometimes not properly recorded in the accounts and AIA and other capital allowances can be missed or even over-claimed, generally leading to a tax enquiry. Tax advisers and accountants need full details of grant terms to ensure this is treated correctly in the accounts.

Slurry and manure volumes should be quantified and charged as a cost to the business, recorded as a double entry in the accounts – for example, a debit for fertiliser cost and a charge for the sale of that fertiliser to the business. ■

IMPORTANCE OF LAND CAPITAL ACCOUNTS

Where land is partnership property, its ownership should be recorded separately in the accounts under a land capital account, advises Julie Butler. Historically, it has often been included in the general capital account of each partner, but higher land values and the increasing incidence of dispute mean that accounts should show separately the working capital element of a partner's share and the property element, so that each partner's account and ownership is clear.

Partnership property

Where land is held as partnership property, partnership law dictates who owns the value, says lawyer Jonathan Stephens, a partner in law firm Wilsons.

He highlights an important issue relating to the rise in land values. "People don't realise that when land is introduced as partnership property, it is partnership law that regulates who owns the value of it. The way ownership works in a partnership is that you look at how the proceeds are divided if it was wound up.

"You might have a farm on the balance sheet at £5m because that was the historic value – but its real value is, say, £10m. The question is: who owns the increase in value? This is known as the "revaluation surplus". Unless this is clearly dealt with, it can throw up unexpected results. It is surprising that this area is so little understood, even among professionals."

Jonathan points out the difference between income profit sharing and capital profit sharing, where the former is the how annual profits are divided, while the capital profit sharing ratio is how the increase in the value of the assets – most importantly the land – is dealt with. If a partnership agreement is silent on the issue of capital profit sharing, then the distribution of those capital profits will follow the income profit sharing arrangements – and these can change from year to year.

Jonathan gives the example of a farming couple who have historically shared the profits equally. Their children are brought in as partners and, over the years, gradually take over more of the business. As the older generation retires, the new generation takes most of the profit share. Unless there is specific provision in the partnership agreement setting out how the capital profits are shared, they would also own most of the increase in the revaluation surplus.

Flexible approach

"Partnership law is flexible because the terms agreed between the partners can vary over time by what is called a "course of dealing". This means that you don't only look at the partnership agreement, you look at the accounts. These can show changing profit shares, which can, over the years, make a significant difference to who is entitled to the revaluation surplus. You need to fix the capital profit sharing ratios, and a well-drafted partnership agreement will do that.

"Unless you have separate capital profit sharing ratios set out in the partnership agreement, then by signing the accounts you can be effectively transferring a big chunk of ownership of the farm over a period, without realising it."

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