Farming partnership

Partial exemption dilemma for farmer.

I act for a farming partnership that has rental income from four cottages as well as arable sales.

The business is partially exempt and uses the standard method but normally the exempt input tax is within the de minimis limits, so we claim everything.

However, for the year ending 31 March 2021 there was no farming income because of a bad year for wheat and barley.

The partnership has sown winter seed and the year ending 31 March 2022 should have sales of both crops.

This means that the farm will not be able to claim any input tax on general overheads, mixed costs or costs relevant to the cottages in the 2021 tax year because the standard method will give zero input tax recovery on these costs and the de minimis threshold will be exceeded.

This seems unfair – do readers have any suggestions to help our client?

Query 19,738 – *Yeoman.*

Too late to ask HMRC to agree a different way of calculating recovery.

It may be that the farmer has only seen this problem coming at the last moment, as the VAT Regulations provide for provisional recovery on overheads through the year on the basis of the previous year's recovery percentage.

That means that 'taxable over total supplies' does not have to be worked out until it is time to make the annual adjustment; in the case of this farmer, 100% recovery could have been claimed in each quarter, but that would have to be revised to 0% on the basis of the annual income figures.

Is that unfair? This is, after all, a farming business that makes zero rated sales of foodstuffs, and presumably in a good year the exempt rental income is the tail on a taxable dog. That is why, in other years, the exempt side has been ignored and all the input tax has been recovered.

The overheads are presumably incurred in running the farming side as much in a year with no income as they are in other years, but the mechanical formula of the partial exemption standard method is based only on turnover.

On the other hand, the de minimis rules of partial exemption have given the farmer full recovery in previous years when some of the inputs have been used to make exempt supplies. This is, in effect, the rough that goes with the smooth – the swing as opposed to the roundabouts.

Can anything be done about it? I think not. It is not possible to apply a special method retrospectively, so it is too late to ask HMRC to agree a different way of calculating the recovery.

It seems unlikely that the standard method override will apply, as that requires at least £25,000 of residual input tax – and even if it did, it would be difficult to argue that 'this year's overheads' are 'in reality' used to make next year's taxable sales. True overheads are consumed in the current year, and in the current year they generated no taxable income.

The best that the farmer can probably do is to go through the expenditure carefully to see if anything that has been identified as an overhead is in reality 'exclusively used or to be used in making taxable supplies'. That will justify recovery, even if the taxable income will come in a following year.

The analysis of expenditure may not have been carried out precisely in previous years, because it did not matter when everything was recoverable anyway. – *Gardener.*

The specifics of what happened to the crops need to be looked into.

This is an extremely timely question not just because of the informative piece in *Taxation* on 1 April 2021 entitled 'Streamlined process for partial exemption alterations' but also with the tax day announcement to simplify the partial exemption special method scheme. As the standard method appears to be failing the client the answer would seem to be to look to the use of the 'special method' calculation for partial exemption which is unique to the business. As part of this the client would ideally be looking at coming up with a more fair split on the residual VAT based on future VATable turnover to be generated from these costs.

Consideration would need to be given to how the special method may affect calculations in the future and should not be something that is rushed into. An area to check also is the statement made by Yeoman of 'no farming income in the year to 31 March 2021'. Such a trading position seems strange as the yields from these crops was light but they generally did not fail – so some crop sales would have been anticipated. It is worth checking the exact position of what happened to the product of the harvest. Reduced yields are caused by a wet winter and spring drought, which the UK is currently experiencing, so it would be worth planning around predictions for the 2021 harvest.

Ideally this would have been looked at in summer or autumn 2020 when considering cashflow, farmers averaging for income tax as well as the partial exemption considerations. It is also worth noting the VAT planning that needs to be in place to ensure that VAT de minimus rules can apply/be reached for example by spreading the let cottage repairs over a period of time which would tie into the cashflow problems created by the drop in yields from the harvest.

It would also be sensible to review how expenses are being allocated as part of the calculation and ensure that the maximum amount is being allocated to the direct supplies. With the impending reduction in farm subsidies and the preferable changes to the special method it does seem that reviewing the tax affairs of this farmer for income tax, VAT and cashflow considerations will be imperative as we approach what looks to be another spring drought! – *Lucy Knighton, Butler & Co Chartered Accountants.*

Contact us

If you have a question or have encountered an interesting tax problem and subsequently found the answer, contact us at taxation@lexisnexis.co.uk.