The future of farm cottages

Julie Butler and **Fred Butler** consider the tax advantages and disadvantages of owning old farm cottages.

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The role of farm cottages in the commercial vibrant farm operation is changing. After *Balfour* [2010] STC 2666, let cottages became more valuable, not only as a good source of income but also as a possible protection under business property relief (BPR) for inheritance tax (IHT) provisions. However, the legal and tax positions of older cottages have changed since *Balfour* and *Farmer* [1999] (SpC 216) as the cost of repair and compliance has made them a challenge in terms of income return.

Negatives of owning old farm cottages

There are many compliance considerations for farmers to take into account in being a landlord (ie insulation, safe electricity) and other standards, for example repairs. These make being a farm landlord more complex, especially with older properties. Many traditional farm cottages do not lend themselves to the letting market. The cost of bringing them up to standard might work better with the private property market. Many farmers are considering selling these cottages and replacing them with easier new builds as appropriate for the following reasons:

- The letting compliance can be too great to achieve commerciality.
- The investment nature of letting means that the farms risk losing BPR if the investments exceed trading so reviews are needed.
- The CGT rates are relatively low for sales (28%) and can be offset by any trading losses which can be created by any annual investment allowance (AIA) up to £1m (although the offset will be used up against income tax profits first).
- The ability to replace the old traditional valuable cottages with 'new builds' and 'farm building conversions' can be easier and be commercially very attractive with the high value that private sector cottages still seem to achieve.

Key points

- Since the cases *Balfour* and *Farmer* the tax position of old cottages has changed.
- Safety compliance and other standards make being a farm landlord complex.
- Mixed usage SDLT is considered with regard to the sale of farm land and associated commercial land.

- The cottage with farmland can have advantages in the market and also provide the possible advantage of the mixed usage rate of stamp duty land tax (SDLT) if correctly structured for the purchaser with genuine commercial land.

Tax advantages and negatives of cottage sales

All farms are different by nature of the land and all farm structures vary so the tax consideration will have to be tailor-made with all the angles put into a melting pot of tax and financial review of cottage values, cash flow, financial needs of the farm, emotional needs of the farming partners and, of course, the tax impact for the whole spectrum of tax planning.

- **IHT** – now is a good opportunity to review if there are too many investments when considering the 'Balfour Matrix' under IHTA 1984, s 105(3). Competing factors will be the quantum of other investments.
- **CGT** – take advantage of the low CGT rate (28%) while it remains. If there are farm trading losses these can be offset against the gain and likewise, negligible value CGT loss claims on purchased basic payment scheme (BPS) entitlements can be offset against gains. This presents an opportunity to review income tax mitigation and CGT losses together with overall planning.
- **Income tax** – with interest rates rising and claims for interest being restricted against the income from buy-to-let or build-to-let properties for individuals, the whole tax planning around loans must be undertaken and their purpose understood.

Funding work to barns and building anew

If new build properties are to be built and let they have the opportunity to be much more compliant with letting regulations and advantage can be taken of the zero-rate potential for new residential buildings. This is provided that the future usage is fully understood as set out below. It could be considered that farm workers move into the new builds which might tie into the planning permission. This highlights the need to fully understand and plan around the actual and potential use of cottages.

Zero rating a new residential dwelling

It is well known to property developers, constructors and their advisers that the construction and supply of a new residential dwelling can be zero rated, but that there are a number of tests to meet. These are set out in VATA 1994, Sch 8 group 5, with note (2) requiring that:

a) the dwelling consists of self-contained living accommodation;
b) there is no provision for direct internal access from the dwelling to any other dwelling or part of a dwelling;
c) the separate use, or disposal of the dwelling is not prohibited by the term of any covenant, statutory planning consent or similar provision; and
d) statutory planning consent has been granted in respect of that dwelling, and its construction or conversion has been carried out in accordance with that consent.

Many additional requirements now exist which prevent supplies being zero rated, such as:

- if any existing building is not demolished to ground level;
- if planning consent does not specify any retained façade; or
- if work commences before planning permission is granted, even if this is granted with retrospective effect. This last point was stated in 2021 by the First-tier Tribunal in the case of *CMJ (Aberdeen) Ltd* (TC8140). See also, *Richmond Hill Developments (Jersey) Ltd* (TC8232).

The rules governing the application of the reduced rate to conversion works are set out in VATA 1994, Sch 7A group 6, but determining the appropriate rate of VAT is a complex process. Primarily, attention is required to what existed before the works began and again to what is created after the conversion. However, there are many additional details to consider before determining the correct rate of VAT.

Care should be taken over factors as varied as whether the domestic reverse charge applies, the status of different parts of a site, and whether materials incorporated qualify for the reduced rate. As for zero-rating sales, there are also requirements that any statutory planning consent and (additionally for conversions) any statutory building controls are in place from the outset (VATA 1994, Sch 7A group 6 para 10).

However, if the property is to be let out, there could be problems on claiming zero rate. Consideration around moving farm workers into the new buildings and them being occupied by agricultural workers could be positive. The overall VAT planning is extremely complicated and must be fully reviewed from every angle – the impact of no planning can be immediate and expensive. Charging the reduced rate of VAT is important even if the client expects to recover the VAT charged in full, as cottage projects frequently change direction with the VAT becoming unrecoverable. There are a number of scenarios where this might happen. One example is if a developer later rents out the new dwelling, which is an exempt supply requiring VAT on attributable purchases to be unrecoverable. This is often seen when new dwellings cannot be sold straightaway, and intentions change.

Mixed usage stamp duty land tax

A subject really hitting the headlines has been the mixed usage SDLT on the purchase of small areas of commercial land attached to the house. This has a big impact on farmers selling off cottages with land to make them attractive to buyers. Read 'Short shrift', *Taxation,* 19 January 2023. The cases are endless – for example *How Developments* at the Upper Tribunal – see 'Woodland idyll', *Taxation*, 27 July 2023, with the new case of *Mr and Mrs Suterwalla* (TC8826) and *Gibson* (TC8869). In *Suterwalla* the grazing agreement was enough and in *Gibson* grazing in exchange for meat was not.

Consider also the case of *Withers* (TC8649). *Withers* showed that a long-term formal agreement was in place to charge a local farmer £800 a year for the grazing rights. HMRC was suspicious as the grazing agreement was signed just before the sale. A timely reminder for property professionals to ensure that all long-standing arrangements should be formalised with a legal agreement and this agreement should be referenced in the conveyance documents.

Farmers can consider selling off old let cottages with fields with grazing agreements which make them attractive for mixed usage buyers.

Merits of tax review

Some of the reviews mentioned for each area of tax are considered by many just to be 'good farm housekeeping'. For example, checking the *Balfour* test, the use of all losses, reviewing the VAT treatments on all buildings together with loan management should all be undertaken and be tailor made to the farm and the business structure. The key driver here is the current worry regarding letting out older cottages for compliance. This shows every headache must be converted to positive tax solutions in these difficult times. All tax planning work must be twinned with excellent property guidance, analysis and advice. Such work should include potential planning permission opportunities so full advantage is taken of the options available. When the Levelling up and Regeneration Bill (LURB) becomes an Act, if it still includes the 'Class Q' permitted development for agricultural buildings to dwellings for National Parks, that will impact farmers' abilities to convert buildings. LURB also looks at increasing the number of dwellings allowed in each farm unit. Interesting times ahead.

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