Will MTD improve accuracy of farm accounts?

Keeping rigorous farm accounts and ensuring that land ownership is totally clear in partnership agreements is paramount. Julie Butler FCA and Lucinda Knighton ACA explain the importance of rigorous financial accounting and the impact of Making Tax Digital for VAT

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The historic accounts of farming operations are not prepared simply to calculate income tax liabilities and meet tax compliance responsibilities. With the elderly farming population facing inheritance tax concerns, accounts also have to be submitted with form IHT400 to HMRC for probate purposes.

They may also be used to decide farm disputes and provide supporting evidence at court. With the increasing digitisation of accounts, compliance with Making Tax Digital (MTD) for VAT is another important development.

MTD and signature approval in the cloud

Many ask the question what difference does MTD for VAT have on the accounts? It is the same issue with the signing of accounts in the cloud via hosted software.

For decades, when trying to decide whether a farm is partnership property, in the absence of a partnership agreement and land registration for example, the legal profession have resorted to using the accounts.

The question of whether a farm is 'in or out' of the balance sheet is a quick route to deciding when a farm is partnership property or not. 'Wet' signatures – traditional ink on paper – to the accounts obtained in partnership meetings are often the written evidence some of those advising farming partnerships need.

It can be argued that MTD is a wonderful opportunity to make sure that the contemporaneous record of farm freehold property is correct and in line with both the partners and the legal understanding of ownership.

It is considered by many that approving the accounts by signatures in the cloud adds an angle of security as they present a time and date of approval. However, ideally 'wet' signatures should still be obtained at informal partners' meetings.

It is also important to ensure that if obtaining electronic signatures, each individual partner has their own email account to approve through. If there is a family email address normally used for correspondence, which completes the online approval, then it is not clear that the accounts have been approved by each partner.

Evidence, understanding and intention

The case of *Ham v Bell* [2016] EWHC 1791 (Ch) came before the High Court to decide whether the farm, which had been an asset of the old partnership of Mr and Mrs Ham senior, became an asset of the new partnership when their son John joined them in the farm partnership on 1 October 1997.

A pivotal point of the case was whether the farm was partnership property, and this was the intention of its original owners, Mr and Mrs Ham. It was decided that accounts were no more than evidence and, if they did not reflect what was agreed, they could be disregarded.

The case shows the need for accountants to ensure that the accounts reflect the partners' intentions and they should, if necessary, ask the clients to take independent legal advice on the understanding of intentions and interpretation.

The central issue was whether the farmhouse, the buildings and the land (together, the farm), as of September 1997 when they had been assets of the old partnership, had become assets of the new one on 1 October 1997, because of their appearance in its accounts between 1998 and 2003.

The defendants submitted that the inclusion of the farm in the accounts for that period had been an error, which had been rectified in the accounts from 2004 to 2008. Mr and Mrs Ham argued that they had never intended to make the farm an asset of the new partnership.

The claimant contended that an implied partnership agreement was to be inferred from the conduct of the parties. Among other things, he relied on the accounts of the new partnership between 28 February 1998 and 28 February 2003, none of which had been signed in manuscript by the three partners, Mr and Mrs Ham, and son John.

Consideration was given to the conduct of the accountants who had drawn up the accounts.

The proceedings related to a dairy farm in Somerset of around 900 acres, which were partly owned and partly rented by the second and third defendants, RH and JH Ham (together, the parents). The parents carried on business in a partnership (the old partnership). The first defendant, Mr Bell, was the parties' land agent.

On 1 October 1997, the claimant, John, was made a partner in the family business. A written partnership agreement was created for the new partnership but did not include answers to all the questions.

Property and land ownership in Ham v Bell

In *Ham v Bell* there was no evidence that any discussion had taken place between the accountants and the claimant, or between the accountants and the defendants Bell and Mr and Mrs Ham senior about whether the farm had become a partnership asset.

On the evidence, the accountants had continued to prepare the accounts after the new partnership started, in the same way that they had always prepared them beforehand, but without giving any proper thought to whether the farm was or was not to be an asset of the new partnership.

It is essential that with every change of legal entity, for example a new partner, that the exact ownership of the farm be considered.

By mistake, the accountants had continued to show the farm as an asset of the new partnership. That had been an error because, on the evidence, there had been no agreement between the parties that this would be the case. That mistake had been corrected in the 2004 accounts and the correction had been duplicated in the accounts for the following years. Ideally, the previous years should have been corrected in the interests of legal clarity.

Many of the recent dispute cases show the complexity and the importance (some would argue stress) of the compliance issues surrounding partnership accounts and tax returns, and the need to ensure they reflect what the partners agree and intend.

MTD and land capital accounts

The disclosure of property income in the accounts has, by definition, important capital gains tax (CGT) and inheritance tax (IHT) considerations. At some point, it is a certainty that the property will be sold or gifted, or the owner will die while in ownership of the property.

This might appear over-simplistic; however, the tax consequences are significant. The CGT rollover relief or entrepreneurs' relief will be needed as will business or agricultural property reliefs to mitigate potential IHT tax liabilities.

The essential time to ‘obtain as much information as possible’ about the farm is during the production of the accounts that support the fact that a trade is being carried on, if that is the case. This is a very clear reminder of the power of the accounts and tax return disclosure, and the need to ask: ‘Is the accounts disclosure correct?’

Review disclosures in accounts

It is critical to review all farm accounts to ensure that the correct disclosure has been made in respect of the land. Likewise, include a ‘capital taxes protection’ checklist with the preparation of all accounts that cross-reference land. The accounts are part of the evidence to support claims for IHT and CGT, and the preparation time is the ideal moment for the interactive ‘fact find’.

MTD presents the perfect opportunity to ensure that the digital accounts tie into the correct legal ownership and the historic accounts, particularly if the fixed asset register is being transferred into MTD compliant software. It is the perfect opportunity to review this with the partners.

The question must be asked, has legal definition been obtained, ie, is there a trust deed that confirms that the property is owned by the partnership? Showing the property on the balance sheet is not enough to prove partnership property but it can provide evidence.

The land capital accounts (LCAs) must be identified so that they reflect the correct legal position and the farmland assets transferred into the partnership by each partner.

Improvements to partnership farm property

Recording farm improvements might seem a simple case of good bookkeeping, especially now MTD has arrived. Be warned that the property that has been upgraded must be identified clearly. Some farms have many property units and types, and it is important to understand exactly when and where the expenditure has been incurred and linked to a full freehold property register.

For example, improvements to residential farm cottages rather than farm buildings will be subject to different treatment for the various CGT reliefs.

The emphasis is on forensic understanding. Advisers must ask questions and the farmers and producers must provide full information as to what is happening and being produced.

The same applies to probate and private client legal advisers in exercises such as Will drafting. To do this correctly, there must be understanding as to whether the farm is or is not partnership property.

MTD is a warning to all farmers, tax advisers and accountants that they must obtain evidence and forensically understand what happens in all marginal areas, and these must be correctly disclosed in MTD records and reconciled to the CGT base cost control.

Farm business property ownership generally proves to be historically complex. Experience dictates that tax planning cannot be carried out until all the basics of legal ownership are understood and evidence scrutinised. Likewise, legal documents such as partnership agreements must be fully researched and verified as valid.

If these documents have been produced or adjusted without the full understanding of ownership and tax implications, there can be serious problems in the future. For tax purposes, the worry would be only 50% inheritance tax business property relief for partnership property.

Impact of probate

With farm probate there are arguments to say that the correct valuation in the accounts is the market value at the date of transfer as part of the probate work. The accounts and the base cost control will have to be updated for the change. The base cost control is simply a way of recording how an asset's base costs develops over time through death, improvements, lifetime transfers, etc.

The CGT base cost control will need to be reconciled with business accounts as applicable and a careful review of the relevant allocation of improvements will be essential as mentioned above.

The need for accurate, detailed probate valuations with well-researched allocations between the various elements of freehold property is essential, as is the need for executors to provide professional instructions on all areas of legal ownership, legal agreements, basic payment entitlements and partnership agreements. The accounts must reconcile to all inclusions on HMRC's form IHT400.

Action plan

These are changing times and an ideal opportunity to possibly correct accounting mistakes and misunderstandings of the past. MTD is potentially a 'brave new world' that ideally means that forensic analysis can be achieved in the short and long-term.

The accounts will be needed for many reasons in the future – potential disputes, tax planning, capital taxes compliance and protection. The key is to establish exactly what should be in the farm partnership accounts and to make sure that the accounts reflect the exact position. The transfer of records for many farmers from manual cashbooks to cloud-based software is a great opportunity to review items in the bookkeeping and accounts.

With all the potential for dispute and cost, IHT opportunities and the changes that farming faces through the Agriculture Bill 2017-19, not to mention a possible final Brexit date, the farm accounts must be taken seriously.

About the authors

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