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Working with farming accountants

Julie Butler *FCA is the author of* Tax Planning for Farm and Land Diversification *(Bloomsbury Professional),* Equine Tax Planning and Stanley: Taxation of Farmers and Landowners *(LexisNexis)*

Fred Butler *MSc ATT is a tax manager in the farm and equine department of Butler & Co Chartered Accountants*

Britain's farmers are aging. According to a 2013 Defra survey, the average age of farming landowners is 59. As such, there is a large amount of work for the farming private client solicitor to do to protect their farming clients and manage their succession planning effectively. It is essential that the solicitor and farming accountant work together on both understanding the farm ownership structure and providing for strong succession planning through well thought-through wills, partnership agreements and tenancies.

THE ACCOUNTS TREATMENT OF FREEHOLD PROPERTY AND PARTNERSHIP ASSETS

The issue in *Ham v Bell and others* [2016] EWHC 1791 (Ch) was whether the land being farmed was an asset of the farming partnership between a husband and wife and their son. The case emphasises how accountants and solicitors must work together in the correct identification of asset ownership, and the importance of drafting a comprehensive legal agreement to help support the understanding of the structure of the partnership and asset ownership by accountants and farmers alike.

The facts of *Ham* were that, in 1997, the son, John, was brought into the partnership and the land was shown as being a partnership asset in the accounts for the new partnership. This treatment was later corrected. Part of the question before the court was what could be inferred from the accounts with regard to ownership. The case focused on whether the inclusion in the accounts for the years ending 28 February 1998 to 2003 of figures representing the historic cost of the farm meant that the farm freehold property was an asset of the new partnership, or if it was simply an accounting error that was put right in the accounts for the years ending 29 February 2004 (a leap year) and subsequently.

Many solicitors would argue that the accounts treatment should not be able to change legal ownership of the farm. However, those charged with preparing farm accounts must realise the consequences of the incorrect treatment of the freehold property, especially with such high agricultural land values. The farming land agent, accountant, tax adviser and solicitor must work as a team to ensure they have a correct understanding of ownership, and that this is reflected in all documents.

JOINTLY OWNED PROPERTY v PARTNERSHIP PROPERTY

Many farmers – and some accountants – do not understand the legal difference between 'jointly owned property' and 'partnership property'. The former is where farmers own the property together in joint names. The latter is where the legal owners hold this in trust for the partnership. The key tax point here is that partnership property achieves 100 per cent business property relief (BPR) for inheritance tax (IHT), whereas non-partnership property achieves only 50 per cent BPR. To consider the tax position of the farm in more detail, it is important to identify and distinguish between the land and other assets, and how they are being used in a partnership. The research here can be from Land Registry, a review of the legal title, and a consideration of the partnership accounts, together with understanding the intent of the partners.

If the farmland is partnership property, it should be reflected in the value of the business itself as an entry on the balance sheet allocated to the specific partners who own in their specific proportion. Partnership property will achieve BPR at the rate of 100 per cent (see sections 104(1)(a) and 105(1)(a) of the Inheritance Act 1984 (IHTA 1984)).

IDENTIFYING PARTNERSHIP PROPERTY

It is important to identify whether the farmland and buildings constitute partnership property, in accordance with section 20(1) of the Partnership Act 1890 (PA 1890). It is up to the partners to agree between themselves whether a parcel of land is to be treated as partnership property. The time when the creation of partnership property would be actioned is either when the land is acquired by the partners, or when a subsequent declaration is made by one of the partners that land is being held for the benefit of the partnership. Once the farm becomes partnership property, the correct accounting treatment is to include the farm as the 'debit' and the land capital account as the 'credit'. When a land capital account has not been used in the accounts to reflect the creation of partnership property, it can become unclear over time as to whether a particular parcel of land is partnership property or not.

Where it is unclear if the farm constitutes partnership property or not, a series of tests must be carried out to establish its status. The first thing to do is to check the legal title to the property. If land has been acquired by the partnership, then the formalities of section 2 of the Law of Property (Miscellaneous Provisions) Act 1989 (LP(MP)A 1989) should have been adhered to. This provides that a disposition of an interest in land 'can only be made in writing and only by incorporating all the terms which the parties have expressly agreed in one document'.

The requirements of section 2 are not necessary if a partner has declared either in a separate declaration of trust or in the terms of the partnership agreement that they are holding the property upon trust for the partnership, and as such, it constitutes partnership property. Such a declaration will take effect under section 53(1)(b) or (c) of the Law of Property Act 1925. In the absence of either of the above, doubts will be raised as to whether the land should be treated as partnership property, and other evidence will be needed to establish the position beyond doubt. Relevant evidence would generally be on the circumstances of the acquisition of the property and how this was financed, the reason for the acquisition and how the property has been dealt with subsequently in, say, the partnership accounts and the individual wills of the partners.

THE RISK OF NOT USING LAND CAPITAL ACCOUNTS

In the past, land deemed to constitute partnership property was often recorded in the partnership accounts as part of the general capital account of each partner. But, with current accounts, the farming partner's 'capital account' (ie their share in the ownership of the farm) should be split between the component elements of that share (eg between working capital and freehold property). Such division will lead to a 'current account' (to reflect the ownership of the share of the working capital of the farm) and a 'land capital account' (to reflect the ownership of the share of freehold property). For an increasing number of modern farming partnerships, a preferable way to record land owned by a partnership in the accounts and the partnership agreement is through a separate land capital account. The land capital account reflects the partners' share in the freehold property. There is still time for accountants to work with the landowner and the farming solicitor to adjust the accounts to reflect the correct position.

The partnership agreement should state who is entitled to the land capital accounts and the profits and losses attributable to the capital profits or losses. Each partner who has introduced freehold property will have a separate land capital account. Such detail may differ significantly from how the partners would wish the general capital of the partnership to be held for the working capital of the farm, and this has been a cause of many farming partnership disputes.

It is advisable to ensure the partnership agreement has a separate schedule showing exactly what each partner owns, and that each partner takes separate independent legal advice to ensure all interests are correctly protected.

THE RISK OF NOT UNDERSTANDING PARTNERSHIP PROPERTY

All those involved in advising the farming client must appreciate that making a substantial asset, like land, partnership property for tax planning purposes, will have important legal consequences. A worse case scenario could be that the former owner of the land may possibly find out that, on dissolution of the partnership, they may have to pay a substantial sum to buy back their own land. The necessary protection against this happening depends on what the partnership agreement says, and it is essential for the farmer to understand this. Regarding land ownership in these situations, the deceptively simple default provisions of the PA 1890 may apply if the partnership agreement does not provide for the understanding of ownership. Partnership property is held jointly as joint tenants, so the property can pass back to the remaining partners on death, and not as was intended.

Furthermore, how the land is held can have implications for the tax planning required to achieve entrepreneurs' relief (ER). In broad terms, if the land is partnership property, for ER to be achieved there must be a complete cessation of the trading business. However, if the land is not partnership property, ie it is held outside the partnership, then the 'associated disposal' rates apply in order to achieve ER, and there must be a withdrawal from the partnership via a reduction in the partners' share in the partnership.

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SUCCESSION PLANNING

Prior to any succession planning, there is a serious need for all the work regarding exact farm ownership to be undertaken, preferably by the solicitor, accountant and tax adviser working together. As shown in *Davies & another v Davies* [2014] EWCA Civ 568 and *James v James* [2018] EWHC 43 (Ch), farming children have taken parents to court over ownership disputes. The professionals must ensure the legal understanding is in place prior to succession planning.

The importance of wills

The farming will should be part of both IHT and succession planning. It will be important to understand what parts of the farm will qualify for both BPR and agricultural property relief (APR) and how this will impact on the use of the surviving spouse exemption.

Assets that qualify for BPR and APR can be passed direct to children tax-efficiently. The intention of the partners to define the farm as partnership property is of key importance to achieve 100 per cent BPR. In *Ham*, the court took account of the parents' wills and noted that they had disposed of their interests in the farmland in their wills: bequests which would have been ineffective if the land had been a partnership asset. The content of the wills was considered evidence that the land was not intended to be a partnership asset.

The solicitor drafting the partnership agreement must be mindful of the detail of both the partnership accounts and wills, and have a general understanding of what the accounts show. Likewise, the solicitor drafting the will must understand how the farm is owned.

Holdover relief

Holdover relief under section 165 of the Taxation of Chargeable Gains Act 1992 (TCGA 1992) is available on the gift of an eligible asset (eg a mixed farm), from one UK-resident individual to another. The relief given is the amount of the chargeable gain that would have accrued to the transferor on the disposal of the whole or part of the farm. This gain is deducted from the cost of acquisition of the transferee, which is deemed to be market value under section 17 of the TCGA 1992. Such an election has the impact of passing the asset at the capital gains tax (CGT) base cost of the transferor; thus, there will be no 'tax-free' uplift on death.

Normally, holdover relief is limited to assets used in a trade, profession or vocation carried on by the donor or their personal company or group. But paragraph 1 of schedule 7 to the TCGA 1992 extends the relief to gifts of agricultural property that qualify for APR, even if these have not been used in a trade, ie let farm land.

Lifetime transfers

With IHT currently under review by the Office of Tax Simplification (OTS), many advisers are looking to serious succession planning, including through lifetime transfers. Before this can happen, the solicitor and accountant must fully understand the ownership of the farm.

If a farmer suggests a lifetime transfer of the farm or part of it, it is essential to consider their financial security as the donor after such a gift. The impact of the residence nil-rate band (RNRB) should also be considered, as well as any gifts with reservation of benefit (GROB) where 'enjoyment' of the farm has been retained.

With strong IHT reliefs currently available for farmers on their death, together with tax case law such as *Farmer and another v CIR* [1999] SSCD 321 and *Brander v HMRC* [2010] UKUT 300 (TCC) favouring generic IHT relief on mixed farming estates, the idea of passing the farm down to the next generation has arguably become much less attractive over recent years – but times are changing.

There are many reasons against lifetime transfers: loss of control and loss of income by the donor, for example. There is also the tax risk of such a transfer, whereby reliefs could be denied.

However, the new RNRB does not take account of gifts made during lifetime, and therefore some landowners may consider reducing their estates below the £2m threshold. If a gift is made within the partnership, ie from one partner to another, to avoid a GROB, the profit share of the donor should reduce accordingly.

Prior to any succession planning, there is a serious need for all the work regarding exact farm ownership to be undertaken, by the solicitor, accountant and tax adviser working together

Holdover relief can apply to the full market value of land, even if it is let agricultural land, so there will be no accounting for 'hope value'. Gifting a percentage of development land to the next generation is currently a favourable tax planning tool.

There are many practical problems relating to the lifetime transfer of the farm or part of it, including questions over the mental capacity of and potential undue influence on an elderly farmer. Every succession planning case will involve making judgement calls on a huge number of factors.

The tax risks of lifetime gifts

Farm succession planning must review the interaction of CGT and IHT; any gift that potentially reduces future IHT has the risk of incurring a CGT liability. If the transferee sells within seven years and the transferor does not survive the seven years, a potentially exempt transfer (PET) may arise, ie a transfer where the transferor does not live the full seven years and the farm has been sold within this time. If the asset gifted still qualifies for relief at the time of gift and time of death, then relief is still granted despite the potentially failed PET. The risk is, of course, that in this time, either part of the farm has been sold for development or the whole of the farm has been sold, which will result in an IHT clawback.

Understanding let property

Let property in isolation will not represent a business for IHT purposes. The let property may qualify for BPR for IHT if it is a part of a wider farming business, although it should be considered on a case-by-case basis. *Farmer* concerned a taxpayer's claim for BPR on a mixed farm that received significant income from let properties.

If the disposal of the mixed farm consists of an asset comprising both land that, viewed individually, would qualify for APR, and buildings that, viewed individually, would not, the transfer will qualify for holdover relief as long as both the land and buildings are let and not used for the purposes of the transferor's trade (section 165(5) of and schedule 7(1) and (2) to the TCGA 1992). HM Revenue & Customs (HMRC) accepts that paragraph 6(2) of schedule 7 applies to land and buildings that are used for a trade and not just to let agricultural property that falls within paragraphs (1) and (2).

Holdover relief is potentially available on the entire capital gain on the disposal of holdover relief property, not just the part that reflects the agricultural value of the property transferred (see HMRC's Capital Gains Manual at CG66962); all parties need to fully understand land values and the impact thereon. Statistics show that farmland values have fallen from the heights of 2015 and 2016. Such changing values can present tax planning opportunities for the farming community.

OVERALL UNDERSTANDING OF THE BUSINESS

In *Farmer* and *Balfour*, HMRC tried to deny relief by virtue of section 105(3) of the IHTA 1984, on the basis that the majority of the farm's profits came from the letting. In these cases, the landowner succeeded on the grounds that the overall business was predominantly farming, by looking at the split of income, profit and time spent, together with capital value. Although the lettings element of the farm was more profitable than the farm itself, the overall business context, capital employed, time spent by the employees and levels of turnover all supported the conclusion in both cases that the business consisted mainly of a farming operation, ie it was a trading operation, not an investment activity. With the current drop in pure farm profits, the ability to argue the *Farmer* and *Balfour* principle could become more and more difficult.

HAYMAKING

It might be considered of minor concern as to how hay is treated for tax purposes. However, environment secretary Michael Gove is encouraging subsidies that work on 'enhancing the natural environment', which could include cultivating wildflower meadows. Fields that are used for haymaking cover a major part of the UK, and HMRC can take advantage of such a change in land use away from hay production to environmental management on the death of a farmer who has perhaps diversified away from traditional farming in later years to haymaking with other let activity. HMRC seems to be taking an increasingly negative approach to 'horse haymaking', arguing that such activity does not qualify for APR. This could have worrying consequences for the farming community as a whole on the claiming of future tax reliefs, eg APR on the farmhouse.

Many elderly farmers in the UK are turning to haymaking, let activity and liveries. The tax consequences of this need to be understood and the structure of the business discussed with all the professionals. Often, it is not until the farmer has died and the probate position has been considered that the IHT negatives surface. When the accountant produces trading accounts that have an emphasis on livery, letting and hay, or indeed any negatives for IHT reliefs, they must pass these concerns to the farmer's successors, land agents and the solicitors drafting the legal documents, so that protection is put in place through the correct trading activity that qualifies for APR (and hopefully BPR), as well as the correct legal position.

The general consensus has always been that a 'farmer who makes hay is a farmer' and whether the crop of hay they grow is to be consumed by livestock or by horses does not have an impact on the death duty benefits. The potentially negative response to such an assumption might come as a shock to many beneficiaries of 'haymaking for horses' farming estates whose inheritance is under attack from HMRC.

If the hay is being sold for consumption by horses, HMRC may argue that the sale is not an agricultural activity in accordance with section 115 of the IHTA 1984. However, it could also argue that unless the hay is sold under section 115(4) for 'the breeding and rearing of horses', it does not qualify for APR. HMRC does allow for hay sold to working horses or horses used in the food chain to qualify for APR. Many farm advisers and family members who are being denied APR due to horse hay sales would certainly argue that such an approach is wrong.

VALUATIONS

With high land values, there is a serious quantum of risk involved in farm tax planning. Valuations are needed in all elements of tax planning and legal agreements.

One obvious example of the importance of obtaining accurate farm property values is that of the probate value of a farmhouse. A market value is needed to calculate the value of the estate, and an agricultural value is needed to know how APR should be applied to the farmhouse. If the farmhouse is agriculturally-tied (a planning permission restriction which means that only people employed in agriculture can live in the property), then agricultural value and market value can be the same.

The 'agricultural value' is the value of the asset used in the trade of farming, as if the asset were subject to a perpetual covenant prohibiting its use otherwise than as agricultural property (section 115(3) of the IHTA 1984).

Agricultural value is also of prime importance in relation to farmland and the difference between farm and potential 'development' / amenity values. Given the high values farms are being sold for (eg £10,000 per acre), HMRC and the district valuer are arguing that agricultural value is lower than sales price, as there is amenity value reflecting that it is not for pure farming reasons that land prices are this high.

The probate value will be the future base cost for CGT. Clearly, where large development values are involved, if full BPR can be achieved on the hope value, then the IHT liability will be lower and future liability will be reduced due to a higher base cost.

As from August 2002, all tax property valuations that are used for tax returns should be conducted within the standards governed by the 'Red Book' (the RICS valuation bible). Professional standards require comprehensive and thorough reports.

A well-prepared report is going to be far better received by the Capital Taxes Office / district valuer than a report that lacks this professional duty of care, and they are more likely to be persuaded of the taxpayer's position by the application of such professional excellence.

ACCOUNTS AND LEGAL AGREEMENTS

As mentioned, if the farming accounts show too much investment activity, this must be flagged up in the same way as problems over legal ownership and protection. Professional land agents can help structure greater trading activity, while accountants and tax advisers can flag up the tax problems so that they can action improvements to trading. Both accountants and solicitors can flag up the lack of legal agreements. Working as a team means there is greater chance of maximising future IHT reliefs, and indeed, protecting all tax reliefs. Strong legal agreements will help protect against disputes and tax confusion.

What HMRC considers to be an investment activity the farming community often considers to be a hard-working trade. What the tax adviser has to achieve is evidence of the trade, the services and the involvement of the farmer. Disclosure in the accounts to protect tax reliefs and support legal documents is vital.

The farming partnership agreement needed to pull everything together must be comprehensive, with a forensic understanding of the farming operation, and must involve a joint effort between the farm professionals and the farming partners.

Quiz

1. **Partnership property achieves how much business property relief for inheritance tax?**
2. **For entrepreneur's relief to be achieved for partnership property, what must happen?**
3. **What is currently under review by the Office of Tax Simplification?**

The answers can be found at the bottom of the online version of this article (communities.lawsociety.org.uk/private-client/ps-magzine/may-2018)