

# Handle with care

**JULIE BUTLER** examines recent First-tier Tribunal decisions that concerned the question of commerciality and losses.

With HMRC's current enthusiasm to examine equine activities, especially losses, it is not surprising that several cases concerning the eligibility of tax relief on trading loss claims have made their way to the First-tier Tribunal recently.

A business must be trading on a commercial basis with a view to making a profit (ITA 2007, s 66) if it wishes to claim tax relief on trading losses. The taxpayer has to be able to prove that there is a reasonable expectation of profit from the trading operation.

## No hope of profit

The taxpayer in *R Murray* (TC3474) was a racehorse breeder and trainer. He began the business in 2005 but did not notify HMRC until he submitted his 2007/08 tax return when he claimed cumulative losses of £51,378. The taxpayer claimed further losses totalling £81,406 for the tax years 2008/09, 2009/10 and 2010/11. The problems associated with racehorse breeding include high infrastructure costs and difficulties achieving targets for sales to ensure a profit.

The First-tier Tribunal described as flawed logic the taxpayer's assumption that his breeding and training activities would be sustainable if the tax relief losses were allowable. HMRC enquired into the taxpayer's 2010/11 return and decided the losses were not allowable because he was not trading on a commercial basis with a view to making a profit (ITA 2007, s 66).

The judge considered that, although there may have been a reasonable expectation of profit at the start of the taxpayer's business, by 2010/11 the economic downturn, together with



the high running costs and consistent losses, led to no hope of profit. The lack of any income supported these concerns, with commerciality therefore also difficult to prove. Although sympathetic to the taxpayer's predicament, the judge considered that the business was not commercial and therefore the losses were not allowable.

The taxpayer lost the case and did not achieve tax relief on the losses.

## Close attention

There is a basic understanding in the equine world that claims for tax losses are being closely reviewed by HMRC who question their eligibility to be offset against total income. Many equine businesses record large trading losses. It is essential that, to protect the accrued losses, the adviser and client put the following steps in place:

- business plans to show that, from the outset, a profit can be achieved in future years under the proposed structure;
- revised rolling business plans responding to the actual trading results; and
- ideally, accounts showing an eventual profit for the operation.

All advisers submitting loss claims on behalf of clients must ask objective questions about potential profit and not just accept in good faith the information provided.

## Just an amateur

Following the *Murray* case, *Thorne* (TC3851) highlighted the mounting pressure in the equine industry to prove commerciality to justify obtaining tax relief on accrued losses.

This involved horse breeding combined with farming. Ms *Thorne* included a self-employment income page in her 2008/09 tax return for her trade as an "equestrian breeder and farmer", showing losses of £79,424.

She claimed loss relief under ITA 2007, s 64(1) and (2) to set off the losses against other income for 2008/09. In her returns for 2004/05, 2005/06 and 2006/07, the taxpayer had described her trade as "equestrian breeder". From 2007/08, she renamed the trade as "equestrian breeder and farmer", with the farming element relating specifically to the new asparagus operations.

HMRC initially refused the claim for sideways loss relief on the basis that the trade was not commercial under ITA 2007, s 66. They argued that the equestrian and asparagus trades should be assessed together because they were not legally separate businesses and had been included in one self-employment return with an amalgamated claim to sideways relief. The taxpayer appealed to the First-tier Tribunal.

HMRC did not dispute the existence of the taxpayer's trade, but argued that during 2008/09 the enterprise had not been carried out on a commercial basis with a view to the realisation of profit. Referring to *Wannell v Rothwell* [1996] STC 450, they argued that, on the equestrian side of the trade, the taxpayer was not seriously interested in profit but was "just an amateur". It could be considered a hobby and such an operation was beyond the scope of the UK taxation system.

HMRC also reported that the equestrian trade had produced losses in the five years to 2009. On the asparagus operation, given that it would take three years from planting to harvesting the first crop, it was difficult to assess how the taxpayer ever had an expectation of profit in the 2008/09 trading period.

## Differentiating trades

The facts in *Thorne* help remind tax advisers of the need to distinguish carefully between separate trades, and be able to present evidence to show exactly how these can be separated. The need for loss-making operations to produce business plans to demonstrate commerciality and support the claim of future profits is paramount.

Also the business plans should be split between the enterprises showing that each is a commercial undertaking. If the plans show potential profitability problems, they should include evidence of the steps that could be and have been taken to achieve profitability and that a strategy has been devised to ensure that future trading will become more successful.

## For pleasure

In *McMorris* (TC4204), the First-tier Tribunal found that the taxpayer was not carrying on a trade while carrying out the

activity of horse ownership. The issue was whether he should be permitted to set losses from a "racehorse activity" against other income of the same tax year. Again, to prove the eligibility of the losses, the taxpayer had to prove that they were the result of a commercial trade.

The taxpayer had bought a half-share in a racehorse in February 2010 and agreed to meet half the livery training and racing costs. Initially, the racing results for the horse were positive and the owners refused an offer of £50,000 to buy it.

The success did not last and, in summer 2011, the owners sold the horse for £1,000, of which the taxpayer received half. In his 2010/11 tax return, he claimed loss relief in respect of a trade, which he described as "racehorse". HMRC refused the claim on the ground that owning a racehorse was a hobby, not a trade. The First-tier Tribunal referred to the badges of trade as explained in *Marson v Morton* [1986] STC 463.

The First-tier Tribunal decided that the deal was a one-off transaction. Further, because the taxpayer had not borrowed any money for the venture, there was no long-term plan for the operation and he "clearly derived pleasure" from the project, all of which pointed away from the badges of trade.

Overall, the tribunal decided that the activities did not amount to a trade. The judge added that, given the informality of the arrangements between the co-owners, ITA 2007, s 66 was not satisfied because the activities were not carried out on a commercial basis.

The taxpayer's claim for loss relief failed.

**“ There must also be close scrutiny of the ‘derives pleasure’ point together with consideration of the badges of trade. ”**

## Scrutiny required

Advisers and taxpayers will have to be prepared to mount a rigorous defence of loss claims, offering evidence to support the ability to achieve future profit.

There must also be close scrutiny of the "derives pleasure" point together with consideration of the badges of trade and the question of whether activities match the definition of a hobby.

It is vital to prepare a well thought-out business plan before questions are raised by HMRC. If loss claims have already been made, now is the time to collect the robust evidence to support them and ensure clients are warned about the potential vulnerability of the claims.

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### KEY POINTS

- The tribunal decided a racehorse business was not commercial and disallowed the loss claim.
- Business plans should set out how a profit can be achieved in future years.
- A client with more than one business must be able to prove they are separate.
- The badges of trade may help differentiate a business from a hobby.

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