BACK TO BASICS 38

Inheritance tax relief on farmland

Julie Butler *FCA is a farm and equine tax expert and the author of* Tax Planning for Farm and Land Diversification *and* Equine Tax Planning *(both Bloomsbury), and* Stanley: Taxation of Farmers and Landowners *(LexisNexis)*

A significant problem facing the farming world today is that the average age of the landowner is very high – an issue compounded by many farmers failing to consider inheritance tax (IHT) planning. With land values currently high and opportunities for property development returning, this can create a potentially nightmarish tax scenario. Younger family members are slowly coming back into farming, but often not in a landowning capacity. It is, therefore, more important than ever that agricultural families take the impact of IHT on succession very seriously. The main priority for all advisers to farming families is to obtain maximum IHT reliefs under current structures, including by possible restructuring of the farming business.

WHAT IS AGRICULTURAL PROPERTY?

The first question that must be asked is: what elements of the farm qualify for agricultural property relief (APR)? The definition can be found in section 115 of the Inheritance Tax Act 1984 (IHTA 1984), and is defined further in HM Revenue & Customs (HMRC) inspector's manuals, as:

- agricultural land or pasture (IHTM 24042), which includes woodland (IHTM 24043), and any building used in connection with the intensive rearing of livestock or fish (IHTM 24044), if the woodland or building is occupied with agricultural land or pasture (IHTM 24111), and the occupation is ancillary to that of the agricultural land or pasture; and
- which also includes such cottages (IHTM 24045), farm buildings (IHTM 24047), together with the land they occupy, as are of a character appropriate to the agricultural land or pasture (IHTM 24036).

APR for IHT is restricted to the agricultural value (AV) of the property. Any element of market value above AV needs to be protected by business property relief (BPR). With the current changes to planning rules for agricultural buildings, it can be argued that all agricultural buildings now have potential development value, which could come with an increased IHT bill for farmers if they cannot secure BPR.

WHO IS A FARMER?

It is important to understand the definition of 'farmer' in relation to APR, particularly with regard to the farmhouse. To be classified as a farmer for IHT purposes, a taxpayer must satisfy the following two tests.

- They must be in occupation of land.
- The purpose of the occupation must be mainly for husbandry.

The actual use of the land will normally be indicative of the purpose of occupation, but this is not necessarily conclusive. Nor does the occupation need to be to the exclusion of others. Share farming is an example in which two persons may occupy land and both be farmers.

BUSINESS PROPERTY RELIEF

If the claim for APR fails (or looks like it will fail), then the representative or tax adviser for the landowner has to turn to the protection of BPR. As mentioned, any element of the farmland property value above AV needs the protection of BPR. The attempt by HMRC to disallow BPR on mixed estates has been well-documented, with its attacks under the so-called 'wholly or mainly' cases (eg *Balfour* and *Farmer* (see below)). There are some tax advisers who consider that all agricultural property should have BPR available as tax protection, that is to say that all farmland should be involved in the farming trade.

The following are not classified as farming activities, and therefore need the protection of BPR:

- the letting of cottages and farm buildings;
- equine activities except the breeding

of horses;

- market gardening and Christmas trees;
- commercial woodland; and
- music concerts etc.

Note that if the activities relating to woodland or Christmas trees are ancillary to the main activity of farming, they qualify for APR.

AGRICULTURAL PROPERTY OCCUPATION

Agricultural property must be occupied for the purposes of agriculture. Farmland has the advantage over other assets in that it can be let property and still achieve APR (subject to the AV restriction). APR will apply, provided the farmland passes the occupation test, as set out in section 117 of the IHTA 1984, which is that there has to be occupation of the farmland for:

- two years, if the farming business belongs to the owner (the owner is the farmer); or
- seven years, if the farming business belongs to a third party (the owner lets the land).

APR on the farmhouse is restricted to AV. The farmhouse has to be 'character appropriate' to the farmland. A review of farmhouse eligibility for APR is needed, and should be expanded to include a total review of properties for ownership / occupation criteria to meet the demands of potential APR. This is particularly important following *HMRC v Hanson* [2013] UKUT 0224 (TCC), where the Upper Tribunal (UT) held that the nexus for 'character appropriate' derives from common occupation, rather than common ownership.

In *Hanson*, the farmhouse was owned by a trust, and had been lived in by the same Mr Hanson who farmed the land surrounding the property. The ruling was that an APR claim could be made for an asset, even when its ownership had been divorced from that of the farmland, provided there was common occupation.

THE CONCERN OF THE INVESTMENT BUSINESS

HMRC v Brander [2010] UKUT 300 (also known as *Balfour*) considered whether a mixed agricultural estate in Scotland was entitled to BPR. The question was whether, having decided that the estate operated as a single composite business – that is to say, a combination of a trading and letting activity – that the combined business operated as a combination of

> *Agricultural property must be occupied for the purposes of agriculture. Farmland has the advantage over other assets in that it can be let property and still achieve APR*

agricultural activity and let property, and so was deemed to be mainly engaging in investment activity: that is to say that BPR could be denied under section 105(3) of the IHTA 1984.

Various factors were taken into account by the tribunal, including the overall context of the business. The turnover and net profit of the business, time spent on the various activities, and the capital value of the business were reviewed. This analysis has come to be known as the '*Balfour* matrix'. Although the capital value of the let properties (£4.3m) exceeded the value of the other properties (£2.3m), the judge confirmed that this was generally immaterial, and would only be relevant if the business were to be sold, which was not the case here. BPR was allowed on the whole business, including the let property.

The *Balfour* judgment extends the decision in *Farmer (Farmer's Executors) v IRC* [1999] STC (SCD) 321. It is generally agreed that the volume of investments in a mixed estate does not tip the balance, and therefore transferring investment assets to the next generation should be reviewed, so that the trading operation is greater than the investment property – that is to say, more than 50%. It is vital that the books and records, together with the control centre of the operation (for example, the farmhouse) and the accounts, all show the mixed operation to be one business.

DEFINING AN INVESTMENT BUSINESS

Recent tax tribunal cases suggest that HMRC, in order to collect more IHT, is trying to reclassify a trading business as an investment business: see, for example, *Pawson* [2013] UKUT 050 (TCC), *McCall* [2009] NICA 12 and *Zetland* TC 02690, where, in each case, the taxpayer lost. If HMRC can prove that a business is an investment business, as opposed to a trading business, then it can deny the business's eligibility for BPR and collect more IHT from the deceased's estate. HMRC's argument is that the business holds investments with regard to land-based businesses; it does not look at a business in the context of the case law surrounding trading status, commonly referred to as the 'badges of trade' and the 'thoughts of an intelligent businessman'.

It is crucial in a mixed farm or mixed farming estate that the diversification in to-let activities (eg cottages or industrial units), other rental income or tenanted land do not 'overcome' or exceed the trading activity on the criteria discussed above, eg income, net profit, capital value, and overall context of the business.

The meaning of 'business' is not defined for IHT purposes, so a business holds its ordinary meaning – that is, a trade or profession carried on for gain. Section 103(3) of the IHTA 1984 states that 'business … includes a business carried on in the exercise of a profession or vocation, but does not include a business carried on otherwise than for gain'. The effect of this is to exclude loss-making or 'hobby' farming from the claims for BPR, although a claim for APR can be made if the land is still occupied for the purposes of agriculture.

FURNISHED HOLIDAY LETS

Guidance on furnished holiday lets was given in *Pawson v HMRC* [2012] UKFTT 51. The First-tier Tribunal (FTT) held that the deceased's letting of holiday accommodation was a business, applying business tests laid down in *McCall* [2009] STC 990 (see below). However, its decision was overturned by the UT in *HMRC v Pawson* [2013] UKUT 50, which held that the additional services associated with the holiday accommodation did not change the nature of the business from investment to trading.

RATES OF RELIEF

In considering the eligibility for a BPR claim, note that BPR is a percentage of relevant business property (RBP). For unincorporated businesses (sole traders and partnerships, as is the case with most farming businesses), the most important categories of RBP are as follows.

- A business, or an interest in a business (eg a share in a partnership) (section 105(1)(a) of the IHTA 1984): rate of relief for BPR is 100%.

- Land or buildings, or machinery or plant used wholly or mainly for the purposes of a company controlled by the transferor or a partnership of which they were a partner (section 105(1)(d) of the IHTA 1984): rate of relief for BPR is 50%.

In short, if a partner owns an element of the farm outside the farming partnership, then only 50% BPR will be achieved. Partnership property will achieve 100% BPR. This is of key importance when looking at development land which needs BPR. HMRC will try to attack property used in a partnership, by arguing that it is not partnership property (property owned by the individual partners for the use of the partnership), and therefore does not qualify for BPR relief. It will therefore seek to restrict BPR to 50%. See example 1 (below).

Example 1

Farmer Green owns his farm outside of the partnership. On death, he owns the following assets that do not qualify for APR:

Two let rental cottages	**£800,000**
Hope value on land	**£500,000**
Let industrial unit	**£200,000**
Total assets not qualifying for APR	**£1,500,000**

As the property is held outside the partnership, BPR will be restricted to 50%, and IHT payable is potentially 40% of £750,000 = £300,000 IHT due.

BPR AND HOPE VALUE

The primary intention of BPR is to enable businesses to cope with a death in the family or another event that may trigger IHT liability, without forcing the sale of the business. For IHT purposes, all property must be valued at full market value under section 160 of the IHTA 1984. BPR covers the whole market value of the land, including any development potential.

Thus, if only APR is claimed by the farming family, there may still be a significant IHT liability arising, whereas a BPR claim would eradicate this extra liability. In general terms, therefore, provided (i) the potential development land is part of a genuine trade; (ii) the section 105(3) IHTA 1984 tests are met with regard to the overall farming business not being an investment business; and (iii) section 103(3) tests of commerciality are made, then BPR should be achieved.

Example 2

Farmer Brown has let all his land on a farming business tenancy on the advice of a land agent, due to his ill health. On death, the APR claim on the farmhouse is denied by HMRC, as it argues the farmhouse is not occupied for agriculture, and that therefore the farm is not a trading operation. The district valuer disputes the land agent's valuation of 300 acres at £10,000 per acre as all being eligible for APR. The district valuer argues that 40 acres have development value of £20,000 per acre, that is, £800,000, and denies BPR on the basis that the farm is not a trading operation.

Property planning potential is an area that advisers will no longer be able to overlook. The positive is that, in reviewing this problem, solutions may be found for other farming tax-related problems, for example ensuring there is an up-to-date partnership agreement to help secure APR and BPR.

FARMING WILLS AND PARTNERSHIP AGREEMENTS

Most farms are usually run as family farming partnerships, involving a husband and wife and their children, or a combination thereof. In view of the current high value of land, this can cause conflicts within the family. *Ham v Ham* [2013] EWCA Civ 1301 is a good example of the problems caused by an inadequate farming partnership agreement. Often, land is still held in the names of the parents, and sometimes, as is the way with farming, only in the name of the father.

A large amount of tax planning needs to be carried out to make sure that the farm operation will be efficient from an IHT point of view: that there is active involvement, active husbandry, evidence of a farming operation and so on. Simple wills are often produced, whereby a husband leaves his wealth to his wife, and vice versa. Statistics show that it is often the husband who dies first, which causes a problem. For example, many farms have been passed to the wife without any tax problems, due to the surviving spouse exemption for IHT. However, this exemption does not make use of APR or BPR. The deed of variation (DoV) is one tax planning tool that is regularly used to protect APR and BPR claims. However, the chancellor announced in the 2015 budget that the use of DoVs in avoiding IHT charges was under review, with a report expected in the autumn.

The practical action point here is that all farming wills should be reviewed as part of APR / BPR protection. Perhaps this will expose an even larger problem: potential intestacy where there is no will. Passing business assets to the next generation using BPR or APR on the first death should be given close attention. Protection can be sought through the DoV, so that assets that do achieve APR or BPR can be passed down, and those assets that do not can be passed to the surviving spouse to take advantage of all reliefs.

> *It can be argued that tax planning and the legal decisions surrounding lifetime gifts need the same protection as those assets gifted by the will*

WILL CAPACITY

Farming is an industry where the farmer hopes to (and needs to, for IHT purposes) die 'with their boots on'. Many landowning farmers are over 70. Capacity will therefore be of great importance, and an updated will is important for succession in the farming community. Many farmers should be contemplating succession planning before death, which must involve a consideration of lifetime gifts.

It can be argued that tax planning and the legal decisions surrounding lifetime gifts need the same consideration and care as those assets gifted by the will. Many doctors do not want the risk of litigation in respect of any medical reports surrounding capacity, and will not help. Rightly or wrongly, many beneficiaries see a will as a measure of the deceased's love and affection, and disappointment at the contents of a will can soon lead to conflict. Every farming will needs a careful choice of executors, and a very clear letter of wishes. All farmers and landowners should also have the protection of lasting powers of attorney (LPAs).

FARM LOANS AND IHT

Some farming operations will have substantial loans, and these should not be overlooked. Tax relief is available on the loan interest for income tax, as is IHT relief where a loan was secured both before and after the Finance Act 2013 (FA 2013) came into force, on 6 April 2013. Further, now that the full impact of the FA 2013 and the annual tax on enveloped dwellings (ATED) is understood for farms and ownership in the limited company, there is scope for loan-planning reviews as part of the wider restructuring programme. It would be far more damaging if a problem were to surface as a result of an HMRC review or probate examination. Likewise, from an estate management viewpoint, the correct choice of executors who will manage matters efficiently post-death is very important.

APR AND LIMITED COMPANY OWNERSHIP OF THE FARM

For some time now, residential property owned in the farming limited company has suffered serious tax disadvantages; currently, such a structure creates even more problems to consider and plan for through the introduction of ATED.

First, there is the question of benefits in kind for directors on the farmhouse. Does the private use of the dwelling result in significant extra payments being required? Second, there is the complex issue that agricultural operations owned in the limited company do not achieve APR for IHT on shareholdings that do not control the company.

Example 3

Farmer Black dies owning 20 % of the farming company that owns the family farm. This is not a controlling interest, so no APR can be claimed on the shares. BPR can be claimed on the holding, but there are complications with the farmhouse and let land.

This means that potential tax savings on IHT are sacrificed, possibly resulting in the taxpayer having to transfer more funds to HMRC than they saved on income tax by adopting this structure. It would therefore appear that it is essential to review residential agricultural property held in the limited company for both ATED and APR purposes, to ensure this potential loss of tax relief is manageable.

It is essential to review residential agricultural property held in the limited company for both ATED and APR purposes, to ensure this potential loss of tax relief is manageable

ACTIVE HUSBANDRY AND THE FARMHOUSE

'Active' has become the important word in order for farming enterprises to succeed in a claim for APR on the farmhouse. As already shown, the *Balfour* IHT case highlights how important it is for the deceased person to have been both involved in the business and active in the farming enterprise, for the purposes of BPR, and for APR on the farmhouse.

Arnander v HMRC [2007] RVR 208 sets out the importance of being an active farmer in order to qualify for APR on the farmhouse. In this case, the contract farming agreement was considered weak, and the deceased's farming involvement was not mentioned in their obituary, indicating a lack of real farming involvement. Contract farming agreements should be reviewed for IHT efficiency, and clear proof of activity must be available – for example, diaries of hours worked, photographs and minutes of meetings. Similarly, for those landowners who have other sources of income and engage in activities in addition to farming, there is an immediate and ongoing need to document active involvement in the farming business.

IHT PLANNING THROUGH REPAIRS AND IMPROVEMENTS

A lot of farmers will exceed the nil-rate band for IHT purposes with chargeable assets (for example, outside investments, excepted assets, the difference between market value and agricultural value on the farmhouse etc). In practice, many frugal farmers are building up cash reserves, while neglecting to keep the farm in a good state of repair. Other planning issues will have to be considered, too (for example, care costs for later years).

Many would argue that the question of the high cash reserve does not matter, as, provided there is a plan for it to be spent on a farm project, it can qualify for IHT relief as part of the business. However, there is still a fight to convince HMRC that this is the case. Therefore, for any tax planning involving repairs / improvements to the farm, it will be necessary for the balance sheet to clearly indicate that the cash is to be used on a future project. Should the farmer die before the works are begun or completed, there is more chance of achieving IHT relief through BPR on the cash concerned. Where there is excessive cash, if the monies can all be allocated towards the repairs, there can be an income tax relief on the cash spent, and IHT reliefs on having everything invested in assets which will achieve APR and BPR. Therefore, the principle of spending cash reserves on repairs is a valued tax planning point, considering the savings on income tax and liabilities. Whatever the very beneficial tax planning options that exist for elderly farmers, care must be taken to consider will disputes and the possibility of undue influence on decisions the farmer makes.

CONCLUSION

The whole area of farm tax is complicated. It is essential for accountants and tax advisers to work with good agricultural legal advisers, who can insist that potential claims for APR and BPR are protected by strong legal agreements. Likewise, the legal profession must ensure that quality accounts are prepared that correctly reflect land ownership. Many farmers try to save costs by using unqualified accountants who do not have a full understanding of the annual accounts in terms of future claims for APR and BPR, and can therefore jeopardise IHT relief on what are now multi-million-pound properties.