

# It's Not A Hobby!

Years of low profits and necessary diversification are making some farmers fall within the hobby farming rules. **JULIE BUTLER FCA** discusses ways of avoiding this problem.

**H**OBBY FARMING HAS its own set of rules which historically have stated that a profit must be made every six years. This is, however, an oversimplification and must be looked at carefully. The hobby farming rules were introduced in 1960 because of Revenue concerns that some taxpayers farmed for recreational purposes rather than commercial ones. The original intention was to restrict loss relief in 'extreme cases' where the trading activities bore no relationship to the criteria of a commercial trade.

The so-called five year rule was introduced as an extension of the original rules, and requires that it must be shown that the business is capable of making a profit under section 397, Taxes Act 1988. Similar provisions for the restriction of corporation tax relief are included in section 393A(3). Other provisions prevent the formation of a company or a change of partnership breaking the five year rule, *i.e.* changing the nature of the business to stop the hobby farming rules being evoked.

The *Inspector's Manual* at paragraph IM2340a states the position as follows:

'Section 397, Taxes Act 1988 denies relief against general income etc. in respect of a farming or market gardening loss, where a loss computed without regard to capital allowances was also incurred in each of the five years of assessment preceding that in which the claimed loss was incurred.'

Section 397 only applies to losses sustained in trades of farming or market gardening, but for this purpose the definitions of those trades are extended, by subsection (5), to include activities carried on outside the United Kingdom.

## An attractive activity

The *Inspector's Manual* at paragraph IM2336a explains that tax relief claims in respect of farming losses can present particular difficulty because farming is regarded by many people as an attractive activity in its own right with taxpayers who have substantial income from other sources taking up farming for recreation, lifestyle or status reasons rather than for genuinely commercial reasons. Yet, under section 53(1), Taxes Act 1988 all United Kingdom farming is treated as the carrying on of a trade and is therefore

eligible for the loss relief provisions applying to trades, regardless of whether it meets the normal commercial criteria of trading.

Special legislation therefore exists to prevent losses from farming activities which lack commercial inspiration being relieved against non-farming income:

'Where losses are sustained in farming activities of an essentially non-commercial nature, relief under section 380, Taxes Act 1988 may fall to be restricted under either:

- section 384 – which restricts relief (see *Inspector's Manual* at IM2336b) where the trade was not run on a commercial basis and with a view to the realisation of profits (see *Inspector's Manual* at IM2338 and IM3375); or
- section 397 – which restricts relief (see IM2336b) where losses were incurred in each of the five previous years (see *Inspector's Manual* at IM2340a onwards).

'Section 397 is generally more straightforward to use as it involves an objective test. It should be applied, subject to *Inspector's Manual* at IM2341a and IM2341b in all cases where the conditions are satisfied (see *Inspector's Manual* IM2450a onwards). Cases where section 397 does not apply, but where the activities appear clearly non-commercial, should be considered for challenge under section 384, subject to *Inspector's Manual* at IM2338 and IM3375 onwards.

'Where relief by way of carry back in respect of losses sustained in the commencing years of a trade is claimed under section 381 the test of commerciality is provided by section 381(4) and is stricter than that of section 384 (see *Inspector's Manual* IM3507).'

Outsiders, looking at the tax position of a farm or estate held as a pleasure activity rather than a genuine working farm, would say that all that has to be achieved is a profit every six years, and there is great scope for claiming what could only be termed as 'quasi business expenses', to subsidise an enjoyable country life.

## Recognise the pitfalls

However, anybody contemplating undertaking the purchase of a country estate or following in the steps of the television comedy 'The Good Life' must embrace the hobby farming rules with eyes wide open. With the move to diversification, it is also necessary to look at standard commerciality rules.

Tax planners must be aware of what would happen if a farm or holding were deemed to be trading as a hobby. Not only would income tax losses no longer be available under section 380, but it could lead to a large potential denial of other tax reliefs. If the farm is deemed to be a hobby, then the assets used therein would not have business status. This could jeopardise future claims for capital gains tax and inheritance tax relief. The loss of business property relief for inheritance tax where income tax loss relief has been denied under the hobby farming rules is a matter on which opinions differ.

A large number of enterprises have had to look seriously at diversification in order to ensure that there is a profit. Some of these activities do not come under the farming definition. As a result, the Revenue has a right to apply to some or the whole of the trade, not just the hobby farming rules but the normal commerciality rules. In the current climate, those involved with the farming industry are painfully aware that it is very difficult to make a profit from pure farming, as it has been for a number of years. Strictly the tax computation of the business should be separated between farming and non-farming, and the tax implications of the hobby farming/commerciality rules dealt with accordingly.

It is vital, therefore, that anyone contemplating entering into such a venture, or advising clients about entering into such a venture, should look carefully at the definition of what is and what is not farming, and do everything in their power to ensure that the hobby farming rules will not apply. Review of farming methods such as the choices between share farming, contract farming and farm business tenancies is a prime example: whereas farming business tenancies do not qualify for business reliefs for capital gains tax, they can result in a higher return. It is a question of personal choice.

## Hobby and recreational farming

The desire for many people to return to 'the country' has over the years been given much media publicity. The recent re-runs of the television comedy 'The Good Life' set a picture of one end of the scale, while stars from the world of entertainment buying very expensive estates in beautiful parts of the West Country present a picture at the other. Furthermore, with the recent fashion for tracing family roots back several generations via the Internet, people are more aware than ever of the United Kingdom's strong agricultural history. Prior to the Industrial Revolution, which in the grand scheme of things is not that long ago, over 70 per cent of the United Kingdom population earned their living from the land. All this contributes to the dream of many hardworking town and country dwellers alike to own a small farm or estate.

The above could link quite closely to the interesting current position in the United Kingdom whereby, despite falling farm incomes, and the farming industry very much in decline, land prices are still maintaining their high levels and, in some instances, still increasing in value. This might appear an anomaly, rather like houses in mining villages going up in price at the time of the collapse of the mining industry. However, a large number of other factors underpin the current strong land prices.

In the home counties, where a large percentage of the workforce is based in the City or the prosperous large towns surrounding London, the increase in land prices is not that surprising. There are the underlying factors of hope value for development, the laws of supply and demand (there is an undeniable shortage of houses as borne out by documents such as the Hampshire Structure Plan), the desire to enjoy the pleasures of a shooting estate, of being surrounded by your own land, and the tax advantages that can be linked with 'the good life'.

A summary of the tax advantages are set out below:

- The ability to rollover gains from business assets into another business asset, and the potential for business asset taper relief for capital gains tax should part of

the land be sold or developed within the allowed timescale. This is even more attractive post Finance Act 2002.

- Business and agricultural property relief for inheritance tax.
- The allowability to claim income tax relief where losses are sustained.
- The ability to repair and improve the property while claiming maximum allowable input VAT and where possible maximum income tax relief.

All reliefs must be carefully scrutinised, and it is essential that all the relevant conditions are met so as to take full advantage of them.

As with any business, all the expense claims must be wholly, necessarily and exclusively for the purpose of the farming trade or estate enterprise, and the operation must be commercial and must be shown to be commercial.

The terms of any contract farming agreement must be carefully reviewed. Some agreements are no more than tenancies dressed up as farming arrangements. Such arrangements are fragile and could fail Inland Revenue scrutiny, so it is imperative to have a well drafted agreement.

Another area of concern is where recreational activities are blatantly incorporated in the farming activities, and subjective decisions have to be made between the allocation of expenses between business and private. Clear examples are shooting estates and farms that incorporate the stabling of private horses.

There are examples where the owners can be greedy in their claim for business expenses, such as those creating large losses for income tax purposes, but jeopardising the five year rule and capital gains and inheritance tax reliefs. The expenditure and income of recreational activities should be excluded except for the element of control of vermin. Professionals must not only warn their clients of the potential problems of trying to claim such expenses, but provide evidence in writing.

## Review the tax computation

With the farming industry moving towards greater diversification, business tax computations must be prepared carefully, with future reliefs planned for.

It is interesting to note that the Country Land and Business Association document *A Tax Framework for Jobs and Enterprise in the Rural Economy*, published prior to the Finance Act 2002, included the request for one set of tax rules to all rural activities managed as one business, as this would be a useful tool for diversification. The association's follow-up document *Reform to Perform* suggests that income from diversification, such as let office space in farm buildings, should be taxed as farming income.

When practitioners prepare the farm tax computation, the correct procedure is to remove non-farming income items and also to match the non-farming expenses to the income. In practice, a lot of accountancy and tax practitioners are just preparing a computation which arrives at an accurate schedule D Case I net profit or loss, and which has little regard for the allocation of expenses and income. It could be that income from items such as quota leasing and grazing by horses, are inflating the profit to assist with the avoidance of the hobby farming rules.

Stanley, *Taxation of Farmers and Landowners* (LexisNexis Butterworths Tolley), states of the hobby farming rules:

‘To state the rule cynically, a profit once every six years is sufficient to avoid the effect of the section. This can sometimes be secured by correct apportionment of expenditure among the years in question.’

Nevertheless, abuse of the hobby farming provisions is foolhardy in the extreme, partly in view of the current high values of the farmland and, above all, farmhouses and their associated inheritance tax reliefs.

As a practical tax planning point, the affairs of all clients who are associated with farming must be reviewed to ensure the correct treatment of income and expenses. It will also be essential to review what future reliefs the client may need to claim, e.g. is there a question of the ‘commerciality’ of the farm or the business? It is also useful to ask such questions as: does the client intend to claim agricultural property relief for inheritance tax purposes? If agricultural property relief is lost, will business property relief still be available?

## Test of commerciality

The tests for commerciality are very well set out in the *Inspector’s Manual* at IM2338:

‘Section 384, Taxes Act 1988 denies relief against general income etc., unless the taxpayer can show that, during the period when the loss was sustained, the trade was being carried on on a commercial basis with a view to the realisation of profit. The fact that a trade was being carried on so as to afford a reasonable expectation of profit is taken as conclusive evidence that it was being carried on with a view to the realisation of profit.’

‘The provision was first introduced in 1960. The Chancellor of the day stated in the course of a parliamentary debate on the section:

“‘We are after the extreme cases ... in which expenditure very greatly exceeds income or any possible income which can ever be made and in which, however long the period, no degree of profitability can ever be reached.”

‘These words should be borne in mind when considering the application of the section to farming cases. The small farmer and the farmer with marginal land who are genuinely trying to make a living from their farms in difficult circumstances are not caught.

‘Nor should the section be used to deny the relief to a farmer who incurs temporary losses while establishing an enterprise, for instance by building up a production herd or bringing land back into fertility, provided the enterprise in which he is engaged is likely in due course to become an economic undertaking. For example, it may take a farmer five years to clear and work land infested with bracken before there can be an expectation of profit. Relief under section 380 should not be refused on the initial losses in such a case.

‘General guidance on section 384 may be found in the *Inspector’s Manual* at IM3375 onwards. Where the application of the section is contested in a case involving a farming loss, the Inland Revenue should make a report to the

Business Profits Division (Farming) before listing the claim for hearing by the Commissioners.’

There is a let-out where farming is part of a large undertaking. This is set out in IM2341b as follows:

‘Section 397(4) provides that relief is not to be denied where the loss-making farm or market garden is part of, and ancillary to, a larger trading undertaking. The subsection is designed to meet cases such as that of a butcher who makes a practice of fattening bullocks for his business, or a manufacturer who grows his own raw materials, or a seedsman or chemical manufacturer who runs a farm for testing or improving his products.

‘The phrase, “part of, and ancillary to” should be interpreted strictly. “Ancillary” means “subservient and annexed to” (see Mr Justice Croom-Johnson in *Cross v Emery* 31 TC 198). It implies a close operating link with and contribution to the larger undertaking.’

The *Inspector’s Manual* also sets out, at IM2342, the principle on how the Revenue looks for avoidance with regard to tax losses:

‘Taxpayers may attempt to avoid the operation of section 397 by ensuring that the farming enterprise periodically makes an isolated profit. The most obvious year to pick for this purpose would be the sixth year, and then every sixth year thereafter.

‘Obviously, there is nothing to say that a farm which has been unprofitable for five years could not make a profit in the sixth year. Furthermore, it may be possible for a taxpayer to arrange his or her affairs in a way that leads to the making of a genuine one-off profit.’

The Revenue will check to ensure that the profit has not been manufactured by means of artificial transactions or devices, particularly in a case where substantial farming losses have been relieved against the income of an otherwise wealthy taxpayer. Examples of what the Revenue will look for follow:

- Charging business expenses (especially interest paid) to the farmer’s capital account or not including them in the accounts at all.
- Recognising sales and expenses in the wrong year.
- Manipulating opening or closing stock valuations.

The Revenue naturally consider these and similar methods as unacceptable. Enquiries could be made, in worthwhile cases, to ensure that the accounts include all the business income and expenses for the period concerned, but only the business income and expenses for the period.

## More than just a profit

Elliot Morley said that tourism was more important to the countryside than farming. In response to this, Willy Poole MBE of the Country Landowners Association said:

‘It is this countryside that brings in the tourists. Tourism may be a larger industry than farming, but it rides on the farmer’s back. A well farmed countryside that maintains its ancient traditions and people who make it work are, or should be, treasured national assets.’

The deputy president of the Country Landowners Association, Mark Hudson, has equally strong views on future conservation policy being underpinned by profitability. In a speech given to a public policy seminar, he stressed the need to reform current measures, many of which prevent good conservation management. Mr Hudson gave full backing to the Curry Report's recommendations on profitability and warned that for farmers to deliver the countryside that the public wants on a sustainable basis, farmers must be able to derive profit from conservation activities. He said:

'Land managers and woodland owners need to make a profit for the same reasons as companies that sell medical equipment to the National Health Service. Nobody would ever suggest that medical companies should supply the National Health Service at their own cost, so it is equally unreasonable to ask farmers and land managers to undertake conservation at their own cost.'

While reviewing the profitability of diversification, the profitability of pure agriculture must not be overlooked. All those involved in farming and land ownership need to keep updated with what farming policy is, together with the outcome of Country Landowners Association and National Farmers' Union lobbying. If profit is to be achieved, action has to be taken, and the farming accountants have to act promptly on that action.

It seems ironic to long-time farmers that they could be caught under the hobby farming rules purely due to the farming crisis.

## Real as opposed to hobby

There is no doubt that in the current economic climate, it is difficult to make a profit from true farming, once all overheads have been correctly allocated. This is particularly so, if a farming unit has borrowings, staff commitments or rent to pay. Unless the word agriculture is broadened, it could be that a lot of farming units will be showing profits from diversification, such as let property, and losses on the actual farming activities. If these losses continue on the farming activity, then the hobby farming rules might have to come into play.

It is imperative that costs are allocated correctly, and that non-farming income has its full share of overheads allocated to it. This could cause arbitrary calculation and some negotiation with the Revenue. The Country Landowners Association is lobbying for a broadening of the definition of agriculture to prevent this, but in the meantime, the tax planner must take care when reviewing tax computations.

At the other end of the scale, is the recreational landowner who enjoys the lifestyle and would like to embrace the tax reliefs as a side issue. The tax planner must point out all the benefits, but at every stage warn of commerciality. ■

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