A sideways swipe at farming

Recent changes to the tax rules affecting farming are putting the industry under considerable pressure. *Julie Butler* explains

On 2 March 2007 the Paymaster General issued a Written Ministerial Statement and HMRC published Revenue & Customs Brief 18/07 announcing measures to prevent the use of what they consider to be artificial partners' losses.

'Sideways loss reliefs' (ie, trading losses arising to an individual that can be set against his other income under *TA* 1988, ss 380 and 381 and capital gains under *FA* 1991, s 72) are coming under review. The measures took effect on the day of the announcement, and there will be provisions to give effect to the measures in Finance Bill 2007.

Currently, the amount of trading losses for a tax year for which a non-active partner can claim sideways loss relief is restricted broadly to the amount of capital that the partner has contributed to the partnership. The government proposes to introduce new legislation to exclude certain capital contributions from this amount that can be claimed, and introduce a time restriction.

Under the changes, additional restrictions will apply to the amounts that a relevant partner may claim as relief for trading losses under *TA* 1988, ss 380 and 381 and *FA* 1991, s 72.

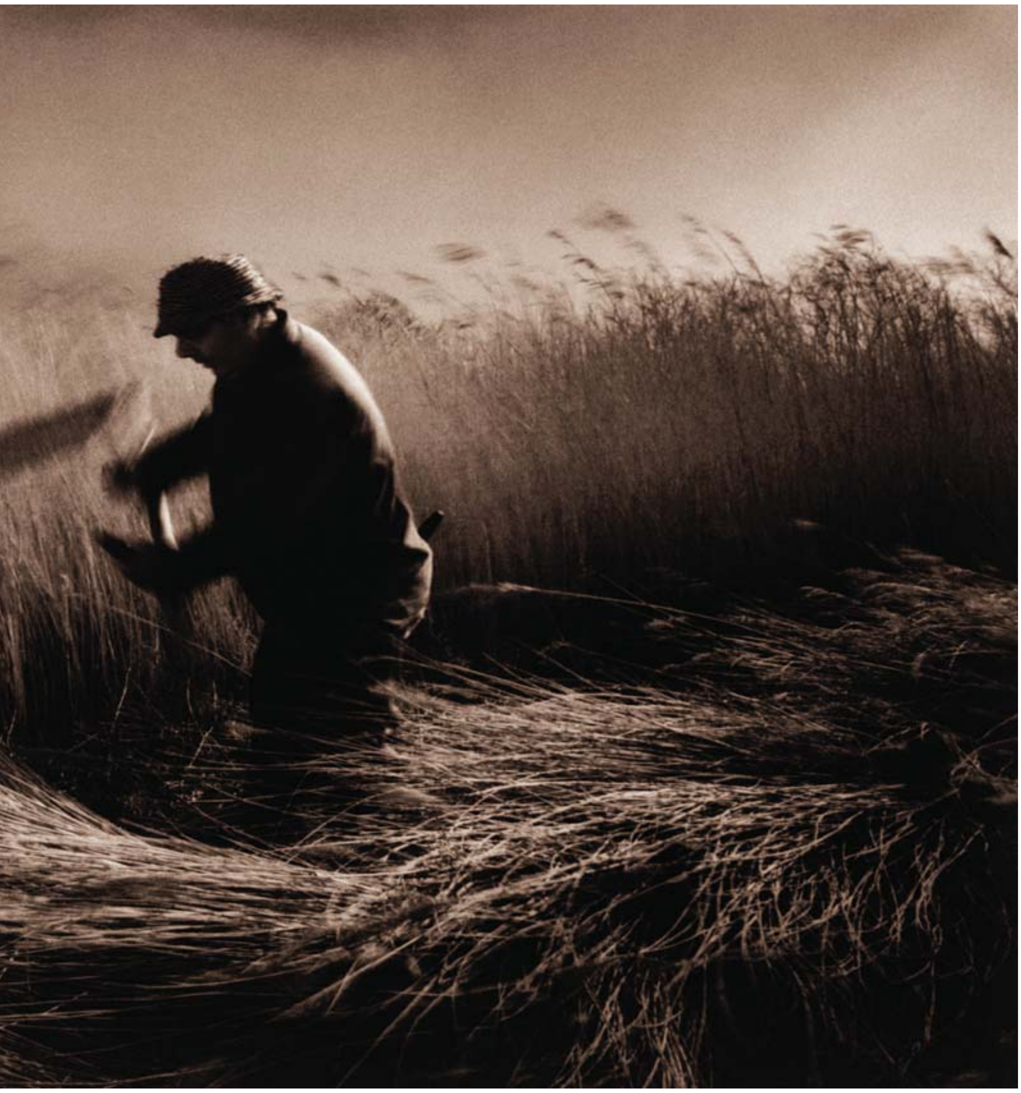
The advantage of loss relief being offset 'sideways' has been one of the fundamental attractions for the 'lifestyle farmer'. A large number of farms have recently been purchased in the knowledge that there will be substantial income tax relief from the trading loss by the 'lifestyler' who has substantial outside income.

The loss has often been boosted by repairs to the farm and what have traditionally been known as lifestyle expenses – such as the 4x4 vehicles, etc.

Partners subject to these restrictions are limited partners, members of a limited liability partnership and other partners who on average spend less than 10 hours a week actively carrying on the trade. The amount of loss relief available to an individual from all the partnerships caught by the new provisions will be capped at a maximum £25,000 for any single year.

Two changes affect the amount of trading losses for a tax year for which a relevant partner can claim relief:

- a purpose test for capital contributions by a relevant partner to a partnership when applying the existing restrictions based on capital contributed in *TA* 1988, ss 117, 118ZB and 118ZE;
- an annual limit of £25,000 (or, if lower, the amount of trading losses for that tax year



for which the relevant partner can claim relief after applying existing restrictions in ss 117, 118ZB, 118ZE and 118ZL).

A relevant partner for this purpose will be an individual who, on or after 2 March 2007:

- carries on trade as a partner in a partnership at any time during the tax year; and
- is a limited partner, or any other partner who does not devote a significant amount of time to the trade in the relevant period for the tax year.

So what is a 'significant' amount of time? What of the traditional farmer who has been forced to diversify into 'paid employment'?

- An individual does not devote a significant amount of time to a trade in the relevant period for a tax year if, in that period, the individual spends an average of less than 10 hours a week personally engaged in activities carried on for the purposes of trade.
- The relevant period means the partner's basis period for the tax year, unless it is shorter than six months.
- If the partner's basis period for a tax year is shorter than six months because the tax year is the first year of trading, the relevant period is the period of six months beginning with the date on which the individual first started to carry on the partnership trade.
- If the partner's basis period for a tax year is shorter than six months because the tax year is the last year of trading, the relevant period is the period of six months ending with the date on which the individual permanently ceased to carry on the trade (if the basis period ends with that date).

How significant time is defined in real terms – bookkeeping, VAT returns, meeting with land agents, accountants and solicitors – will all be part of carrying on the trade. Work must be carried out to ensure that all work is documented.

Partner's capital

There is also to be a motive test in relation to capital contributions. At the moment loss relief is broadly restricted to the amount of the capital contribution that the partner has made. For contributions after 2 March 2007 there will be no relief if the main purpose, or one of the main purposes, for contributing the capital to the partnership is to obtain loss relief.

A relevant partner's contribution of capital to the partnership for the purpose of applying restrictions in ss 117, 118ZB and 118ZE will exclude any amount of capital the partner pays to the partnership where one of the main purposes for contributing the capital is to obtain a reduction on the tax liability by means of sideways loss relief.

The purpose test will apply to all contributions of capital paid by a relevant partner to a partnership on or after 2 March 2007, except those paid under a relevant pre-existing obligation, ie, an obligation in a contract made before 2 March 2007 that cannot be varied or extinguished by the exercise of a right conferred on the individual (whether or not under the contract).

The limit on the amount of trading losses for that tax year for which sideways loss relief can be claimed will be the lower of £25,000 or the amount of trading losses for that tax year for which the relevant partner can claim sideways loss relief after applying restrictions based on capital contributed in ss 117, 118ZB and 118ZE.

The annual limit will apply to the aggregate of all trading losses for a tax year from all partnerships in which the individual was a relevant partner for that tax year, and will only apply to trading losses sustained by a relevant partner on or after 2 March 2007. It will not apply to losses from a trade that consists of the underwriting business of a member of Lloyd's.

Pre-announcement losses

As a large number of farmers' year ends are 31 March or 5 April, this will have a significant impact on the year to 5 April 2007.

Losses sustained on or after 2 March 2007 for a partner's basis period that straddles 2 March 2007 are the losses for that basis period less any 'pre-announcement losses', which are:

- any part of the trading losses for the basis period as is derived from a capital allowance or relevant film-related expenditure deducted under *ITTOIA* 2005, Chapter 9 Part 2 where the expenditure giving rise to these specific statutory reliefs was paid before 2 March 2007, or was paid on or after 2 March 2007 in meeting a relevant unconditional obligation to pay; and
- the relevant proportion of any part of the trading losses for the basis period not

derived from a capital allowance or relevant film-related expenditure.

Allowances to be phased out

As part of the chancellor's 2007 Budget reform of capital allowances, industrial buildings allowances, introduced in 1945 to encourage post-war reconstruction by productive industry, and agricultural buildings allowances are to be phased out over four years.

The measure withdraws balancing adjustments and the recalculation of writing-down allowances in respect of balancing events occurring on or after 21 March 2007, unless they are in pursuance of a relevant pre-commencement contract, or in respect of qualifying enterprise zone expenditure.

There has been much hype and press coverage, but the loss to agriculture has been overlooked.

'Currently capital expenditure on new buildings and structures that meet the criteria set out in legislation qualify for tax relief on that expenditure at 4% a year with tax relief being available to subsequent purchasers within a 25 year period of first use of the building.' This relief is to be phased out so that by 2011, industrial buildings allowances will be abolished, 'leaving companies with industrial assets unable to claim tax relief on these assets other than if they qualify for plant and machinery allowances. The phased introduction will mean that in 2008-09 three quarters of the normal agricultural buildings allowance will be available, 2009-10 half and by 2010-11 a quarter. From 2011 no relief will be available'.

Previously a sale at a profit could result in a clawback of tax allowances previously given. This will no longer happen; although the taxpayer can no longer claim allowances on an asset he does not own, he keeps the relief previously given. However, if the building is sold or demolished at a loss, a balancing allowance will not arise on expenditure that has not yet been the subject of relief. Although there are minor small exceptions to these transitional rules, the new rules will catch the majority of agricultural buildings and structures.

There might be some happy farming tax clerks who sigh with relief over not having to deal with the administrative strain, problems and complications of calculation – especially with tracking the historic expenditure – but overall this is a further loss of incentive to invest in the infrastructure of farming.

Input tax and the 4x4

The case of *Shaw v CRC Chancery Division*, 15 November 2006 raised the issue of business use of a 4x4 motor vehicle, and guess what? The outcome was not favourable for the farmer and the eligibility to claim input tax on purchase.

The taxpayer was a sole trader operating a farming and contracting business. He purchased a diesel 4x4 motor vehicle for business purposes, and it was parked on the business premises. The vehicle was insured for both business and personal use. The taxpayer wished to claim the VAT paid on the vehicle's purchase as input tax, but the claim was rejected. The taxpayer took the case to the VAT Tribunal on the grounds that the vehicle had been modified for business purposes, business-related equipment was permanently stored in it and that he had three other vehicles available for his personal use. His appeal was upheld.

HMRC appealed this decision, saying that since the taxpayer had taken no positive steps to prevent the vehicle from being available for his own personal use, as a matter of law, the vehicle had not been purchased with the sole intention of business use.

The High Court ruled that since the taxpayer's insurance cover permitted personal use, this led to the conclusion that he intended to make the vehicle available for personal use, and so the VAT paid on its purchase could not be reclaimed as input tax. HMRC's appeal was upheld.

As with other similar cases, eg, *CCE v Elm Milk Ltd* [2006] STC 792, *Upton (trading as Fagomatic) v CCE* [2002] STC 640, the result in favour of HMRC in this instance shows how very difficult it is to convince the authorities and the courts that a vehicle has been bought for business purposes only, with no possibility of personal use. As well as being able to show potentially helpful factors such as the vehicle perhaps having been adapted for the business and being kept at the business premises, the taxpayer should ideally ensure that the vehicle insurance precludes personal use. In *Elm Milk* the taxpayer was successful, but his contract stated that any private use of the vehicle in question would put him in breach of his contract.

Farmed on a day-to-day basis

The recent *Arnander* case has raised issues of the principle of the working farmer and how robust the contract farming arrangement should be.

The Lands tribunal's decision in *Antrobus 2* has now largely been adopted in the Special Commissioner's decision in *Arnander*, which concerned the Rosteague estate in Cornwall. The Special Commissioner confirmed the principle that:

'…a farmhouse is a dwelling for the farmer from which the farm is managed [and] that the farmer of the land is the person who farms it on a day to day basis…'

She went on to say that one should look at why the house is occupied, and it should not be extravagantly large. Having done that, one should look at the size, content and layout of the house in the round in deciding whether it is a farmhouse.

Therefore in the future, to secure Agricultural Property Relief (APR) for IHT on a farmhouse, it will no longer be enough to show that the house is of a character appropriate to the holding and it is occupied for agriculture. It will also have to be shown that the house was occupied in order to farm the land and, most importantly, the occupier farmed the land on a day-to-day basis. Being in overall control of the agricultural business is not sufficient. In *McKenna* the use of contracting agreements led to the conclusion that the deceased was not farming on a day-to-day basis.

In the future the use of contracting agreements must be viewed with extreme caution if relief on a farmhouse is hoped for – particularly where contractors carry out all the farming operations. Even contracting agreements that are run more rigorously than those used at Rosteague (which were akin to tenancy agreements) are unlikely to reserve to the owner the day-to-day decision making. The wish to delegate such decision making is after all one of the reasons for appointing a contractor.

Conclusion

This case highlighted areas HMRC regularly addresses with regard to farming IHT reliefs:

- weak contract farming agreements;
- the vulnerability of the farmhouse with regard to qualifying for IHT reliefs;
- the importance for outbuildings to be used in the business of farming;
- a review of what is happening on a 'day-to-day' farming basis, especially with regard to the last two years;
- commerciality.

How robust are your farming clients' trading operations? The farm tax relief honeymoon is over. The tax adviser should look at every farm operation to see where and how the enterprise could be attacked, eg, VAT on farm buildings, VAT on shooting, commerciality, loss relief, ABAs, the 4x4 vehicles, etc. The action plan has to be to look into those dusty, straw-filled corners of the farmhouse, the outbuildings and the whole enterprise.

Julie Butler FCA runs her own practice, Butler & Co. Tel: 01962 735544. Email: j.butler@butler-co.co.uk