Julie Butler considers what structures are suitable for farming businesses following recent

KEY POINTS

- **What is the issue?**
Recent changes to the taxation of corporate partners and the introduction of the annual tax on enveloped dwellings need to be considered when planning the best business structure for a farming operation
- **What does it mean for me?**
The current 'fashion' in farming structures is to trade through an independent limited company completely separate to the original farming partnership
- **What can I take away?**
Some elements of the farming activity do lend themselves very well to using a standalone company and there has been a recent rush of incorporation of, for example, the dairy elements of a farming operation

For the farming operation, there are so many alternatives and considerations about which is the best business structure through which to trade. Elderly farmers, in particular, also have many additional factors to consider, such as potential inheritance disputes and development opportunities following the local area plan changes. This all makes structure decisions complicated and complex, even before consideration is given to the tax planning strategies intended to negotiate these problems and opportunities in the most tax-efficient way.

AIA – final nail in the coffin?

The farming community originally embraced 'corporate partners' with enthusiasm. The fiscal advantage of the corporate partner was in providing an immediate reduction in 31 January and 31 July income tax payments for the individual partners. This ensured that many immediately adopted this structure as their preferred trading vehicle.

However, under the December 2013 legislation on mixed member partnership, excessive profits are now taxed as income. This is obviously quite a major disadvantage to the 'corporate partner' structure. Many advisers, nonetheless, argue that, by focusing on the return on capital, there is a potential workable answer to the problem of excessive profits, and this business structure will remain tax efficient. However, with the annual investment allowance (AIA) having been increased to £500,000 until 31 December 2015, there is a real disadvantage to partnerships which include a corporate partner, as such entities cannot claim AIAs

legislative changes

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in accordance with CAA 2001 s 38A(3)(b). A recent case that has proved this point is *Hoardweel v HMRC* [2012] UKFTT 402 (TC), which found that the AIA remains beyond the 'corporate partner' structure for the immediate future.

So what is to happen to corporate partners? One workable option is to leave the corporate entity dormant and revert to the original partnership structure, with the business now made up of individuals rather than involving an incorporated entity. The AIA will once again be available, but there are questions as to how much this will increase the income tax payments for the parties concerned.

In light of so many important considerations, including Common Agricultural Policy (CAP) reform, which will be introduced from 1 January 2015, the farming community must therefore ask: what is the best trading structure to match the complex alternatives within the farming industry? There are so many considerations for farming family operations and their advisers at the moment, including potential inheritance tax (IHT) liabilities and minimising these through agricultural and business property relief, disputes regarding inheritance and future diversification strategies, and development opportunities needing the protection of capital gains tax (CGT) reliefs to avoid substantial bills at the end of the projects.

Separate limited company

The current 'fashion' in farming structures is to trade through an independent limited company, completely separate to the original farming partnership. The existing corporate partner could be recalibrated and become a separate standalone company, allowing many entities to convert to this business structure. The separate limited company has the advantage of isolating some area of the farming activity without transferring in the land; in so doing, the problems of disallowed agricultural property relief (APR) for minority shareholdings, etc are solved. Some elements of the farming activity do lend themselves very well to this model and there has recently been a rush to incorporate, for example, the dairy elements of a farming operation. Farm contracting is another activity that suits well to existing in its own unique incorporated body.

The tax advantages of incorporation of, say, the dairy operation are numerous. The most obvious advantage is that this structure achieves a tax free uplift on the realisation of the herd at market value, assuming there is a herd basis election.

There is a very narrow window in which to enjoy the full AIA and much planning should be made for 2014/15 (though time is running out) and 2015/16. Obviously, there must be caution around the *pro rata* of AIA where there are non-fiscal year ends to ensure that investment occurs at the most tax efficient time. Indeed, even for fiscal years careful planning must be undertaken, as the AIA of £500,000 is reduced in the tax year 2015/16. There is no doubt the farming operation can take the maximum advantage of the increase to AIA. The reduction in AIA for more than one business entity under common control must also be considered, to ensure there is no danger of breaching the investment limits and thus not gaining the tax advantage.

Associated disposals

One of the other considerations for the farming operation in relation to business structure is development land and the configuration that best suits this kind of trading operation. This raises the question of 'in or out of the balance sheet' or the personal or partnership ownership of key relevant assets.

Where the farm is operated as a partnership but the land is owned by one or more partners personally, there is the possibility of tax complications. Although the description above is not normally advisable for IHT purposes, if capital gains tax entrepreneurs' relief (ER) is needed with regard to development land disposals, it may be helpful to set up this kind of structure in advance of any works being undertaken. The tax planner will be seeking to structure the sale of the land as an 'associated disposal' and thus maximise the tax advantages available. An associated disposal is where there has been a 'material disposal' of a business or of assets used in the business, where the ownership of these assets does not lie with the trading entity itself, but with a party associated with it. For a partner, a material disposal is relatively easy to achieve because a reduction in the partner's interest in a partnership share will be a disposal of part of the business by the partner concerned.

Such a structure, as described above, opens the way for the partner to dispose of the land as an 'associated disposal' qualifying for entrepreneurs' relief. The disposal must be made 'as part of the withdrawal of the individual from participation in the business carried on by the partnership', but HMRC accept that this refers to equity participation and is not usually measured as time spent. Accordingly, the partner can continue to be a full-time working partner; and as long as there is a reduction in equity interest, there is a partial withdrawal from the partnership and reliefs can therefore be claimed.

Rollover relief

Ramsay and the need to prove degree of service for rollover relief

Many farming operations will want to have a structure that allows for rollover relief for CGT in order to maximise the business's tax efficiency.

The case of *Ramsay v RCC* [2013] UKUT 226 (TCC) highlights some important areas on the current structure debate, as well as illuminating activity concerns when considering making claims for CGT relief and ensuring that robust evidence is in place to support the claims made.

In *Ramsay,* HMRC questioned the meaning of the business when the transfer was made, and turned to the six tests laid out in the *C&E Commrs v Lord Fisher* [1981] STC 238 VAT case as to what exactly defined a business. In their view, the service provided was not enough to qualify as a business for CGT purposes and thus the rollover relief claim was disallowed. There is a parallel with farming here – is there too little activity on the farm site to actually qualify for reliefs such as this?

The taxpayer appealed on the basis that rollover relief should be applied; however, the First-tier Tribunal (FTT) initially upheld HMRC's decision. The taxpayer tried again to obtain relief, this time appealing to the Upper Tribunal (UT).

The UT found in favour of the taxpayer and held that the word 'business' in the context of s 162 should be interpreted broadly. The judge stated that criteria as to what constituted a business in the *Lord Fisher* case were helpful. In this instance, the UT agreed that the work carried out by the taxpayer actually did satisfy the business tests set out in *Lord Fisher*, contrary to HMRC's interpretation. As to the question of degree, the taxpayer's activities in respect to the property did amount to a business for the purposes of s 162. The taxpayer's appeal was therefore allowed.

The above example demonstrates that, in terms of future development land sales, the degree of services provided by the landowner will be key for proving that diversified farming operations, such as those that involve some letting, eg grazing agreements, qualify as a business. When looking at the correct business structure to employ in cases such as this, the degree of service provided by the farmer must be considered. *Ramsay* could also help other cases where there are 'blurred boundaries' between the holding of an investment and the operation of a business. These are all factors that need to be considered when restructuring farming entities.

Problems for land-owning farming companies

The ideal trading structure for farms has been given much consideration over the decades and is again now with the current 'corporate partner meltdown'. One solution to the problem is the suggestion of transferring the whole of the partnership into the ownership of the limited company, though this has created problems, as shown below, with issues such as annual tax on enveloped dwellings (ATED) and APR. For various historic reasons, some farming operations are owned by a limited company which includes some possible ownership of residential property, possibly a farmhouse. This can result in multiple problems, not least ATED.

ATED 'casts a wide net'

FA 2014 now extends stamp duty land tax (SDLT) at 15% and ATED over the next two years to apply to residential properties that are valued at more than £500,000 and are purchased and owned by non-natural persons (NNPs). There is specific relief available for a farmhouse occupied for the purposes of the farm trade.

For those limited companies that own farmhouses and farmworkers cottages, now is the time to seriously consider the options of how to mitigate any possible penalty and to consider disclosure requirements.

APR on limited company ownership

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

First, there is the question of benefits in kind (BIK) 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 minority shareholdings, ie shareholdings that do not control the company. 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 loss of tax relief is manageable.

Inheritance tax and hope value

The primary intention of business property relief (BPR) is to enable businesses to cope with a death in the family or another inheritance tax event without causing the entity to have to be sold. It is meant to be a 'relief'. It is important that BPR is considered in addition to APR, as the latter only covers the agricultural value of land and not the 'hope value' (the difference between agricultural value and market value). BPR instead covers the whole market value of the land, including any development potential inflating the price calculated. So the next important question has to be asked: does the current structure protect BPR?

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 entirely. In general terms, therefore, provided the potential development land is part of a trade and the IHTA 1984 s 105(3) tests are met, BPR should be achieved. If there are too many investments to qualify for BPR, a withdrawal of these assets must be considered. The whole issue of the trading operation and the investment line must be reviewed to ensure future inheritance tax liabilities are minimised.

Loans and inheritance tax

The review of the business structure should also include a review of any loans, as these can be substantial for some farming operations. Maximising tax relief on loan interest for income tax, together with IHT relief where the loan is secured pre and post FA 2013, are two such examples of the tax efficiencies available. Further, now that the full impact of FA 2013 and ATED is understood, there is scope for historic/retrospective 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, etc than identifying and reviewing loans at an earlier time.

Summary

There are many short- medium- and long-term goals for the farming community with regard to inheritance tax, CGT or development, together with more short-term objectives of issues such as ATED, AIA etc. The farming community must focus on what suits them and their businesses best, to involve their professional tax advisers in pulling together the various angles and to ensure that the planning is specifically tailor-made to their farming operation.

FURTHER INFORMATION

For further information see: *Tax Planning for Farm and Land Diversification* (Bloomsbury Professional); and *Stanley: Taxation of Farmers and Landowners* (LexisNexis).