Tax advantages drive desire for change

Land values, potential development value and the current tax regime are having a major impact on the choice of agricultural tenancy, *Julie Butler* reports

There has been a flurry of legal cases emphasising how enthusiastic landowners and landlords are to escape from *Agricultural Holdings Act* 1986 tenancies. This Act's objective was to give tenants security of tenure virtually for life, and this is underpinned by the *Agricultural (Miscellaneous Provisions) Act* 1976, which introduced a scheme of rights of succession to farm tenancies by members of the tenant's family.

The preferred farming opportunities for landowners are farming in hand or a farm business tenancy (FBT) or contract farming. The desire for landowners to be free of the 'succession' tenancy and to achieve 100% inheritance tax (IHT) relief can be a serious driver for change. Most landowners consider the FBT to be the answer. However, FBTs come with their own hidden tax problems, eg, no business property relief (BPR) and no IHT relief on the farmhouse; likewise, contract farming arrangements can be fragile and come under attack from HMRC.

The FBT means that farm assets only qualify for agricultural property relief (APR) and do not achieve BPR on land with development potential (hope value).

Despite the fact that since September 1995 no new '1986 Act tenancies' can be created (except for those arising on a statutory succession, and some additional rare exceptions) the Agricultural Land Tribunals still, broadly speaking, receive as many applications from tenants for a direction entitling them to succeed tenancy as ever they did.

Agricultural arbitrations continue to abound. Tenant farmers generally do not want to give up their tenanted farms, and the total rent can be very cost-effective in terms of farmhouses and cottages.

The continuing rise in land price fuels landlords' enthusiasm to challenge succession applications or otherwise to seek vacant possession 'via the seven deadly sins'. Development land potential also seems to be a focus of landlord/landowner attempts to 'reclaim' farmland as 'in-hand' farming.

In sharp contrast to the 1986 Act, the new FBT regime is simpler and almost wholly devoid of the statutory labyrinth that surrounds 1986 Act tenancies.

So what has been brought to the Agricultural Land Tribunal's attention?

Atrocious husbandry

The Tribunal found that fields had been abandoned, fields had been used for dumping rubbish, scrap metal, tyres and plastic, and that long-term poor management was going to adversely affect production for several years. The tenant lost on a certificate of bad husbandry. The case is *Phillips v Davies* 2007, ALT Wales. However, such cases of neglect are rare.

Notice to remedy, equitable set-off and notice to pay

In *The National Trust v Rose,* notices to quit had been served on behalf of the National Trust following the tenant's failure to comply with two notices to remedy and a notice to pay. The tenant argued that by reason of the landlord's failure to undertake certain repairs there was a defence to the arrears of rent claimed, and therefore the arbitrator should not uphold the notices to quit. The argument was that of equitable set-off. In this case, the discussions between landlord and tenant about repairs to be undertaken by the landlord had occurred six years before the service of the notice to pay. The notices to quit were held to be valid.

Succession – tenants' livelihood from agricultural work on the holding

Thomson v Church Commissioners for England 2006 ALT, (Northern Area). The Agricultural Land Tribunal refused a succession tenancy when the requirements of the *Agricultural Holdings Act* 1986, s. 36(3)(a) were not fulfilled, ie, that the tenant's livelihood was derived from agricultural work on the holding for a continuous period, had not been satisfied to a 'material extent' pursuant to s. 41(1)(b) of the Act.

The claimant's hard work on the farm was acknowledged, but her livelihood had in part come from other sources as well. In seven years, the percentage of livelihood derived from the holding ranged between 36% and 39%, and she had reached an average of 75% in terms of her time. However, this was not sufficient to meet the conditions of the Act.

Retirement – livelihood test

Crabtree v Shirley ALT/M/SR/5 (2006). This was a retirement case between retiring father and an applicant daughter. The legal issue concerned the principle livelihood test (ie, that the applicant's only or principal source of livelihood is derived from his agricultural work) set out in s. 50(2) of the 1986 Act.

What are the 'eligible person' rules where there is succession?

'(2) For the purposes of sections 49 to 58 of this Act, "eligible person" means (subject to the provisions of Part 1 of schedule 6 to this act, applied by subsection (4) below) a close relative of the retiring tenant in whose case the following conditions are satisfied –

(a) In the last seven years his only or principle source of livelihood throughout a

continuous period of not less than five years, derived from his agricultural work on the holding or on an agricultural unit of which the holding forms part, and
(b) He is not the occupier of a commercial unit of agricultural land.

The question is for what period does the livelihood test have to be demonstrated?

(1) In the case of succession on death the relevant provision refers to the last seven years ending with the date of death.
BUT
(2) In the case of a retirement no specified date is given.

Action plan for landowners and tenants

Where the landowner and tenant have an amicable relationship, they should be encouraged to discuss the whole area of succession, retirement and possible replacement of the AHA 1986 tenancy – but what of the tax consequences?

Landlord – at risk of a large IHT bill if tenancy stays

The IHT relief is restricted to 50% IHT relief via APR. *IHTA* 1984, s. 116(2)(a) allows 100% relief with vacant possession. ESC F17 extends this where there is a right to obtain vacant possession with 24 months. With the current property values, very few farms and landed estates are restricted to agricultural value. There is an important need for landlords to be able to enjoy BPR on 'hope' (potential development value) and 'special value' (premium above agricultural value – eg, valuable sporting location, close to road and train links for 'lifestylers').

If the landlord makes a payment to the tenant, he will be doing so to secure vacant possession by way of surrender of the lease, so enhancing the value of his reversion. The payment will therefore augment the landlord's cost base for capital gains tax purposes, and relief will be secured if and when the freehold is sold for an ultimate capital gain. For the tax position of the tenant – see later.

If the landlord pays nothing, no tax considerations arise unless the market value rule operates, eg, because the landlord and the tenant are connected persons.

Landlord with development value

The most intense action by the landlord to remove the tenant could arise when there is potential development value on the land he owns.

Where vacant possession is acquired and there is a disposal of the whole interest at a later date, liability may arise on trading income as an adventure in the nature of trade, but HMRC have indicated that they would not mount an attack under *TA* 1988, s. 776.

The tenant accepts payment for surrender – what is the tax position?

If the landlord makes a capital payment to the tenant, the latter will be liable to capital gains tax. In computing the tax, deductions will be due for expenditure by the tenant on improving, etc, the land and any buildings surrendered with the tenancy (see later for details).

If the landlord pays nothing for the surrender, the whole of the tenant's assets will have been lost or destroyed in the act of surrender, and it may be that a loss will arise for capital gains purposes, on the principles described. On the other hand, if the landlord and tenant are connected persons, it may be that HMRC will seek to infer or substitute an 'arm's length' price as consideration for the surrender, with consequential effects on the capital gains tax computation (*TCGA* 1992, s. 17), but holdover relief may be claimed. If, exceptionally, the tenant pays the landlord, the payment will fall to be treated as expenditure incurred in the disposal of an asset, so, presumably, producing a loss.

The tenant accepts compensation

The tenant's position will differ if what he receives is not a payment for the surrender of his tenancy, but compensation in respect of disturbance under the *Agricultural Holdings Act* 1986, ss. 60 and 63. Such payments are intended to reimburse the tenant for the loss or expense suffered in having to quit. Up to one year's rent can be claimed with proof of loss and up to two years rent if particular proof can be provided. These receipts are not derived from an asset and therefore no liability arises. Similar treatment is accorded to comparable payments of up to four years rent made under the *Agricultural (Miscellaneous Provisions) Act* 1968, as compensation for surrendering the tenancy on a notice to quit from the landlord or on a notice of entry served by local authority.

Payments of this class are made where land is required for private or public development or for other non-agricultural purposes, and the tenant would be entitled to compensation under the *Agricultural Holdings Act* 1986, ss .60 and 63. This receipt is wholly exempt from income taxation and capital gains tax (*Davis v Powell* [1977] STC 32).

The question arises as to the taxation treatment where a tenant does not serve out a period of notice following the receipt of a notice to quit, but instead enters into a surrender agreement with his landlord.

In the past HMRC have taken the view that, in such circumstances, the surrender agreement broke the chain of causation, so that the tenant was not quitting in consequence of the notice to quit, but in consequence of the surrender agreement. HMRC's view was that payments made by the landlord were not statutory compensation and that the whole of such payments were chargeable to capital gains tax.

Compensation to tenants for milk quota on the termination of a tenancy is also now regarded as within the scope of capital gains tax. The *Agricultural Act* 1986 Sch 1 paras 1-4 imposes liability on landlords to pay compensation to tenants for milk quota on the termination of a tenancy.

The detail of the tenant's CGT position

The tenant should consider his capital gains tax position. The surrender of an existing tenancy for consideration is the disposal of a capital asset for capital gains tax purposes. The tenant could therefore become liable to capital gains tax where he surrenders the old tenancy, either where he is connected to the landlord, or because the bargain with the landlord is not considered to be a bargain at arm's length. In either case the tenant will be deemed to receive the open-market value of the tenancy as consideration (see *TCGA* 1992, ss. 17, 18).

The CGT reliefs available to the tenant range from principal private residence relief on the element of the farmhouse to rollover relief into another asset.

Surrender of the family farming tenancy

The question is whether an existing family farming tenancy should, in the light of the existing reliefs, be brought to an end. That is inevitably a more difficult question, because the answer may depend on the precise advantages and disadvantages being secured under an existing structure, the tax costs of making a change and as to what new structure should be substituted for the old.

The landlord/tenant dilemma

The summary is that every landlord and every tenant should review their current commercial and tax position and take action to protect their goals.

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