Tax – APR and farming

Julie Butler summarises tax planning and compliance issues for farms and landed estates

Tax planning and tax compliance issues relating to farms and landed estates are extremely complex. Land values have more than doubled since 2005 and, therefore, there are strong arguments to say that tax risks are now far greater. There has been significant diversification from pure farming in the last decade which has, in many instances, put the eligibility for claims for agricultural tax reliefs, particularly Agricultural Property Relief (APR) for inheritance tax (IHT) purposes, in doubt for certain areas of the farm. Farmers therefore have to look to the protection of Principal Private Residence (PPR) relief and Business Property Relief (BPR).

Farming is currently profitable in many sectors of the industry but various short-term, one-dimensional tax planning measures can damage the potential to claim other tax reliefs.

General agricultural property – occupation

Subject to the following provisions, APR under section 116 of the Inheritance Tax Act (IHTA) 1984 does not apply to agricultural property unless:

a. The property was occupied by the transferor for the purposes of agriculture throughout the period of two years ending with the date of the transfer; or
b. The property was owned throughout the period of seven years ending with that date and was throughout that period occupied (by him or another) for the purposes of agriculture.

In summary, to pass the occupation test for APR purposes there has to be occupation of the farmland for:

- Two years if the farming business is that of the owner
- Seven years if the farming business belongs to a third party

Complex farming ownership and occupation

In many family farms and landed estates there can be considerable moving around of farm properties for many reasons, not least the changing size and succession rights of farming families. In times when there have been cashflow problems within the landed estate, selling residential property has helped farms to survive, particularly if the property qualifies as the principle private residence. The situation is made even more complex by the fact that the farmhouse can qualify for APR and result in considerable IHT saving. For farmers this might involve a move from the original manor house to, say, the farm manager's house and the sale of the main house, or the conversion of barns to create principal private residences and using the farmhouse to claim for APR.

To claim Principal Private Residence Relief (PPR), the occupation of the residence must be permanent and there must be evidence of this. It is not enough to have a temporary lodging situation and to then claim PPR. There have been many tribunal cases in the past few years on the question of PPR and these show that HMRC has a hunger to verify that PPR claims are genuine. The recent case of *Harte* has increased the need for evidence.

Many farms and landed estates have involved properties being swapped around between siblings, or the evolution of strange ownership arrangements that seemed necessary or sensible at the time to sort out family arrangements and shares of the property; however, decades later these might seem inefficient for PPR and for APR.

The complications caused by these muddled structures also have ramifications for IHT. Does the ownership and residence of the farmhouse and cottages give maximum relief for IHT purposes?

Occupation and *Hanson*

The recent case of *Hanson as Trustee of the William Hanson 1957 settlement v HMRC* [2012] UKFTT 95 (TC) changed views about farmhouse and land ownership and APR. Following the success of *Golding v HMRC* [2011] UKFTT 351 (TC), the *Hanson* case has shown another victory for the taxpayer, although it is considered that the case will be appealed by HMRC.

The case overturns the decision in *Rosser v IRC* [2003] STC (SCD) 311 looking at the strict interpretation of the IHTA section 115 for agricultural property, and deems that APR can be obtained on the farmhouse provided there is a match between the occupation of the farmhouse and the occupation of the land.

In the *Hanson* case, the farmhouse was owned by a trust and it had been lived in by the same Mr Hanson who farmed the land surrounding the property. Mr Hanson owned most of this land. 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. Again, like *Golding*, this occupation had been long term – since the 1970s – and the decision in this case does blatantly disagree with the decision of *Rosser*, looking at the strict interpretation.

So the plan moving forward has to be for all farms and estates to review ownership of the residential property to see that potential claims for PPR and APR are protected to the best of the understanding at the time. It is important at least to ascertain exactly who owns which property and who occupies which property and to carry out an 'ownership and occupation audit'.

The corporate partner

One of the current farming fashions is the introduction of the corporate partner.

With the current increased profitability, many farmers are looking to the limited company as a way of helping mitigate the onerous burden of the 50% (reducing to 45%) income tax rate and the Class 4 National Insurance liability. Tax mitigation can be achieved by having a limited company as a partner in the farm and timing the dividend extraction correctly. Separate limited companies have been set up for dealing with the various diversified activities which can make the whole area of trying to claim both BPR and APR on the mixed estate complicated with the interaction of a limited company. The tax planning cannot just involve the single dimension of short-term income tax and national insurance without

considering APR and BPR.

When the farm is owned by a limited company it should be noted that, under s. 122 IHTA 1984, only a majority shareholding achieves APR. All minority shareholding of farming companies should be reviewed.

Grazing rights

There has been much written about the VAT position on grazing rights, especially where the grazing involves horses. Likewise, a lot has been discussed about the possible loss of IHT relief on grazing agreements following the *McCall* case. One of the points arising from *McCall* is that there must be proof of providing services and not just grazing in order to achieve BPR. Ironically, William Massey QC tried to argue in *McCall* that the service provided with the grazing was similar to a "hotel for cattle" and indeed similar to a boarding kennel. In order to achieve BPR as opposed to APR there must be a high degree of service.

Grants of grazing rights (the right to allow someone else's animals to graze the land – also known as grass keep lettings) involve both the granting of a licence to occupy land and a supply of animal feeding stuffs (i.e. grass). In the grazing rights situation, the supply of animal feed takes precedence over the supply of a licence to occupy, and the supply is zero-rated for VAT. It is possible to identify a grant of grazing rights by examining the contract, which will clearly limit the grantee's rights over the land to grazing only. APR should always apply where a landlord allows someone else to graze livestock on their land.

If the grazing agreement includes an element of shepherding or oversight of the animals, and this extends to more than once or twice a day, then the supply may be the keep of animals as opposed to grazing (VFOOD3140). If the grazing arrangement is subject to zero-rated VAT (i.e. simply the supply of food), it is difficult for some advisers to see how a claim for BPR can be justified. After the *McCall* case there was much written about the need to ensure a grazing agreement with a full and robust service in place and adhered to in order to achieve IHT relief. There are many who argue that in order to achieve BPR on grasslands, the farming arrangement has to move to being "in hand" in order to achieve BPR. The clear advice is to make sure that there is clarity – there must be an understanding of VAT and IHT requirements of the need for the grazing to be part of the business operation.

FRS15 and revaluation

It is quite normal for a freehold farm to have been inherited or purchased at say £2,000 in the 1970s and to be worth over £2 million today. In addition, the improvements to freehold property can look out of balance because of this historical difference. It is quite easy for a modest modern improvement to have cost more, in cash terms, than the original acquisition value of the land.

Most UK accounts should be prepared on a historical cost basis, which would mean valuing land and buildings at their initial acquisition cost. However, Financial Reporting Standard 15 (FRS15) allows assets to be shown in the accounts at their modern valuation instead of their original cost, at certain circumstances. The revaluation profit should not be recognised in the profit and loss account but in a separate revaluation reserve, as it is unrecognised at the balance sheet date.

There are many who would consider that to show the freehold property at valuation in the accounts would be so much more reflective of the "true and fair position". With many farms wanting to borrow money for expansion, unless the freehold property is included at market value the result is a distorted and strange looking balance sheet.

If some of the freehold property is to be revalued, then this policy must be applied to all the freehold property included in the business accounts without exception. Also the notes to the accounts should be clearly drafted to show that the accounting policy has changed.

Once revalued always revalued

The consideration is then to the future – what happens once a revaluation has taken place? Do a few more decades go past without valuing it again? The answer is no. Under FRS15 (which was introduced in 1999), once you start revaluing then there should be a valuation at least every five years, with an interim valuation after three years.

This regular revaluation cycle can be quite an onerous and expensive operation. Many farming businesses would like their accounts to show a true and fair view but are very cautious about the cost of having to revalue the freehold property on a regular basis.

Revaluation process

The full (five-yearly) and the interim (three-yearly) revaluations must, under FRS15, be carried out by a "qualified valuer". The interim valuation is a much simpler process, based on market transactions in similar properties and market trends. An interim valuation by the same valuer that carried out the last full valuation usually need not require an inspection visit to the property unless there have been "recent changes to the property or the locality". However, the full five-yearly valuation requires, as well as the usual research and questioning:

- detailed inspection of the interior and exterior of the property;
- inspection of the locality; and
- inquiries of the planning authorities.

Clearly this is not a simple process, but there are commercial and tax advantages to going through with it.

Advantages of regular revaluations

It can be argued that most farms need valuations for other purposes, for example to obtain borrowings secured on freehold property. In addition regular valuations are essential for accurate capital tax planning moving forward, particularly IHT planning and capital gains tax planning. To operate a revaluation policy on the class of fixed assets, i.e. "land and buildings", is therefore something that most farming enterprises will have to consider.

A farm revaluation is not something that can be undertaken lightly. There are a lot of complex issues and it can be difficult to arrive at market value on certain areas of the farm, for example where there are both ongoing and potential planning applications. There is also hope value (the difference between market value and agricultural value) to consider under section 115 IHTA 1984, which is essential information for successful IHT planning. Such work can also be very useful for ensuring ownership and occupation are understood!

The furnished holiday letting

The recent decision of *Mrs N V Pawson's Personal Representative v HMRC* [2012] UKFTT 51 has allowed a BPR claim on a furnished holiday let cottage. The judgment has helped provide useful guidance on the business nature of the ownership and management of a holiday letting property with regard to the possibility of claiming BPR.

Unfortunately, however, the matter cannot yet be regarded as settled, because it is considered very likely that HMRC will appeal against this decision, particularly as it is

understood that a number of similar cases are awaiting a verdict. The case provides useful guidance on the degree of services provided in order to achieve BPR.

Action plan

With farmland prices increasing and farming operations becoming more complex with diversification and corporate partners, it is essential to review every farm for the eligibility of APR and BPR. In a farming probate problem it is certain HMRC will ask complex questions about ownership, occupation and what type of farming or diversification land is used for.

When claiming APR and BPR, the 'best witness will be dead'; it is, quite literally, a case of 'silent witness', and it is important that information is gained at the earliest possible moment. All farm records and working papers should be able to provide details of ownership, occupation and activity, and these should be ascertained before making a claim. ■

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