The *Arnander* case and the HMRC attack on the two-year rule

Practitioners are finding that more emphasis is being placed on the two-year occupation rule. **Julie Butler** explores the situation

One of the most frequent areas of attack by HMRC against a claim for inheritance (IHT) tax relief is whether or not the agricultural property has been occupied for the purposes of agriculture for the two years prior to death. The recent *Arnander* case was not just about the farmhouse. In deciding whether Rosteague House was a farmhouse for the purposes of agricultural property relief (APR), Dr A N Brice (Special Commissioner), states "that Rosteague House was not occupied for the purposes of agriculture throughout the period of two years ending with the relevant dates of death within the meaning of section 117(a)".

The emphasis of the two-year occupation rule

Whilst the *Arnander* case (*C J Farnander, D T M Lloyd and M M Villiers Executors of David McKenna deceased v HMRC* (2006) Spc 565) adds to the legal principals established in a string of previous IHT authorities which have looked at APR and the farmhouses, a significant point is that the Commissioner determined that the farmhouse and certain outbuildings had not been occupied for the purposes of agriculture throughout the period of two years ending with the relevant dates of death within the meaning of section 117(a).

Practitioners are finding that more and more emphasis is placed on the two-year rule by HMRC. Has the property been occupied for the purpose of agriculture in two years prior to transfer?

The big problem in achieving the APR appears to be where there is a reduction of physical presence by the owner through old age or infirmity. Although the occupation requirement of s.117 does not require physical presence, there are problems where there is an absence for more than a minimal period. The key to a successful claim for relief is being able to show evidence of the taxpayer engaging in farming matters. It could be argued that the "physical presence" can be evidenced and demonstrated with greater ease with regard to the farmland and buildings than the farmhouse, through contract farming arrangements, which involve genuine decision making and input by the landowner.

The outbuildings – the burden of proof of "for the purposes of agriculture"

In practice the outbuildings often have a high probate value and therefore a high potential IHT liability. There is often scope for planning permission and some form of development of the buildings.

The *Arnander* case also placed focus on the outbuildings. For the Appellants Mr Massey argued that all the outbuildings were occupied for the purposes of agriculture as they were used or kept ready for use predominantly for the purposes of the storage of farm machinery and utilities. His argument was that they were not used for any non agricultural purposes.

For HMRC, Mr Karas accepted that the Dutch barn (building area 1) and the grain silo (building area 9) were used for the purposes of agriculture. The Dutch barn and grain silo passed the test, but what of the others?

It was stated that "the burden of proof in these appeals is on the Appellants to show that the outbuildings were used for the purposes of agriculture throughout the period from 2001 to 2003" and that "the Appellants have not discharged the burden of proving that these buildings were used for the purposes of agriculture for the two years prior to the dates of death".

How many of the achieved APR in *Arnander*?

The outbuildings that achieved APR on the basis of being used for the purpose of agriculture were as follows:

1. Dutch barn – allowed
2. Dung stead – disallowed
3. Informal tack room – disallowed
4. Horse stabling – disallowed
5. Storage: seasoned timber for rent – disallowed
6 Storage: field troughs, gates, fencing stakes – disallowed
7. Storage: creosote, hand tools, farm tools – disallowed
8. Storage: cement and blocks for construction – disallowed
9. Grain silo – allowed
10. Storage of agricultural machinery – allowed
11. No evidence – disallowed

For the purposes of agriculture

Dr A N Brice's conclusion and reasoning with regard to the above is set out below:

She stated, "My conclusion on the fourth issue in the appeal is that the farm outbuildings numbered 1, 9 and 10 were occupied for the purposes of agriculture throughout the period of two years ending with the relevant date of death within the meaning of section 117(a) but that the farm outbuildings numbered 2, 3, 4, 5, 6, 7, 8 and 11 were not occupied for the purposes of agriculture throughout the period of two years ending with the relevant date of death within the meaning of section 117(a)".

Dr Brice considered that the two-year rule decision applied to the farmhouse: "that Rosteague House was not occupied for the purposes of agriculture throughout the period of two years ending with the relevant dates of death within the meaning of section 117(a)" and to the outbuildings.

It can be argued that this case again emphasises that horse liveries are not agricultural (s.115(2) IHTA 1984). It is important to ensure that evidence is in place to support the claim for Business Property Relief (BPR) on outbuildings 2, 3, 4, 5, 6, 7, 8 and 11. The BPR position was not discussed in *Arnander,* but the adviser must be prepared for the claim for BPR where the APR claim fails.

The tax adviser and the two-year rule

For the tax adviser, in the panic that the agricultural world is making over the farmhouse and the potential loss of IHT relief the two-year rule is overlooked. There would be more agricultural tax relief casualties, i.e. IHT relief disallowed and not just on a few agricultural buildings.

Former agricultural buildings (buildings whose purpose was agriculture but is no longer) need robust contemporaneous proof that they qualify for APR. BPR under s.110 IHT 1984 would be needed to be called upon so that the BPR claim can succeed.

Practical questions from HMRC

Probate practitioners are receiving numerous questions over what agricultural activity had actually been taking place in the last two years before their client's death. Not just the history of agricultural activity. Questions are being raised over proof of what was happening. The approach cannot be: "well she was farming it 50 years ago so obviously she is farming it now". Historical documentation helps to give background and insight but it does not override the need to satisfy s.117(a) IHTA 1984. There are many farmers who will not just lose APR on the farmhouse, but might lose the eligibility to APR on farmland and buildings. HMRC are presenting strong arguments in an attempt to disallow the relief. Examples are as follows:-

Barter – the burden of proof

Many rural farming communities survive and thrive on the principle of "barter", undocumented agricultural exchange of services and produce. For example, the haymaker will swap bales of hay in return for cutting, turning and bailing. The hedge cutter will trim the hedges in return for grazing a few cattle, or for taking some calves to fatten. The end result can be a set of farm accounts showing little activity.

The machinery might belong to the deceased e.g. the hedge trimmer, the baler and the tractor but are just used by the contractor. So where is the burden of proof? Clearly the answer is to record and document barter as part of the contemporaneous accounting records. The farming family should also take photographic evidence of the machinery being used on the fields also being stored in the barns and outbuildings in anticipation of questions that might arise in future claims for IHT reliefs.

Contract farming is real farming – genuine commercial risk

Many farmers engage in contract farming arrangements through a combination of economic necessity, commercial reality and failing physical health. If the agreement does not require any real input from the landowner, e.g. repairs, seeds and fertilizers, or use of machinery, how can buildings be justified as qualifying for APR?

Practical suggestions are to retain a mix of "real" farming, for example suckler herd, separate grazing agreement where landowner responsible for hedges, ditches, mowing, fertilizer and spraying. Another alternative is to ensure that the contract farming agreement requires real physical input and genuine commercial risk and there is no "guaranteed" income.

In *Arnander* the contractor claimed the farm subsidy payments and the landowner received quarterly payments which could be argued are weak factors.

Grazing agreements must be documented

Grazing arrangements are the trade of farming (real farming!) provided that the landowner as mentioned above, deals with all the maintenance of hedges, ditches and grass, but if they are not in writing, where is the documentation to say that there is not just let land? Where is the burden of proof? The practical action for the farmers and their advisers has to be to sort out those grazing agreements now!

The deciding years – an IHT audit

An IHT audit should ideally be carried out on the farm property to check the availability of future IHT reliefs and what rescue work can be undertaken in order to protect future relief.

Assets comply with s.117 (a) IHTA 1984 of being occupied for the purposes of agriculture for the two years prior to death.

Would the assets qualify as agricultural property under s.115(2) – "agricultural land or pasture... and also includes such cottages, farm buildings and farmhouses, together with the land occupied with them as are of a character appropriate to the property".

If the assets failed to achieve APR would BPR be achieved on the other assets s.110 IHTA 1984? Tests must be carried out to see if the 1999 case of *Farmer* applies *(Farmer and Another (Executors of Farmer deceased) v IRC* (1999) STC SSCD 321 SpC 216).

The contract farming arrangement should be reviewed and the evidence of activity must to be documented.

Conclusion

In *Arnander* the special commissioner made emphasis of the two-year rule. History and memories are meaningless if s.117(a) cannot be satisfied. Family members and tax advisers must place enough importance on the purpose of agriculture in the last two years. If the agricultural use fails there must be enough evidence of the business activity to support the BPR if APR fails.

Some long standing farming families are being too complacent. May the tax advisers are not placing sufficient emphasis on the problem. The fuss over tax relief on the farmhouse is possibly masking the vulnerability of future basic reliefs for APR and BPR on buildings etc. These concerns are placing too much emphasis on what the farmhouse looks like and not on its occupation.

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