

Briefings

The definition of 'farming'

Julie Butler takes a closer look at this important definition.

The definition of farming, set out in section 832(1), ICTA 1988, states:

The occupation of land wholly or mainly for the purposes of husbandry.

With farmers looking to diversify, how is this definition applied in practice? Activities which are considered to be farming include:

- set aside;
- income from grazing;
- short rotation coppice; and
- farm shop selling farm produce.

Conversely, activities which are not considered to be farming include:

- contract farm income;
- share farming agreements with minimum return (taxable under Schedule A);
- miscellaneous receipts;
- quota leasing;
- farm shops selling bought in items;
- land let for 365 days or more;
- crops that grow naturally;
- fishing rights;
- grazing by horses; and
- industrial units.

The hobby farming rules were introduced in 1960 because there were concerns over taxpayers farming for recreational purposes and not for commercial reasons. The original intention was to restrict loss relief in 'extreme cases', where the trading activities bore no relationship to the criteria of a commercial trade. The so-called five-year rule set out in section 397, ICATA 1988 was introduced as an extension of the original rules.

The Inland Revenue will normally allow up to 11 years' of losses for certain activities involving horse-breeding. It must be shown that the business is capable of making a profit. Similar provisions for the restriction of corporation tax relief is included in section 393A(3), ICTA 1988. There are provisions introduced to prevent a formation of a company or a change of partnership breaking the 'five year rule'. In this example, husband and wife are treated as the same person.

However, anybody contemplating the purchase of a farm should do everything in their power to ensure that the hobby farming rules will not apply. Review of farming methods such as the choices between contract farming and farm business tenancies is a prime example. Whereas the latter does not qualify for business reliefs for capital gains tax, it can result in a higher return.

The terms of the contract farming agreement must be carefully reviewed. Some agreements are no more than tenancies 'dressed up' as farming arrangements. Some arrangements are fragile and could fail Inland Revenue scrutiny. It is imperative to have a well drafted agreement.

Another area of concern is where 'recreational activities' are clearly incorporated in the farming activities and subjective decisions have to be made between the allocation of expenses between business and private use. Clear examples are shooting estates and farms that incorporate private horses.

There can be examples where the owners/taxpayers can be greedy in their claim for business expenses, those creating large losses for income tax purposes but jeopardising the 'five year rule' and important capital gains and inheritance tax reliefs. The expenditure and income of recreational activities should be excluded except for the element of control of vermin.

Professionals must not only warn their clients of the potential problems of trying to claim such expenses but evidence it in writing.

Oliver Stanley, author of *Taxation of Farmowners and Landowners* (Butterworths) quotes of the hobby farming rules 'To state the rule cynically, a profit once every six years is sufficient to avoid the effect of the section. This can sometimes be secured by correct apportionment of expenditure among the years in question'. However, abuse of the provisions is foolhardy in the extreme. This is partially in view of the current high values of the farmland and, above all, farmhouses and the associated inheritance tax reliefs etc.

The recent case of *Dixon v IR Commissioners* (2001) SPC 297 gives an interesting ruling in this area. In this case agricultural property relief was denied on the basis that the cottage was not of a type and character appropriate to agricultural land. In actual fact the opposite was the case. The orchard and garden were of a character appropriate to the cottage which in truth was a private residence in a rural area and could be regarded by a lay person as a residential cottage with land.

Although there had been some agricultural activity on the land it was not enough to encourage the Revenue to allow agricultural property relief in respect of the cottage, garden and orchard on the grounds. Sheep had been allowed to graze on the land and from time-to-time fruit from the orchard was sold for money. The owner of a neighbouring property grew vegetables and fruit commercially and would pick fruit in the orchard and sell it with his own fruit. The sale proceeds were about £70 per year. A farmer had at times been allowed to graze sheep on the land and in return his wife carried out general household duties for the deceased. The price received for the fruit had not been included in income tax returns and this is an important point.

The principle appears to be that the purpose of agricultural property relief was not to provide relief for private residence and gardens but to relieve land and pasture use for agriculture. This decision indicates that it is not simply enough for a person to buy an attractive cottage in the country, keep some form of livestock there and try and avoid inheritance tax on the value of the property.

It is essential that the property is first of all truly used for agricultural purposes and then relief should also apply to any cottages and farm buildings occupied with the land as long as they are of a character appropriate to the property.

Practitioners are currently very worried about claims for agricultural property relief on farmhouses following the recent farming crisis where farm activities have become much less and value of farmhouses has become much more.

The whole question of the validity of agricultural property relief is something that is causing a large number of agricultural practitioners some sleepless nights. At one end of the scale there are some genuine farming activities which if looked at in the cold light of day by a harsh tax inspector might result in some loss of agricultural property relief on certain parts of the asset. At the other end of the scale there are tax practitioners who are actively encouraging anybody who lives in anywhere like a rural or semi-rural location with some degree of land to try and establish some form of business often of an agricultural nature on this land, so as to become eligible for not only agricultural property relief for inheritance tax but also business asset taper relief for capital gains tax.

It is a pity that the Dixon case was at such an extreme level of the scale, ie hardly any activity at all, without accounts being prepared, without income being declared on the tax return, etc. Sadly, the facts of the case cannot be used to help give practitioners' and clients' guidelines as to what is and what is not allowable in the eyes of the Inland Revenue under the current trading conditions.

The self-sufficient family farm unit could exist happily with as little as 100 acres. The farmhouse was part of this 'business' unit and had many advantages re input VAT claims, business expense claims and, above all,

agricultural property relief for IHT. Where does this leave the farmhouse now? Do these small family farms still exist on a commercial basis? The farmhouse is likely to have a very high value but is it less likely to achieve all the reliefs it previously enjoyed.

With regard to the farmhouse, the first point to consider is the 'character appropriate' test. If land is put to a non-agricultural use, or is gifted or sold, then the land may no longer be 'of a character appropriate' and advisers must be prepared. The CTO manual says that there will be interest in cases where the value of the farmhouse is in excess of £250,000 but no more than 100 acres is farmed. Likewise, if the value of the farmhouse is less than £250,000 but no more than 20 acres is farmed.

The business operation and tax structure of any potential farm or estate purchase needs very careful planning. Enjoy the recreational elements but be mindful of tax implications.

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