The Equine Limited Company

JULIE BUTLER FCA looks at the advantages and disadvantages of incorporation for the equine industry.

AS THE FINANCE Bill proposals relating to close company distributions are of concern only to very small companies, the incorporation of businesses remains firmly on the tax planning agenda. The equine industry is involved in this as much as any other. So what are the pros and cons?

Many equine businesses might look to the protection of limited liability in view of the high-risk nature of the equine and stud industry. The problems are that losses can be trapped inside a limited company for tax purposes and not otherwise relievable. Similarly, land and buildings held in the limited company will not qualify for business asset taper relief.

> *"The risk of a company falling foul of these tests of investment activity cannot be understated and are relevant for both capital gains and inheritance tax.*

All equine businesses which own land inside a limited company will suffer the same problem. Companies continue to accrue indexation allowances instead of taper relief but, at current low inflation rates, this is unlikely to represent real compensation for the inability to claim taper relief inside a company.

If the stud activities are carried out at a stud farm, it may be advisable to own the stud farm personally and to operate just the trading activities through a company. The shareholder would then be the landlord and grant a lease over the stud farm to the stud company. The owner could receive a market rent from the stud company for the use of the farm, and this may offset any interest charge payable on the mortgage used to originally acquire the land. Business asset taper relief would also then be retained, as rented property of this sort qualifies in full.

The implications of inheritance tax and the tax treatment of shareholders must also be considered. For inheritance tax purposes only, controlling interests qualify for agricultural property relief (section 122, Inheritance Tax Act 1984), although a minority interest may attract business property relief. If a company qualifies as an investment company, rather than a trading company, business property relief will not apply. Likewise, a subsidiary company does not qualify for agricultural property relief, but might qualify for business property relief if the conditions are right. Every equine shareholding should be reviewed for eligibility for these two reliefs.

Reconciling the trading structure

A specific problem will be reconciling the trading structure chosen with the need to try to retain entitlement to valuable capital taxation reliefs currently available in respect of agricultural and business property for both capital gains tax and inheritance tax purposes. Fundamental to this situation will be the need to ensure that there is in place a properly drafted lease agreement which retains the right to vacant possession within 12, or in some cases, 24, months for the landlord. The fact that, generally, the activity of the stud farm is taxable, while horse-racing activities are not, can also pose some difficult questions for a limited company carrying on a stud activity.

It may even be more convenient to separate taxable and non-taxable activities into separate limited companies. If this is not practical, it will be important to ensure that the respective income and expenses from each source are clearly distinguishable from the company's records. Alternatively, the non-taxable income could be retained outside the company in the taxpayer's own name. Consideration should also be given to looking at areas such as sponsorship, entertaining, marketing, advertising and public relations. For example, does the stud owner have a separate business that could incorporate a sponsorship agreement?

Agricultural property relief

To attract the full agricultural property relief on shares in a stud company, the company must have occupied the relevant agricultural property for the purposes of agriculture, *i.e.* the stud farm, throughout the period of two years before the transfer of the shares. 100 per cent agricultural property relief is also available against the value of shares in such a company, if the company has owned the agricultural land and it, or another, has used it for

agriculture throughout a period of seven years before transfer. An example could be where a company leases its land out to be farmed under a tenancy.

Where the shares have been acquired as consideration for agricultural land, normally on the incorporation of a pre-existing partnership or sole-trader's business, the shares issued as consideration are deemed to stand in the shoes of the original property in calculating the period of ownership, and in ascertaining whether the original property is still held on death. This is important for replacement property.

Agricultural property relief is restricted to the agricultural value. Agricultural value is set out in section 115(3), Inheritance Tax Act 1984 and is defined as:

'… the value which would be the value of the property if [it] were subject to a perpetual covenant prohibiting its use otherwise than as agricultural property.'

Agricultural value applies to that part of the value of shares in (or debentures of) a company, which is attributable to the agricultural value of qualifying agricultural property, provided that the particular conditions set out in section 122, Inheritance Tax Act 1984 are satisfied. This will be determined by the Shares Valuation Division, which will notify the district valuer of any agricultural property owned by the company, which qualifies for relief (form VAL 63 or 63A) when referring the case to the valuer; see section 16.21, Chapter 1B, *Valuation Office Agency Instruction Manual* (see www.voa.gov.uk/instructions/Index.htm).

Stud house

A stud house owned by a limited company will potentially cause income tax accommodation benefits to be assessable on the occupants where they are the directors or are otherwise employees of the company. There will also be potential capital gains tax issues, as no principal private residence relief will be available on the stud house if it is not owned by the individual in occupation. These difficulties can sometimes be surmounted *via* the use of trust arrangements, under which a qualifying beneficiary occupies the property which is let to the company in which the trust is also a shareholder.

Business asset taper relief

Shares in a limited company carrying on an equine trade should qualify for business asset taper relief. The tax planner's aim must, therefore, be to ensure that nothing is done to put this status at risk. Most equine activities have high asset values. The proprietor will want to achieve business asset taper relief on any sale of the shares where there is likely to be significant capital gain on rising property values.

Full business asset taper relief continues to be available as long as a company or group is substantially engaged in trading activities. To avoid losing the favourable status for shareholders, it will be important to ensure that any investment activity does not exceed, broadly, 20 per cent of the overall activity (see Inland Revenue *Tax Bulletin* issue 53, June 2001), or perhaps to conduct the activity through a different business entity. Furthermore, for some companies, periods of inactivity should also be avoided, as these can stop the taper relief clock running tax efficiently.

So what is the practical impact of the *Tax Bulletin* article? Having introduced a favourable capital gains tax relief for primarily trading situations, the Revenue has had to distinguish situations which are trading and which are not trading. The Government has not specifically set down this distinction in legislation, so the Revenue has made its own pronouncements on when it considers investment activities to be sufficiently significant as to affect trading status for taper relief purposes with regard to the 20 per cent mentioned above. That percentage could be applied in a number of ways, for example:

- turnover;
- net or gross profit;
- asset/balance sheet value;
- management time.

The Revenue recognises that the circumstances of any particular case will need to be individually examined in order to ascertain which of these criteria is most appropriate, and that there can be leeway for unusual circumstances. Specifically, the Revenue has indicated that where the 20 per cent test is breached, for instance because the company has surplus cash earmarked for future investment in the business, those funds will not necessarily be included for the purposes of the test.

The risk of a company falling foul of these tests of investment activity cannot be understated and are relevant for both capital gains and inheritance tax. An investment company does not qualify for any capital gains or inheritance tax reliefs. The areas of equine activity potentially at risk here are the letting of equine property, holding large cash balances or reserves, and possibly holding non-trading assets in a company, such as expensive horses kept for personal use. The position of a valuable stallion should also be considered: is it being retained as an investment or a trading asset?

Is it a trading company?

An equine limited company risks being regarded as a non-trading company for a variety of reasons. It might, for example, choose to invest surplus funds in a property for letting. Alternatively, former trading premises, such as stables or stud land, may be retained long term for investment purposes. A company or group could lose its trading status by virtue of a property's investment performance improving relative to the trading activities during a particular period and rising above the 20 per cent threshold mentioned above.

The message is that carrying on investment activities within a trading company or group can jeopardise the taper relief status of shareholdings in that company or group. As a result, the effective capital gains tax rate on a sale could be much higher than the ten per cent achievable under the more generous business asset régime with relief at the maximum of 75 per cent. If any investment activity is to be carried on, it will be vitally important to monitor its significance. Alternatively, the activity should be carried on outside the company, possibly by the owners personally or in a separate company.

It is possible for the equine company to apply to its Inspector of Taxes for confirmation of his opinion on this issue. Inspectors have been instructed to respond 'positively' to such requests. This does not mean that they have to answer 'yes', but at least they must give some clarification of their views, based on the known facts as they stand. Such an application can be made after the end of a particular accounting period and would be considered in relation to the accounts of that period.

For inheritance tax purposes, some guidance on whether a company is an investment company, *i.e.* 'making or holding investments', can be found in section 105(3), Inheritance Tax Act 1984.

Are the tax losses trapped?

Equine tax losses incurred under the unincorporated trading status can be offset against total income (see section 380, Taxes Act 1988). However, losses made by a business run *via* a limited company are not available for offset against the income of the shareholders or directors.

Companies can claim relief for the loss from equestrian businesses as follows:

- against their total profits in the period or against the profits of the preceding period (if the trade was carried on during that period) under section 393A;
- if the company is part of a group or consortium, the loss can be set against the profits of the same period of another group or consortium company (section 402);
- against future profits of *same* trade under section 393; and
- in the case of terminal losses, against total profits of the preceding three years under section 393A.

The hobby farming/non-commercial restrictions apply equally to losses incurred by companies and individuals. The provisions of section 397, Taxes Act 1988 will mean that if losses are sustained and restricted under section 384, the trading status of the company will be at risk. Losses restricted as non-commercial in this way will not be allowable to be offset against other income of the company, for example property that is let.

The incorporation fever must be approached with extreme caution in all areas of equine activity. ■

Julie Butler FCA of Butler & Co, Alresford, Hampshire can be contacted on tel: 01962 735544, e-mail: j.butler@butler-co.co.uk. Julie is the author of the Butterworths Tolley book *Equine Tax Planning* ISBN 0406966540, orderline: 020 8662 2000.