A Thorne in the side

Julie Butler considers the validity of income tax loss claims

KEY POINTS

- **What is the issue?**
HMRC are paying close attention to tax loss claims, particularly if the trade appears uncommercial and possibly a hobby
- **What does it mean for me?**
Beware of processing tax loss claims without all the checks and controls in place, including a review of the commercial viability, a loss memorandum, and a business plan. And warn the client
- **What can I take away?**
Tax losses are under attack by HMRC. There is now a greater benefit to be gained by keeping a history of the losses claimed than previously. When a client starts a business, there is a need to put warnings in place for a possible attack on the validity of any tax losses. As pre-5 April work, the responsibility is to review historic and ongoing tax loss claims to see whether there are an underlying concerns which should be flagged up

For many reasons, including the fact that HMRC are under escalating pressure from central government to increase revenues collected, the department is scrutinising more tax loss claims. Agricultural tax losses, particularly from the horse breeding sector, seem to be under increasing threat from HMRC enquiries, resulting in some claims being disallowed. Indeed, hot on the heels of *Richard Murray v HMRC* [2014] UKFTT 338 (TC), an income tax loss claim tribunal case in which such action was taken, the recent *Thorne* hearing indicates the mounting pressure the industry as a whole is under to prove commerciality in order to obtain a tax relief.

Equestrian breeder and farmer – the facts

In *Thorne v HMRC* [2014] UKFTT 730 (TC), Ms Thorne included a self-employment income page in her 2008/09 tax return for her trade as an 'equestrian breeder and farmer', showing a loss of £79,424.

She made a claim for loss relief under ITA 2007 s 64(1) and (2) to set off these losses against other income for 2008/09.

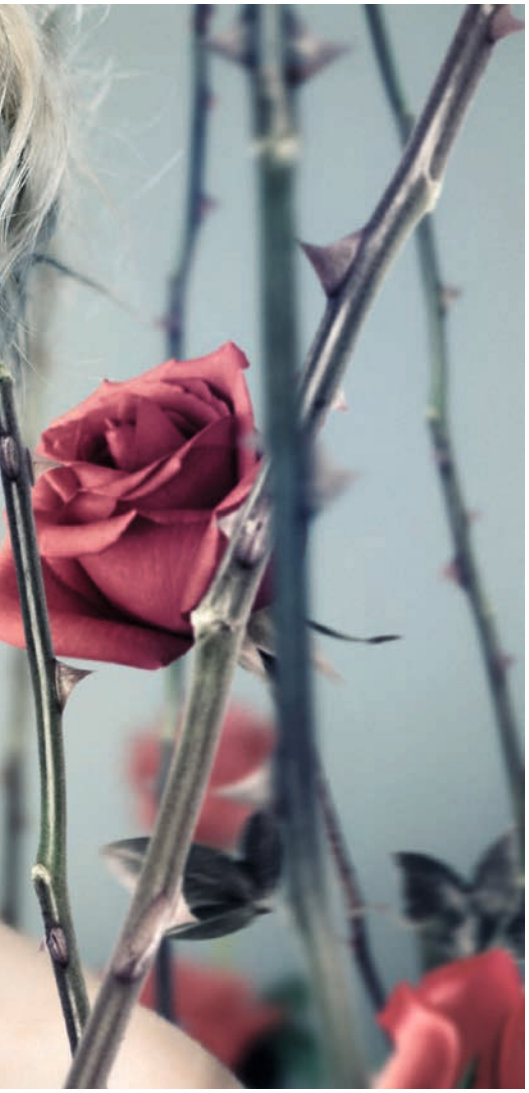
For the three years to 2007/08, Ms Thorne's trade was included in her tax returns under the description 'equestrian breeder'. However, from 2007/08 the trade was re-titled and described as 'equestrian breeder and farmer', with the farming element relating to a new asparagus growing operation.

HMRC initially refused the claim by Ms Thorne for sideways loss relief on the basis that the trade was not commercial under ITA 2007 s 66 and was considered to have little chance of receiving significant future cash inflows. HMRC also argued that the equestrian and asparagus trades should be assessed together because they were not legally separate businesses and had been included in one self-employment return with an amalgamated claim to sideways relief. Ms Thorne decided to appeal against this decision at the First-tier Tribunal (FTT).

'Just an amateur'

HMRC did not dispute the existence of Ms Thorne's trade, but argued that during 2008/09 the enterprise had not been carried out on a commercial basis with a view to the realisation of profits. Reference was made to the case of *Wannell v Rothwell* [1996] STC 450. HMRC submitted that, with regard to the equestrian side of the trade, Thorne was not seriously interested in profit but was 'just an amateur', participating in what could be considered a hobby. Such an operation was therefore beyond the scope of the UK taxation system and the tax losses not allowable.

HMRC reported that the equestrian trade had produced losses in the five years to 2009. In addition, given that it would take three years from planting the asparagus in that year to obtain the first crop, it was difficult to envisage how Ms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Thorne ever had an expectation of profit in the 2008/09 trading period.

Action plan

The facts of this case help remind tax advisers to carefully distinguish between separate trades, and present evidence to show exactly how they can be differentiated. The generic need for loss-making businesses to produce business plans to demonstrate commerciality and support the claim of future profits is highlighted by this case. If such plans showed potential profitability problems there should be evidence of what steps could be and have been taken to militate against them and a strategy devised to ensure that future trading could be more profitable.

The need for a 'loss memorandum' showing how many years a business had made a loss would also have been a useful planning tool. This enables the adviser to highlight the fact that the limit of five years of allowable losses (or 11 for horse breeding) were close to being breached, and that the client should take action to ensure a profit was made to satisfy HMRC that a commercial venture was being undertaken. It is key to ensure that the subjective and objective tests can be passed by the taxpayer.

Start-up costs and not legally separate trades

Ms Thorne argued that her business had met the reasonable expectation of profit test. She argued that most of the losses had related to the high start-up costs of the asparagus trade and HMRC had incorrectly focused on the equestrian losses. As a result Ms Thorne said that the sideways loss relief should be split into two categories.

The FTT decided that, because both trades were not legally separate and the loss claim was amalgamated in the tax return to cover them both, the claim should indeed be considered in relation to one composite trade.

The composite loss claim

On consideration of the composite trade, the FTT found that the business was not run on a commercial basis because, although the asparagus farming did meet the definition of a business earnestly undertaken with the aim of generating profits, the equestrian side met the definition of a hobby rather than a commercial operation. Ms Thorne argued that she did have a view to the realisation of profits for the asparagus business; she thought it would be profitable.

However, when considering the two businesses together, the FTT found it was difficult to see how Ms Thorne could have had this view because there were increased losses in the equestrian business compared with previous periods, and it would take years to obtain the first crop of asparagus and thus receive cash inflows.

Disallowed losses

The claim for tax losses against other income was not allowed. The HMRC position was therefore upheld by the FTT and the taxpayer's sideways loss claim was denied. It should be noted that there have been many enquiry cases in which a profitable business has been amalgamated with a loss-making equine business.

HMRC have been keen each time to separate the entities in order to disallow the equine losses from the individual's tax return. The case of *Thorne*, however, does demonstrate the professional challenges being faced within the agricultural and equine industry. Professional advisers must be prepared to support loss claims with hard evidence and business plans to ensure the tax authorities will accept the claim.

Managing client expectations can be very difficult.

Hansard to support the claims

Many have mentioned the importance of *Hansard*, the official parliamentary record, which can be used to help interpret tax legislation. It can be useful to remind HMRC that, when the legislation was introduced into parliament, the Chancellor of the Exchequer said:

'We are after the extreme cases in which expenditure very greatly exceeds income or any possible income which can ever be made in which, however long the period, no degree of profitability can ever be reached.'

This can be found in paragraph BIM85705 of HMRC's *Business Income* manual. There are not many decided cases on 'uncommercial' trades. However, evidence to support the view to the realisation of profits is still important in every loss claim supported.

Practical tips

The practical tips have to be for all advisers to consider all tax loss claims with regard to commerciality if this is not already being undertaken. Warnings must be made to clients and practical evidence of the 'view to the realisation of profits'.

The most fundamental method to demonstrate that the business will make a profit must be the preparation of business plans showing future profit.

With so little evidence being prepared, HMRC definitely have this area of tax relief in their sights. It is likely that all sizeable losses will be questioned by HMRC and the adviser has to be prepared with evidence and well prepared arguments.

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