What a summer!

MALCOLM GUNN and **JULIE BUTLER** provide advice on some topical tax issues that will be of interest to practitioners and their farming clients.

The 2012 harvest has been described as a 'wet affair' and in the majority of cases reported, yields have been disappointing. Farming has enjoyed strong profitability over the past few years, set against agricultural statistics of farmland values being on course for a tenth consecutive year of annual growth. However, there is still uncertainty about the impact of proposed common agricultural policy (CAP) reform on farm profitability. One of the proposed conditions of the reform is the possibility of 'active farmer' conditions being introduced to secure future 'single farm payment' subsidies. There are those who argue that on a large number of enterprises profitability from the pure farming operation is still below the income received for the single farm payment.

Some areas of the farming industry still have problems with profitability and commerciality and some farmers are suffering large tax losses. These tax losses can be created by a number of problems, for example:

- the purchase of the farm has been funded primarily with borrowings;
- the large drop in bloodstock prices impacting on stud farming;
- large farm property repairs and replacement; or
- high wage bills being needed to run the farm.

HMRC have been closely reviewing income tax loss claims. The correspondence has often been in considerable depth and has contained extensive analysis of the whole business. HMRC commonly raise questions about proof of commercial motive, proof that the farm can be potentially profit making and, particularly in the case of stud farms, it is evident that a huge amount of research has been embarked upon before an enquiry is opened. A business plan is nearly always requested. Even so, with persistence, a satisfactory outcome to the department's enquiry can be achieved.

KEY POINTS

- Profits under threat and an increasing level of HMRC investigations.
- Repairs and replacements and the question of tax relief.
- The averaging of partnership profits.
- The use of companies in farming businesses.
- Maximising entitlement to inheritance tax business and agricultural property reliefs.

CAs and VAT

Another area of HMRC interest is the long-standing debate concerning what expenditure qualifies as repair, what is capital, and what expenditure qualifies for capital allowances (CAs) as plant and machinery. Recent farm enquiries have focused on the nature of repairs, private usage percentages and the source of capital introduced.

A recent case, *G Pratt and Sons v HMRC* (TC1269), involved income tax relief on resurfacing a farm drive and the result should bring a smile to the farming community. The First-tier Tribunal agreed with the taxpayer that the work on the farm drive consisted of a concrete surface being placed over the existing one, and was a repair to an existing asset and therefore allowable for income tax. The appeal by the farming partnership was therefore allowed by the tribunal. The key tax planning point of the *Pratt* case has to be that there was an existing concrete track. Had there just been a 'muddy path', HMRC would have had a much stronger argument. This highlights the need for all farm improvements and repairs to be fully reviewed by both the taxpayer and tax practitioners; ideally before the expenditure is incurred.

The VAT position on farming and diversification is complex. Most farms have a number of cottages that are let out and this is an exempt supply causing partial exemption problems. If the farm has a pony or two or maybe more as liveries, the VAT position can be complicated. A livery with a dedicated stable can

be exempt, grass liveries can be zero rated, and 'special purpose' liveries are standard rated. As if this is not complex enough, the VAT status can then change with the degree of service provided by the trader.

Averaging the profits

The averaging of farm profits under ITTOIA 2005, s 221 to s 225 can produce beneficial results in some circumstances. Key points are that averaging claims cannot be made for the years of commencement or discontinuance.

If one year has a loss, then it is to be treated as nil for the averaging of profits and it is not possible to average a profit against a loss, as proposed by the taxpayer in *P G Donaghy* 2012 [UK UT148] (TCC).

The appellant in that case claimed that the rules were discriminatory and breached his human rights, which got the predictable response that it was a 'hopeless argument'. The correct way in which the rules work with losses is to average the profit over the two years, treating one year as nil and so effectively charging half the profits in each year; the loss is then dealt with separately along normal lines. So, for example, the loss can be claimed against the averaged profit allocated to its year, which can then be reduced by set-off of the loss, thus producing an overall favourable result.

Because most farms operate under some form of partnership, it is relevant to note that averaging is to be claimed by the individual partners and a partner's claim will only affect his particular share of the profits. Accordingly, it is open to each individual partner to decide whether to claim averaging or not.

Now that capital gains tax is geared to the total income of the taxpayer, an averaging claim will impact on the capital gains tax position for the year. It is therefore important to review the full position, including capital gains. If averaging reduces the taxable profits for the year, it can also reduce the rate of tax payable on capital gains.

Use of companies

From time to time, we come across cases where a farm business has been incorporated, and the advisers have gone the whole hog and put everything into the company, including the land and the farmhouse. Unfortunately, the inheritance tax legislation tends to incite this sort of action because retaining the land outside the company reduces business property relief to only 50%. The level of agricultural property relief is not affected by retaining the land outside the company so long as the seven-year period of ownership test is satisfied or, alternatively, the company is controlled by the transferor and the two-year period of ownership test is satisfied.

Farmhouse in company

There can, however, be significant problems when holding the farmhouse in a company. The immediate and obvious problem is that capital gains tax main residence relief ceases to be available in respect of the property. There are also benefit in kind problems although it may fairly be said that it is necessary for the farmer to live at the farmhouse or, alternatively, it is customary to do so for the better performance of the job. The normal exemption in such circumstances does not apply if occupation is by a director who has a material interest in the company. An alternative escape route from a benefit in kind charge is where the property was transferred to the company at no cost, but this will cease to provide a let-out on a change of occupation of the farmhouse more than six years after its acquisition by the company, after which a market value rule applies for the purposes of the benefit in kind charge.

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All in all, farmhouses are best left out of the farming company. As far as agricultural property relief is concerned, the farmhouse should still qualify for relief as the only relevant test is that it is occupied for agricultural purposes. Thus the fact that the agricultural land may be in the ownership of the company should not affect the relief; see for example the decision in *Hanson v HMRC* [2012] UKFTT 95 (TC). HMRC's *Inheritance Tax Manual* at IHTM24051 acknowledges that land owned by a company controlled by the person residing in a farmhouse can be taken into account for the purposes of the character appropriate test, although equally if there is no control this suggests that HMRC will deny relief. For the purposes of agricultural property relief, control counts in shares which are related property, i.e. those in the ownership of a spouse.

The company as partner

Probably a better use of companies is to bring them in as a partner in the farming business. Fears are often expressed that the profit share allocated to the company can be treated as a 'settlement' by the person transferring the profit share to it and so the company's profits will be caught by the relevant anti-avoidance provisions

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and taxed on the 'settlor'. Quite apart from the fact that we have not come across a case where HMRC have suggested that this is the case, this could give rise to double liability on the profits allocated to the company, once to income tax in the hands of the 'settlor' and secondly to corporation tax in the hands of the company. A similar point was discussed by the House of Lords in *R V Allen* [2000] 3 WLR 273 and it was held that the liability on an individual under anti-avoidance provisions did not exclude assessment on the company as well. HMRC apparently stated that their practice was not to take double liability in this way and their Lordships also said that 'the High Court might be invited to prohibit it as an abuse of power'. All in all, the notion that HMRC might want to proceed in a manner which results in a UK resident company not being liable to corporation tax on its profits seems highly unlikely, and it would surely have to be an extreme case where they might do so, not a run-of-the-mill farm business.

Entrepreneurs' relief

A frequent issue which arises for those advising farmers is capital gains tax on a disposal of some of the land held for the purposes of the farm business. Quite often, gains will be substantial where the land is sold off for possible development. It then becomes a question of reviewing whether entrepreneurs' relief will be available. There are various possibilities, depending on the facts of the case.

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The simplest situation is where there is an outright disposal of parts of the farm business. Although for income tax purposes all farming carried on by one individual is treated as one collective trade (even though the farming may be at two totally separate locations), this rule does not apply for capital gains tax purposes. Accordingly, it can be possible to secure entrepreneurs' relief by a disposal of part of the farm business, including some of the land. Normally a disposal of a business involved a transfer of all the assets, the stock and contracts with customers, and it would be advisable to ensure that, so far as possible, this is what takes place for the disposal of part of a farm business.

Entrepreneurs' relief and partners

Another possibility is where the farm is operated as a partnership, but the land is owned by one or more partners personally. Although this is not normally advisable for inheritance tax purposes, if capital gains tax entrepreneurs' relief is the more immediate goal, it may be helpful to set up this kind of structure in advance. What we will be seeking to do is to structure the sale of the land as an 'associated disposal' where there has been a 'material disposal' of a business. For a partner, a material disposal is relatively easy to achieve because a reduction in the partner's interest in a partnership share will be a disposal of part of the business by the partner concerned. The reduction could in theory be simply 1% as there is no de minimis limit for partners. This then opens the way for the partner to dispose of the land as an 'associated disposal' qualifying for entrepreneurs' relief. The disposal must be made 'as part of the withdrawal of the individual from participation in the business carried on by the partnership', but HMRC accept that this refers to equity participation and not time spent. Accordingly, the partner can continue to be a full-time working partner and so long as there is a reduction in equity interest there is a partial withdrawal from the partnership.

The third route to achieving entrepreneurs' relief on the disposal of a business asset while the business continues is to incorporate the business itself, but retain the land outside the company. The incorporation causes a cessation of business by the farmer so that there can then be a disposal of land qualifying for entrepreneurs' relief so long as it takes place within three years of the incorporation. Clearly, there are many other matters to consider before incorporating a business, not least the rate of inheritance tax business property relief on the fixed assets, so entrepreneurs' relief must not be looked at in isolation.

The elderly farmer

The focus of this article is not inheritance tax reliefs for farmers as that is a large topic in itself. However, it is worth underlining one point under the inheritance tax heading which is increasingly a major problem. This is that agricultural property relief looks solely at the use of the land or the farmhouse in the final period up to the time of a chargeable event, often the death of the farmer. So any earlier long history of the ownership and operation of the farm as a full-time working farmer is not taken into account at all.

A typical example of the problems introduced by this test was the situation in *HMRC v Atkinson and Smith* [2012] STC 289. In this case, a bungalow was let to a family farming partnership and the farmer who owned the bungalow was one of the partners. He had lived in the property for many years until he became ill and had to be moved into a care home where he died four years later. His furniture remained in the bungalow and he made some visits to it during his time at the care home. The other partners also made visits to the bungalow to keep it in a habitable state, but apart from this the property was not used up to the time of the death of its owner. The claim for agricultural property relief on the bungalow was refused by HMRC and the Upper Tax Tribunal upheld HMRC's view. The tribunal held that use and occupation for the purposes of the farm business is essential in the final two-year period up to the chargeable event.

Given that people increasingly now end their days in some form of care, it is harsh for the legislation to require that the farmer must effectively work up until the time of his death or else relief on the farmhouse will be in jeopardy. The inheritance tax relief can be preserved if advice is taken well in advance and acted upon, but too often farmers are unaware of the inheritance tax consequences of either moving out of their home into care, or even just reducing their time commitment to the farm business. ■

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