Ellacotts
Chartered Accountants & Business Advisers

AGRICULTURE & PROPERTY

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Structuring farming operations- minimising tax risk from environmental schemes

Many factors can lead farmers to consider a change of strategy from typical farming to other land uses. Off-farm commitments, health, or inconvenient farm layout can all prompt conversations about other ways to use the farm. Sometimes there is just no obvious contractor with kit suitable for the farm.

HM Revenue & Customs' current view on the tax implications of moving some or all of the farm from active farming (albeit perhaps using a contract farmer) to environmental schemes is not helpful. Changes are needed to align the tax system with government climate change and environmental objectives.

Various cases and legislation seek to define farming and agriculture. In summary, the production of food and the cultivation of short rotation coppice meet this definition. Energy crops and other uses of land do not. Certain habitat schemes are deemed to fall within the definition of agriculture, but the list of relevant schemes is outdated and does not include currently operating schemes such as Countryside Stewardship. We therefore proceed on the basis that land in Countryside Stewardship is not considered to be agricultural land. There is pressure for this point to be reviewed, but we should proceed and make decisions based on current legislation.

What then is the impact of this? Dealing with each relevant tax in turn:

Capital Gains Tax

- If HM Revenue & Customs were to view any part of the farm as not being used for agriculture, Capital Gains Tax Holdover Relief could not be claimed in any straightforward manner. This is the useful relief whereby agricultural property can be gifted without Capital Gains Tax being paid, as the gain passes untaxed to the recipient for them to be taxed on in future.
- To claim Capital Gains Tax Rollover Relief, land and buildings must be occupied and used only for the trade. The old asset must be used wholly for the purposes of the trade for the entire period of ownership. A time-apportioned restriction applies if there has been non-trade use (e.g. where an asset has been rented out). Tax rules unhelpfully define a trade as including "any venture in the nature of trade". If the whole farm was entered into Countryside Stewardship, HM Revenue & Customs could view this as a rent, with no commercial risk, rather than a trade, and thus restrict the availability of Rollover Relief.
- Similarly, if the farm was not used in a trading business, Business Asset Disposal Relief (formerly Entrepreneur's Relief) would not be available, for the period of ownership during which the land was not used for the purposes of the trade, as a proportion of the total period of ownership.

Inheritance Tax

Inheritance Tax gives the greatest concern should a significant proportion of the farm move into an environmental scheme.

Inheritance Tax- the current position

Imagine a partnership Balance Sheet including farmland, farm barns, perhaps two rental properties, and the farmhouse, within a combined business. As long as the whole business is "not wholly or mainly holding investments" (currently a 50% threshold), we would hope to be able to claim Inheritance Tax Business Property Relief. This threshold test may tighten to a higher percentage, if legislation changes, and we keep this under review.

To qualify for Business Property Relief, the business must be a business as regards five key tests:

- Turnover
- Profitability
- Asset value
- Time spent
- Overall feel/context of the business

Should the Business Property Relief test not be met, Agricultural Property Relief should cover the agricultural value of the farmland and farm buildings, provided they have been owned and farmed in hand for two years, or owned and let out for seven years. Any “hope value” above agricultural value is not protected by Agricultural Property Relief- i.e. Agricultural Property Relief offers no protection against a development premium, or the value of a barn which is useless for modern farming. Business Property Relief is therefore of significant importance to our tax planning.

Farmhouses often pose a challenge for Inheritance Tax planning purposes. The challenge increases as the farming activity declines. To qualify for Agricultural Property Relief for Inheritance Tax, a house must be both:

- ‘The dwelling for the farmer from which the farm is managed.’ Unless farming operations or management activities are conducted at the property it cannot be a farmhouse.

- Of a character appropriate, by reference its size, layout and context with the farm buildings and the particular area of farmland being farmed.

Particularly with a modest acreage, there are no guarantees that H M Revenue & Customs would accept these definitions are met, and allow a claim for Agricultural Property Relief. If there are no farming management operations run from it, a claim for Agricultural Property Relief on a farmhouse would be fatally weakened.

Inheritance Tax- the potential position

Should HM Revenue & Customs view Countryside Stewardship as rental rather than trading, the trade / non-trade balance of the whole business would be tilted significantly towards non-trade, exposing any rental properties and any non-agricultural value in the land and buildings to Inheritance Tax, and also the farmhouse, as mentioned above.

Income Tax

- Any loss suffered from a commercial trade carried out with the aim of making a profit can generally be offset against other income, reducing the tax due on that other income. For farmers, HM Revenue & Customs query whether the trade is genuinely commercial, rather than a hobby, after five successive years of losses (before Capital Allowances). Their test criteria is whether there is a reasonable expectation of profit. If HM Revenue & Customs view Countryside Stewardship as rental rather than trading, this offset is not available.

- There is a cap on this useful loss relief. The maximum loss relief that can be relieved against other income is the greater of £50,000 (each partner) or 25 per cent of the individual’s adjusted total income for a tax year.

VAT

Government grants and subsidies are overwhelmingly outside the scope of VAT. If these were the farm’s only income, other than rents (which are Exempt from VAT), there would be no grounds for being registered for VAT.

If the business is not making VATable supplies (whether Zero Rated supplies of food, or Standard Rated supplies of (for example) contracting work, it cannot remain registered for VAT. No Input VAT would then be recoverable. Although arable inputs would cease if there was no farming carried out, the Input VAT on farm and other repairs, vehicle costs, telephone etc. would not be reclaimable.

Conclusion?

Pending any update or clarification to legislation, the advantages of entering the whole farm into environmental schemes are likely to be significantly outweighed by the potential increase in Inheritance Tax, and possible adverse impact of other taxes on the farm, family and business.

Grassing the farm down and growing a crop of grass to be grazed or mown by a third party could be an alternative, provided there are no horses on the farm. Practical limiting factors of fencing, footpaths and water supplies of course could rule this out.

Similarly a one year fallow within the rotation, to achieve soil and weed management advantages, can be explained to HM Revenue & Customs as part of normal farming operations, with the land then continuing in agricultural use. Any longer fallow period would be inadvisable.

Of course, if a small arable acreage is reduced further, finding a contract farmer could become even more challenging.

Please consult your usual Ellacotts contact before making significant changes to your farm business. We will be pleased to explain the possible tax implications and risks.

Basis period reform

Although the tax year runs from 6 April to 5 April, many farming partnerships draw up their accounts to a different year end for example they could have a 30 September year end in order to align with the harvest year.

The business cycle year end can provide important information on the business and the season's results, supporting decision making. Having a year-end half way through a harvest when all stock may not have been sold, and inputs for next year harvest may have been purchased, makes comparisons difficult. For example sales may be down as there may be stock in the shed, which if sold would have meant overall sales were up. Although Ellacotts adjust the accounts in order to give this information on a harvest year basis (no matter what your year end is) many non-agricultural specialist accountants do not do this.

Currently businesses are taxed on the profits of the accounting year that ends in the tax year, for example, accounts drawn up to 30 April 2022 are taxed in the 2022/23 tax year. An advantage of a year end early in the new tax year, such as 30 April, is that it allows for tax planning: a 30 April 2022 year end means the tax liability won't be due until 31 January 2024, giving the business time to plan cash flow, reduce payments on accounts where appropriate and decide whether to make pension contributions before 5 April 2023.

Unfortunately in conjunction with the introduction of Making Tax Digital from the 2024/25 tax year, HMRC are now looking to tax profits on partnerships and sole traders in line with the tax year, no matter when their accounts are drawn up. This makes 2023/24 the transitional year for moving from the old to the new basis.

In future businesses can continue using non-fiscal year ends but will need to apportion them into fiscal years for tax purposes or it may be that management accounts are going to be needed to provide businesses with this vital information. HMRC's ways of simplifying matters will no doubt create more administration burden and cost at a time when many farming businesses are adapting to lower support payments and higher input prices.

Transitional year

During the transitional year taxable profits will be based on all accounting periods ending in 2023/24, plus the profits arising between end of the latest period and 5 April, less any overlap relief brought forward.

When an individual starts to trade or joins a partnership and the year end for the business is not aligned with the tax year, some profits are taxed twice, in both the first and second tax years of trading. These profits are 'overlap profits'. The 1996/97 and 1997/98 years are used to calculate overlap profit for those trading before 1997.

It is important to determine the amount of overlap relief available now rather than waiting until 2023/24. It is not possible to defer the use of overlap relief and save it up to use later, for example on retirement.

Worked example:

- Year ended 30 April 2022 - £65,000 profit
- Year ended 30 April 2023 - £75,000 profit
- Year ended 30 April 2024 - £70,000 profit
- 1 May 2024 - 5 April 2025 - £65,000 profit
- Assuming overlap relief of £10,000.

2022/23 tax year - £65,000, profits of the year ended 30 April 2022
2023/24 tax year - £75,000 profits of the year ended 30 April 2023 + £70,000 x 11/12th for the profit 1 May 2023 to 5 April 2024. Total profits taxable: £139,166 (23 month period) less overlap relief of £10,000 = £129,166.
2024/25 tax year - £70,000 x 1/12th for the profit 6 April 2024 – 30 April 2024 + £65,000 for the profit 1 May 2024 – 5 April 2025 = £70,833.

If the profits are higher due to the transitional rules, the Government proposes that taxpayers can elect to spread any "excess profits" in the transition year over a maximum of five years. So in the above example the £64,167 could be taxed over five years.

It has been suggested that the excess profits should be treated as a one off item rather than normal trading income, so that it won't impact on Child Benefit or pension allowances. It would also not count as part of adjusted net income and therefore will not impact on the availability of the personal allowance. This will all be confirmed when the finer detail is published.

Plan ahead

If you know you are going to make a loss or have some unusually large kit purchases, it may be worth changing the year end sooner. This is a complex decision that we would be pleased to consider with you.

Incorporation

These rules only apply to partnerships and sole traders. There are many advantages of operating your businesses through a limited company, and keeping your year end unchanged may be one, however this is a significant decision to be considered carefully.

Accounting bodies have lobbied hard against this reform and implementation has been pushed back already from 2023/24 to 2024/25. Fingers crossed HMRC will realise the negative impact the proposed change could have on many businesses, however at this stage, a change of plan seems unlikely.

Ellacotts Agricultural & Property Team News

Ellacotts Agriculture & Property recently held our annual benchmarking event, the first face to face event since COVID began. It was an insightful evening where we revealed amongst other things a summary of our farming clients' 2020 harvest data along with observations on 2021 harvest results. With increasing uncertainty in the UK agricultural economy we explored a number of business and tax planning opportunties.

We also bid a fond farewell to Steve Gardner as he starts his retirement, this being Steve's last offical event with Ellacotts. Over 50 clients attended the event to say 'goodbye ' to Steve and "hello" to their new contact, and the rest of the Ellacotts' team.

Interested in working in accountancy?
We are always on the lookout for the best talent to join Ellacotts' market- leading Agriculture and Property team. Do you share our interest in agriculture and enjoy working with farmers and landowners? We are always keen to meet talented trainee, part-qualified and qualified accountants or tax advisers to join our teams in Banbury and Kettering. Please get in touch!
See our latest vacancies or email hr@ellacotts.co.uk

Meet some of the team

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