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Agricultural Focus

Sowing the seeds for future prosperity

Contents:

HAZLEWOODS

DRIVING LIFELONG PROSPERITY

Welcome to the latest edition of our Agricultural Focus. In this issue we highlight tax planning opportunities for farmers, landowners and agriculturally related businesses. Please call if you would like to discuss any of the points raised.

Annual Investment Allowance

Make the most of the existing allowance before it is reduced

Maximising the relief from the Annual Investment Allowance before April 2012 could reduce the top rate of tax for an unincorporated business from 50% to 40%, or 40% to 20%. For a company, the top rate of tax could be reduced from 27.5% to 20%.

Currently, businesses can spend up to £100,000 on an annual basis on qualifying plant and machinery and obtain a full tax deduction in the year of expenditure. With effect from 6 April 2012 (1 April 2012 for companies), the Annual Investment Allowance limit is being reduced to £25,000. Therefore businesses should review their capital spending plans in the near future and consider whether planned future purchases of plant and machinery need to be made before April 2012 in order to fully utilise the £100,000 Annual Investment Allowance limit, and accelerate the available tax relief. A business with a year end other than 31 March or 5 April will need to calculate what expenditure can be made before April 2012 to maximise the available allowance.

To ensure that tax relief is obtained at the earliest opportunity, if an asset is being purchased outright, with no finance, the acquisition date for tax purposes is the date that the invoice is issued. However, extended payment terms cannot be available. If there is a gap of more than four months between the invoice date and the date on which payment is required to be made, the expenditure is not incurred until the date on which payment is required to be made.

If an asset is to be acquired with hire purchase, the acquisition date for tax purposes is the date that the asset is brought into use. Therefore, for agricultural machinery, the machinery must have been delivered before the relevant date for a tax deduction to be obtained, and the hire purchase must be on "normal" payment terms. If the machinery is a tractor which needs to travel on public roads to move around the farm, to be brought into use a tractor would have to be issued with road tax.

Mineral royalty payments

Tax changes are likely

Currently, farmers and landowners who receive royalty payments when minerals are extracted from their land, are liable to pay income tax on half of the sum received, while the remaining half is subject to Capital Gains Tax (CGT). This treatment has been allowed to reflect the fact that extracting minerals will reduce the capital value of the land.

CGT rates are currently 18% and 28%, which is lower than the current income tax rates of 20%, 40% and 50% for individuals. Therefore, the current treatment of the payments is likely to mean that the tax liability is less than if all of the income was charged to income tax.

It was indicated in press releases issued at the time of the Budget in March 2011 that the current tax treatment is likely to be removed. It is expected that changes will be introduced in the 2012 Budget.

Therefore, individuals who may be affected by any change in the treatment of royalty payment receipts should consider if it is possible to maximise the mineral royalties received in the near future, in order to maximise the amount of income that will be chargeable to CGT.

Alternatively, individuals should ensure that future annual royalty payments are at a level to ensure that they are not chargeable to higher rate of tax. This could involve transferring an interest to a spouse to make use of any unused lower rate tax bands.

It may be possible to obtain a tax benefit by crystallising a capital gain on the land, by transferring the land to another legal entity. For example, a limited company owned by the individual.

Any tax planning will depend on the level of royalty payments to be received, and the period for which the payments are expected to be received.

Farming agreements - Ensure they withstand scrutiny

Many farmers use grazing licences and contract farming agreements to farm their land. One of the main objectives of using such agreements is to protect the farming status of the landowner.

Securing treatment of the income as farming trading income gives several tax advantages. These will include the treatment of the income as earned income, allowing the landowner to deduct various expenses against the income, and to claim back VAT. The farm should also qualify for Capital Gains Tax rollover, holdover and entrepreneurs relief. However, probably the most "valuable" tax advantage is that for Inheritance Tax purposes the owner may still be in agricultural occupation of the farmhouse and obtain Agricultural Property Relief. In addition Business Property Relief should also be available for any value over agricultural value of the farm land and buildings. Agricultural and Business Property Relief can reduce Inheritance Tax liabilities significantly.

For the income to qualify as farming trading income attention must be paid to the legal agreement and the activities the landowner performs. As the landowner, to be farming, you must be in occupation of the land and your occupation must be for the purposes of "husbandry". In contentious cases the approach by the courts is to determine the primary use of the land and then to ascertain the identity of the person who had that use. In case law the courts have been prepared to accept the landowner as the person with the primary use, provided he conducts some activities which are husbandry.

For example, a grazing agreement should provide that the landowner is responsible for growing the crop of grass and actively performs some activity on the land. This would include mowing, fertilising, seeding, and controlling weeds on the land. Mere acts of maintenance would not be treated as husbandry. Similar clauses will be required in contract farming agreements to ensure the landowner is responsible for acts of husbandry to protect their farming status.

It is also important that there is always some business risk for the landowner. A guaranteed income every year would not give such risk, and is unlikely to be regarded as trading income.

Therefore, landowners with grazing or contract farming agreements should ensure that current arrangements mean that income arising will be treated as farming trading income, with the resulting tax advantages. Landowners who have arrangements in place which are not likely to be regarded as trading should take advice on how matters should be restructured so as to be regarded as trading income. Failure to do so could result in significant future tax liabilities.

VAT and Bed & Breakfast income

Do not be caught out

Many farming families operate a Bed & Breakfast business in premises located at the farm. If matters are structured correctly, subject to the Bed & Breakfast business not exceeding the usual VAT annual registration limit (currently £73,000), the income will not be subject to VAT. However, the business structure must stand up to scrutiny from HM Revenue & Customs (HMRC).

It is a basic principle of VAT that a VAT registration attaches to the person or the entity which is registered, rather than to a specific business activity.

So if Mr & Mrs Farmer, who run an agricultural enterprise in partnership, are registered for VAT, then any income arising from a new business venture operated by Mr & Mrs Farmer will also fall within the VAT regime, irrespective of the level of turnover generated.

If this consequence is undesirable (for example if the new venture involves making taxable supplies to the general public, and has few taxable inputs, such as a bed & breakfast activity), then one possible solution is for the new activity to be carried out by a different person or entity - e.g. the B&B could be run by Mrs Farmer as a sole trader.

However, HMRC can challenge such an arrangement if they consider that there has been "artificial separation" of business activities resulting in an avoidance of VAT. In such a case, HMRC are able to issue a direction (effective from a current or future date) that the two supposedly separate businesses should be treated as a single taxable person for VAT. In deciding whether any separation is "artificial", HMRC are required to have regard to the extent that the different persons carrying on the activities are closely bound to one another by "financial, economic and organisational links".

A good example is the recent Tribunal case of Howard and Jennifer Patrick. They operated a farm partnership together, and Mrs Patrick provided B & B. HMRC issued an aggregation direction on the basis that, amongst other factors, joint bank accounts were used for both businesses, the same bookkeeper was used for both businesses, and there was a combined insurance policy. The taxpayers appealed, but the Tribunal considered that, on the facts, HMRC had reasonable grounds for their actions (note - this does not mean that HMRC were right, but the Tribunal could only find for the taxpayer if HMRC had acted "unreasonably").

By contrast, the taxpayers were successful in A D and J Forster TC01319. The business activities were exactly as in the Patrick case, however son John was also involved in the farm partnership. In the hearing before the Tribunal, it was revealed that the VAT Officer's notes indicated that he had considered 14 factors when reaching his decision to issue an aggregation direction, and in fact only four of those actually pointed in favour of a direction being made! So unsurprisingly the Tribunal considered HMRC's conduct to be unreasonable.

The Forster case is helpful in providing a full list of the specific factors which HMRC considered, as below. What the list reinforces, in particular, is the need for the businesses to operate on an "arm's length" basis, so if one business pays for resources that are used jointly, appropriate cross charges should be made to the other business.

Given that a direction cannot be made retrospectively by HMRC, some taxpayers will always be tempted to "have a go" at separation arrangements, no matter how flimsy. However it is open to HMRC to argue that there was never any "separation" at all, let alone an artificial one, and consequently an assessment for back VAT and a penalty may be issued.

Discuss your farm diversification activity with Julian Millinchamp to ensure that the argument for the business being separate to the farming activities can be sustained. t: 01242 237661 e: julian.millinchamp@hazlewoods.co.uk

	Factor	For or against aggregation direction
i	B&B run from farmhouse by Mrs Forster with 3 bedrooms as guest rooms used both for farm and B&B	In favour of direction - premises
ii	Mrs Forster has own records, bank account, and annual accounts, and considers the B&B to be her own separate business which she has operated since the 1970s	Against direction
iii	Mrs Forster takes bookings, cooks the breakfasts, and cleans the rooms herself with the help of a part-time cleaner that is paid for by the B&B	Against direction
iv	In the case of absence or illness, bookings are cancelled	Against direction
v	Mr Forster plays no part in the B&B	Against direction
vi	The current turnover of the B&B business is about £8000 which Mrs Forster does not intend to expand as she is 67 yrs old	Neutral
vii	There has been no DEFRA grant	Neutral
viii	The only refurbishment costs have been a new carpet which was bought by the B&B	Against direction
ix	The kitchen is shared for domestic use and for cooking and serving breakfasts for the guests	In favour of direction- because of shared use of kitchen
x	Direct costs of B&B such as furnishings, part-time cleaner, food and cleaning materials are all paid for by the B&B	Against direction
xi	Mrs Forster is responsible for any profits or losses of the B&B and declares the income on her own tax return	Against direction
xii	The farm pays for rates, domestic fuel, electricity, insurance and phone	In favour of direction
xiii	There are no cross-charges from the farm to the B&B for rent or a share of the utility bills	In favour of direction
xiv	John has nothing to do with the B&B which he understands is run by his mother	Neutral

Tax credits to be withdrawn

Tax credits are to be phased out between 2014 and 2017 and will be replaced with a new Universal Credit.

Some farmers with low personal incomes have been able to benefit from tax credits in recent years. Tax credits have been based on household taxable income and so decisions on the division of partnership profits, the timing of dividends, pension contributions and buying machinery eligible for 100% tax relief would all have an impact on taxable income and hence the eligibility for tax credits. For families with children these tax credit payments could add up to thousands of pounds each year.

Under the new system from 2014, all self-employed people will be deemed to earn the minimum wage, currently £6.08 per hour for those aged 21. This means that even if a self-employed person makes a loss then their Universal Credit award will be based on the minimum wage for the number of hours they work each week.

For example, a couple with two school age children earning £10,000 between them would be eligible for £8,847 in tax credits in 2011/12. Under the new rules they will have deemed income of over £25,000 and Universal Credit will be tapered away to almost nothing.

Tax credits are based on income and do not take into account capital assets such as savings. However, the new Universal Credit will not be available to those with over £16,000 of capital.

In recent years when income levels rose there was no requirement to repay tax credits if the increase in household income was less than £25,000. Now if incomes increase in 2011/12 by more than £10,000 compared to the previous year then tax credits will have to be repaid. This "income disregard" will fall to £5,000 from April 2013.

The changes mean that the amount of tax credits received by the self-employed are likely to be much lower in the future. This will have a potentially big impact on some farming families and they will need to plan accordingly.

Tax credits are still available at the moment so if you think you may be eligible you should have a protective claim in place to ensure you benefit. You should also keep an eye on your current income levels in case you are due a repayment.

Business use of the farmhouse

Ensure you can justify any claim

HM Revenue and Customs (HMRC) are taking a stricter approach when it comes to the claim for business use on farmhouse expenses for Income Tax purposes.

The general principle for claiming any business expense is that it must be incurred wholly and exclusively for the purposes of the business. The phrase 'for the purposes of' is particularly demanding.

HMRC have made it clear that the days when one third of all expenses relating to the farmhouse were allowable have gone. Instead there needs to be a justification for the claim which must be based on a reasonable split of the total costs. Typically when establishing the allowable proportion HMRC will look at three factors:

- Area - parts of the house, which have active use geared specifically towards earning profits. (It would seem reasonable to discount the upstairs floor area in most cases)
- Usage - based on how much is utilised
- Time - how long it is used for business purposes relative to the total time available rather than the time it is chosen to be used.

In many cases where there is no specific designated office in the house, one must calculate the relative costs of running each room used (relative to the total costs for the house) before applying a time apportionment for when the room is used partly for business purposes.

It is often easier to justify a claim where part of the house is set aside solely for business use for a specific period. Clearly a separate office would be such a space. However, if the room is used exclusively for business purposes one should bear in mind that there would need to be a restriction to any claim for Principal Private Residence relief on a capital gain arising on the sale of the house.

In practice it would normally be possible to argue a small amount of incidental private use of the office to avoid a Capital Gains Tax liability.

It may be possible to split expenditure between fixed and running costs, and apply a different proportion to each. Where there is significant business use it would be more beneficial to apportion running costs by reference to the facts of that usage. For example the cost of all business telephone calls is allowable and so too is a proportion of the line rental (based on the ratio of business use to total use).

Going forward it is important to be able to demonstrate that the business use proportion has been determined using facts and also that this percentage is kept under review. Evidence relating to a sample period of time should be sufficient to ensure a tax deduction is obtained.

Year end planning

Ensure full use is made of annual tax allowances and reliefs

There is still an opportunity to review matters and ensure full use is made of annual tax allowances and reliefs for the year to 5 April 2012.

1 Married couples should use both personal allowance and basic rate tax bands

For the year ended 5 April 2012, each individual has a tax free personal allowance of at least £7,475 and a 20% tax band of £35,000. Income between £42,475 and £150,000 is charged to tax at 40%. Where an individual has taxable income over £100,000 they will lose some or all of the personal allowance giving an effective tax rate of 60% on income between £100,000 and £114,950. Income tax is charged at 50% on income exceeding £150,000.

Possible planning could include varying profit shares in a partnership or ensuring that dividends paid from a company are paid to the spouse with the lowest tax rate.

2 Pension contributions should be considered particularly where tax relief at 40%, 50% or even 60%

The rules relating to tax relief on pension contributions now allow an individual to contribute up to 100% of earned income (for example salary, or partnership profit) subject to an annual limit of £50,000. However, any unused relief can be carried forward for up to three years. Therefore, pension contributions can be a useful tool in reducing the amount of income suffering higher rates of tax.

The 2012 Budget is likely to take place in the middle of March. It is possible that tax relief on pension contributions will be restricted to 20% in the Budget. Therefore, individuals should consider bringing forward future contributions, in case relief is restricted in the Budget.

3 Capital Gains Tax annual exemption

Each individual currently has an annual exemption of £10,600, which means that the first £10,600 of capital gains are tax free. Therefore spouses should consider transferring assets to each other before disposal to ensure the annual exemption is utilised, which could save tax at 28%.

It is more tax efficient to crystallise a capital loss in the year before making a capital gain, than in the same year as the gain, as a loss brought forward is only set against gains after the annual exemption is utilised.

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