

## NATIONAL TUTORIAL 2023

### TAX ISSUES

### MODEL ANSWER

*This is an Outline Answer, covering the points raised in a very broad problem, covering more content than might be covered in an exam question tackled in 40 minutes.*

**This Outline Answer Sheet is intended to be read alongside the detailed Tax Notes provided to Delegates**

We know that the estate currently consists of a mixture of commercial, residential, and agricultural land, and that Phil and Jill have never farmed any of the land themselves.

We are also told that Jill has raised concerns about the availability of tax relief in the event that the land was entered into an environmental scheme as suggested by Shark Developers Ltd.

We are asked to set out the tax issues facing the estate generally. Accordingly, we need to start by considering the availability of any potential reliefs from IHT for the composite parts of the estate.

#### **1. Agricultural Property Relief**

Where applicable, Agricultural Property Relief (**APR**) will provide 50% or 100% relief from IHT on the agricultural value of property / land occupied for the purposes of agriculture.

As per section 115 IHTA 1984, APR applies where the property / land has been used for agricultural purposes and either:

- (a) occupied and used for agricultural purposes by the owner for at least two years prior to the owner's death; or
- (b) occupied and used for agricultural purposes by a third party for at least 7 years prior to the owner's death.

APR will only cover the agricultural value of the land (the value the agricultural property would have if it was subject to a perpetual covenant prohibiting its use other than as agricultural property – section 115(3) IHTA 1984). This may not be the same as the full market value of the land. If the land as a market value in excess of its agricultural value, then the excess value will not be covered by APR.

#### **Home Farm**

We are told that Home Farm is let to Brian under an AHA 1986 tenancy which he succeeded to in 1990 following his father's death.

Agricultural land let before 1 September 1995 will only qualify for 50% APR (unless certain conditions relating to land owned pre-10 March 1981 are fulfilled). This is compared with 100% APR that is available on land subject to a Farm Business Tenancy (**FBT**) entered into from 1 September 1995 onwards.

Given the existence of the AHA tenancy, it appears that Home Farm would only qualify for 50% APR in Jill's hands (as the landlord).

If possible, Jill could look to replace the AHA tenancy with an FBT so that 100% APR would be available.

However, the position is more complicated; APR is only available on assets used for agricultural purposes. Therefore, consideration needs to be given to whether the land will continue to be farmed / used for the purposes of agriculture. We are told that David wants to construct a research lab (and related accommodation), which may take (at least part of) the land out of agricultural use. If it is not being used for agricultural purposes, it will not qualify for APR. This should be carefully considered by Jill in the context of her own IHT and estate planning, and David should also take his own advice in relation to the occupation of the land in the context of the tax position of his own startup company.

The position on Brian's retirement should also be considered, particularly given his health scare. Farmers who continue to own farmland and assets may never "retire" as this can jeopardise the availability of APR. Will the land continue to be used for agricultural purposes following Brian's retirement / death? It appears that Brian's daughter, Jolene, may be in a position to take over farming the land, and we are told that Brian would wish for her to continue the farming business after his retirement / death. However, we are told that Jill would like to obtain vacant possession with a view to using it for development and environmental purposes; this could, of course, mean that it is no longer being used for the purposes of agriculture, so that APR would be lost.

As the succession aspects are very much linked to the overall tax position, it would be prudent for Jill to take advice as soon as possible so that any succession strategy can be implemented tax efficiently.

## ***The Farmhouse***

We must also consider the farmhouse in which Brian lives. APR can apply to the agricultural value of a farmhouse if it is occupied with the agricultural land or pasture and is of "character appropriate" to the agricultural property.

The availability of APR on a farmhouse is a complex area guided by caselaw. In simple terms, the farmhouse is the place from which the farmer (the person who farms the land on a day-to-day basis) conducts the farming operation. In practice, the position is almost always more complex where (for example) farmers let land to others, enter partnerships and ultimately retire / cease to carry out agricultural activities.

When assessing whether a farmhouse is of "character appropriate", HMRC base their approach on the Antrobus case which sets out the main factors to be considered, including its size, layout, and content, whether it is "proportionate" to the farming activities being carried out, and how long the farmhouse has been associated with agricultural production. HMRC also apply the "elephant" test – you know a farmhouse when you see one.

In this case, the farming operation is significant – a 300ha beef and sheep enterprise and we are told that the farmhouse is grade II listed. The farmhouse is currently being used as the place from which Brian conducts the farming operation. Therefore, it appears that APR will be available in respect of the agricultural value of the farmhouse provided that it is of "character appropriate" to the overall farming operation. Further information would be required to establish whether the farmhouse was of character appropriate to the overall farming operation. For example, if the farmhouse was a significant country house, then it would be far less likely to be of character appropriate to the overall farming operation.

Note too that the position may change if Brian was to step back from the day-to-day farming operation due to his health issues.

## ***The Cottages***

The agricultural value of farm cottages can qualify for APR if the cottage is occupied by persons employed solely for agricultural purposes (supported by the case of HMRC v Atkinson), and provided that they are of "character appropriate". In Atkinson, it was said that there should be "some sort of connection between the residential use of the cottage and an agricultural purpose sufficient to make the use occupation for the purpose of agriculture".

We are told that one of the cottages is occupied by Brian's daughter, Jolene, who works on the farm. As per our earlier discussions, Jolene is likely an Assured Agricultural Occupant and therefore APR should apply to the agricultural value of that cottage.

Similarly, the agricultural value of the second cottage, occupied by Neil who is a farmworker (and who has occupied the cottage since 1988, and who is a 1976 Act protected tenant) should be covered by APR.

However, we are told that the third cottage is occupied by Susan, who does not work on Home Farm. Therefore, APR is unlikely to be available on this cottage as it is not being used for the purposes of agriculture. (Please see the detailed notes for further information re rates of APR).

## **2. Business Relief**

BR can provide 50% or 100% relief from IHT on the full market value of the land where it applies. It can be extremely valuable in relation to agricultural property that qualifies for APR but has an excess market value; BR would cover any difference between the market value and agricultural value of the land.

Crucially, where land is owned by an individual and used by a partnership or business then it will only receive 50% relief for BR purposes.

Unfortunately, BR would not apply to the land in these circumstances. The fact that the land is let to Brian under the AHA tenancy means that it will be deemed to be an "investment" asset in Jill's hands – she is simply receiving a rent, as opposed to actively "trading", as required for BR. The same would apply to any commercial or residential lets on the estate – these would be deemed to be "investment" assets, simply generating an income as opposed to being used for a trade.

The position might change if vacant possession was obtained, and the land was farmed "in hand" by Jill. This might enable the overall estate to be structured as a single, composite, wholly or mainly trading business, which can qualify for BR as a whole, despite the assets of the business including what would ordinarily be deemed to be "investment" assets if considered on an individual basis.

This potential planning strategy would be based on the principles laid out in the case of Brander (representative of James (deceased), Fourth Earl of Balfour) v Revenue and Customs Commissioners [2009] UKFTT 101 (TC), [2009] 374 9 (the so-called Balfour case - see notes) - if the majority of the business is carrying on trading activities, then BR should be available on the business as a whole.

When judging whether this is the case one would need to consider the turnover, profitability, underlying market values and time spent in the trading and investment sides respectively of the business. For example, does the majority of the turnover come from the **trading** farming business, or from the commercial and residential lets (which would constitute **investment** income)?

The large country house in which Phil and Jill live would not, on the face of it, attract BR (or indeed APR, as it is not used for the purposes of agriculture). If the property was "pre-eminent" for its historical, cultural, or artistic merits, it may potentially qualify for Heritage Relief and be conditionally exempt from an IHT charge. Further information would be required to advise in this respect.

It would also be important for Phil and Jill to consider the country house in the context of their overall estate planning. It may be that the property can be gifted to the next generation in due course (in the hope of surviving seven years from the date of the gift – please see notes), provided that they move out and do not retain a benefit in the property given away. They could also consider insuring against this potential IHT liability using life insurance.

For completeness, we should note that BR will usually be available for farming business property such as the business banking accounts, farm machinery / plant (this would apply to Brian's farming business property in this context).

### 3. Environmental Schemes / Shark Developers Limited

As this is an emerging market, there is a real lack of legislation and guidance governing the tax treatment of environmental schemes. We are awaiting the outcome of the UK Government's consultation of the Taxation of environmental land management and ecosystem service markets.

Landowners are being presented with attractive commercial opportunities – both from the public sector (through government grants) and potentially from the external market. This is very attractive to many farmers, who are gradually losing existing subsidies like the Basic Payment Scheme and want to diversify into different income streams. Therefore, at the moment, we have to advise on general tax principals given that the commercial markets are driving these deals so quickly.

In this context, Jill has been approached by Shark Developers Ltd who want to enter into an arrangement whereby they will use the land in a way which will help off-set their biodiversity targets.

For Jill as the landowner, the ongoing use of the land would be absolutely key to its future tax treatment. If, for example, Shark Developers Ltd intend (under the terms of the arrangement) to take the land out of agricultural usage (for example, by planting woodland or using it for other environmental (but not agricultural) purposes), this would risk the availability of APR in Jill's hands. This obviously has the potential to adversely affect Jill's IHT position if APR is lost.

The removal of land from agricultural use could have wider implications for Jill too. Whilst each case would need to be considered on its own merits, the removal of land from agricultural use has the potential to alter the interpretation of whether a farmhouse is of "character appropriate" to the wider farming operation. For example, if a landowner owns 300 acres of agricultural land which they farm in-hand, then a fairly large and grand farmhouse may be more likely to be of "character appropriate" to the larger 300-acre farming operation than, say, 150 acres of land farmed in hand and another 150 acres contributed to an environmental scheme, which is no longer used for agricultural purposes.

There have been calls to widen the scope of APR so that it includes land entered into these types of environmental schemes, which would be favourable of course for Jill as the landowner, but this is a significant area of uncertainty at the moment.

The tax treatment is also likely to turn on the nature of the scheme itself. Two schemes relating to woodland planting and peatland recovery are already in force – the Woodland Carbon Code and the Peatland Carbon Code. HMRC have said that "*land entered into and verified by these schemes to generate credits which can be sold to individuals, businesses or companies to offset their emissions... will in principle qualify for BR in their own right, and that the activities necessary to create, manage and maintain the land for the purposes of generating credits for use or sale will mean that any business undertaking these operations will, in general, be "trading" for BR purposes*". Therefore, in theory, if Jill entered the land into one of these schemes, she would potentially benefit from BR on the land (subject to the usual qualifying conditions – please see notes), despite losing APR on the basis that the land is no longer used for the purposes of agriculture.

Overall, the key point to remember is that it will be very important for Jill to consider the underlying tax implications of any potential environmental scheme before entering into it, as they have the potential to generate significant and longstanding tax implications for landowners. Depending on the nature and structure of the deal, capital gains tax (**CGT**), Stamp Duty Land Tax (**SDLT**) and Value Added Tax (**VAT**) could all be in play.

There are interesting valuation issues to be considered too – for example, whether existing land has an excess "hope" value based on its potential environmental / Natural Capital uses. It would be prudent for Jill to take this into account in relation to her future estate and succession planning, particularly from a tax perspective.