Trouble ahead for farms and agricultural estates?

In January 2018 the Chancellor asked the Office for Tax Simplification to look into possible simplification of the inheritance tax (IHT) regime.

Late in 2018 the OTS released its first report which included various non-contentious "administration" type recommendations.

It has now released its second report, containing 11 main recommendations. Some of these are genuine simplifications of technical points and attempts to clear up uncertainties. However, others appear to have little to do with simplification, but are likely to have a substantial impact on certain businesses.

While any of the recommendations might impact those in the agriculture sector to a greater or lesser extent, we have identified the following which are likely to have a more substantial impact on that sector. For our comments on the full list of recommendations please see our briefing entitled 'OTS recommendations on Inheritance Tax'.

Business Property Relief (BPR)

The recommendation is to consider aligning the qualifying criteria for qualifying for IHT business property relief with that for certain capital gains tax (CGT) reliefs.

The qualification for a business to qualify as "trading" for CGT purposes is that 80% of "what it does" must be trading. Currently, in order to qualify for BPR for IHT purposes the business needs to be "mainly" (more than 50%) trading. On the basis that the Chancellor is unlikely to make it easier for individuals to get CGT reliefs, aligning the two would presumably mean that the threshold to obtain BPR would increase to an 80% test.

Our view is that this could potentially lead to a complete loss of BPR for many farms and agricultural estates which have diversified to create income streams from non-trade sources, for example, rental income from unused farm buildings and cottages or solar panels.

Note that the test for the 50/80% level is looking at the business activities "in the round" – taking account of income, profit, asset values and time spent. However, we know that many such businesses have been striving to qualify under the 50% test – clearly, they will have issues if the target now moves to 80%.

Although APR would still be available to protect assets used for the purposes of agriculture, it would only protect their "agricultural value".

Information

The removal of BPR would mean that certain very high value assets could fall liable to IHT on death such as:

- Cottages and farm buildings that are let out;
- Land where the value (e,g due to having development potential) outstrips its agricultural value.

This could well create problems with passing the farm on to the next generation. If there was significant potential development value in the land at the date of death it may well need to be sold to fund that IHT liability.

Similarly, it could be necessary to sell off let properties to fund the IHT arising thereon. If the rental income has been a “safety net” for the farm business, that safety net could be ripped away leaving the farm that much more vulnerable.

Possibly those looking at this project were more used to advising in a corporate background, and often for companies the trade is almost all of what they do. The modern-day farm / agricultural business is a hybrid in which, while farming would certainly the majority of the business, that is supported by making use of assets (such as farm buildings not needed for the trade) to generate income streams that help hedge the farm trade in difficult years. I suspect this “mixed business” reality was not something that was considered when making this recommendation.

Furnished Holiday Lets (FHL)

On a more positive note, the proposal is that all properties qualifying as furnished holiday lets would qualify for BPR.

The IHT treatment of FHLs has been the subject of much disagreement in recent years and the subject matter of a number of tribunal decisions. Some clarity is sorely needed. There is sense in aligning the treatment of IHT, income tax and CGT for these properties.

This would amount to a substantial tax break for owners of FHLs, though it is not hard to see why the Government would not want to go down this route – not least because there would be a temptation for owners of rental properties to move away from AST letting and toward FHLs as they get older and IHT becomes more of a concern.

Interestingly the OTS have put the BPR and FHL points above as a single recommendation – presumably as a bargaining point – i.e. “you will get much more tax as a result of the BPR change but you should give a break on FHLs”.

Reduction in 7 year Period for Potentially Exempt Transfers

Potentially Exempt Transfers (or PETs) are gifts from one individual to another.
Under current legislation, if the donor survives the date of the gift by 7 years its value falls outside of their estate (provided they have not continued to benefit from the asset). The proposal is to reduce this period to 5 years.

Again, this would be a positive for the taxpayer as value could be passed from the estate more quickly. There would also be a simplification in that on death executors would only need to look back 5 years rather than 7 for information relating to possible gifts.

While welcome we cannot see that this would make a substantial difference to IHT planning.
It will be interesting to see whether the same time-frame would apply to trusts in that, currently a trust to the value of the nil rate band (£325,000) can be created by an individual every 7 years. Would the Government be willing to allow such trusts to be created every 5 years?

APR on Farmhouse after the Farmer Occupier has had to Leave

The proposal is to have more certainty from HMRC as to when a farmhouse would cease to qualify as such for APR purposes if the owner is forced to leave – for example to go into care or to have medical treatment.
Greater certainty on this point would certainly be useful as the issue has proved troublesome for professionals advising in this unfortunate, but increasingly common, situation.

Removal of the CGT uplift on death in certain situations

The recommendation is to consider removing the CGT uplift in relation to assets which do not suffer IHT on death as a result of the operation of an IHT relief (for example spousal relief, BPR or APR).

While there is a logic behind this proposal, it is very difficult to see the simplification – and indeed it is not an IHT point!

If enacted it would mean that, if an asset is left on death with no IHT falling due, the deceased's base cost for CGT purposes would be inherited by the next generation meaning that when they eventually dispose of the asset the full untaxed gain since acquisition by the deceased will become taxable.

In truth it has always seemed a little odd that someone could inherit an asset free from IHT and then sell immediately with no CGT falling due. Nevertheless, some clients have used this in their IHT planning. It is sometimes used in "deathbed planning" where the spouse whose death is considered imminent is passed the asset prior to death and leaves it back to the surviving spouse in the will. The surviving spouse inherits at full value (with no IHT) and can immediately sell or pass the asset on with no CGT.

While understandable, the proposal certainly does not represent a simplification. Under current legislation there is no need to consider the CGT position on death and no need to retain historic information beyond death. If the CGT uplift were to be removed in cases where an IHT relief has restricted the IHT liability there would not only be some complex legislation needed (e.g. what if there was only partial IHT relief?) as to which assets do not get the value uplift, but also records of base costs of assets might need to be passed on from generation to generation until an asset is sold.

Overview

Of the 11 recommendations made, some are positive for the taxpayer and others are negative. Overall it is unsurprising that, if all were enacted, the amount of tax payable across the board would increase quite substantially.

Unfortunately, for individuals with certain agricultural businesses it seems they would not fare well if all of the recommendations were to be followed.

The Chancellor has been quick to point out that the OTS has merely made recommendations and that "..changes to inheritance tax…are the prerogative of the Government and of Parliament".

This, of course, means that he is free to cherry pick those that have most appeal to him, and to a Government looking for opportunities to raise tax revenues.

It is important to remember though that this is at an early stage – nothing may happen for several years, indeed nothing may happen at all.

The Chartered Institute of Tax has made the point that any proposals to the complex tax system need a full and proper consultation process so that unfair outcomes do not slip through. It is to be hoped that the Government are prepared to properly engage in such a process and that, if relevant, the professionals who advise the agriculture sector make the appropriate representations.

It is our view that while it is too early to take action at this stage, clients should be aware of the recommendations that are being mulled over such that they can start to crystalise thoughts of remedial action to take if/when matters progress further.

We are, of course, happy to talk through and offer advice as necessary. Please speak to your usual Ensors contact or Danny Clifford on 01473 220083 or danny.clifford@ensors.co.uk