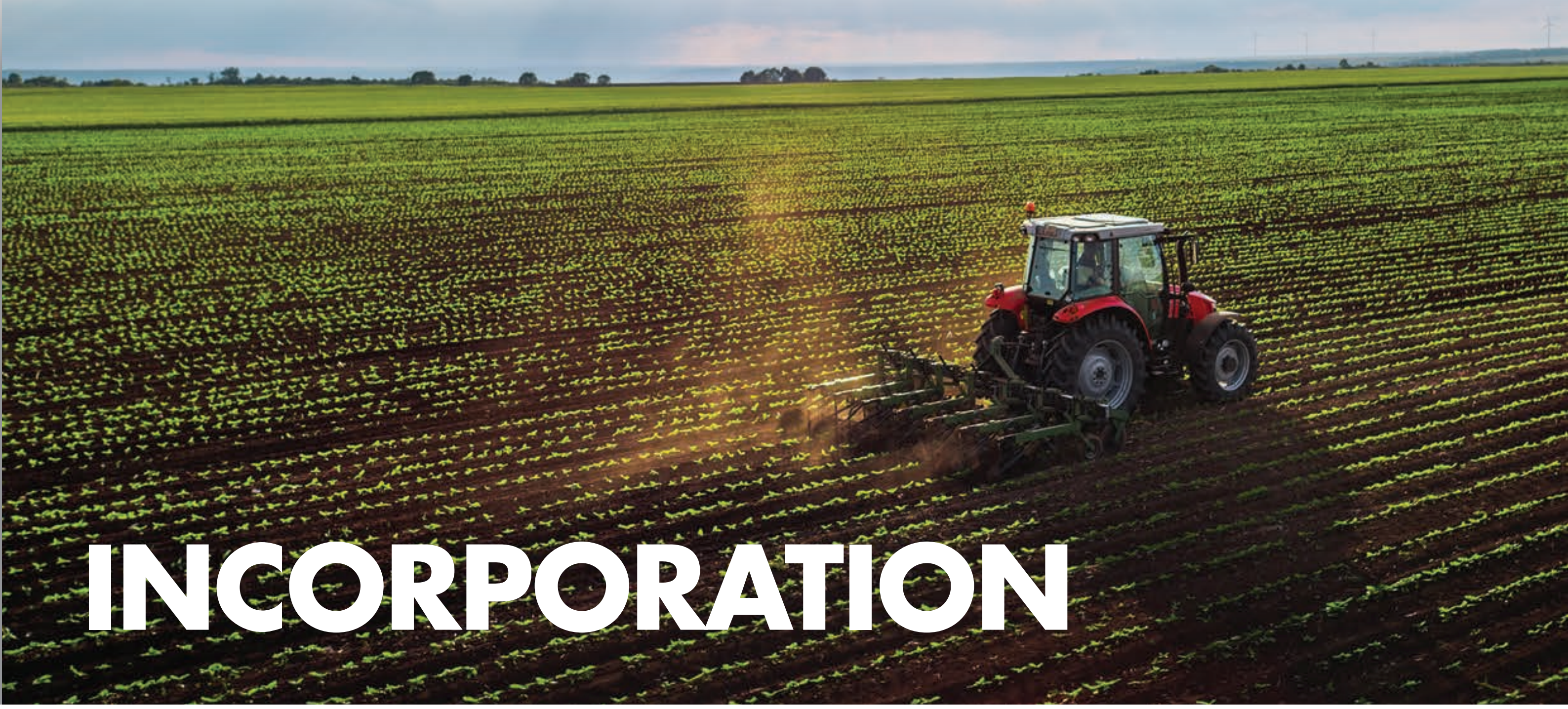
DEDICATED NEWS AND SUPPORT FOR FARMING FAMILY BUSINESSES
FROM **ENSORS CHARTERED ACCOUNTANTS**

SPRING/SUMMER 2021
EPISODE 12

LIFE ON THE FARM



INCORPORATION

Henry walks into the kitchen to find George surrounded by paperwork, lunch untouched, head in hands...

Meet the Barleymow family

Every issue we will be following the fortunes of the Barleymow family and the issues they face as a family farming business.

George
- Henry *m* Mary
  - David *m* Carolyn
    - Mark
    - Emma
- John *m* Sarah

Henry: *You OK, Dad? It can't be that bad!*

George looks up and groans. David comes into the kitchen, whistling happily. Takes coat off.

George *(grumbles): I just can't understand why we pay so much tax, yet never seem to have any cash available. It's not as if we take much of the profit out of the business…*

Henry sits down next to his dad.

Henry: *Tell me all about it! My last tax bill was as high as my blummin' drawings…*

George: *Didn't Ensors recently mention 'incorporation'… I wonder whether we should talk some more with them about this?*

David sits down, looking pleased with himself.

David: *And where do you think I've been this very morning?*

Henry *(smiles): Ah, so what did Ensors say, Son?*

David: *We had a really good chat and there are some possibilities we need to talk about. The main point is whether we consider incorporating the whole farm, or just the contracting side of the business.*

George: *But why would you incorporate only a part of the business?*

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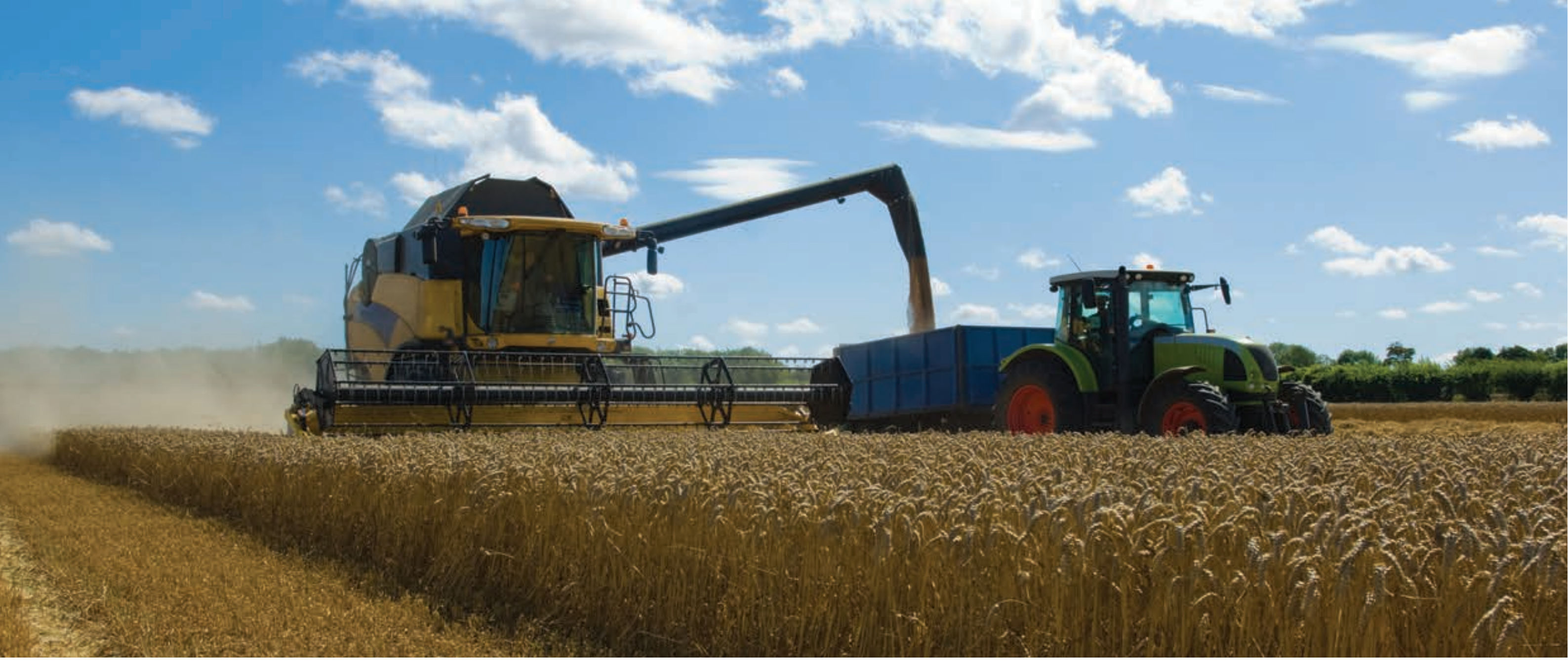


David: *Well… (he pulls his notebook out and glances at notes) Ensors say there may be Capital Gains Tax and Inheritance Tax issues if we incorporate the whole farm due to the non-business assets that we own, like our cottages and rented business units. The immediate and potential long-term tax impact of incorporation would need to be calculated and very carefully considered.*

Henry: *OK, but you mentioned incorporating only the contracting side of the business. How would that work?*

David: *Well, Ensors suggested we might ring fence the contracting business and transfer it into a company.*

Henry and George look at each other.

David: *The shareholding can be in the same ratio as our farm partnership and we can all be directors so that we all have input in how the company is run. Of course, the farm equipment would need to be transferred from the partnership into the company, along with the staff. However, the land and property can stay in the partnership.*

Henry: *But won't there be a tax charge if we sell the equipment to a company?*

David: *Apparently not. Although the equipment can be sold at market value, there is something called a tax election that can be made so that it is transferred to the company at Tax Written Down Value (TWDV), thus creating no taxable profit or loss …*

George *(snorts): But how does the company pay us for the equipment? It won't have any rollicking money!*

David: *I asked Ensors that exact same question and they said that directors' loan accounts are formed equivalent to the market value of the equipment, and these loans can be paid down to us over time, tax free, as money becomes available in the company.*

Henry: *Hmm… that makes sense. How will we farm our own partnership land though, if we no longer own the equipment or have any staff?*

David: *Well, the new company will contract-farm our land, in the same way that it will take on the other farm contracts we have.*

George *(mulling): So… the profits from all the existing contracting work, together with profit made by the company in contracting our own land, will sit in the company, rather than the partnership? But how does this actually save tax? I heard the corporation tax rate is going up!*

David: *Yes, Ensors did warn me that corporation tax rates will be increasing to a maximum of 25%, but the first £50,000 profit remains at 19%, and there is a sliding scale rate increase until profits reach £250,000 when the 25% rate then kicks in.*

Henry: *But I still don't really see how it's going to save us tax?*

David: *Ensors did advise that they'll need to run some numbers but, in very simple terms, we only suffer income tax on any profits we draw from the company. Whereas in the partnership we suffer income tax on the profits… regardless of our drawings.*

George: *Well that would be good as I draw very little from the business each year but always seem to end up with a large tax bill!*

David: *Exactly Grandad! If we don't need to draw profit personally from the company, then we will not suffer any income tax on the profits. If we do need to draw some funds out, we can firstly draw down on our directors' loans tax free, or otherwise declare dividends, which are at lower income tax rates than self-employment profits, and carry no National Insurance charge – although that won't exactly help you at your grand old age, Grandad!*

George *(chuckles): Oy, cheeky beggar – just wait until you are old enough to draw the state pension!*

Henry *(still processing it all): This all sounds a bit too good to be true, Son. I mean, where is the catch?*

David: *You are right to be cautious, Dad. Ensors did stress that careful planning is needed and the circumstances need to be right for it to be worth proceeding with. There will also be initial set-up costs, including legal fees, together with ongoing administrative costs of running the company.*

George: *And that's not to mention the fact that we will be running two businesses alongside each other – surely that's going to complicate matters a bit?*

Henry: *I think we need to consider matters seriously before we decide whether to go ahead, it's not completely straightforward. Could you arrange another meeting with Ensors, Son? So we can get our heads together with the experts and work out a plan.*

David: *Will do, Dad. But first of all, I'm hungry…*

He reaches for a tomato off George's untouched plate. George whacks his hand away…

George: *Oy! On yer bike!*

David *(laughs): Blimey Grandad! The minute you think there's a way of saving tax you spring back to life!*

VAT IMPLICATIONS OF CONVERTING REDUNDANT FARM BUILDINGS INTO COMMERCIAL LETS

In anticipation of the future reductions in Basic Payment Scheme income, many farmers are exploring the possibilities of converting redundant farm buildings into commercial lets in order to create an additional revenue stream. It is not unusual for there to be significant amounts of VAT incurred on such projects, so it is important to plan carefully in order to maximise VAT recovery.

Where a farm building is converted and then let to a commercial tenant, provided that it is not being let for storage purposes, the default position tends to be that this is an "exempt supply" for VAT purposes, meaning that no VAT is added to the rent. However, as a result, it is likely to follow that any input VAT incurred in relation to the cost of converting the building relates to this exempt supply. The implication of this is that in most cases the VAT on the conversion works and other directly related costs cannot then be reclaimed from HMRC. This can present a serious problem as there is often a significant amount of VAT at stake.

There is potentially some relief for businesses who also make "taxable supplies" for VAT purposes, such as the sale of crops and farm produce. Where there is a relatively modest cost to the conversion, coupled with measures such as non-VAT registered tradesmen being used where possible and the work being spread over two VAT years, it is sometimes possible to utilise the partial exemption de minimis rules to recover the 'exempt' input VAT. This is a very complex area and requires detailed calculations to assess whether or not the VAT is recoverable and, in our experience, the level of VAT on costs associated with many of the conversions that we advise upon breaches these de minimis thresholds and further VAT planning is required.

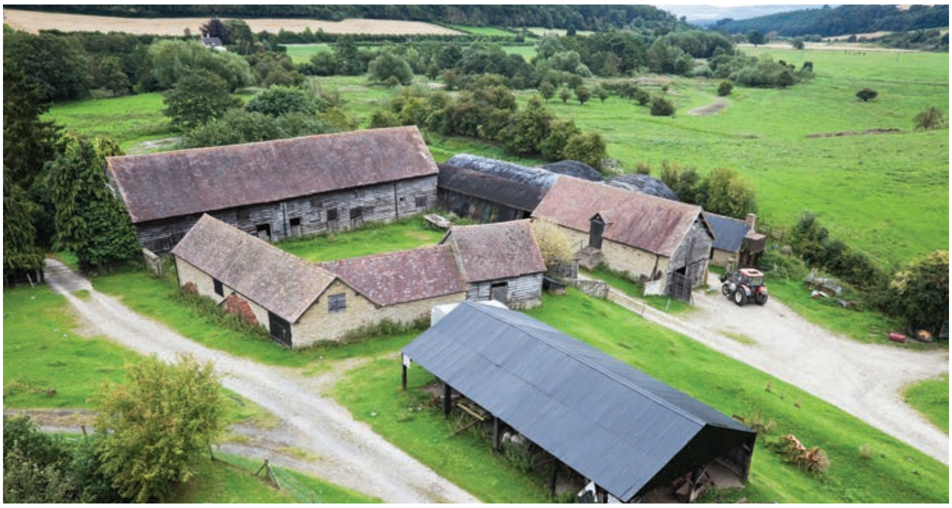
One possible planning route is to elect to charge VAT on supplies of the building, often referred to as "opting to tax". Electing to charge VAT on future income from the building means that taxable, rather than VAT exempt supplies, will be made and that the associated input VAT can usually then be recovered. It is important to note that HMRC must be notified of the option to tax within 30 days for it to be effective and once in place it cannot be revoked for 20 years. There are some unusual situations where permission is required to opt to tax or a particular supply may be excluded from an option, but these are outside the scope of this article. If an option to tax is intended it is important that this is made before there are any supplies of the converted building to avoid exempt supplies and potential VAT recovery issues.

Although securing the recovery of the input VAT is clearly desirable, it is important to consider the impact of charging VAT on the rent on any potential tenants. Where tenants are able to recover the VAT charged they are unlikely to object. However, if a tenant cannot recover the VAT from HMRC (if for example they are not VAT registered) then the VAT may become a cost to them, which may in turn lead to pressure to reduce the rent. In this situation, the benefit of upfront recovery of VAT on costs will need to be compared with the potential future cost of a reduced rent.

Where the total cost of the conversion work exceeds £250,000 plus VAT, changes to the VAT status of the building over the first 10 years of use will need to be considered and change in use could result in a proportion of any VAT recovered at the outset being clawed back under the "Capital Goods Scheme". Particular care is needed (regardless of whether an option to tax has been made) if there is any change of use of the building during this period.

This article only provides general guidance and it is important to assess each project on the specific facts as there may be further issues and options to consider. Although similar principles are likely to apply for any new build commercial lets on the farm, the VAT rules surrounding residential property conversions / builds and holiday lets are very different to those in relation to commercial property.

Finally, there are a number of other tax consequences to be considered when undertaking diversification on a farm so VAT should not be considered in isolation.



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"Ensors have an excellent understanding of how a rural agricultural estate operates and as such are able to work closely with clients and fellow professional advisors to ensure maximum benefit."

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