

LIFE ON THE FARM

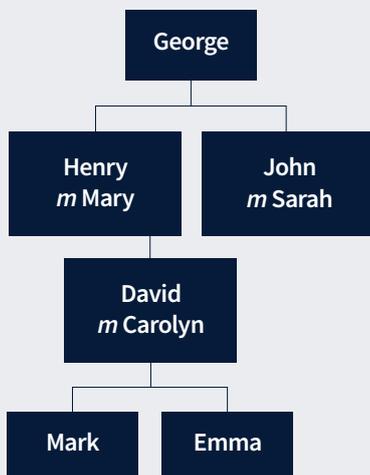
Diversification: VAT

David is at the kitchen table looking at paperwork, George is snoozing in a nearby armchair. Henry walks in...



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.



Henry: What's all this, son?

David: These are the preliminary architect plans and drawings for the old barn.

Henry: So, what are the options?

David: Well, it's all subject to planning permission, but if we're lucky we could get full residential use, a holiday let, as well as commercial use. But I really don't know the best way to go here. The costs of each will vary as will the income earning potential, but we also need to consider VAT...

Henry: Is that going to be a problem?

David: Having spoken to Ensors it all depends on which route we take as to the VAT position.

George (stands up with a groan): Surely we'd get the VAT back? We once stored hay in that old barn which is about as rickety as me nowadays! Why can't we just say any works we

do, are repairs to an old farm building and then claim it back?

David: It's all about the future intended use of the barn Grandad, not its past...

Henry: But if we let the buildings we'll have to charge VAT. Wouldn't we then be able to get the VAT back on our conversion costs?

David: It's complicated as each option has a different VAT outcome. If we convert to residential use and then let it, we're not able to charge VAT on the rentals. Residential lets are known as an 'Exempt Supply' which means VAT isn't charged and we're unlikely to be able to recover any VAT on the costs of converting the property. There is one advantage as we'd be converting an old non-residential building into a residential building, a building contractor will be able to charge us only 5% VAT on his invoices rather than the usual 20%...

Continued overleaf ➤



Henry: That's not too bad, but isn't this still a cost which needs to be factored into our building budgets?

David: That's right, Dad. However, if we convert and use it for holiday lets, then the VAT position changes. As the partnership is already VAT-registered for our farming business, if we let the barn as holiday lets, then we must charge VAT on the letting income whatever. The advantage is that we can then recover all of the VAT on the conversion work and on all future running costs.

George: Sounds all right, but wouldn't that mean we'd be viewed as expensive to holidaymakers if our charges have VAT on top?

David: Maybe. Alternatively, we could reduce our VAT-inclusive rental charges to be more in line with competitors, but we'd then lose out. This is a factor to consider though, we shouldn't forget there's a major advantage in being able to recover VAT on the conversion costs which could amount to a lot of money...

Henry: So, what's the position for commercial letting?

David: This is where it gets a bit tricky. The basic principles are that the commercial letting of buildings is exempt from VAT, so we wouldn't then be able to recover any of the VAT on the conversion costs and this would be charged at the 20% rate for this type of conversion, rather than 5% on a residential conversion. There's one other point; buildings

let for storage are automatically treated as being subject to VAT which would allow us to get the VAT back on the works, as we must charge it on the rentals - but we are not looking at this for this particular building.

George (irritated): We can't afford to suffer that VAT cost. This would be huge. Might even make the project unviable...

David: Well, providing certain conditions are met we can make what is known as an 'Option to Tax' election over the building. This must be lodged with HMRC which makes all future supplies of the building subject to VAT and that would extend to both future rental income and sales of the building.

Henry: Would this allow us to get all of the VAT back on the building works?

David: Yes! As we'd then be charging VAT on the rental income, we'd recover all of it.

Henry: Hmm, there's a lot to think about. Anything else from a VAT standpoint?

David: Well, if we wanted to convert the barn for say, Grandad to live in, there's more to consider. As he owns it and would be converting it into a future residence, it would fall into the 'self-build VAT' scheme.

George: What the heck's that?

David (smiles): Well, the building contractor would still be able to charge 5% VAT on the

works but, once the barn is completed and you've moved in, you'd then be able to get all of the VAT back from HMRC under a 'self-build VAT reclaim.'

Henry: Wouldn't we get that back through the partnership VAT return?

David: No, this has to be a separate VAT claim specific to Grandad...

Henry: OK. Anything else?

David: Well, depending on the extent of our rental income that is exempt from VAT, and also upon the costs that we incur on those properties generating that income, we may not be able to claim any of the VAT on costs towards those properties. Plus, we would actually lose some of our VAT on our general overheads under what is known as 'VAT Partial Exemption.' There is an annual limit of £7,500 of VAT which we can claim on costs for these exempt supplies and if we are within that we should be okay, but if we exceed that we lose all of the VAT. This would just need some careful planning if it came to it.

Henry: We need a meeting with Ensors!

David: Yes, the whole VAT thing is complicated and what I've said is just the tip of the iceberg. Depending on our decisions over the barn, the details will need to be drilled into before we commit one way or another.

George: Well go on then lad, give Ensors a call!

Back to Basics on Balfour

Agricultural businesses will be acutely aware of the squeeze on their profits following the phased withdrawal of the Basic Payment Scheme (BPS). This has naturally given rise to an increase in diversification activities, to replace the income BPS once provided and smooth the business cash flows, particularly in poor harvest years.

For some farmers, this will be the first time they have ventured into any business activity outside of farming, and so the Inheritance Tax (IHT) protections that have previously been in place, may start to fall away without careful planning and monitoring.

When the diversification activity is a trade in its own right, this will of course be protected by Business Property Relief (BPR).

However, there is a risk to the IHT reliefs available when farms diversify into investment activities, such as residential or commercial property rentals, DIY livery, furnished holiday lets, or leasing land for renewable projects.

This is where the 'Balfour' principles come into play; provided that the various activities are run as one business, and the business, as a whole, is wholly or mainly trading, relief can still be obtained at 100% on both the trade and investment assets.

Wholly or mainly trading

Wholly or mainly trading is considered to mean that more than 50% of the business is focused on trading activities and there are several measures that are considered when determining this. The different measures effectively compare the trading side of the business, to the investment side and if, on the whole, more than 50% is trading, relief should be available at 100% on all assets in the business. However, if in the round, more than 50% is investment activity, BPR would be lost completely. The farmland used for agricultural purposes may still qualify for Agricultural Property Relief (APR), but this only provides relief up to the agricultural value of the land.

The areas considered under Balfour to assess whether the business is looked upon as predominantly trading in the round are as follows:

1. **TURNOVER**
2. **NET PROFIT**
3. **CAPITAL VALUE**
4. **TIME SPENT BY MANAGEMENT AND STAFF**

Usually on a typical farm where the diversification activity is a few rental properties, turnover, capital value and time spent will tend to favour the trading side of the business. On the net profit front, particularly in a poor harvest year, the net profit generated from the investment activity can exceed that of the trading activity.

However, failing on one of the metrics would not necessarily mean that business property relief is lost, as again the focus is on the business as a whole.

Important considerations

Firstly, in the case of businesses trading as unincorporated partnerships, it is important to consider who actually owns the business assets. At the outset of a partnership, the founding partners will likely have used land, owned personally to carry out the business activity, but unless this land has been formally introduced into the partnership, IHT reliefs may be reduced or even not available at all. This is where the Land Capital Account within the annual set of accounts becomes a vital piece of evidence for future business property relief claims. Are these up-to-date and accurate? Does this cover all the land farmed in the partnership, or is there land sat off the balance sheet that needs to be introduced? Does this agree with the land stated in the most recent partnership agreement? The importance of having evidence to support that the land is partnership land, rather than land that the partnership has the right to use, cannot be understated.

If potential diversification activities may result in any of the existing land being converted into an investment asset, it is then important to consider if the ownership should remain with the current owner or gifted to say the younger generation prior to the investment activity commencing. In cases where the investment activity may remove a significant acreage from the farm, (say for a solar park) should this be put into a different structure, such as a trust or company? It is critical that these considerations occur well in advance, to ensure the structure is correct from the outset.

Also, when considering diversification into furnished holiday lets and glamping sites, although these are usually classified as trading activities for income tax purposes, they are NOT usually treated as trade for inheritance tax purposes, unless significant additional services are part and parcel of the operation. Therefore, if you believe your diversification activity will be a trade, are you doing enough to ensure it can actually be considered as such, for IHT purposes?

There are other tweaks to business operations that may be appropriate to help support the trading vs. investment activity ratio such as ceasing to let out land on an FBT and farming it in hand under a robust contract farming agreement instead. While this wouldn't affect the availability of APR, it could help tip the scales into the business being a trade, rather than an investment.

Future risks

The now abolished Office for Tax Simplification had been asked to review the current IHT reliefs. As part of their recommendations, they suggested that instead of a business needing to be wholly or mainly trading to obtain BPR on all the assets in the business, it should instead be a much stricter 80:20 test, whereby over 80% of the business would need to be trading in order to obtain the relief. These recommendations were published in 2019 and so before the Covid-19 pandemic. While these proposals have been shelved by the current Government, it would be unwise to assume that the IHT protections which farmers depend on to pass businesses down to the next generation, will not be looked at again, particularly as we approach the next General Election.

If you are considering a diversification activity, please do contact one of the team at Ensors where we will be happy to work with you, to ensure the correct structure and ownership is in place from the outset to maximise the efficiency of IHT and other tax reliefs for your business.

Meet the team

Agriculture specialists



Graham Page

PARTNER

01284 722300

graham.page@ensors.co.uk



Carl Page

PARTNER

01728 603005

carl.page@ensors.co.uk



Neil Meekings

PARTNER

01284 722346

neil.meekings@ensors.co.uk



Elaine Baxter

DIRECTOR

01284 722326

elaine.baxter@ensors.co.uk



Hugh Simpson

DIRECTOR

01284 722300

hugh.simpson@ensors.co.uk



Wayne Horrex

CLIENT MANAGER

01284 722327

wayne.horrex@ensors.co.uk



Chrissie Deller

TAX MANAGER

01223 428339

chrissie.deller@ensors.co.uk

“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.”

Charles Loyd – Strutt and Parker

Technical specialists



Danny Clifford

CAPITAL TAXES &
TRUSTS PARTNER

01473 220083

danny.clifford@ensors.co.uk



Helen Carey

VAT DIRECTOR

020 7830 9669

helen.carey@ensors.co.uk

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