

AGRICULTURAL

Whitley Stimpson
PARTNERS IN YOUR PROGRESS

SPOTLIGHT

Winter 2011 \ Issue 03

www.whitleystimpson.co.uk

CAP REFORMS

What will be the impact to the farming community?

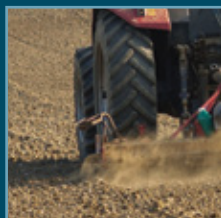


PLUS: FARMHOUSE ACCOUNTING, VAT ON FARM DIVERSIFICATION

CONTENTS

04 CAP Reform

Background to the proposals
Basic payment scheme
CAP 'greening'
Active farmer test
Capping
Modulation
Immediate issues



07 Farmers averaging and the higher rate of Capital Gains tax

07 VAT on farm diversification



08 Farmhouses – Accounting and income tax issues

10 Phasing out of tax credits and replacement of Universal credit



11 Inheritance Tax issues



THIS NEWSLETTER FOCUSES ON THE PROPOSAL FOR THE NEW SYSTEM OF DIRECT PAYMENTS, AS THIS HAS THE MOST IMPACT AND WILL BE OF MOST CONCERN TO YOU AS FARMERS

WELCOME

Welcome to the third issue of our Agricultural newsletter which is designed to enhance the awareness of the recent developments and tax planning opportunities for all those involved within the agricultural sector.

Our lead article this quarter concentrates on the new Common Agricultural Policy reforms which are scheduled to be in operation from 1st January 2014.

Cap Reform

After several leaked drafts, in October 2011 the European Commission published its proposals for four Council Regulations for the reform of Common Agricultural Policy from 1st January 2014. These are as follows:

- 1 Direct Payments (the new Single Payment Scheme);
- 2 Single Common Market Organisation;
- 3 Rural Development (Pillar II);
- 4 A Horizontal Regulation for financing, managing, and monitoring the CAP.

This newsletter focuses on the first of these – the proposals for the new system of Direct Payments, as this has the most impact and will be of most concern to you as farmers and the professionals who advise you. We also take a brief look at what actions should be considered in respect of the CAP reforms in the near future.

CAP REFORM

Background to the proposals

The proposed document states that its aim is to meet the following CAP objectives: 1) viable food production; 2) sustainable management of natural resources and climate action; and 3) balanced territorial development. The proposals seek to "promote resource efficiency with a view to smart, sustainable and inclusive growth for EU agriculture and rural areas". The two Pillar system will be maintained, with Pillar I covering direct payments and market measures, and Pillar II covering rural development.

Basic payment scheme

Entitlements held under the current Single Payment Scheme (SPS) are due to expire on 31st December 2013. The Basic Payment Scheme (BPS) is intended to replace the SPS with new BPS entitlements being issued on the basis of the eligible land being occupied in May 2014. The BPS element of the total potential payment will be that remaining after the other elements of the scheme are accounted for (see CAP 'Greening' below).

For Scotland and Wales the historic element will effectively be phased out by 2019, although these regions can elect to set different regions internally over which to average the historic amount (which can be up to 50% in the first year). For England, which already has the regional payment in place, there will be no change in the payment basis.

Where land is farmed under a tenancy agreement and it is likely that the tenancy will cease under the new rules it is not yet clear whether an outgoing tenant will be able to transfer their rights to receive the allocation, back to the landlord in the same way that a farmer selling his farm would be able to transfer to the purchaser.

CAP 'greening'

Farmers wishing to claim the Basic payment will be required to satisfy a number of 'greening' measures to qualify for this additional payment. This 30% payment is proposed to be conditional on farmers meeting obligations to benefit the environment.

Three items in particular are specified as becoming part of the 'Greening' of the CAP:

- 1 Crop Rotation – at least 3 crops in the rotation, none of which can be less than 5% or more than 70% of the arable area.
- 2 Permanent Pasture (grassland over 5 years) has to be maintained at the same area on each farm.
- 3 A requirement for 7% of the farmland to be managed for some sort of ecological benefit with ponds/hedges, etc potentially counting toward the total. The permanent pasture proposal has some implications for the flexibility of land use and capital values if 'set' as permanent pasture. Additional information will be needed in due course to be able to meet these requirements.

CAPPING WILL MEAN THAT THE IMPORTANCE OF ENSURING THAT SEPARATE BUSINESSES COMPLY WITH THE RPA RULES IS INCREASED

Active farmer test

The EU is keen to ensure that the new scheme is targeted at 'active' farmers. The task of defining who is and who isn't an 'active' farmer will be very difficult and at this stage is currently left as a farmer who receives at least 5% of their annual receipts (before subsidy) from agriculture. It will become clearer over the next few months exactly what will qualify as an agricultural receipt and it will be important to monitor the developments in this area and how the definitions will affect our clients and claims moving forward. If implemented it may have profound implications for farmers farming under Contract Farming Agreements, larger specialised businesses, diversified businesses and landlord / tenant arrangements. Agreements may need to be reviewed to ensure that they comply with the new requirements.

The active farmer test will not be applied to those who receive less than 5,000 of direct payments in the previous year.

Capping

Under current proposals direct payments will be reduced as follows:

- 1 By 20% for the amount between 150,000 – 200,000
- 2 By 40% for the amount between 200,000 – 250,000
- 3 By 70% for the amount between 250,000 – 300,000
- 4 By 100% for any amount over 300,000



They will be calculated after salaries paid in the previous year including taxes and related social contributions and relate only to the Basic Payment Element, not the Environmental element.

There are a number of practical issues which will need to be clarified in the final regulations with regard to what constitutes a labour cost (particularly for partners in family businesses). Clearly these could be major issues which will depend on the farming operations.

Capping will mean that the importance of ensuring that separate businesses comply with the RPA rules is increased. Any businesses that are concerned about falling foul of the ruling should review contractual arrangements and their operational structure, which would include family arrangements, such as contracting services.



CONSIDER HOW THE 'ACTIVE' FARMER TEST MIGHT AFFECT YOUR BUSINESS STRUCTURE

Modulation

Voluntary modulation is set to go under these proposals making it likely that the UK environmental schemes will have to be cut back further. Currently Natural England is stating that they will honor existing ELS agreements and those in place before 1 January 2012. Those considering entering or with renewals coming up should ensure they submit their forms as soon as possible.

Immediate issues

The draft regulations regarding the new scheme are unlikely to be operational until 2013 at the earliest, and more probably 2014. Therefore some areas that require a initial thought process at this stage and continued to be monitored are as follows :

- 1 Entry Level Scheme – it may be worth considering entering into or renewing your scheme as soon as possible to improve the chances of locking into it for 5 years.
- 2 Decide who should be occupying the land when the proposals are introduced and check that they are eligible to claim and secure the entitlements. If the tenancy agreement is likely to cease how this impacts these payments.
- 3 Consider the implications for the 5 year pasture proposal. While it may be set retrospectively, putting land back into an arable rotation may keep your options open where appropriate.
- 4 Review the potential impacts of Capping on the business and consider options to mitigate these.
- 5 Consider how the 'Active' farmer test might affect your business structure and in particular ensure that your land tenure and contract agreements are sufficiently robust to ensure you qualify. Farmers and landowners should think seriously about the impact of the regulations on their businesses and seek advice on how to manage these appropriately to avoid being disadvantaged as and when they are implemented.

Please note that the details above are a limited summary of the proposals as they stand. Over the forthcoming months it is likely that EU Member States will be fighting their own corners to refine the Proposals before EU Farm Ministers and the EU Parliament agree the new CAP perhaps in late 2012.



FARMERS AVERAGING AND THE HIGHER RATE OF CAPITAL GAINS TAX

For those farmers who are reluctant to pay the increased 28% as opposed to 18% capital gains tax rate there is scope for using 'allowable capital losses' via the routes of selling assets to realise losses and/or making negligible value claims.

Tax advisors need to look at CGT loss realisation leading to 5 April 2012. When sorting out historic CGT computations the specific transfer provisions under Finance (No 2) Act 2010 for 2010/11 need to be considered when determining whether there is any unused basic rate band. It is essential to ignore gains accruing PRIOR to 23 June 2010 which will no doubt cause issues in the build up to the filing deadline of 31 January 2012.

For the farmer/landowner this is of particular concern as there are fluctuating income profits/losses which can be averaged and this will impact on the use of the basic rate band for disposals that do not qualify for the CGT business reliefs.

Action Plan

- ▶ When carrying out farmer's averaging claims it is essential to check the impact on any actual and potential capital gains tax liability;
- ▶ Look to realising current tax year losses to protect the utilisation of the lower CGT rate.



VAT ON FARM DIVERSIFICATION

Many farmers have over the years considered diversifying into other trading activities to support the farming income.

Two recent cases involving the letting out of metal storage containers and Bed and Breakfast income have highlighted the importance of seeking advice for a project before commencement of the diversified activities as such activities may affect the ability for the farm to claim all its input tax as the VAT partial exemption rules may come into operation.

If this diversification is being considered then it may be worth considering the trading vehicle that any diversification is to be operated under, as this may have tax as well as VAT benefits.

When considering these options any such diversification should be reviewed with regard to the impact that this decision may not only have on the VAT position of the farm itself, but also issues with regard to income tax, capital gains tax and inheritance tax.



FARMHOUSES – ACCOUNTING AND INCOME TAX ISSUES

We thought that it would also be useful to revisit the now well established principles in respect of the accounting and income tax issues arising from Farmhouses. Farmhouses have always had unique and specific issues from an accounting and taxation perspective. Historically, the farmhouse enjoyed a favoured tax status with up to one-third of the expenses being allowable for tax purposes. This was changed by HMRC in 1993 and since then the allowability of farmhouse expenses must be considered in each case based on its merits.

The first step is to establish the allowable proportion, for which one needs to take into account:

- 1 whether there is more than one farmhouse on the holding and if so how much 'business use' there is with each house;
- 2 whether the majority of the business is carried out within a separate farm office;
- 3 any specific parts of the farmhouse which are used exclusively for business;
- 4 the degree to which business use is carried out throughout the whole house. (It may be that farm 'business' is not confined exclusively to one room.).

FARMHOUSES HAVE ALWAYS HAD UNIQUE AND SPECIFIC ISSUES FROM AN ACCOUNTING AND TAXATION PERSPECTIVE.

Typically the proportion will be less than one-third but quite often can be agreed in the range of 10–25%. For example, where there is a separate farm office and the house is only used for occasional meetings the percentage of allowable expense will be minimal. By contrast, where all farm business is transacted from the house, which might include a staff room, office, showers, archive store etc, the square footage used for business purposes may imply a much higher figure. It is important to keep the percentage under review. Many businesses cope with this by keeping evidence for a sample period of time only to indicate average costs and/or usage. This exercise needs to be repeated from time to time to verify that the position is unchanged. Having established the allowable proportion one needs to consider what expenses are attributable to the farmhouse. The costs of running the farmhouse would normally include:

- ▶ gas, electricity, heating oil, firewood, etc
- ▶ property repairs
- ▶ insurance
- ▶ domestic cleaning
- ▶ council tax and water rates

Where a farmhouse is rented further problems arise. It is necessary to establish what the rent is before calculating the allowable amount. Previously, a tax add-back was made based on the gross rateable value, which is no longer acceptable unless it is subjected to a realistic indexation adjustment.

Part of the problem lies in the fact that the farmhouse and land are normally subject to a single tenancy agreement, but the rental of the parts would be far in excess of the amount charged for the whole. Accordingly, it is not appropriate merely to look at an open market rent for the farmhouse, nor can one look at the rent for the bare land and take the farmhouse as the balancing figure.

The HMRC manual (BIM 55255) accepts that 'farmhouse rents pose particular problems' but does not go on to suggest the mechanics of an adjustment other than that it should be 'realistic and fair to both sides' – in practice, and when the matter goes under enquiry, the figure is normally settled by negotiation with the Inspector or District Valuer at a level between the gross rateable value (GRV) and the open market rent (subject of course to a restriction for agricultural use only).

Additional lifestyle expenses and costs

In addition to the running costs of the farmhouse itself there are often a number of other costs paid by the farm business which relate to the farmhouse or the farm in general and which is partly, wholly or largely private in nature. These costs should be reviewed on an individual basis to see if there is any private usage. Where there are clearly mixed use costs you will need to be able to demonstrate that the allocation is reasonable.

For each activity and relevant expense, it will be necessary to establish a realistic private use percentage. Having established the level of disallowances for all of the farmhouse and recreational costs the question then arises of what tax adjustments to make.

It is normally appropriate to make adjustments through the partnership tax return. This has the advantage of simplicity but it also means that the disallowance is effectively borne by the partners in their profit-sharing proportions, which may not be appropriate (particularly as one partner may enjoy most of the benefits but receive a relatively small profit share). It can also mean that accounting and taxable profits are significantly different. The alternative for partnerships is to treat the relevant expenses as drawings within the individual partners current account, which may be a fairer way of dealing with these private costs.

PHASING OUT OF TAX CREDITS AND REPLACEMENT OF UNIVERSAL CREDIT

The White Paper "Universal Credit: welfare that works", published on 11 November 2010, sets out the Coalition Government's plans to introduce legislation to reform the welfare system by creating a new Universal Credit. Universal Credit are aimed at simplifying the system to make work pay and combat worklessness and poverty.

Some farmers with low personal incomes have been able to benefit from tax credits in recent years, for example by the sharing of partnership profits in certain ways, timing of dividends or by buying machinery that qualifies for 100% tax relief and reduces their income in that year. For families with children these tax credits payments could add up to thousands of pounds a year.

If introduced in its current format, under the new proposed system, all self employed people will be deemed to earn the minimum

FOR FAMILIES WITH CHILDREN THESE TAX CREDITS PAYMENTS COULD ADD UP TO THOUSANDS OF POUNDS A YEAR.

wage. This means that even if they make losses their universal credit award will be based on an assumed income of the minimum wage for the number of hours they work per week.

For example, a couple with two school age children earning £10,000 between them would have been entitled to £8,348 in tax credits. Under the new rules however they will be deemed to earn the minimum wage for 40 hours per week each – an income of £24,669. As a result their universal credit will be tapered away to 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.

The changes mean that the amount of tax credits received by the self employed are likely to be much reduced in the future. This will have a big impact on farming families who often rely on tax credits to fund their living expenses.

There are still opportunities to make tax credits claims, so if you think you may be eligible you should have a protective claim in place to ensure you benefit from the more favourable old rules for longer.



INHERITANCE TAX ISSUES

The continuing development of case law within the area of Inheritance tax continues to cause concerns with advisors. It is becoming necessary to regularly revisit Wills in the light of these cases and any changes to the business activities to ensure that these assets continue to qualify for either Agricultural Property relief or business property relief wherever possible, as these are very valuable reliefs.

A recent case where H.M. Revenue and Customs sort to restrict Agricultural Property relief on a farm where the farmer, as he had grown older, had reduced his farming activities on a smallholding of 16.29 acres. The farmer had continued to make a small profit each year from his farming activities which consisted of growing and selling fruit and vegetables, selling eggs and producing hay for sale.

H.M. Revenue and Customs argued that the house was not of a character appropriate to the land and that its value should be liable to Inheritance tax. They argued that the holding was not an economic unit and that the farming activities did not require the use of a house. H.M. Revenue and Customs also argued that after his death the house was unlikely to be used again as a farmhouse, so no relief should be due.



Fortunately the original tribunal judge (and also the subsequent appeal) found against H.M. Revenue and Customs and this case should now demonstrate that H.M. Revenue and Customs will find it difficult to argue that inheritance tax relief should not be due for working profitable farms. In many cases where tax is charged it is as a result of the way certain businesses are structured and managed and this is an area that can be addressed in good time with some thought and advice.

Talk to someone who understands the real issues

Accounting for agriculture, farming and rural business is a specialist area that requires expertise and an understanding of the industry. Our dedicated team come from farming backgrounds and offer a clear understanding of the issues facing farmers.

We provide professional knowledge and hands-on experience in the agricultural sector. We have worked with agricultural businesses for over 75 years, providing the expert advice that is required to help you enhance the potential of your farming business.

Whitley Stimpson LLP

Banbury

T. +44 (0)1295 270200

E. info@whitleystimpson.co.uk

High Wycombe

T. +44 (0)1494 448122

E. hw@whitleystimpson.co.uk



Meet the Agricultural Team



Martin Anson

Agricultural Partner

MartinA@whitleystimpson.co.uk



Owen Kyffin

Tax Partner

OwenK@whitleystimpson.co.uk



Christine Copeman

Qualified Senior



Ben Allman

Qualified Senior



Vicky French

Senior

Whitley Stimpson LLP is a Limited Liability Partnership registered in England and Wales, registered number: OC 331505. Registered office at Penrose House, 67 Hightown Road, Banbury, Oxfordshire, OX16 9BE. A list of members is available for inspection at the office of the firm Whitley Stimpson LLP, Chartered Accountants are registered to carry on audit work and regulated for a range of investment business.

This report is for general information purposes only. It may not be published, reproduced or quoted in part or in whole, nor may it be used as a basis for any contract, prospectus, agreement or other document without prior consent. Whilst every effort has been made to ensure its accuracy, Whitley Stimpson LLP accepts no liability whatsoever for any direct or consequential loss arising from its use. The content is strictly copyright and reproduction of the whole or part of it in any form is prohibited without written permission from Whitley Stimpson LLP.

Image Credits

Page 01: [©iStockphoto.com/Leadinglights](https://www.istockphoto.com/Leadinglights)

Page 05: [©iStockphoto.com/mikedabell](https://www.istockphoto.com/mikedabell)

Page 06: [©iStockphoto.com/WEKWEK](https://www.istockphoto.com/WEKWEK)

Page 07: [©iStockphoto.com/jtyler](https://www.istockphoto.com/jtyler)

Page 08: [©iStockphoto.com/RachelDewis](https://www.istockphoto.com/RachelDewis)

Page 10: [©iStockphoto.com/kryczka](https://www.istockphoto.com/kryczka)

Page 11: [©iStockphoto.com/kodachrome25](https://www.istockphoto.com/kodachrome25)