

## IHT and farming. Long range tax planning

### Michael Steed's tax blog – September 2012

#### Introduction

There is no doubt that IHT has a major impact on long-range tax planning for farms. Farms are valuable assets and long-range IHT planning is a major part of professional advice to clients who are farming or who own agricultural land.

Well it's not just traditional farming that we have to take into account. What about farm diversification? Lots of farmers have diversified in response to historically low agricultural prices and wanting to make better use of farm assets.

There's also the matter of property development on farms. Redundant farm buildings are often converted into holiday lets and commercial rental units and land may be sold off for housing.

In this blog, I'd like to have a look at some of the IHT drivers for our advice. Even if you are not an IHT expert and may have to refer the matter to an IHT expert, it's still very useful to understand the concepts and reliefs and their scope and limitations.

Let's first look at the shape of the IHT reliefs.

The IHT legislation currently grants four major 100% exemptions/reliefs from IHT that are potentially of interest to farmers:

1. Spousal transfers – subject to your spouse being domiciled or deemed domiciled in the UK;
2. Agricultural Property Relief (APR);
3. Business Property Relief (BPR);
4. The Potentially Exempt Transfer (PET) rules on lifetime gifts.

There are also a number of other lower value reliefs, such as the £3,000 annual exemption for lifetime giving, but these are not considered in detail here.

When we talk about IHT planning, we need to consider the CGT angles as well and I'll refer to these, as appropriate, but without the detail, as we are essentially considering the IHT issues in this blog.

OK, here's a question. I own a farm in Kent and at some stage I'll be gifting this to my children.

So the question is: Do I gift it in life or do I wait for death?

You need to look at the issue from both the IHT and the CGT angles – they must both be considered.

Let's start with the IHT and PETs.

A PET is a lifetime gift from one individual to another individual. It doesn't have to be a family member, although it normally is. The key thing for a PET is that there is no IHT to pay in life, either by the donor or the donee. If Mum survives 7 years, then the gift falls outside the scope of IHT.

However, if the donor dies within 7 years of the gift (years to the anniversary of the gift – not tax years), then there is potentially some IHT to pay (it will depend on the numbers and whether the property qualifies for APR or BPR). If there is tax to pay, then it's payable by the donee of the gift. Yes I really did mean that – it's the donee that pays.

So if Mum gifted say £2million cash to her daughter and if Mum dies say 4 years later, then her daughter could be in for a tidy IHT hit. Mercifully, there is some relief in the form of a taper relief, such that if Mum survives at least 3 years from the date of the gift, then the tax hit will start to taper off (for example a 20% reduction in the tax bill if Mum lives more than 3 years but not more than 4 years).

Let's separate a point of detail out. If Mum were to gift the money to her husband (or civil partner) rather than her daughter, then although that is a gift from one individual to another individual, it is covered by the spousal/CP exemption for IHT in point 1 above. (S18, IHTA 1984).

OK, that's the general rule. Now let's put it into an agricultural setting.

Supposing that instead of £2million in cash, Mum were to gift the family farm worth £2 million to her daughter. If she gifted the farm and she survives 7 years, then just like the cash, the gift will fall outside the scope of IHT and this is independent of any reliefs.

But this may leaving it to chance! And in any event there are reliefs that will help her.

## Agricultural Property Relief

This is where Agricultural Property Relief (APR) begins to come into play. Remember, APR operates in both life and death, but here we are considering only the lifetime aspect. It is a very generous relief and it lets free from the charge to tax many farms in the UK.

The lifetime gift is still a PET but its value has been reduced by the "relevant percentage" (normally 100%, but it can be 50%) APR relief. So if we meet the conditions, the value of the gift has reduced from £2 million to nil.

So what qualifies?

Farmland is land in the UK **occupied** wholly or mainly for the purposes of husbandry such as the production of cereals, milk, dairy products, livestock and their products. For IHT purposes, farmland is extended to include **ancillary** woodlands and any buildings used in connection with the farming business and the occupation of which is of a character appropriate to the farmland. This can include cottages, farm buildings and farmhouses. Farmland is also extended to include stud farms.

Would this relief apply to a person who owned just a block of woodland? In my view, no, because the woodland is not ancillary to the farming. However, it is worth noting that there is a special woodlands relief in S125, IHTA 1984, which does give relief on the transfer of woodland, but only on death. The tax charge is deferred until the disposal of the woodland.

Interestingly, APR is not just limited to land in the UK; it also covers land in the Channel Isles, the Isle of Man and the EEA (that's the EC plus Norway, Liechtenstein and Iceland).

The word "occupied" is interesting. It allows for owners of farms to hand over day-to-day running to another (say through share farming or contract farming), but to still remain in occupation of the land.

The following items also don't qualify for Agricultural Property Relief:

- Farm equipment and machinery such as tractors;
- Derelict buildings;
- Harvested crops;
- Livestock.

These may, however, qualify for BPR (see below).

There is an important ownership qualification. The agricultural property must have been owned by the donor for at least two years if the donor farms the land and 7 years if another person, say a tenant) farms the land (S117, IHTA 1984). There are special rules if the agricultural property has been replaced by other agricultural property in the ownership period (S118, IHTA 1984).

Practical problems inevitably arise and these are often over the difference between the agricultural value of the farm (which does qualify for APR) and the market value of the farm. The size and use of the farmhouse and cottages on the farm can also cause problems.

It is essential to appreciate that APR only relieves agricultural value (which would incidentally include value such as a milk quota); it does not necessarily relieve market value, which is often above agricultural value (perhaps because of supply and demand or development potential). So, if the agricultural value of a farm is say £1.5 million and the market value is say £2 million, then what happens to the £500,000?

Well it will depend on the facts, but it is often the case in farming that Business property Relief (BPR) will cover the difference (covering deadstock, livestock etc.), so the value of the gift may well be reduced to zero. If BPR does not cover the excess, then not all of the gift will qualify for the relief.

## Cottages

If a cottage has a value above its agricultural value because it could be attractive as a second home, for example, that additional value will not attract agricultural relief.

Normally a farm cottage or farmhouse occupied by someone who is not employed in agriculture will not qualify for relief. By concession, a cottage occupied by a retired farm employee or their widow, widower or surviving civil partner is treated as being occupied for agricultural purposes if either

- The occupier is a statutorily protected tenant, or
- The occupation is under a lease granted to the farm employee for his or her life, and that of any surviving spouse or civil partner, as part of the employee's contract of employment by the landlord for agricultural purposes.

The farmhouse can also cause problems. S115, IHTA 1984, specifically says that the relief, "..... also includes such cottages...and farmhouses...as are of a character appropriate to the property".

This means that HMRC are unlikely to entertain a case for a £5million "des-res" house sitting in 5 acres to qualify for APR! If, however, that same house sat in 1,000 acres, then the house is much more likely to qualify.

Is relief available if the gift was shares in an agricultural company?

If the property that was originally given consists of shares in an agricultural company, the relief is still available, but extra conditions apply.

## Diversification

We said above that farmers often diversify. So what effect does this have on our IHT planning? The obvious point to make is that the diversification may take the farm either in part or in whole, outside the scope of APR. We then need to consider whether BPR could come to our rescue.

## Business Property Relief (BPR)

You can claim business relief on (inter alia):

- a business or an interest in a business (such as a partner in a partnership)
- Unquoted shares. This includes shares which are traded in the Unlisted Securities Market (USM shares) or the Alternative Investment Market (AIM shares).
- Land, buildings, plant or machinery owned by a partner or controlling shareholder and used wholly or mainly in the business of the partnership or company immediately before the transfer

So, you can see from this that BPR is a useful first cousin to APR. It is normally available at 100%, but only 50% in some circumstances (S105, IHTA 1984) (notably in the last of the above scenarios). Incidentally, if both APR and BPR are in play over the same business, then APR takes priority.

You only get BPR for trading businesses, not investment businesses, so care would be needed here to correctly identify the activities of the diversification.

## Trusts

So just how useful are trusts when it comes to long range IHT planning?

Some advisers would say that they are very important indeed. So why is this? What does a trust offer our clients?

In my simple head, a trust is just a box into which property can be placed and where the legal ownership of that property passes to the trustees and the beneficial interest passes to the beneficiaries. I don't propose to cover trusts in detail here because I did them in detail in my November 2011 tax blog.

The essential points are however, that putting a farm into a trust can happen in both life and death.

A lifetime gift say into a discretionary trust (so lots of flexibility about income and capital to the beneficiaries) will attract the lifetime rate of 20%, but APR should reduce the value of the gift to zero (assuming you meet the conditions).

As ever, we also need to consider the CGT angles and this would be a disposal for CGT and hence a potential CGT charge for the donor. Fortunately, however, holdover relief is usually available either under S165 TCGA 1992, because the farm is a business asset, or under S260 (where there is an immediate charge to IHT – even if the charge is zero!). There will of course also be CGT issues when the trustees gift the farm to the final beneficiaries, but it is possible that a holdover relief will operate even then.

OK, let's finish by going back to my farm. I said I could choose to gift it either in life or death.

From an IHT perspective, a lifetime gift would be covered by APR, but only on the agricultural value, and BPR may help any excess (either way, as long as I survive at least 7 years from the date of the gift, there will be no IHT liability).

There would be a disposal for CGT purposes, but there is a possibility of holdover relief operating to defer the CGT charge.

If I leave the farm at my death, then there will be no CGT and the APR/BPR combination will probably cover any IHT liability.

So which is best? I think all up that leaving the farm at my death would be better for tax purposes. The reason for this is that if I make a lifetime gift of the farm, then any CGT hit will eventually come out of the freezer, if only on the children when they sell the farm. A death gift, by contrast will be free of CGT - any gain so far will disappear.

But there are also s non-tax considerations that we will have to take into account and our clients will try you out on all sorts of “what ifs”.

In my experience, it often comes down to personal preference as well as the tax. Some people are very bad at passing on the farm in life and hang on to the bitter end and some are better at letting go in life.

For myself, I think I’ll be quite good at letting go and letting my children have the farm, but I need to think carefully about all the tax aspects as well.