Sideways loss relief

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It adds insult to injury when competent farmers who are unable to make a profit due to the volatility and overall decline in global commodity prices in recent years are then unable to reduce the Income Tax payable on other income (perhaps from diversified farming activities) by the offset of their farm trading losses. However, due to some arcane historic tax legislation from 1967, a string of cases have recently come before the Tax Tribunal with loss relief being denied.

Trading losses are in general subject to a number of statutory restrictions on "sideways" loss relief (where the loss reduces the tax payable on other income in the same year), of which the primary restriction is that the trade must be carried on "on a commercial basis and with a view to the realisation of profits".

These restrictions have increased in recent years to include a general cap on tax reliefs at 25% of income or £50,000 if greater[1] and a cap of £25,000 on losses incurred in a non-active capacity.[2] Where sideways loss relief is not available, the loss is carried forward to set against future profits of the same trade.

However, for farmers (and market gardeners) there is a further statutory restriction[3] on sideways loss relief where a loss (before capital allowances) was made in each of the previous five tax years. The calculation of the loss is before capital allowances, which can create losses for otherwise profitable farms, especially in recent years due to large Annual Investment Allowance claims on machinery purchases.

Also importantly for these purposes the losses are calculated on a tax year basis (i.e. 6th April to 5th April), with the results for accounts prepared with different year ends being time apportioned (e.g. the result for a 30th September year end, would be split about equally between the two tax years it straddles).

This can create a situation where there are assessable taxable profits in a year (based upon the results of the accounts ending in that year), but when the results are time apportioned into tax years, losses are made due to the losses in adjacent accounting years.

Hobby farming restriction

The specific restriction for farmers, colloquially known from the statutory description as the "hobby" farming restriction, can potentially be deferred, extending the period for which sideways loss relief can be claimed, if the farmer can satisfy the "reasonable expectation of profit" test now set out in the legislation in s.68(3), Income Tax Act 2007,[4] as follows:

The test is met if:

(a) a competent person carrying on the activities in the current tax year would reasonably expect future profits (see subsection (4)), but

(b) a competent person carrying on the activities at the beginning of the prior period of loss (see subsection (5)) could not reasonably have expected the activities to become profitable until after the end of the current tax year.

In practice, once five consecutive tax years of losses have been made, it is difficult to convince HMRC that the farmer satisfies the legislative requirement that a competent person carrying on the activities almost six tax years ago (the beginning of the prior period of loss) could not reasonably have expected the activities to become profitable until after the end of the current tax year.

Application in practice

In the 2014 case of *French v HMRC*,[5] the farmer was able to successfully argue that relief was available after more than five consecutive tax years of losses, as the Tribunal was persuaded that a competent farmer in 2004 could not reasonably have expected the activities to become profitable until after 2010. The case wording starts with the sympathetic preamble:

> This was an interesting case, dealing with the very considerable difficulties encountered by a life-long farmer, in trying to change his farm from a dairy farm when it became completely uneconomic to continue producing milk, and his struggle to make a profit out of arable farming when his land and the soil were relatively unsuitable for crop production.

The facts involved a farmer who ceased his dairy enterprise in 2001 (cattle sold December 2000), let the farmland to a neighbour on a licence for three or four years and then started an arable enterprise in 2004.

There was some understandable confusion caused to HMRC by the farmer reporting the licence income from 2001 to 2004 as trading income rather than rental income. However, the Tribunal looked at the farmer's prospects on that particular farm once trading restarted in 2004 and decided (with the benefit of hindsight) that profits could not have been anticipated for seven years (after which they did in fact start) and so, on that analysis, the claims for loss relief were not restricted.

From reading the case report, one gains the impression that the farmer was a very good witness, the Tribunal describing him as "not only a competent farmer, but rather that he was almost uniquely qualified". It is interesting to note that there is no explicit reference in the case report to evidence, such as business plans, to support the Tribunal's judgement that in 2004 the farmer did not expect to make profits for seven years.

Unfortunately, since *French v HMRC* in 2014 there have been five unsuccessful cases (*Erridge v HMRC*,[6] *Silvester v HMRC*,[7] *Henderson v HMRC*,[8] *Donaldson v HMRC*[9] and *Scambler v HMRC*[10]) and in each of these cases an

extension to the period of loss relief was denied where there had been no substantive change to the farming enterprises recorded, although there were changes to the manner in which the enterprises were carried on.

In *Silvester v HMRC*, the Tribunal discussed the application of the objective test, concluding that an extension to the period of sideways loss relief was not possible from looking at the reasonable expectation of profit test, as this test has to be satisfied at the beginning of the period of loss. This was the case even though the Tribunal accepted that Mr Silvester was a highly competent sheep farmer who did not farm sheep as a hobby but sought to do so as a profitable, commercial business.

In *Scambler v HMRC* the dairy farmers similarly failed and this case appears to "set the bar" at a very high level of being able to provide evidence to convince a Tribunal that loss relief should not be restricted by the objective "hobby farming" restriction under s.67, Income Tax Act 2007.

Reasonable expectation of profit

When looking at the reasonable expectation of profit test, the farmers argued that the "expectation of profit" must be more than a mere hope of profits and, in these circumstances, no competent farmer would have been able to be sufficiently certain of profits. However, the Tribunal did not consider that an assumption that the milk price was only likely to move downwards over the five years at the beginning of the period of loss (2005) was a reasonable assumption.

The only reasonable assumption was that the price of milk was volatile and could move either up or down over that period. For these reasons the Tribunal agreed with HMRC that a competent farmer carrying on the Scamblers' dairy activities as they were carried on in 2005 would not have had a reasonable expectation that no profit would be made for the next five years.

Also, the Tribunal considered that the legislation did not only deny sideways loss relief to those who were involved in farming with no intention to generate a profit (true hobby farmers) or those who were incompetent (the interpretation of the legislation's purpose suggested in *French*), but also "a category of farmer which was probably not envisaged at all when this legislation was first introduced in 1967; farmers whose profitability is dependent on a global, or at least European, wide market in commodities which significantly influences their business but over which they have no, or very little control".

Another article would be necessary to look at what factors might be influenced by a farmer to help maximise the chance that a farming profit is made for tax purposes (such as when "discretionary" expenditure such as repairs is incurred or reorganising borrowings).

However, with most farmers' profitability dependent on a global market in commodities, and the value of agricultural subsidies generally declining, the restriction of sideways loss relief for competent, rather than hobby, farmers is likely to become an increasing practical problem.

Farmers need to be made aware of this in good time, so as to have time to actively consider ways in which the potential risk of restriction can be minimised.

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1 s.24A, Income Tax Act 2007
2 s.74A, Income Tax Act 2007
3 s.67, Income Tax Act 2007
4 Originally s.44(3), Finance Act 1967
5 TC04053, [2014] UKFTT 940 (TC)
6 TC04294, [2015] UKFTT 0089 (TC)
7 TC04682, [2015] UKFTT 0532 (TC)
8 TC04730, [2015] UKFTT 0584 (TC)
9 TC04779, [2015] UKFTT 0661 (TC)
10 TC04842, [2016] UKFTT 047 (TC)