BUDGET 2020 SUBMISSION

The Rural Business Unit

Simplifying the tax rules for diversified rural businesses

Date: 7th February 2020

Introduction

CLA membership extends to around 30,000 members managing 10 million acres across England and Wales. As well as agriculture and forestry our members operate 250 different types of business located in the rural area. Their businesses are often at the foundation of the local economy in providing homes, jobs and services to their local communities. They are multi-generational businesses and take a long-term view in business and environmental planning, extending beyond a single generation.

It is the CLA's long-established view that there should be one set of coherent tax rules to be applied to all business activities that may be undertaken by entrepreneurial farmers and land managers which are managed as one economic activity, in effect a single business unit (which we call the Rural Business Unit or RBU, for short). Enabling all economic activities to be operated as a single taxable unit will remove the fiscal impediments to the development of new rural business opportunities by empowering rural entrepreneurs to make their own decisions.

Background

Farming and land use has changed over the years with greater emphasis now placed upon the delivery of environmental objectives and, in the future, climate change mitigation and carbon sequestration will feature. According to the Defra Evidence Compendium, 66% of farm businesses in England in 2017/18 included some form of diversified activity, generating around £680m additional profit (£18,700 average per farm). For those farms with a diversified activity, their income from that activity accounted for 28% of their profit in 2017/18 and 22% of farmers total income was derived from some form of diversified enterprise. **With the UK exit from the European Union, and the consequent changes in agriculture policy, there is a need for farming businesses to adapt, increase productivity, seek new markets, change land use and diversify to add additional income streams to support the farming operations and continue to make a fundamental contribution to a thriving rural economy that makes its proper contribution to the Exchequer.**

The wider economy of rural areas – including tourism - depends upon continued stewardship of the countryside that cannot be provided by traditional agricultural businesses unless those businesses are both profitable and can deliver the future environmental management of the countryside for the public good.

Proposal for taxing diversified rural businesses

- **A business that undertakes agricultural, environmental, forestry and/or heritage activities with other interdependent commercial activities can elect to be taxed as a single business entity (the Rural Business Unit)**
- **To qualify to make the election, the business needs to meet the qualification tests: activities (agricultural, environmental, forestry and/or heritage); management; size and income.**
- **The effect of the election is that every commercial economic activity is treated for tax as a single business unit and that business is a trading business for tax purposes.**

Our proposal is designed to ensure the Rural Business Unit provides flexibility for land based businesses to embrace not only all those commercial activities traditionally associated with agriculture or heritage but also new commercial and environmental activities that are constantly being integrated to provide further sources of income, employment and to increase biodiversity and mitigate climate change. In order to protect against possible abuse, however, we have proposed that certain qualifying tests should be applied with the object of ensuring that only those activities that are truly integrated and which create a self-supporting entity are eligible for inclusion within the Rural Business Unit.

We believe that our proposals will allow greater freedom of investment within rural businesses leading to productivity growth and more tax paid to the Exchequer, more income available for environmental protection and conservation, and more jobs. **The administration of our proposed system would be a simplification, saving time, both for HM Revenue and Customs and for rural businesses.** Over the long term, we would expect this proposal to be at least cost-neutral.

I commend it to Government for their consideration.

Mark Bridgeman

Mark Bridgeman
President

BUSINESS, ENVIRONMENTAL AND FISCAL CHALLENGES

Business challenges

Over the last 30 years the profitability of agriculture has been in sharp decline. Nevertheless, primary agricultural production remains the major use of land in rural areas, employing over 500,000 people and contributing around 1% of the UK's GVA. It also supports a food industry worth over £120bn GVA per year and a vast array of ancillary industries which supply goods and services.[1]

In England, rural businesses generate £246bn GVA per year, around 16% of total UK GVA[2]. It has been estimated that there is a potential to increase this to £289bn GVA if productivity rates in rural areas catch up to match the national productivity average. The farmed landscape forms the backbone of rural areas but the rural economy encompasses a wide range of activities. For example, the rural tourism sector is a significant economic contributor, among land businesses, that generates some £19bn per year and employs some 350,000 people. Data from Historic Houses shows that their member properties welcome 26 million visits each year, generating £1bn of tourism income.

The Government has committed to keeping funding for agriculture at the same level until the end of the current Parliament, which is welcome. However, the new domestic agriculture policy that will see the removal of direct payments over a 7 year transition period from 2021, and introduction of a new Environmental Land Management System from 2024, will result in significant changes for the industry and individual businesses. These businesses will need to adapt to change.

Post Brexit, the new agriculture policy enabled by **the Agriculture Bill is likely to result in restructuring of the agriculture sector and may lead to increased diversification of business interests, including environmental land management and forestry.** There is a natural evolution of restructuring in the sector with a reduction in farming numbers of around 1% - 3% per annum, leading to greater economies of scale. The proposed policy is likely to speed up this restructuring, and government's intention to allow de-linking of payments in the Agriculture Bill may provide greater incentives for the agriculture sector to diversify.

UK farming and forestry costs of production are higher than many other parts of the world, due in part to labour costs, but also scale of production, high standards and regulatory compliance in environmental protection, animal welfare and food safety. While the post-Brexit trade deals will influence our competitive position, it is likely that the UK will struggle to compete at world market prices without major productivity gains. Both these factors will impact on farm profitability, making diversification to support the farming enterprise essential.

Rural businesses may conduct many interdependent commercial activities as part of their over-arching business strategy on their land, such as rental accommodation, tourism ventures or renewable energy, in addition to farming. These commercial activities are invariably arranged to complement each other, with the overall object of preserving a viable long-term business that seeks to balance environmental objectives with the economic well-being of the countryside and the provision of employment opportunities for local communities.

[1] Statistical Digest of Rural England, 2019
[2] Statistical Digest of Rural England, 2019

Climate change and environmental challenges

The post Brexit structural changes come alongside new public expectations about what the countryside is for. While sustainable food production remains at its core, there will be more focus on environmental delivery and the wellbeing benefits from living in and visiting rural areas.

The Agriculture Bill that has been introduced into the House of Commons includes provisions to provide for a contractual mechanism for the delivery of public goods, such as wildlife and habitat, clean water and air, climate change mitigation, landscape and heritage etc. This could result in more land being used to deliver environmental benefits or other public goods rather than be used to support the farming or other commercial enterprises. We expect this move to be underpinned by the targets flowing from the Environment Bill and the 25 Year Environment Plan in England, and the Environment Act in Wales, and the new legal commitments to net-zero greenhouse gas emissions (GHGs) targets in both England and Wales by 2050. The policy recommendations made by the Committee on Climate change in their most recent report[3] mean that we expect a continued focus on reducing GHGs from agriculture alongside changes in land use to sequester carbon through restoring peatland and growing trees, and for these to be a feature of future agriculture and land use policy. Many actions that reduce the carbon footprint also improve business efficiency.

Development of markets for public goods through, for example the proposed Environmental Land Management Scheme, or through private markets for carbon or biodiversity offsetting, could provide alternative long-term secure incomes.

A landowner with varied sources of income from their land management/business activities is better placed to take a long-term view. The landowner is thus able to consider the amenity and environmental perspectives, and is more likely to be in a position to sacrifice short-term gain for that longer-term amenity. This sacrifice may take many forms, from accepting lower rents from tenants in return for obligations to farm less intensively, to capital investment in tree planting, to full re-wilding.

Challenges in the current taxation system

Land-based rural businesses have some distinctive features. **These rural businesses are far more likely to be small businesses run by unincorporated traders and partnerships**. They hold assets long term. Another common feature of these rural businesses is an economic and commercial unification of a variety of business activities. Despite this, the UK tax regime has long sought to impose artificial boundaries and restrictions to these businesses being taxed as one entity. This introduces a costly and time-consuming administrative burden and one that can be disproportionate to the tax payable.

The current definitions of agriculture in tax legislation, and the lack of consistency in the definitions between the different taxes, do not reflect modern farming practices and outputs. While food is a primary function of farming, other profitable land use activities includes livestock feed, energy generation, materials (for building, clothing etc), pharmaceuticals and public goods such as habitat and landscape. This should be reflected in a modern definition, which we have included in our qualifying tests below.

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[3] Land use: Policies for a Net Zero UK: https://www.theccc.org.uk/publication/land-use-policies-for-a-net-zero-uk/

The changes in land management and attendant investments needed to deliver Government objectives such as climate change mitigation, enhanced environmental benefits and increased biodiversity, alongside increased long-term productivity of rural businesses, will benefit society as a whole. However, such changes will expose landowners who undertake diversification or environmental/public goods schemes to increased administration and unintended tax consequences. As such the **current tax rules operate as a disincentive to diversification or undertaking environmental activities**.

The distinction between land-based businesses and other trades results in fiscal disadvantages for businesses who are setting out to become more resilient through diversification. In our view, there is room for an alternative basis of taxation which is attuned to the economic facts of a rural landowner's business. In most diversified farms the activities are interconnected, interlaced and interdependent.

Income tax issues

Complications in reporting for income tax

The income tax acts distinguish between the profits of a trade, profession or vocation and the profits of a UK property business. All income received from the ‘business’ of letting property is assessed to income tax under Part 3 Chapters 1 -12 ITTOIA 2005. Tax is charged on the annual profits arising from a business carried on for the exploitation, as a source of rents or other receipts, of any estate, interest or rights in or over land in the United Kingdom[4].

Section 10 ITTOIA provides that the commercial occupation of land is treated for income tax purposes as the carrying on of a trade or part of a trade if it is managed on a commercial basis and with a view to the realisation of profits. However, farming is specifically excluded from this which means that it has to be reported separately. The Salisbury House[5] case confirmed that income from property can be assessed as a trade. Where it can be assessed either as income from a trade or income from property, the replication of the primacy rules as to how income is to be treated in section 4 of ITTOIA means that the income has to be reported separately and assessed as property income.

When accounts are produced for a diversified business, they provide data which is useful management information but when they are amended to reflect the need to make multiple tax reports they become less useful for business owners.

For example, A manages a farm and runs a B&B. The use of some poor-quality agricultural land is changed into a campsite and A also runs a 4x4 experience on some boggy land. A also has an Anaerobic Digester plant using products of cows, crops etc. which produces renewable energy used on the farm but also exported to the grid. A’s costs are fixed and all the new activities add cash to the business. But A needs to apportion the time they and their staff spend between all the activities for tax purposes. This can make an element of the business appear to be loss-making and uncommercial once a share of fixed costs has been deducted despite the fact that when the whole business is viewed in the round in the management accounts it makes a positive income contribution to the overall financial health of the business. The instinctive response of HMRC inspectors to such diversified

[4] Section 266 ITTOIA 2005
[5] *Fry (Inspector of Taxes) v Salisbury House Estate Ltd* [1930] AC 432, [1930] All ER Rep 538

businesses has been to say that every activity is a separate trade and HMRC has been known to disallow a trading loss from the apparently uncommercial element.

Sideways loss relief

The issue of what constitutes a trade and whether some of these activities can be combined into a single trading business have become more important with the restrictions on sideways loss relief. The effect of these is that the losses from one activity cannot be set off even if the overall business made a profit. The effect is felt particularly keenly by some, where a heritage building (house or feature) that is of architectural and historic importance to the rural landscape may be open to the public but is financially unsustainable (due to expenditure on repairs, maintenance and insurance) without the support of ancillary agricultural or commercial income from other parts of the estate.

Pension contributions relief from income tax

Pensionable earnings are the relevant UK earnings on which a 'relevant UK individual' may claim tax relief. This includes not only income from employment but also income chargeable to tax as trading income under Part II of ITTOIA 2005.[6] Income from non-trading activities, such as residential and commercial let property, are not pensionable earnings for these purposes. This means that the tax relief is not available if pension contributions derive from these non-pensionable earnings, thereby constraining the incentive to invest sufficiently into a pension fund.

Income from other activities, such as environmental schemes (currently Countryside Stewardship or Higher Level Stewardship) if not undertaken as part of an existing farming business will also not qualify as relevant earnings, so there is no tax relief on any pension contributions from that income. So, if a farmer decides to cease their farming trade and enter into an environmental scheme (e.g. an environmental land management contract with government when the scheme commences in 2024) so that their main source of income is from that scheme, there is no tax incentive to make contributions to a personal pension. The rationale for the continued application of this distinction is not clear when the Government has a wider policy objective to encourage taxpayers to save for their old age, in addition to the environmental policy objectives discussed above.

Making tax digital for income tax

The forthcoming introduction of Making Tax Digital for income tax[7] will impact on unincorporated rural businesses. It has become apparent that whilst there is a requirement to provide information on income and expenditure to HMRC 4 times a year, with a formal return submitted digitally after the year end, this will have to be done for each business activity. This could mean that a diversified business with farming income and income from a campsite, a 4x4 experience and from exporting electricity to the grid from an Anaerobic Digester will have to submit 17 returns a year. This is incredibly burdensome for an SME, particularly if there is a lack of clarity around how to apportion business costs between different aspects of the business. Business overheads are typically shared across these multiple different activities and not separated out in the business management accounts. The processes that businesses will need to adopt to be compliant with making tax digital for income tax will be time consuming, impact on business efficiency and productivity. SME

[6] Section 189(2)-(7) Finance Act 2004

[7] At the Spring Statement in 2019 the Government confirmed that it remains committed to the Making Tax Digital programme, and that the introduction of MTD for VAT was "an important first step in this modernisation of the tax system".

business owners are likely to need to pay for support from their accountants to assist them to comply with their reporting obligations, thus increasing their business costs.

A view from an accountant

An accountant piloted a few capable clients on a spreadsheet that in addition to inputting the VAT, required the client to select capital/revenue and to classify the transactions. Not one client performed this cost effectively: in all cases the accountant had to make many corrections. Whilst spreadsheets can be used effectively for VAT, they cannot for Income Tax – appropriate accounting software has to be used.

The accountant then undertook a pilot of a small sample of clients on full accounting software (Sage and QuickBooks) rather than spreadsheets to get a feel of the cost/difficulty levels that would be experienced with Making Tax Digital (MTD) for Income Tax. As with spreadsheets, not one client has been able to input data correctly, even when they are using QuickBooks bank feeds and rules. The cost of reviewing/correcting the data input was more than if the accountants input of the data themselves.

The cost for the accountant undertaking the bookkeeping role and inputting the data from scratch was a minimum of £95 per month up to £250 per month – so £1140 to £3000 pa, an average of £2070. This enabled the accountant to account for transactions sufficiently for VAT but it was not the end of the story for Income Tax. For example, there were no accruals, prepayments, stock etc. The extra accounting adjustments would add on an extra £250 per partner to deal with the additional Income Tax MTD requirements. Most of the accountant's farming clients are partnerships so that's at least an extra £500 on top of the £2070 so the average additional costs for a business would be **£2570 per annum**.

Capital gains tax

The owner of a diversified rural business is also disadvantaged by the absence of capital gains tax (CGT) reliefs if business assets are disposed of which are not used for the purposes of a trade. In particular, rollover relief cannot be claimed when land that has been let on a farming tenancy is sold, except in the very special circumstance where it is compulsorily purchased. Even then, this relief cannot be claimed if the proceeds of sale following the compulsory purchase are reinvested in new agricultural buildings on any remaining let farms, even though the modern agricultural buildings would help to improve the tenant's productivity or replace a building lost when the land upon which it stood was compulsorily purchased.

In our view the capital gains tax rules add yet another set of barriers which prevent the optimal deployment of rural capital to meet environmental delivery and profit objectives.

Inheritance tax

Within inheritance tax too, curious rules exist that may increase the tax burden for landowners where diversification takes place into non-agricultural activities, whether by the landowner themselves or by a farm tenant. Furthermore, a danger exists that where land is managed predominantly to meet the governments public goods objectives, such as environmental concerns (biodiversity, tree planting, carbon sequestration, etc) or social objectives, those valuable inheritance tax reliefs are completely lost leading to an inheritance charge that may adversely impact on the ongoing viability of the business as a whole and the environmental or other public benefits it delivers.

THE RURAL BUSINESS UNIT (RBU)

Alleviating business and fiscal challenges through a 'Rural Business Unit'

There is a whole range of activities undertaken by land owners as rural businesses, both commercial and required by legislation, which are interdependent and which together comprise self-supporting entities. This will become more common under the new domestic agricultural policy. **Land owners normally regard all activities as integral parts of one business unit** that involves a substantial degree of personal involvement and financial risk in its management on the part of the owner despite the fact that the current taxation regime rigidly compartmentalises many of the various sources of income which are, in reality, economically interdependent. In this activity they do not, in our view, differ materially from the proprietor of a group of companies with diverse business interests which are managed as a whole with a single profit-making objective.

To meet the challenges facing diversified rural businesses, a simplified taxation regime would provide the fiscal certainty and confidence they need to invest to meet the environmental, climate and productivity challenges ahead. Our solution will assist by giving rural businesses flexibility of response to the changing economic environment.

We propose that there should be a new approach to the taxation of diversified rural land-based businesses. We have called this the Rural Business Unit (RBU). The essence of our proposal is that a qualifying business may elect for all elements of that business to be treated as a single business entity, the RBU, for all tax purposes. This would mean that all the economic activity undertaken by that one business entity would be treated for tax purposes as a trade. This would apply to any diversified rural business regardless of whether the land and assets utilised by the business are owned or rented.

There would be rules to ascertain which businesses can qualify as an RBU to prevent the exploitation of the new system by those that only carry on non-commercial, investment or personal activities.

If the business chooses to be treated as **an RBU**, that business **would be able to undertake a single computation for income tax purposes** (in a similar way as a VAT registered business would do for VAT reporting) that looks at all the income generated by the various activities, deducts all the expenses incurred without the need to apportion them between different types of activity to arrive at the taxable profit figure. CGT reliefs currently applicable only to trading businesses would be available on the disposal of assets used within the RBU and the RBU would be a trading business for inheritance tax purposes.

The move in recent years to align the taxation of businesses more closely with accountancy principles further supports the removal of fiscal distinctions between trades and businesses. These principles focus, quite rightly, on the more relevant distinction between capital and revenue rather than on divisions within each category. Such a move was also recommended by the Office of Tax Simplification who recommended 'schedular reform' to deliver a reduction in administrative burden to business so that the accounts and tax figures for a business are brought closer together. This would mean for "companies with different sources of income, bringing these together into one business profit or loss for tax purposes, with losses fully pooled" [8]. Whilst the report was focused on corporation tax computations,

[8] Simplification of the corporation tax computation (July 2017), page 8 and chapter 2. Follows on from Recommendation 2 in Review of the competitiveness of the UK Tax administration: final report (October 2014);

the OTS recognised in the executive summary to the report that the recommendations could also apply to the taxation of unincorporated businesses.

The underlying principle of a single economic activity

The underlying principle of our scheme is that modern rural business owners will typically use their property in several different ways beyond the mere passive holding of land and buildings to produce rent, together with undertaking agricultural, environmental, forestry and heritage activities. As we have set out above, such business owners will normally arrange for its activities to complement each other, with the overall object of preserving the whole as a single viable unit.

The Sixth Directive - an analogy

The rationale of the EC Sixth Directive in relation to taxes on turnover presents a distinct contrast to the UK's system of taxing income[9] – that rationale is, of course, already reflected in UK tax law relating to VAT. The Sixth Directive is aimed at catching the fruits of the "economic activities" of "taxable persons". Those activities comprise "all activities of producers, traders and persons supplying services...". The Directive goes on to say that "*the exploitation of tangible or intangible property for the purpose of obtaining income there from on a continuing basis shall also be considered an economic activity*" (Sixth Directive, Title IV, Article 4.2, emphasis added).

We find this a helpful analogy for the RBU, because it aptly describes what a landowner/land manager is attempting to do in managing their diversified business, and focuses on the economic purpose of the activities rather than (as does the UK tax system) the legal nature of the rights which are exploited, or the classic distinction between a trade and an investment business.

Defining the scope of the rural business unit (RBU)

In accordance with the general philosophy of this paper we believe that **the aim of the RBU should be to promote the economic well-being of the rural economy to the general public benefit.**

At the heart of a rural business are the activities undertaken by that business that comprise the deriving of income from undertaking agricultural, environmental, forestry or heritage activities on the land - either alone or with others. We believe that the starting point should be to look at the type of economic activity carried on. Thus, it would be possible for a rural business owner to include within the same RBU all economic activities related to the land/farm such as:

- an in-hand farm which is owned and farmed personally (either alone or in partnership);
- land included within environmental schemes (whether publicly or privately funded);
- forestry, timber production, amenity woodland, woodland for carbon sequestration
- a tenanted farm from which the owner receives rent (this land may also be included in environmental projects undertaken by the landowner across the whole of his land holding);

[9] Whilst the historic schedular system has been abolished the concepts remain.

- a farm contracting business;
- farm-based industries, including the manufacture of craft items, food processing and purification, processing of timber, and repair of farm machinery;
- farm shops;
- direct sales of fruit and vegetables, including "Pick your own" sales;
- provision of food, drink and accommodation, such as a farm café, B & B or holiday let; provision of educational facilities connected with farming, environmental protection and the countryside;
- provision of a tourist attraction, such as a historic house and garden that is open to the public on a regular basis;
- provision of facilities for sport and recreation, including amenity woodland;
- provision of premises and facilities from which others generate economic activity or the provision of local housing, including affordable housing.

Under our approach, an RBU could comprise several physically distinct areas of land, so long as all the land was in the UK and the business met the relevant tests. This reflects the current approach in legislation for all farming in the UK by any person to be treated as the same farming business[10].

The rural business purpose test

We propose that the rural business test should follow the example of recent tax legislation that is drafted following Tax Law Rewrite principles and set out a purpose test, a broad statement of the purpose or activity which "qualifies" to be taxed as a rural business unit, followed by a list of specific exclusions.

We believe that some kind of advance clearance procedure would be essential, for the protection both of taxpayers and the Exchequer, especially in the context of optional arrangements. With such a procedure in place, it ought to be possible for legislation to set out broad parameters rather than exhaustive lists or what activities are included.

We have identified three types of activity which we believe should always be excluded from the scope of an RBU.

1. First, we suggest that activities conducted on land outside the UK should in all cases be excluded.
2. We suggest that activities that are not a considered to be business should in all cases be excluded. Without such exclusion, non-commercial activities could be placed inside an RBU merely to allow the landowner to obtain tax relief for related expenses. If a broad definition on the lines of the Sixth Directive were adopted for the RBU, this could amount to a test which business would have to pass at outset before it could make the election.
3. We would expect the letting of property assets not on the land holding to be excluded from the RBU. This would include, for example, a large-scale industrial development, or office or retail development, or residential rental properties elsewhere.

Rural Business Unit qualifying tests

We have already stated that a modern rural land-based business will typically utilise the property in many ways to generate business income, that supports the profitability of the

[10] Section 9(2) and (2) ITTOIA 2005 and *Bispham v Eardiston Farming Co (1919) Ltd* (1962) 40 TC 322

over-arching business. The RBU should provide a vehicle sufficiently flexible so that it enables rural businesses to develop and diversify to deliver environmental benefits or other public goods and increase their productivity and profitability for the future whilst ensuring that it is not abused. We therefore propose that a rural business may only elect to be treated as an RBU if it meets each of the following tests:

- an agricultural, environmental, forestry and/or heritage test
- a management test;
- a "size" test;
- an income test.

The agricultural, environmental, forestry and/or heritage test

The rural business must undertake agricultural, environmental, forestry and/or heritage activities on land it occupies. For these purposes:

"agricultural" means
(i) the cultivation of any crop to produce food for human and animal consumption, energy production, pharmaceuticals/industrial use;
(ii) horticulture, fruit growing (including for cider, wine and other beverages) and market gardens;
(iii) dairy farming and livestock breeding and keeping, including any creature kept for the production of food, wool, skins.
(iv) the use of land as grazing land, meadow land, osier land and nursery grounds; and
(v) the use of land for woodlands where that use is ancillary to the farming of land for other agricultural purposes.

"environmental" means managing land or water in a way that protects or improves the environment; maintains, restores or enhances cultural or natural heritage; mitigates or adapts to climate change; prevents, reduces or protects from environmental hazards; protects or improves the quality of soil, whether under any land or environmental management contracts (public or private) or self-funded.

"forestry" means managing land comprising a forest or woodland, for commercial use (including the production of timber), environmental (including carbon sequestration) or public (including recreational, health and well-being) use.

"heritage" means buildings of historic or architectural interest (usually statutorily listed) exploited on a commercial basis which offers the public the opportunity to make use of, stay in or otherwise enjoy the historic building for a minimum of 28 days per year.

The management test

A rural business with agricultural, environmental, forestry or heritage activities must operate all commercial activities as a fully integrated, single composite business. This reflects the established principles from the *Farmer*[11] *and Balfour*[12] cases.

[11] *Farmer v IRC* [1999] STC (SCD) 321
[12] *Brander (representative of James (dec'd), Fourth Earl of Balfour) v Revenue and Customs Comrs* [2009] SFTD 374

The size test

A rural business must occupy a minimum of 5 hectares of land for agricultural, environmental, forestry or heritage purposes as part of the composite rural business. Using the term occupy will enable any rural business (such as tenant farmers) to apply for RBU status and diversify for improved productivity and profitability, regardless of whether they own, let or a combination of both, the land used for this purpose.

The income test

A rural business will only qualify as an RBU if the business turnover from the agricultural, environmental, forestry or heritage activities exceeds a minimum threshold.

The election and duration of the RBU

The RBU should not be compulsory for all diversified businesses but a choice each business makes to reflect their circumstances, in the same way as a shipping company may choose whether to elect to participate in the tonnage tax regime.

Where the economic activities of the rural business are carried on in partnership or by joint owners of undivided interests, all the partners or joint owners would need to make the election for the business to be treated as an RBU.

There would be good practical arguments for including provisions as to the duration of the RBU once an election has been made as it would add administrative complexity for both the business and HMRC if the election had to made on an annual basis or if the business could change its mind year by year. It is also impractical to make the election irrevocable. We suggest, therefore, that the election should be revocable only after a minimum period of six years' operation by the same landowner (compare the treatment of maintenance funds here). After this initial period of six years, if the election is revoked, the business can opt back in again at a later date, at which point the minimum six-year period commences again.

THE TAX TREATMENT OF THE RURAL BUSINESS UNIT

Income tax

An election would mean that the RBU business should consist of every business which the RBU carries on for generating income as a single trade. Its profits will be calculated as trading receipts under Part 2 of ITTOIA and in accordance with the generally accepted accounting practice[13]. Thus, a single trade concept will mean that the profits and losses from each business activity are aggregated into one single taxable amount.

If an expense is not incurred wholly and exclusively for the purposes of the RBU, then only any identifiable part or proportion of that expense which is incurred wholly and exclusively for the purposes of the business is deductible in calculating the taxable profits, in accordance with the current rules in section 24(2) ITTOIA 2005. Consequently, no new rules will be needed to exclude expenses relating to the landowner's private use of the assets.

Losses from a UK property business are usually carried forward and cannot normally be set off against other income. However, because an RBU is treated as a single trade, any losses arising from it should therefore be regarded as trade losses for income tax purposes. It therefore follows that the RBU losses can be relieved against general income[14] and then carried forward.

Given that the RBU will be subject to a series of stringent tests (see above), it would not be necessary to retain the current hobby farming restriction or sideway loss relief[15]. The removal of hobby farming restriction should not cause any abuse as the RBU will still be subject to the same statutory commerciality tests as other businesses[16].

Currently, farmers can make averaging claim to reduce the fluctuation of their trading profits from one year to the next. As the main objective of the RBU is to allow the landowner to diversify their activities which supports them with a sustainable and steady income, farmers' averaging rules would not apply to the RBU.

We believe that the resultant simplification could lead to administrative savings for HMRC and cost savings for the taxpayers. This measure could also make it simpler to bring forward Making Tax Digital for income tax as they would more closely resemble VAT reporting where multiple trades are reported together under the same VAT registration.

Capital gains tax

As an election for the business to become an RBU means that the business is treated a trading business, capital gains tax (CGT) rollover relief, gifts holdover relief and entrepreneurs' relief will be available on the disposal of the business or the business assets, subject to the qualifying conditions for the reliefs.

[13] Sections 25 and 26, ITTOIA 2005
[14] Under sections 64-65 of the ITA 2007
[15] Section 67 ITA 2007
[16] Under sections 66 and 74 ITA 2007

To prevent potential abuse by electing immediately prior to a disposal, we suggest that there should be a qualifying period of 2 years after the RBU election before the RBU can claim CGT reliefs.

Inheritance tax

The combination of the existing agricultural property relief (APR) from inheritance tax (IHT) and the ability to pay IHT by annual interest free instalments over 10 years means that the burden of this tax is no longer as great as it once was. Nevertheless, it does in some cases still present landowners with a problem which can only be resolved by selling business assets, an action which can have negative consequences for the delivery of long-term environmental/carbon sequestration projects or business productivity, or even the ongoing viability of the business. The following suggestions are therefore put forward on the basis that the scheme of IHT whilst remaining broadly unchanged should be modified with a view to bringing it into line with the general philosophy of this paper.

We propose that the logical extension of the RBU concept is that business property relief (BPR) at 100% should apply to all property within the RBU. This would override any exclusion which might operate on the grounds that the "business" consisted wholly or mainly of holding investments.

It is accepted that as an anti-avoidance measure a minimum period of ownership of the property contained in the RBU should be required in order to qualify for BPR.

Currently, claiming BPR is subject to a minimum period of ownership of 2 years before being available to claim (section 106 IHTA 1984). It is proposed that a similar regime is followed with the classification of assets within an RBU for BPR purposes subject to a minimum ownership period.

Therefore, an application by a new owner who has either purchased or inherited property that qualifies under the RBU regime, will only qualify for treatment of the assets within an RBU for BPR after a minimum of 2 years' ownership.

However, where an enterprise would qualify for BPR already, then, on conversion to an RBU, that qualification would still automatically apply. This is similar to the provisions in section 107 IHTA 1984 regarding replacement assets.

Additionally, where a spouse or civil partner inherits or is gifted an RBU, then the spouse or civil partner shall also be deemed to have owned it for any period during which the spouse or civil partner owned it (section 108 IHTA 1984).

Example 1 – new ownership

Mrs Smith purchases Hollyhock Farm on 19 December 2021, she elects for Hollyhock Farm to be treated as an RBU on 20 December 2021. Although Hollyhock Farm qualifies as an RBU, the assets within it will not attract BPR until 20 December 2023 at the earliest. If Mrs Smith were to die before 20 December 2023, BPR would not be available to set against the value of the assets in the RBU.

Example 2 – converting to an RBU

Mr Jones owned a diversified rural business from 1996 when he inherited Old House Farm from his father. Old House Farm was wholly or mainly trading and would qualify for BPR. In March 2022 Mr Jones applied for RBU status, which was granted. As he had owned Old House Farm as a wholly or mainly trading business for more than 2 years prior to it becoming an RBU, BPR automatically continues and he does not have a qualifying period when changing from a non-RBU to an RBU.

Example 3 – inheriting an RBU from a spouse/civil partner

Mr Wallace owned a farming enterprise from 2001 to 2021 and converted it to an RBU in 2022. Mr Wallace died in July 2025 and left it to his husband Mr Henderson. Mr Henderson died in August 2026 and left the RBU to his and Mr Wallace's son. BPR is available on Mr Henderson's death even though he did not survive his husband for more than 2 years because spouses are able to carry over the qualifying period of ownership.

Example 4 – inheriting from someone other than a spouse/civil partner

Mrs Chan inherited an RBU from her uncle in November 2026. Her uncle had owned the RBU for more than 2 years and so BPR applies. Mrs Chan died in January 2028 leaving the RBU to her daughter. The RBU will not qualify for BPR as Mrs Chan did not own the RBU for 2 years + and cannot benefit from her uncle's period of ownership as she is a niece of the deceased and not a spouse or civil partner.

Pension contributions relief from income tax

To encourage more farmers and landowners to save for retirement, the definition of relevant earnings for tax relief on pension contributions in section 189 of the Finance Act 2004 should be amended, for the avoidance of doubt, to include profits from an RBU. For those farmers that have not diversified[17] section 189 should also be amended to ensure income from entering into contractual arrangements for the delivery of public goods through, for example the proposed Environmental Land Management Scheme, or through private markets for carbon or biodiversity offsetting should also qualify as relevant earnings.

[17] The Defra Evidence Compendium (Sept 2019) suggests that 34% of farmers have no diversified activity