TC04294

Appeal number: TC/2014/02198

Income Tax – Loss relief for farming losses – Correct application of sections 67 and 68 Income Tax Act 2007 – Appeal refused.

FIRST-TIER TRIBUNAL
TAX CHAMBER

NEIL ERRIDGE **Appellant**

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS **Respondents**

TRIBUNAL: JUDGE ANNE SCOTT, LLB, NP
MR PETER R SHEPPHARD, FCIS, FCIB, CTA

Sitting in public at Baron Taylor Street, Inverness on Tuesday 9 December 2014

The Appellant attended in person

Matthew Mason, Officer of HMRC, for the Respondents

Decision

1. The Tribunal decided that the appeal is dismissed, the Closure Notice is upheld and therefore the restriction for loss relief against other general income is applied.

Introduction

2. Although HMRC stated in their revised Skeleton Argument that this is an appeal against an assessment issued on 15 August 2013, it is in fact in respect of a decision contained in a letter on that date. That was a Closure Notice in terms of section 28A(1) and (2) Taxes Management Act 1970 ("TMA") in respect of the appellant's self assessment for the tax year 2010-11. The self assessment was amended in line with that decision and HMRC disallowed sideways relief of the appellant's share of the partnership's farming losses. That gave rise to an additional tax liability of £64,182.93.

3. HMRC did not challenge the quantification of the losses and agree that they remain available to be carried forward in accordance with other legislative provisions. The only issue before the Tribunal was whether or not those losses could be relieved against the appellant's other income ("sideways relief").

4. The appellant was unrepresented, not least since his previous agents had agreed with HMRC that the losses were not allowable and had been claimed by them in error since they had been unaware of the five years of losses. The appellant fundamentally disagreed with them.

5. We explained that unrepresented appellants regularly appeared before the Tribunal and that we would assist him. Mr Mason also very helpfully offered explanations, where it was appropriate so to do.

6. The facts were not in dispute.

The Facts

7. The appellant works full time as a dentist in Wick.

8. Mr and Mrs Erridge commenced farming in partnership in 1982 when they borrowed the funds and bought their first farm. In 2002, they bought the neighbouring farm, Spittal Mains. That acquisition was funded entirely by bank borrowings. For the tax year, 2004-05, the farming business produced a profit before capital allowances of £2,977. In every tax year thereafter until 2012/13 the farming business has generated a loss before capital allowances.

9. In 2006, with the assistance of the bank and the sale of some properties, they purchased Milton of Banniskirk for £362,000. In 2007, they purchased a large farm bordering their farm. The rationale for the purchase was to obtain a further 166 acres of land contiguous with their own and an increase in subsidy payments of £40,000 at virtually no net cost. It was intended to repay the borrowings as quickly as possible giving them greater scope and increased income thereby increasing the profitability of the farm.

10. The purchase of Dale Farm was again funded by a bank loan of £2 million. The intention, from the outset, had been to sell part of that farm, extending to 1008 acres, to obtain planning permission for three fields and then sell plots for housing. It was also intended to sell some machinery. The anticipated sale proceeds amounted to £2,075,000. That was the basis of the proposal to the bank at the time. The projections indicated a timescale for the sales of six months.

11. The appellant articulated to the bank his expectation of profits stemming from increased stocking capacity and increased Single Farm Payments.

12. The banking crisis in 2008 impacted on the housing market so the planned plot sales were not feasible. The bank insisted on the farming debt being restructured on term loans at a higher rate of interest. The appellant was led to believe that there would be no penalties for early repayment of the loans.

13. A buyer for the land was found but to the appellant's horror it then transpired that early repayment would trigger what was then a £300,000 breakage fee since the loan had an embedded interest rate hedging product ("IRHP") or interest rate swap arrangement ("IRSA"). The sale was abandoned.

14. In 2010, the appellant commissioned a farm review from the Scottish Agricultural College ("SAC") with the objective of returning the business to profitability and reducing the debt burden. The other primary objective was to ensure that the management structure and farm strategy were aligned with the cost infrastructure. The conclusion of that review was that this was a business that had grown in scale at a remarkable rate, but the infrastructure had failed to evolve in line with business growth.

15. The recommendations included therein were implemented immediately. That included reducing costs, selling assets, diversifying and letting out part of the redundant steading. The impact thereof was that the business could then afford the breakage fee (then estimated at £240,000) and refinance to more affordable finance.

16. The management accounts for the six months to 30 September 2013 showed an expected profit of £69,238.

The Legislation

17. Three provisions restrict the sideways relief for trading losses, namely sections 66, 67 and 68 Income Tax Act 2007 ("ITA"). Section 66 applies to losses in any type of trade and it precludes the additional reliefs if the trade is not conducted on a commercial basis with a view to realisation of profits. That was not an issue in this appeal since HMRC willingly conceded that the appellant did farm commercially with a reasonable expectation of profit.

18. In summary, section 67 ITA restricts relief in the case of farming and market gardening trades and provides that, subject to various exceptions, sideways relief will not be available if there have been losses, before capital allowances, in the previous five tax years. As far as this appeal is concerned, the relevant exception is to be found at section 67(3)(b) which reads:-

> "the farming or market gardening activities meet the reasonable expectation of profit test (see section 68),"

19. That test is to be found at sections 68(3), (4) and (5) which read:-

"(3) 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.

(4) In determining whether a competent person carrying on the activities in the current tax year would reasonably expect future profits regard must be had to-

(a) the nature of the whole of the activities, and

(b) the way in which the whole of the activities were carried on in the current tax year.

(5) "The prior period of loss" means-

(a) the 5 tax years before the current tax year…".

For the purposes of this appeal, the "current tax year" is the year to 5 April 2011. The "5 tax years" are the years 2005/06 to 2009/10 inclusive. The "current tax year" is therefore the sixth year of losses.

HMRC's arguments on the legislation

20. HMRC say that the test in section 68(3)(a) is met. In their view, as in fact has proved to be the case, there should be a reasonable expectation of future profits where the farming is competent.

21. They allege that the test in section 68(3)(b) is not met. Essentially they say that at the start of the prior period of loss, in other words 5 April 2005, the business would reasonably have been expected to be profitable by 5 April 2011. If that is the case, then the test is **not** met since the subsection requires that the competent person could **not** reasonably have anticipated that the farming business would have been in profit by 5 April 2011.

22. Accordingly, the restriction on relief for losses at section 67(2) ITA where there have been five previous years of losses applies.

23. The amended Skeleton Argument cited three cases (see Appendix 1) but they were not referred to specifically.

The appellant's arguments

24. Although in his written argument the appellant strenuously argued that the intention was always to make profits, at the hearing, he initially ran an argument that farming is not in itself profitable since the profit is essentially derived from the subsidies and grants.

25. He argued that the finance costs were part of the "activities in the current tax year". Since they had not inherited the farm, unlike 84% of farmers, they, like the 8%

of new entrants to farming are in the position of having to borrow and repay loans in order to establish a land base. Farming is a long-term venture. The flock and herd have had to be increased in order to fund the expansion of the business over the six year period with which we are concerned.

26. He argues that the nature of the "activities" for the purposes of the legislation should include the expansion of the business with the knowledge that such expansion would require a period of loss as stock, machinery, labour and material inventories grow to service the increase in borrowing to fund the expansion.

27. He also advanced arguments in regard to the "duplicity" of bankers and the miss-selling scandal. He argued that he was in a unique circumstance where, as a result of the Government's failure to regulate the banking industry, he faced an unanticipated substantial breakage fee and was trapped in high interest loans. In those circumstances, the "five year rule" should not be applied since it would be wholly unfair.

28. Since he farms commercially, he is not in the category of "terminal loss maker" or "hobby farmer" which are the "extreme cases" that the legislation is designed to exclude.

29. The statutory review by HMRC was not independent since HMRC operates a bonus culture.

30. He relied on the cases *French v HMRC*[1] and *Walls v Livesey*[2] albeit he did not quote therefrom. He also produced but did not refer to the cases, set out in Appendix 1.

Reasons for Decision

31. We explained to the appellant that the Tribunal's only function is to find the facts and then apply the relevant law. We do not have discretion. Specifically, we cannot disregard the legislation on the basis that its application might be unfair because of the action, or alleged inaction, of another arm of Government.

32. We have to apply the law as it has been promulgated by Parliament since, although we agree with Judge Nowlan in *French* at paragraph 23 that the subsection is slightly oddly worded, it is not so obscure, ambiguous or absurd that it falls within the parameters of *Pepper v Hart*[3] whereby one can look beyond the wording of statute.

33. The review has been conducted in accordance with the statutory requirements. Any argument on the independence, or not, of the reviewing officer is not within our jurisdiction and is a matter, if so advised for another forum.

34. Whilst we understand and accept that for many farmers the only reason that they make a profit is that they benefit from grants and subsidies, we do not accept that those should be excluded from the consideration of profit. In any event, if we did accept that, then the appellant would presumably not meet the test in section 68(3)(a).

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[1] [2014] UKFTT940 (TC)

[2] (1995) STC (SCD) 12.

[3] [1992] UKHL 3

He would not therefore be able to get relief for the losses in any event. We prefer his original argument that he reasonably expected future profits. The problem is the application of section 68(3)(b) since both the requirements of section 68(3) must be met for the loss to be allowable against other income.

35. The onus of proof under this subsection lies entirely with the appellant. The test is an objective one on the balance of probabilities and uses a hypothetical competent farmer.

36. Our starting point was to consider what was meant by "the activities". That is defined in section 68(1) as being the farming activities and in this case the activities are specifically the farming activities in 2010/11 being the year of claim.

37. What is farming? Section 832 Income and Corporation Taxes Act 1988 ("ICTA") provided a statutory definition:-

> "'farm land' means land in the United Kingdom wholly or mainly occupied for the purposes of husbandry….and 'farming' shall be construed accordingly".

Both Section 996(1) ITA 2007, with effect from 6 April 2007, and its predecessor provision define farming for tax purposes as :

> "the occupation of land in the United Kingdom wholly or mainly for the purposes of husbandry….".

We are therefore looking at husbandry. That term is not statutorily defined. The Oxford English dictionary defines it as agriculture, farming and land under cultivation. That is indeed what the farming partnership undertook.

38. Obviously the actual farming undertaken is the core activity. By that we mean, for example, the crops, the cattle and the sheep. Of course there are other receipts such as the Single Farm Premium.

39. We agree with the appellant when he states that one cannot farm without a land base. Where we differ is when he argues that the financing costs are part of "the activities" ie farming. We totally accept that farming is no different to any other business in that it has to be financed. Financing costs are an integral and crucial risk factor for every business. They are not the activity of the business; they are the means of facilitating the business. An example would be that a hospital cannot trade without a building, equipment and qualified staff. The costs of the building and the staff are not the activity of providing healthcare. They are a means of providing same.

40. When looking at section 68(3)(a) we must look at the "activities in the current tax year". Although it is a hypothetical and objective test, we agree with HMRC (BIM75640) that we must look at how the activities were actually carried out and therefore borrowing etc are relevant since that is the framework within which the "competent person" would be deemed to assessing the likely future profits. In this case there is simply no doubt that in the current year the appellant certainly expected future profits and those were indeed achieved.

41. What then of the second test in section 68(3)(b)?

42. We need to look at the 2010/11 current activities but in the context of the beginning of the period of loss, namely 5 April 2005.

43. In our view, the core farming activity has expanded in scale but remained essentially unchanged in the period with which we are concerned. What did change were the financing costs and, as a result of the banking crisis, there was an inability to sell assets as quickly as anticipated. Does that matter? In our view, from a taxation perspective only, the answer is no. Why?

44. The answer is extremely simple. In 2005, as the appellant and HMRC both state the banking crisis was beyond prediction. As the appellant told us, he was an optimist then. After the banking crisis he was deeply cynical, yet he projected achieving a profit within a short timescale in 2010, and achieved it. In the brighter economic climate of 2005 he did certainly expect to achieve a profit within a very short timeframe. In 2005, if the partnership had had the same land bank as in the "current year" we find that on the balance of probabilities, he not only would not have anticipated a problem in disposing of the land bank but the same profit expectations which he produced in 2010/11 would have been even more optimistic.

45. The case law to which we have been referred to, other than where we comment thereon herein, whilst interesting, is all decided on its own facts and is not directly in point with the facts in this case.

46. In summary, whilst we, and HMRC, have sympathy with the appellant in the distressing situation in which he and his wife find themselves because of the alleged behaviour of the bank in question, nevertheless they took the commercial decision (albeit with little choice) to fund their land purchase as they did. That undoubtedly delayed their move into profit. The anticipation of profit in subsection (3)(b) could not possibly have taken into account the banking crisis and alleged miss selling by the bank in question since that would have been entirely unforeseeable by either the appellant or the notional "competent person" in 2005.

47. For all these reasons the appeal cannot succeed and is dismissed.

48. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

ANNE SCOTT
TRIBUNAL JUDGE

RELEASE DATE: 18 December 2014

Amended pursuant to Rule 37 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009 on 23 February 2015.