# The Chartered Institute of Taxation

## Application and Professional Skills

## Taxation of Owner-Managed Businesses

## May 2025

## Suggested answer

**Report to: Mr and Mrs Austin**

**Subject: Farm tax planning**

## Introduction

As agreed, this report provides advice on the best way to introduce Fred into the farm business and when the outbuilding, that you plan to develop, should be transferred to Fred.

We have not considered other alternatives to a partnership, such as a limited partnership, limited liability partnership or a limited company, as you have said that you wish to continue with the partnership structure.

The report is based on the final accounts for the partnership to 31 March 2024, the Management Accounts to 31 March 2025 and your estimate that profits will continue at the same level.

The report is based on the legislation as at today's date. There may be changes in the future for example in a Budget or in your circumstances, in which case you should contact us to clarify if there is any impact on the advice and recommendations.

Askbridge Chartered Accountants
8 May 2025

## Executive summary

We make the following recommendations:

1) At first sight, employing Fred is a simple solution. As a partner with a percentage share, Fred may feel more involved in the business and would also be treated as self-employed for tax purposes. In profitable years there would be lower overall tax and national insurance due for the family as a whole and more flexibility on the use of any tax losses, provided Fred works for more than 10 hours per week on the farm. Fred should therefore be admitted as a partner with a 25% share of income profits and losses and working for more than 10 hours per week.

2) At least a 5% capital share should initially be allocated to Fred by John. This would also enable John to claim a reduced 10% tax rate on the gain arising on the sale of the field that he owns. Although the transfer of a share in the assets of the partnership to Fred would trigger a Capital Gains Tax (CGT) disposal in the same way as a sale, a claim can be made for gift relief which would defer any tax until Fred disposes of his share in the assets. This could increase the tax payable by Fred were he to sell the farm in the future, but this is outweighed by the benefit of increasing the funds available now for the development of the outbuilding. Fred would need to agree as the claim has to be signed by both parties. Fred's entitlement should be set out in a partnership agreement and reviewed in the future.

3) The outbuilding should be gifted to Fred before any development is carried out. The capital gain would be small and this would minimise any potential future Inheritance Tax (IHT) exposure.

## Introducing Fred to the business

Profit sharing arrangements for a partnership need to consider both income and capital. In the absence of any contrary agreement, Fred would acquire a share in both the trading profits and the assets of the farm.

We have considered

1) Fred's share of trading profits and losses and
2) his share in the partnership assets.

**1) Share of trading profits and losses**

Your aim is to bring Fred into the partnership and you are considering two options:

a) Employ Fred on a salary of £25,000 pa, or
b) Allocate a 25% share of partnership profits or losses to Fred.

**a) Employing Fred**

The advantage to employing Fred is certainty, for both the farm and Fred, on the income that he would receive each year even in loss making years. This might help with his personal budgeting and if he ever applies for a mortgage to buy a home.

The disadvantage is that National Insurance is higher for an employee, leaving Fred with net income in 2025/26 of £14,254 (see Appendix 1).

It is unlikely that there would be any employer's National Insurance liability as this should be covered by your Employment Allowance.

Fred's salary would be a tax-deductible expense for the partnership and reduce the profit or increase the loss allocated to you.

**b) Allocate a 25% share to Fred**

Fred may feel more involved in the farm under this approach, as he would share in any increases in profitability.

From a tax point of view, a variable profit share would mean that Fred would be treated as a partner rather than an employee. In a profitable year, he would still be subject to tax at 20% but the National Insurance would be only 6% over the annual threshold of £12,570, rather than 8% as an employee.

If a tax loss is made in the future, perhaps due to substantial capital expenditure qualifying for income tax relief, Fred would be able to offset his share of the loss against the profit from his building business. In the first few years of being a partner, he could also elect to carry back the loss up to four years to offset against his other income.

For Fred to offset any losses against other income he would need to spend at least 10 hours per week working on the farm. Otherwise, he would be classified as a 'non-active' partner and losses set against any income other than profits from the partnership restricted for his first four tax years to the amount of capital he had contributed to the partnership, which is nil and £25,000 in later years. If he works for more than 10 hours per week, he will be restricted to the greater of £50,000 or 25% of his total income.

The balance of any losses would be carried forward and set against Fred's partnership profits in subsequent years. Fred would also be able to carry forward and offset losses set against income not subject to national insurance against the partnership future profits for national insurance purposes.

**Recommendation**

We would recommend that Fred is given a 25% share of trading profits as there would be lower National Insurance costs in profitable years and Fred would be able to offset any losses against his other income.  If losses are likely, he should also work for more than 10 hours on the farm to ensure he is able to maximise the use of his share of any losses

## 2) Share of assets

**No share of partnership assets**

If a £25,000 salary is considered to be the limit of Fred's involvement, then we presume he would have no entitlement to a share in the capital assets in the farm.

One disadvantage would be that Fred might feel less involved in the farm growth e.g. expansion plans.

A further disadvantage involves the CGT due on the sale of the field by John to fund the development of the outbuildings. Without John also disposing of at least 5% of his interest in the partnership, Business Asset Disposal Relief (BADR) would not be available on the sale of this field (explained below).

**Giving Fred a share of assets**

If Fred was allocated a profit share of 25%, then the initial assumption would be that he also acquires a 25% interest in the partnership assets.

The advantage of giving Fred a share of assets is that he would have an immediate sense of ownership of the farm.

The gift of an interest in the assets of the partnership would however have CGT and IHT implications.

You would be considered to have made a disposal to Fred of 25% of the current value of the assets of the partnership. The main asset as far as Capital Gains Tax is concerned is the farmland and buildings currently included in the partnership accounts. This assumes that none of the plant and machinery is valued at more than cost as the other assets (such as stock, debtors and cash) are not subject to CGT.

The calculation of the gain for you would be based on a comparison of the current value of the land and buildings and a cost value. In this case, the cost would be the probate value at the death of John's father. The current open market value has to be used because you are connected to Fred for tax purposes even though no money changes hands.

The total gain of £187,500 (Appendix 2) would qualify for Business Asset Disposal Relief (BADR) as you would be making a material disposal (12.5% each) of your partnership interest. BADR means tax would be payable at a reduced rate of 10%, rather than up to 20%. However, this would still give a liability of around £18,000. This would not be beneficial when you require funds for the development.

However, provided the land and buildings are all still used by the business as at the date of gift the gain would qualify for gift relief as the assets have been used for business purposes. A gift relief claim means that the tax due on the gain (and potential tax liability) would not crystallise until Fred makes a disposal. Assuming CGT rules remain unchanged. Fred would need to agree this as the claim needs to be signed by both parties.

The time at which Fred gets part or all of the farm will affect his cost and hence the CGT he will pay if he sells the farm in the future.

If he inherited the whole farm on your deaths, then the cost figure used in the calculation would be the probate value on your deaths (ie market value at that time). If Fred already owned a 25% share of the land and buildings, only the 75% inherited would have a cost of the value on your deaths with the 25% already held effectively having a cost based on the probate value of the land on death of John's father due to the gift relief claim. This would mean a larger gain on a future sale of the farm by Fred.

The gift of a share in the farm assets would also be a potentially exempt transfer for IHT. If you died within seven years, then IHT would become payable on this gift. However, assuming that Fred would still be farming at that point, then the gift would be covered by agricultural property relief and business property relief. For IHT purposes, agricultural property relief reduces the value of a transfer by 100%

of the agricultural value. The reduction applies to the agricultural value of land and buildings (including the farmhouse) used for agricultural purposes. Business property relief is a similar relief and would apply to the remainder of the assets of the business as well as to any difference between the agricultural value and the open market value. The two reliefs together would mean no IHT should be payable on your deaths.

**Implications for disposal of share in field**

In order to fund the development John would be selling a field which he owns in his own name and is currently used by the partnership. There would be a gain on the land of £150,000 based on the difference between the sales proceeds of £250,000 and the value when John inherited it from his mother: £100,000.

CGT would be payable on this gain, after an annual exemption of £3,000. Tax would be payable at 10% up to the basic rate tax band of £37,700 and 20% thereafter, depending on how much of the basic rate band has been used against income.

Business Asset Disposal Relief (BADR) can be claimed if a taxpayer makes a disposal associated with a material disposal of a business asset. The lifetime limit is £1m and you have made no claims so far. A material disposal of a business asset includes at least a 5% partnership share. As such if John were to gift at least 5% of the partnership to Fred then this would qualify as a material disposal of a business asset. If this is associated with the disposal of the field then this would qualify for BADR and the gain tax would be taxed at a flat 10%. To associate the sale of the land with the gift of the shares, they would need to be shown as part of John's withdrawal from the business.

If Fred is not given any share in the partnership assets, then John would not be able to claim BADR on the sale of the land as he would not have made a material disposal.

**Recommendations**

We recommend Fred is allocated at least a 5% interest in the partnership assets by John. John would be then making a material disposal of his partnership interest. The sale of the land could then be an associated disposal and the 10% tax rate applied.

We further recommend that a partnership agreement should be drafted that precisely sets out the terms on which Fred joins the partnership. His share of income profits could be set at 25% and his share in any capital profits to 5% initially. The agreement could then be reviewed to give Fred a greater share in the future.

**Other issues:**

**Self assessment**

HMRC will need to be informed of any partnership change.

**VAT**

If Fred has a percentage share in the partnership, the partnership would need to inform HMRC of the change to the VAT registration. It would not affect the VAT number used. Fred would still not be VAT registered personally as the registration limit has not been reached for his sole trader business. The partnership is a separate person for VAT purposes.

**<u>Transfer of outbuilding</u>**

Turning to the proposed development of the outbuilding into a residential property let, you are considering the following options:

1) Gifting the outbuilding to Fred, or
2) Holding the outbuilding within the partnership with Fred inheriting it with the farm on your deaths.

We have considered the options below:

**1) Gifting the outbuilding to Fred**

Fred is suggesting the development and has relevant skills, so we would expect that he would be involved in the majority of the work on the project. If the property is gifted to Fred, then any rental income would be taxable on him alone. If the property is retained in the partnership, then the income would be treated as rental income from the partnership and would be allocated in accordance with the agreed profit-sharing ratios although it could be agreed that it is allocated to Fred.

A transfer of the outbuilding to Fred would be a disposal for CGT deemed to take place at open market value, in the same way as allocating him a share of assets. The gain would be calculated as the difference between the market value and the appropriate percentage of the probate value when the farm was inherited from John's father. As market value is used, then it would be beneficial to transfer the property earlier rather than later as the gain would be higher if planning permission is granted. If the transfer is done now then the gain would be approximately £10,000 each (50,000 – 50,000/1,950,000 x 1,200,000).

This gain would be split equally between you. Unless used elsewhere, you could offset your CGT annual allowance of £3,000 against the gain. Because this is a sale of an asset within the business then there would be no possibility of BADR. The same claim for gift relief could be made as explained above for a gift of a share in the farm partnership.

The gift of the outbuilding would be a potentially exempt transfer for IHT purposes, in the same way as the transfer of a share in the land and buildings. However, if the partnership continues to use the building before it is developed, this could be classed as a 'reservation of benefit', which would mean that the timing of the gift would be delayed. If you died within seven years of the gift/removal of the reservation, IHT would become payable. No reliefs would be available as the building would no longer be used for agricultural or business purposes. However, it would be the value transferred i.e. £50,000 if transferred before any development, rather than the developed value that would potentially be chargeable.

If the building is transferred to Fred prior to development, then the funds given to Fred to fund the development would also be a potentially exempt transfer.

The development of the building would count as "construction operations" as it relates to the alteration of a building. As Fred is already involved in construction services, then the rules of the construction industry scheme will need to be followed. Deductions would need to be made from subcontractors, records kept and returns made to HMRC. Fred should already be aware of these rules so the burden should not be too onerous.

The supply of rented accommodation is exempt for VAT. This means that the VAT on the conversion of the building would not be reclaimable and VAT would not be due on the rental income. If the property is owned by Fred, he would not be required to register for VAT as it is only taxable turnover over a 12 month period that is compared to the registration threshold. (The alternative test of exceeding the threshold in the next 30 days is unlikely to be met).

VAT on the conversion costs would be reclaimable under partial exemption rules, but Fred would need to register voluntarily for VAT which might affect his other customers.

**2) Retaining the outbuilding in the partnership**

The main advantage of retaining the building within the partnership would be that you would retain control of the asset, for example if there are problems with tenant behaviour. It would be possible to mitigate this by including covenants in the transfer to protect the farming activities. The income would also remain part of your partnership profits.

A disadvantage of developing and retaining the outbuilding in the partnership is that, for IHT purposes, the developed value may be included in the estate of the last of you to die. The anticipated developed value would be £500,000 reduced proportionally by any equity share given to Fred. Rented property does not normally qualify for business property relief, but in certain circumstances it is possible to argue that such activity is simply part of farm diversification. This has been considered in the Courts and much will depend on the overall balance of traditional farming and “other” activity. Depending on how much of the rest of your estate qualified for 100% relief as either agricultural or business property, then the value of the rental properties may be covered by your nil rate bands of £325,000 each. However, this would be an issue if the IHT rules change and reliefs are limited.

**Recommendation**

In view of CGT and IHT issues we would recommend that the outbuilding is gifted to Fred as soon as possible. A claim should be made for gift relief to defer capital gains.

Anne Accountant
Askbridge

**Appendix 1**

**Estimated net income for Fred 2025/26**

| | £ |
|---|---|
| Additional income (9/12 x £25,000) | 18,750 |
| | |
| Tax due at 20% | (3,750) |
| Class 1 NIC at 8% x (18,750 – 9,428) | (746) |
| Net income for Fred | £14,254 |

**Appendix 2**
**Capital gain on land and buildings on the admission of Fred as a partner**

| | John and Margaret £ |
|---|---|
| Market value (25% x 1,950,000) | 487,500 |
| Cost (probate value) (25% x 1,200,000) | (300,000) |
| Gain | 187,500 |