stfa

4th December 2024

Fiscal barriers to the letting of land in Scotland (and the rest of the UK), current position prior to changes set out in Autumn Budget

This paper attempts to summarise the main UK tax frameworks which are acting to prevent the letting of land on tenancies by both large traditional rural estates and smaller family farms under owner-occupation. These tax frameworks governing Inheritance Tax, Capital Gains Tax, and Income Tax are reserved to Westminster.

Income from in-hand farming, which includes correctly managed grazing lets and contract farming agreements, is classed by HMRC as trading income and the asset, ie the land, is classed as a trading asset. This allows in-hand farming operations significant tax advantages in relation to Inheritance Tax (IHT), Capital Gains Tax (CGT) and Income Tax.

In contrast, income from the renting out of farmland is classed by HMRC as non-trading income, and the asset, ie the land, is classed as an investment asset. This can result in ineligibility for IHT and CGT reliefs, and for Income Tax the rental income is treated as non-trading income which has disadvantages.

Unless the landowner is exempt from tax, eg a charity or Crown body, then these tax frameworks and the rules around the treatment of non-trading income and let land is likely to be the single biggest barrier to the letting to land on tenancies throughout the whole of UK.

IHT reliefs

The main IHT reliefs which may not be available for investment assets are:
Agricultural Property Relief (APR) and;
Business Property Relief (BPR).

While APR may be considered a generous relief, it only applies to the agricultural value of buildings and land used for in hand farming. It does not apply to any hope or development value of land, nor mineral value, nor other agricultural assets such as stocks, machinery and fertiliser etc, nor does it apply any residential or industrial properties not used for agricultural purposes. This is where rural estates (both traditional estates and smaller owner occupiers) require BPR, in order to provide IHT relief where APR cannot be applied.

CGT reliefs

The main CGT reliefs which may not be eligible for investment assets are:
Business Asset Disposal Relief (BADR, formerly Entrepreneur’s Relief);

Business Asset Rollover Relief and;
Gift Holdover Relief.

BADR and Rollover Relief are required to reduce the CGT liability on the sale of a business asset.
Gift Holdover relief allows business assets to be gifted at less than market value without paying CGT, often used as a mechanism to transfer rural estate assets to the next generation.

Income Tax

With income tax there are disadvantages of income being classed as non-trading including limited ability to offset expenses, restrictions on the offset of losses and ineligibility for averaging of farming income.

Balfour structuring and BPR

The Balfour case (HMRC v Brander) established that where a composite business is mainly trading, all the assets within the business should benefit from BPR assuming they don’t already benefit from APR. This case allows rural estates to shelter non-trading investment assets, which if looked at alone would not be eligible for BPR, from IHT by including them in the composite rural estate which is mainly trading, ie the trading assets (eg in-hand farms) must outweigh the investment assets (eg let farms). These investment assets will then benefit from BPR assuming they account for less than 50% of the composite estate’s value.

Balfour structuring has resulted in rural traditional estates seeking to terminate tenancies and to not renew fixed term tenancies and instead use contract farming agreements or grass lets in order to achieve a position where the majority of the estate is trading, ie not land let under tenancies.

CGT reliefs

To be eligible for the CGT reliefs, a business has to be 80% trading to qualify, rather than the lower threshold of 50% for BPR established by the Balfour case. This adds a further incentive for landowners to bring tenancies to an end and not renew fired term tenancies.

APR on farmhouses

Where an owner occupier farms in-hand a holding with a farmhouse, including through the appropriate use of grazing lets and contract farming agreements, then the farm house is eligible for APR. However, if the farmland is let out on a tenancy then the farmhouse will not be eligible for APR because the landowner is no longer considered to be an active and trading farmer. This loss of APR on the farmhouse serves to deter any owner occupier with a farmhouse from letting the farmland on a tenancy, and instead an owner occupier seeking to step back from farming will use grazing lets or contract farming agreements.

Exemptions from tax

Some land owning bodies are charities and benefit from tax exemptions, and the Crown land owning bodies benefit from the Crown exemption for tax. It is clear to see across the UK that these landowners with tax exemptions continue to let land through tenancies, for example Crown Estate Scotland and Mount Stuart Trust (a charity) in Scotland, and in England the Duchy of Cornwall (a Crown body), the Church of England (a charity), the National trust (a charity) and Crown Estate.

Speculation as to future fiscal changes

The Office of Tax Simplification's 2019 Report on IHT suggested that the BPR trading threshold for estates be increased from 50% to 80%, thus bringing the BPR threshold in line with the CGT reliefs. Many advisors believe this recommendation to be an indicator of possible future changes which in turn further discourages the letting of land with some rural estates seeking to reach the 80% threshold for trading assets.

Of even more concern for the tenanted sector is speculation as to the future of APR. If APR were to be abolished any farmland farmed in-hand would be unaffected as it would remain eligible for BPR, but tenanted farmland would have no relief from IHT. This is a further driver for landlords to terminate tenancies and instead farm in-hand.

Current fiscal influences on landlord decisions

With the exception of Crown and charity landowners which continued to use tenancies across the whole of the UK, any well-advised large traditional landowner is taking steps to reduce exposure to IHT and CGT by significantly reducing the amount of land let on tenancies within their rural estates. There are many examples - Roxburgh Estate and Lothian Estates in Scotland, Lowther Estates in England - where, for the purposes of tax planning, tenants are being replaced by contract farming agreements or grazing lets.

In the case of the numerous owner occupiers seeking to retire from day to day farming, their only options are grazing lets or contract farming agreements. They cannot let out their farmland on a tenancy because in doing so they would no longer be eligible for APR on their farmhouse, nor be eligible for BPR, nor be eligible for any of the CGT reliefs should they eventually decide to sell their holding.

Future position following changes in Autumn Budget

Impact of Autumn Budget announced on 30th October 2024 on the tenanted sector

The Autumn Budget includes significant changes to IHT relief available to landowners and tenants in the UK. The key changes reduce the availability of APR and BPR, with the combined reliefs restricted to an allowance of £1,000,000 per person where 100% relief would continue to be available, thereafter the balance will qualify for 50% relief resulting in an applied IHT rate of 20%.

Though some budget details and thresholds are still subject to consultation, at first sight there appear to be no changes which remove any of the barriers to the the letting of land covered above: Balfour structuring still stands and will be required for eligibility of APR and BPR at the reduced rate of 20% instead of the full rate of 40%; similarly, for the smaller owner occupiers seeking to retire, the tenancy option remains excluded due to the resulting loss of IHT relief on the farmhouse should the retired owner remain in the farmhouse; and the disadvantages of non-trading income for Income Tax remain in place.

There appears to be no measures in the recent Autumn Budget which reduce the fiscal barriers to the letting of land, nor any measures to encourage the letting of land.

Furthermore, there are no fiscal measures in the Autumn Budget which will encourage land reform through more diverse ownership: the reduced rate for APR and BPR is uncapped which means large scale land ownership will remain an attractive investment opportunity for wealth; roll over relief from CGT remains in place, so roll over buyers will continue to drive land prices upwards leaving land unaffordable for new entrants to the land market; and the likelihood of farm tenants buying their farms is reduced given the new IHT burden on average sized family farms.

Impact of the Autumn Budget on Scottish farm tenants

The Autumn Budget includes significant changes to the IHT reliefs available tenants. The key changes reduce the availability of Agricultural Property Relief (APR) and Business Property Relief (BPR), with the combined reliefs restricted to an allowance of £1,000,000 per person where 100% relief would continue to be available, thereafter the balance will qualify for 50% relief resulting in an applied IHT rate of 20%.

It appears that the £1,000,000 allowance will not be transferable between spouses if not used on the first death, so for successors with only one parent still living £1,000,000 will be the maximum allowance for 100% combined APR and BPR relief.

While the impact of these changes on owner occupiers has been well noted, they pose a more serious threat to Scotland's secure 1991 Act tenancies.

The total value of a tenant's farming interests are likely to exceed the £1,000,000 threshold for most intensively farmed lowland 1991 Act tenancies of over 300 acres, which is an average sized lowland tenancy.

As a result of the assignation provisions of the Agricultural Holdings (Scotland) 2003 Act and the Land Reform (Scotland) 2016 Act, tenants should be able to use the 7 year rule to gift leases to successors, avoiding IHT providing they survive for 7 years. It is fortunate for tenants that these assignation provisions are in place, without which tenants would not be able to use the 7 year rule to mitigate IHT.

However, tenants are at a significant disadvantage compared to owner occupiers due to their lack of ability to sell/relinquish/gift part of their lease: their only option is to sell/relinquish/gift the whole lease or nothing.

In recent weeks representatives of landowners have provided worked examples to demonstrate the likely need for landowners to sell 10-20% of their landholding in order to pay for the future IHT liability, given that current returns from farming mean that the IHT liability cannot be afforded in full from farming profits. Secure tenants will be faced with the same problem, that the IHT liability cannot be paid through farming profits alone. While tenants may have a less valuable interest in the land and a correspondingly smaller IHT liability compared to similar sized owner occupiers, due to paying rent they also have less profit available to fund the small IHT liability. While the owner occupiers have the ability to sell part of their holding to cover the IHT liability and still continue to farm a smaller area, tenants have no ability to realise a part of the value of their lease. This is a major disadvantage for tenants and is likely to leave many of the next generation of tenants in a position where they cannot continue farming despite benefitting from security of tenure.

These IHT changes will also act as a barrier to tenants buying their farms. It is common for tenants buying to borrow 20-40% of the value of the holding over a term of 20 years, and it is difficult to see how that level of borrowing is sustainable when combined with the possible requirement to raise a further 20% of net asset value to cover IHT. Tenants seeking to buy would be assisted by a reduction in land values, but most agents appear to think there will be no significant fall in land values as a result of the Autumn Budget due to the continuation of roll over relief for Capital Gains Tax.