

# Inheritance Tax

## Business Property Relief and the Estate Owner



By Alan Neal

Whilst successive Court decisions have narrowed the scope of Agricultural Property Relief (APR) for the purposes of Inheritance Tax (IHT) by, for example,

restricting the definition of a farmhouse, laying down tests for “character appropriateness” and giving a restrictive interpretation to agricultural value, the trend, so far as Business Property Relief (BPR) is concerned, seems generally to have been going the other way where the Court’s approach has been much more liberal. This has been evidenced in the cases of *George* (in relation to caravan parks); *Farmer* (in relation to diversified farms) and *Piercy* (in relation to property development and property investment), though this has been countered to an extent by the decision in *McLean* (grass keep lettings).

We now have the case of the Fourth Earl of Balfour which again widens the scope of BPR and could to an extent be viewed as “the Estate Owners Charter”.

Before examining the case in more detail, I think it is important to understand the critical issue that is applicable in all these cases. BPR, subject to satisfying certain conditions, is available in respect of businesses, whether they be sole traders, partnerships or companies, but there is a specific exclusion where the business consists “mainly of holding or making investments”. HMRC have attacked caravan parks on the basis that the business is one of letting the site or caravans; have tried to disallow relief on diversified farms where, for example, former agricultural properties

or buildings are no longer let for agricultural purposes; and to deny relief to property developers where some of the development property is let-out.

HMRC’s tactic has either been to try to segregate the different assets of the business and to look at each of these separately thereby denying BPR on those elements which fall within the above exception but allowing it on the balance, a sort of “divide and rule approach”; or to argue that BPR is simply not available at all because of the preponderance of property letting within the business.

Fortunately the Courts have taken a much wider overview and have stood back and looked at the whole of the business entity with a commercial eye, with a view to assessing the totality of the operation rather than forensically analysing each individual aspect. In particular, in the *Farmer* case, the Court laid down five tests to be applied:-

- a) A comparison of the value of the assets being traded as opposed to the value of the investments.
- b) A comparison of turnover between trade and investment.
- c) A comparison of the net profit from trading as opposed to investment.
- d) A comparison of the employee utilisation in the business as opposed to the investment activity.
- e) A general overview.

This was the approach adopted by the Courts in the *Balfour* case, though the Court in that case seems to have been more liberal in the way that it approached matters.

There are some slightly technical issues with regard to the IHT position which are not relevant to the main point arising from the case and with which I shall not deal.

The situation was that the *Whittinghame* Estate extended to 771.85 hectares. It was a classic Scottish landed estate. The original estate had extended to over 10,000 acres but large parts had been sold off, primarily to pay Estate Duty, in previous years. On the estate were two in-hand farms, three farms let on secured agricultural tenancies, 26 houses and cottages let mainly on Assured Shorthold Tenancies and two premises let out commercially. The two in-hand farms extended to about 269 hectares (about 35% of the estate), the three let farms amount to about 371 acres (about 48% of the estate). There were also parks let on a seasonal basis and sporting rights.

A selective approach could have led to the conclusion that only the in-hand farms i.e. about 35% of the estate, would qualify for BPR, the rest being excluded as it involves property letting of different sorts. It could also have been argued that in view of the fact that the in-hand farms amounted to less than 50% of the whole, that the enterprise consisted “mainly of holding or making investments” i.e. fell within the exclusion thereby denying relief altogether. This could well have been the anticipated result since the in-hand farms were run on a contract farming basis. Happily the Court reached a different conclusion.

All of the activity on the estate was run effectively as one business by Lord Balfour, who was the principal beneficiary of the trust which owned the estate. No distinction was drawn between the different elements on the estate or any distinction between capital and income expenditure. Therefore everything went into and came out of “one pot”. Neither was there any demarcation between the employees who worked very much across the board.

Lord Balfour also employed a land agent who spent the bulk of his time on farming operations rather than on the letting side.

Looked at as a whole the Court viewed the enterprise as a “unified rural estate” which incorporated “agriculture, forestry, other land based businesses, dwellings and commercial premises, and community and public facilities including conservation and historical and cultural features”. It is stated that the assets were used as part of an overall business enterprise carried on for gain and that given the nature of a traditional Scottish landed estate it would be difficult to do otherwise than this. Everything effectively dovetailed into each other and one part of the business benefited from another and so on.

In considering the exception from BPR the Court drew a distinction between passive and active management. They considered that a business which consisted wholly or mainly holding investment was a passive activity designed to achieve an investment or a capital gain.

Once the investment had been made income and capital gain would follow from the soundness of the investment taking into account the general state of the market, rather than the continuing efforts of the owner. This was the conclusion reached in the recent McLean case which went to the Court of Appeal in Northern Ireland and involved an arrangement very similar to grass keep letting. The Court viewed the activity very much as a passive activity and even though the landlord undertook fencing etc it did not consider that this was sufficient to take the business out of the exclusion. By contrast, the Court in the Fourth Earl of Balfour case considered that a trading activity involved the buying and/or selling of goods or the provision of services or a mixture of both. The extent of the profit they considered directly depended upon the effort and the efficiency and quality of effort put into the business by its owner and employees.

In a telling passage from the case it is stated that the Court found that “to suggest that the activities carried on at Whittinghame Estate comprised wholly or mainly the making or holding of investments is to belittle the efforts required properly and profitably to manage the various components of an

estate of this nature. Even the residential letting aspect of the activities required Lord Balfour’s expertise, business acumen and careful planning. They are an important component in the overall business; the cottages were historically part of the overall farming enterprises or housed full time estate workers... Even if one assumes the letting of the 26 houses and cottages (... which unlike the let farms do not attract agricultural property relief) constitute making or holding investments, I am not satisfied that the estate management and farming activities managed by Lord Balfour as a single composite estate management business ... was a business which considered wholly or mainly of making or holdings investments. The estate management did not, on any view, consist wholly of making or holding investments”.

The Court identified that it was necessary to establish what the preponderance of business activity is. This very much follows the Farmer approach to which I have referred above and indeed the Court makes passing reference to the five tests in that case though without examining each of these in detail in turn. As to the fifth test identified in Farmer, the Courts comment in this case is that “as a matter of more general assessment and impression as to where the preponderance of business activities lies. .... my impression is that management of a landed estate such as Whittinghame Estate even when a significant amount of income is derived from letting income is, overall, mainly a trading activity. That is where the preponderance of activity and effort lies”.

This is an enormously valuable case and following the trend of previous cases, shows a very much more balanced and commercial reality in the approach of the Courts to BPR.

One must be careful to distinguish this case from earlier ones simply involving the letting of property, even if that letting is actively managed e.g. by personal collection of rent, personal undertaking of repairs etc. The very fact that there is a business element which involves risk is absolutely critical. The previous use of let buildings for the purpose of the underlying business is an important factor. The personal involvement of the transferor is critical. The pooling of income and expenditure is essential.

It remains to be seen whether the case is appealed by HMRC or whether they allow it to rest. If it is appealed it will be a highly important decision as inevitably a Higher Court will need to consider very carefully the width or narrowness of the exception which hitherto has been HMRC’s way of trying to restrict the relief. Any such decision may well impact upon the earlier cases to which I have referred.

It will be interesting also to see if the Chancellor turns his mind to this. For sometime there have been murmurings that APR may be abolished simply leaving BPR. There was a fear that this may happen in this year’s Budget following the challenge by the EC as to the restrictive application of APR. That did not happen as the jurisdictional reach of APR has now been extended to EC countries. If the case remains and is not appealed and no legislation comes forward, this gives tremendous scope for planning not just with landed estates but with other landed diversified operations.

What is interesting in the Balfour case is the use of agents. In the APR case of McKenna the virtual abdication by the taxpayer of any involvement in the contract farming arrangements, allowing his agent to do virtually all the work, proved a fatal flaw. I myself have been involved in two cases where contract farming was utilised and in each case the taxpayer played an active role albeit that agents were employed. In both cases I have been successful in claiming relief.

It is very much therefore a question of balance between the extremes of turning everything over to the agent and being completely hands on. Underlying that is the need for evidence and a proper paper audit trail to show the taxpayer’s involvement in all aspects of management of the business even if part of that activity is delegated to the land agent.

If you could be affected by this case and are concerned as to whether or not your business activities are organised in a manner to secure the relief please contact me to review your position.

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