Agriprofessional
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Taxable profits and pitfalls

Apart from dodging the rain, farmers have, for the last six weeks, been mulling over the news contained in their envelope from the Scottish Government advising them of their new subsidy entitlement and how that will decrease by 2019.

For most farmers in the area the subsidy they are due to receive for 2015 is already substantially less than the sum received for 2014, but by 2019 the subsidy will be half the sum received in 2014. Our recent survey identified that only 15% of local farmers made a profit in each of the last five years if subsidies were excluded, so this sharp decline in subsidies to 2019 gives farmers some serious challenges.

With falling profits in the short term, tax planning is important to maximise any income which does remain.

At present, farmers can average profits and losses over a two-year period, but this relief is being extended to a five-year period from 2016/17.

The first applicable year will therefore be, for example, Accounts for the year to November 30, 2016.

A farmer who wishes to utilise five years averaging would then be able to go back to the tax year 2012/13 or, in the example, to the year ended November 30 2012.

There will be a volatility test applied such that the fifth year must have taxable profits which are at least 25% lower than the average taxable profits (or losses) of the previous four years.

This new rule could provide valuable relief for those with exceptionally high taxable profits in 2012/13 or 2013/14 and now find themselves facing much lower profits or losses due to subsidy reductions, flooding, milk price meltdown, potato price variations or any other reason.

Those looking for the Chancellor to give them a tax refund, however, must be aware of the pitfalls that can arise for the unwary.

Taxable profits (or losses) are not the same as book (or accounting) profits.

The most notable adjustment between the two is the adjustment for depreciation and capital allowances.

Capital allowances claims are the Government's way of giving tax relief on machinery purchases and since 100% relief is given in the year of purchase for machinery totalling £200,000, this can make the taxable profit very different from the accounting profit, where depreciation writes off the machinery over its useful life.

As accounting profits fall, farmers may reduce what they spend on machinery and by doing so, perversely, find that taxable profit is actually higher than the year before, resulting in more tax to pay, not less.

Farmers therefore need to understand how their taxable profit is arrived at each year so no shocks arise.

Losses themselves can also be restricted. If the farmer has other income, for example, a salary, pension or rental income, then the taxable farming loss which can be offset against that other income will be restricted to £50,000 in the year.

In addition, those farms which make losses in most years need to be aware that HMRC seek to restrict the offset of those losses against other income if a loss is made six years in a row.

In this regard, there have been two recent tax cases brought by HMRC as to whether or not the farmer was farming 'with a reasonable expectation of profit'. In both cases the farmer lost the case and relief was denied.

In one case (P Sylvester), an experienced sheep farmer, was told by the tribunal that had he known the business would be loss making for so long there would be 'no doubt that he would have changed the business model'.

In the other case (J Henderson), the taxpayer could not convince the tribunal that he intended making a profit, relying instead on living on his rental income and selling the odd parcel of land from time to time.

The outcomes of these cases may seem harsh so farmers making losses are advised to take advice and plan ahead with their accountant.

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