

Income tax and sideways loss relief

(Lecture P1128 – 21.44 minutes)

The First-Tier Tribunal decision in *Naghshineh v HMRC* (2018), which went in favour of the taxpayer, considered the impact of the ITA 2007 'reasonable expectation of profit' test in connection with substantial losses incurred over a number of years by a farming sole trader (Mr N).

The case was an appeal by Mr N against closure notices issued by HMRC on 7 May 2014 in respect of his farm's years ended 31 March 2008 through to 31 March 2012. The trading losses for the years under appeal were (per HMRC):

	£
Year ended 31 March 2008	422,244
Year ended 31 March 2009	521,680
Year ended 31 March 2010	390,174
Year ended 31 March 2011	101,697
Year ended 31 March 2012	28,529

HMRC determined that the sideways loss relief claimed by Mr N for each of those years should be denied. This resulted in additional income tax payable, in comparison with the original self-assessments, of almost £600,000.

Mr N was a successful businessman with a wide range of activities who, in 1995, purchased a 75-acre working farm north of Norwich. He had no previous experience of agribusiness and so he employed a farm manager and, at a later stage, a general manager. Early on in Mr N's ownership of the farm, he realised that he could obtain premium prices for organic farm produce compared to conventional produce (which is how the farm had hitherto been operated) and he therefore decided to convert the farm to organic production.

He also formed the view that the farm was unlikely to be economically viable without increasing its size significantly so that he could then obtain the benefits of scale. With this in mind, he made the following further purchases of land:

1998	221 acres of agricultural land
2000	89 acres of agricultural land
2007	25 acres of agricultural land
2007	a 28-acre apple orchard

In the years with which this appeal is concerned, Mr N's farm therefore extended to 438 acres.

The losses which arose were partly due to a downturn in the organic food business resulting from the financial crisis in the first decade of the present century, but they were also caused by the generous way in which Mr N remunerated his farm workers who were paid on a similar basis to the workers in his other unrelated enterprises.

Mr N's agricultural activities had made losses in every tax year since he started the business up to 2011/12. His first profit was in 2012/13 and the business was profitable thereafter. Sideways relief under S64 ITA 2007 was claimed against Mr N's general income. Although there is a special 'five-year rule' for farming losses in S67 ITA 2007 (beyond which sideways relief is not given), this restriction does not apply if the farming activities meet the 'reasonable expectation of profit' test in S68 ITA 2007. It is this provision with which the case is concerned.

The legislation in S68 ITA 2007 can be summarised as follows:

- The test is decided by reference to the expectations of a hypothetical competent farmer carrying on the farming activities (S68(2) ITA 2007).
- The first requirement for this test to be met is whether or not the hypothetical competent farmer had, in the current tax year, a reasonable expectation of profits in the future (S68(3)(a) ITA 2007).
- The second part of the test involves consideration of whether the hypothetical competent farmer carrying on the farming activities at the start of the loss-making process could not reasonably have expected those activities to become profitable until after the end of the current tax year (S68(3)(b) ITA 2007).

It is instructive to examine the First-Tier Tribunal's analysis of the two limbs of the test in S68(3) ITA 2007, which ended up allowing Mr N's appeal, but, before we do so, a really important point to note is that the First-Tier Tribunal had the benefit of (and relied heavily on) the written and oral evidence of an expert in the field of farming operations and profitability (a Mr William Waterfield). Mr Waterfield was appointed by Mr N, but both sides agreed that he was a credible expert in this area. As the two tests in S68(3) ITA 2007 require consideration of farming competence and profitability, it was definitely an astute strategy on Mr N's part to have presented this expert evidence. The result could well have been different in the absence of Mr Waterfield's report.

With reference to S68(3)(a) ITA 2007, HMRC accepted that this part of the test was met for 2010/11 and 2011/12, but they contended that, in the preceding three tax years, costs had been allowed to spiral out of control and also that the farming activities had become too diverse. HMRC argued that a competent farmer could not have expected to make profits in the future because of the high level of those costs.

Mr Waterfield's report disagreed with HMRC and stated that, in each of the tax years under consideration, the hypothetical competent farmer would have had a reasonable expectation of future profits.

Swayed by this, the First-Tier Tribunal rejected HMRC's submission that the farmer would have been unable to make a profit because of the farm's high cost structure on the ground that, at a later stage, he could always have reduced the level of his overheads (just as Mr N had actually done) such that he would then have had a reasonable expectation of future profit.

As far as S68(3)(b) ITA 2007 was concerned, the First-Tier Tribunal followed the reasoning of the Upper Tribunal in *Scambler v HMRC* (2017) and therefore did not take into account unforeseen and unforeseeable events which had affected Mr N's farming operation. However, they held that it was reasonable for the hypothetically competent farmer to allow a contingency for any such events and that this contingency would inevitably have the effect of prolonging the time by which the farming venture became profitable. Using Mr Waterfield's timeline on expected profitability as a starting-point, the First-Tier Tribunal found that it would have taken the hypothetical competent farmer the following lengths of time to move into profit:

Finding and acquiring the necessary land	3 – 5 years
Conversion of the land to organic status	4 years
Producing a wide range of farming products	4 – 10 years
Selling farm produce directly to the consumer	4 – 10 years
Achieving profitability	10 years from converting to organic status

Given that Mr N's first fully organic harvest was in 2003, this last point suggests that the business would not become profitable until 2013. Therefore, Mr N satisfied the second limb of S68(3)(b) ITA 2007 for all the years up to and including 2011/12. As a result, he was entitled to his sideways loss relief under S64 ITA 2007.

The value of the expert witness evidence in this case cannot be overemphasised.

Contributed by Robert Jamieson