Adventures in Timberland

KEVIN SLEVIN ventures down the rabbit hole into the strange world of capital gains tax entrepreneurs' relief, where nothing is quite what it seems.

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Please do not stop reading this article when you *think* you realise what it may be about – not least because you might be wrong. The reason for reading to the very end is that this article includes comment on the application of the capital gains tax entrepreneurs' relief provisions to gains arising on assets that have only been partly used in a taxpayer's business – a not uncommon occurrence. That said, the central theme is the interaction of entrepreneurs' relief with the special tax treatment afforded to certain woodlands. There, I've said it – it is an article focusing on the entrepreneurs' relief implications of non-business activities – including woodlands. At least I can now drop the American term of 'timberland'.

When it comes to considering entrepreneurs' relief, there is nothing special about woodlands. Indeed, woodlands are not alluded to at any point within TCGA 1992, s 169H to s 169V – the core entrepreneurs' relief provisions. Further, and for the avoidance of doubt, I should record that nothing in this article is intended to promote woodlands as a tax planning tool.

The central question to be addressed is this. Can capital gains arising in respect of the disposal of land used for growing trees attract the 10% entrepreneurs' relief rate? The simple answer is maybe or, as the case may be, maybe not. This response is not an attempt to be flippant and neither is it an attempt to sit on the proverbial (timber) fence. It is simply that the outcome in any given situation depends on the precise facts. Indeed, the same taxpayer making two seemingly similar disposals of land on which he used for growing timber on a commercial basis, may find that he is entitled to claim entrepreneurs' relief on just one of the gains arising, on both of the gains or on neither.

KEY POINTS

- The implications of non-business activities – including woodlands – on entrepreneurs' relief.
- The capital gain on the growing of trees is exempt under TCGA 1992, s 250.
- The commercial occupation of UK woodlands is not a trade or part of a trade for any income tax purpose.
- Are the woodlands part of a larger parcel of land or completely separate?
- For trustees' disposals, it is necessary to look at each asset and apply the business use test.

The Readers' Forum query

Let's start by examining the situation raised recently in the Readers' Forum question 'Woodland relief' (23 June 2016, page 21 – tinyurl.com/j5ntneq). We can use this to explore why entrepreneurs' relief is not available in the particular circumstances described in the query.

Lumber Jack's client had acquired a plantation some 15 years ago and this had been managed on a commercial basis throughout his ownership. In a nutshell, the taxpayer was contemplating its disposal and wished to know whether the anticipated chargeable capital gain on the land used for growing trees would be taxed at 10% or 20%. Remember that the capital gain on the growing trees themselves would be exempt under TCGA 1992, s 250. Lumber Jack was clearly alert to the basic entrepreneurs' relief issues – and was aware of the special treatment of certain woodlands for income tax purposes – but was receiving contradictory information from websites about entrepreneurs' relief.

The query seemingly related to an activity that was a separate and distinct woodlands activity, conducted on a commercial basis and with a view to the realisation of profit. The responders highlighted the fact that, to qualify for relief, there must be a disposal of a business (or a part of a business), which the individual making the disposal must have owned for a minimum

period of a year before the date of disposal. It was recognised that, for the purposes of entrepreneurs' relief, a business means a trade, profession or vocation conducted on a commercial basis with a view to the realisation of profits. It was also noted that TCGA 1992, s 169(8) states that the word trade 'has the same meaning as in the Income Tax Acts' (see ITA 2007, s 989).

Section 989 simply states that 'trade' includes any venture in the nature of trade, but ITTOIA 2005, s 11 states:

(1) The commercial occupation of woodlands in the UK is not a trade or part of a trade for any income tax purpose.
(2) For this purpose the occupation of woodlands is commercial if the woodlands are managed:
  (a) on a commercial basis; and
  (b) with a view to the realisation of profits.

It will be seen that s 11 does not simply exempt the profits derived from the commercial occupation of UK woodlands. It goes further. It states that such activity *is not a trade or part of a trade for any income tax purpose.* It is not simply that the profits are exempt from tax; the activity is deemed not to be a trade by s 989. Given that, to enjoy entrepreneurs' relief, it is necessary to demonstrate that a trade has been carried on within the meaning of the Income Tax Acts (see above), it is difficult to argue that HMRC's approach of not regarding the commercial occupation of woodlands as a trade for entrepreneurs' relief purposes is flawed. Indeed, it is my view that this was the clear intention of parliament.

For those who need further persuasion as to the correctness of the above analysis of the situation, it should be noted that the provisions relating to capital gains tax rollover relief (in respect of certain business assets) also apply, in the first instance, to assets used in a trade (see TCGA 1992, s 152), and here 'trade' is defined (along with other terms) as having 'the same meaning as in the income tax acts'.

TCGA 1992, s 158 specifically addresses 'activities other than trades'. It was thought necessary by the draftsman to include subsection 1(b), specifically extending roll-over relief to situations involving 'the occupation of woodlands where the woodlands are managed by the occupier on a commercial basis and with a view to the realisation of profits'.

Likewise, TCGA 1992, s 165(8) also states that '"trade" ... [has] the same meaning as in the Income Tax Acts', but then proceeds to state in subsection 9:

> 'In this section ..., the expression "trade" shall be taken to include the occupation of woodlands where the woodlands are managed by the occupier on a commercial basis and with a view to the realisation of profits.'

HMRC will argue, given the identical terminology for rollover relief and holdover relief purposes, that the absence of a specific provision – along similar lines to the aforementioned – can only mean that the business of occupying and managing commercial woodlands is not to be regarded as a trade for entrepreneurs' relief purposes. A very persuasive argument.

Accordingly, those responders who confirmed that Lumber Jack's client could not claim entrepreneurs' relief are, in my opinion, quite correct.

An alternative scenario

If we now explore another situation, it will be seen that a different outcome arises. Let's say that Farmer Gyles purchased Growmore Farm in 1990. Of a total area of 1,000 acres, the farm comprised 800 acres of arable farmland, with the balance of the 200 acres being woodlands that are occupied by Farmer Gyles on both a commercial basis and with a view to the realisation of profits. Accordingly, no income tax arose in respect of the profits derived from the felling of the trees and selling the timber (with the otherwise assessable capital gains thereon being exempt from capital gains tax under TCGA 1992, s 250).

Let's assume that, in 2016, Farmer Gyles disposes of Growmore Farm in its entirety and that he makes an assessable capital gain on the disposal of £5m. Will it be necessary, for example, to apportion the gain so as to identify that part attributable to the 200 acres occupied as commercial woodlands? The answer is that the entire gain can attract entrepreneurs' relief in these circumstances.

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Why? Well, assuming the disposal of the Growmore Farm will result in the disposal of the business hitherto carried on – which would not be so if Farmer Gyles continued to farm the land post disposal, for example, if he continued as a tenant – the conditions found in TCGA 1992, s 169I(2)(a) will have been met. Accordingly, with the farm business having been operated for more than 12 months, the disposal will be regarded as a material disposal of a business asset for entrepreneurs' relief purposes. One must also have regard to the test laid down in TCGA 1992, s 169L which restricts entrepreneurs' relief to gains on 'relevant business assets' comprised in a qualifying business disposal.

In the case of a sole trader, such as Farmer Gyles, s 169L(3)(a) states that only assets that are assets used for the purposes of a business carried on by the individual in question can satisfy the relevant business assets test. Therefore, the question becomes: can Farmer Gyles correctly say that the asset known as Growmore Farm has been used for the purposes of the business carried on by him as a sole trader?

The answer is clearly 'yes' and, because the legislation contains no provision requiring an apportionment to be made in circumstances where part only of an asset is so used, the whole gain will attract relief. The only additional hurdle to be jumped is also to be found in s 169L.

Section 169L(2) and (4) combine to prevent claims to relief in respect of assets that are held as investments – the so-called 'excluded assets' test. Farmer Gyles has clearly acquired a working farm, which will not be viewed as an investment asset in the circumstances described.

Thus, in the above example, the capital gain attracting entrepreneurs' relief will be the full assessable gain (assuming that the £10m lifetime cap will not restrict the relief). Farmer Gyles will enjoy entrepreneurs' relief despite his non-qualifying woodlands activities.

Farmer Gyles' situation can be compared with that of a sole trader who, say, owns a factory which is only used to the extent of 50% in his sole trader business. He will not suffer any restriction to his entrepreneurs' relief entitlement merely because a tenant occupies part of the asset from which he trades and, as a consequence, he receives rental income. Further, such an asset will not normally be regarded as an excluded asset within s 169L(4)(b). That said, such are the vagaries of the entrepreneurs' relief provisions, it may well be necessary to look at the circumstances surrounding the acquisition of an asset. It might, for example, be that the aforementioned sole trader first acquired the factory to hold as an investment. If so, HMRC might try to argue that a distinction must be made between an asset acquired with the primary purpose of using one-half in the acquirer's trade and a similar asset acquired as an investment asset and only later it is decided to bring one-half thereof into use in the owner's sole trader business. To my knowledge, no such dispute has arisen in practice – yet.

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Farmer Gyles' brother

Following on from the above comments about woodlands, we can now examine a slightly different scenario.

Let's say that Farmer Gyles' brother, Ted, bought Whitehouse Farm in 1990 – a very similar farm to that of Farmer Gyles, except that it comprised only 800 acres of arable farmland and no woodlands. However, Ted was impressed by his brother's activities as regards woodlands, so when, in 1993, he had the chance to buy 200 acres of commercial woodland adjoining Whitehouse Farm he leapt at the opportunity. Ted acquired the 200 acres and immediately began to operate as a commercial woodland business.

What is Ted's position if he also disposes of his entire farm in 2016? In other words, if he disposes of Whitehouse Farm plus the adjoining 200 acres of commercial woodlands, to a single purchaser – also realising a £5m assessable capital gain?

Ted's disposal will essentially comprise two assets – one acquired in 1990, and the other acquired in 1993. Unless there is some ground under property law for the two assets to be regarded as one, HMRC will expect each asset to be subjected to the s 169L relevant business assets tests described above.

Here, only the gain attributable to Whitehouse Farm will attract entrepreneurs' relief. The gain attributable to the 200 acres of commercial woodlands (but not the value of the standing timber) will attract the full rate of capital gains tax. Ted is unlikely to be able to demonstrate that any part of the 200 acres of woodland is used in his business of arable farming. That said, an interesting question would arise if Ted were to seek professional tax advice a year or two before his disposal – unlikely, I know.

Ted might be advised to introduce a number of beehives into the woodlands area, with a view to assisting in the fertilisation of the arable crops being grown on the 800 acres farmed by him, and thereby demonstrating that the woodlands were also used for the purposes of his arable farming business. Such an argument would be enhanced if it was supported by an expert report from a recognised melittologist extolling the benefits of situating beehives on the land in question. (According to Wikipedia, a melittologist is an entomologist specialising in the study of bees.)

Examine the facts

As indicated at the start of this article, it is essential to examine closely the full facts. For example, it may be that if Ted enquires into the history of the 200 acres of woodland, he discovers this land was part of Whitehouse Farm 125 years ago. In such circumstances, it may be possible to argue that there has been a single disposal of one asset acquired in two parts from two different vendors. If it can be argued that Whitehouse Farm and the woodlands comprise a single asset, Ted should advance the argument that his entire gain attracts entrepreneurs' relief (giving full details of the basis for his claim when submitting his tax return).

HMRC may well look at the structuring of the conveyancing document, but this should not be conclusive by itself – no more than would a decision by Ted to re-register both the farm and the adjoining woodlands as a single asset in his name be conclusive in his favour. Nothing can be taken as certain in this area and so locating a respected melittologist – and following his advice – could still prove helpful.

Uncommercial woodlands

Because entrepreneurs' relief applies only to assets used in businesses conducted on a commercial basis and with a view to the realisation of profit, it is tempting to think that land used for the growing of trees on an uncommercial basis will be less favourably treated than land used for commercial woodlands operations. However, because of the exclusion of commercial woodlands from being a trade for entrepreneurs' relief purposes it matters not whether the operations on the land are carried out commercially and with a view to making a profit or otherwise. Entrepreneurs' relief will only be available if the land comprises part of an asset used in a farming business, as explored in the above examples.

Associated disposals

None of the comments above should be taken as applying to circumstances where the taxpayer disposes of an asset that he owns personally, but which has been used in a business

conducted by a partnership of which he has been a member or by a trading company. He should be either a director or an employee and own at least 5% of the issued ordinary shares, as well as having at least 5% of the voting rights in the company.

Entitlement to entrepreneurs' relief for such so-called 'associated disposals' is set out in s 169K. It is not proposed to cover the complexities of this provision in this article. However, it is important to note that this section must be read in conjunction with s 169P. The latter imposes a number of restrictions, including one where there is an asset with mixed use. As a result, in a situation where, say, a partner owns the land on which a partnership (of which he is a member) trades, it will be necessary to examine the use of the land owned outside the partnership.

Bearing s 169P in mind, to the extent that any part of land is used for woodlands (irrespective of whether or not conducted on a commercial basis), the gain arising thereon will not attract entrepreneurs' relief by virtue of a 169P(4)(b). Contrast this with the position highlighted earlier in the example of Farmer Gyles.

Trading company and woodlands

TCGA 1992, s 165A contains the definition of trading company for entrepreneurs' relief purposes. In short, it states that 'trading company' means a company carrying on trading activities whose activities do not include to a substantial extent activities other than trading activities.

Where a company carries on the activity of managing commercial woodlands with a view to the realisation of profit – or indeed it carries on woodlands activities on an uncommercial basis – such activities will be regarded as *activities other than trading activities*. The woodlands activities must be augmented with any other non-trading activities in order to establish whether or not the non-trade activities are 'substantial'.

Trustees owning woodlands

Where trustees realise a capital gain by disposing of land, this must meet the 'settlement business asset' test, if there is to be any possibility of the trustees being able to benefit from the entrepreneurs' relief 10% rate. A detailed analysis of the entrepreneurs' relief provision in relation to trust gains is outside the scope of this article (see s 169J for details) but it is sufficient to state here that the trustees must demonstrate the following, in respect of any asset disposed of:

- The asset has been used for the purposes of a business carried on by a 'qualifying beneficiary' (broadly an individual with an interest in possession in all or part of the asset(s) disposed of) either as a sole trader or by a partnership of which he is a member:
  (1) throughout the period of one year ending with the disposal of the asset in question; or
  (2) throughout any other period of one year ending within the three-year period ending on the date of disposal.
- In addition, the qualifying beneficiary is required to show that he ceased to carry on the business in question either:
  (1) on the date of the disposal of the asset in question; or
  (2) on a date falling within the period of three years before the date of the disposal of the said asset;

and that the s 169L 'relevant business assets' test is met (outlined above).

It will be noted that there is no specific provision relating to land used as woodlands and neither is there any provision seeking to restrict relief where there is mixed use of an asset. There is, however, a need to demonstrate that the qualifying beneficiary has ceased to be involved in the business as a sole trader or partner, yet there is no requirement that the business itself (or part thereof) be disposed of.

Accordingly, whether the trustees may benefit from entrepreneurs' relief in a particular situation will be determined by whether it is possible to satisfy the above tests and, in particular, demonstrate that the land assets has been used at least in part (throughout the required time) for the purposes of a business carried on by a qualifying beneficiary as a sole trader or as a partner. As explained earlier, 'business' means a trade, profession or vocation conducted on a commercial basis with a view to realisation of profits (and that s 169(8) states that the word trade 'has the same meaning as in the Income Tax Acts, (see ITA 2007, s 989). It will be seen from the earlier analysis of Lumber Jack's position that this specifically excludes the activity of commercial woodlands.

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In summary, for trustees' disposals, it is necessary to look at each asset and apply the business use test. Where the entire asset has been used for a woodlands activity carried on by a qualifying beneficiary throughout the relevant one-year period, the gain thereon will not attract entrepreneurs' relief because there will be no qualifying 'business use' of the asset. However, where part of the land asset has been used, say in a farming business carried on by the beneficiary as a sole trader, and only part thereof has been used for commercial woodlands, it appears that the entire gain has the potential to attract entrepreneurs' relief – assuming that all other conditions of the relief as it applies to trust gains are satisfied.

Conclusion

While the stimulus for this article was the entrepreneurs' relief query on commercial woodland activities, the central message is that readers should be fully aware of the mechanics of entrepreneurs' relief for mixed-use assets generally. ■

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