The Personal Tax Review

THE HISTORICAL BACKGROUND TO SECTION 397 – HOBBY-FARM LOSSES

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Introduction

Section 397 TA 1988 is an anti-avoidance provision which was originally enacted in 1967. In broad terms it restricts the set off of current year farming losses against other income if there have been five or more consecutive years of losses immediately prior to the current year.

The purpose of this article is to examine the events leading up to the introduction of this legislation by reference to the relevant files of the Inland Revenue and the Chancellor of the Exchequer now held at the Public Records Office. Understanding this legislative background should aid the debate on whether circumstances are now so different that there is merit in the recent calls for the repeal of the section or whether some other way of dealing with the problem may be more appropriate to current conditions.

The Position Before Section 397 Was Introduced [2]

Section 397 was not the first attempt to restrict loss relief for the so-called hobby farmer. The matter had been reported on in 1955 by the Royal Commission on the Taxation of Profits and Income which had recommended that "nothing more is

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[2] For details see 1999 *British Tax Review* pp. 106-113 'Creating Anti-Avoidance Legislation – A Look Behind The Scenes'. D.P Stopforth.

required than a small amendment to the tax code".[3] It suggested the remedy which the Inland Revenue had proposed to it, ie the insertion of the words "on a commercial basis and with a view to the realisation of profits" in the definitions of farming and of market gardening.[4] However, action was only prompted in 1960 when a report of the Comptroller and Auditor-General showed that a substantial proportion of all loss relief claims related to farming, particularly by surtax payers. By that time the Revenue's attitude had hardened and they advised the Chancellor that to be effective loss relief would need to be disallowed unless the farming was carried on on a commercial basis and with a *reasonable expectation* of profit.[5] They were clearly aware that without the substitution of the words "reasonable expectation" a mere reliance on "a view to the realisation of profits" would involve questions about a farmer's intentions which would probably be resolved in his favour on any appeal. However, on advice from the Ministry of Agriculture and following pressure from the Conservative Party Finance Committee, the Chancellor decided to follow the wording suggested by the Royal Commission but to do so by amending the loss relief rules rather than by altering the definition of farming and market gardening. By this means it did not appear that the farmers were being singled out, even though "losses on other hobby activities do not provide a serious problem".[6] Despite what now seems to be the relatively innocuous nature of the proposals, they were subject to extensive parliamentary debate but survived unscathed to become what is now sections 384 and 393A of the TA 1988. Political pressure and representations had forced the acceptance of legislation which the Revenue knew would be problematic to apply given its lack of an objective test.

The Revenue's Predictions Come True

Undeterred by only having acquired a rather weak weapon, the Revenue nevertheless used it to attack many extreme cases. In appeals to the General Commissioners, they had "a fair measure of success [having] won more than half of the cases".[7] However, their experience before the Special Commissioners was entirely the opposite and by early 1967 they had not won a single appeal. Their frustration is illustrated by the following example. Early in 1966, leading counsel

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3 Cmnd. 9474, para 494.

4 *Ibid.*

5 PRO File T171/508. Memorandum to Mr Bell, February 18th, 1960.

6 PRO File T171/508. M263 dated March 1st, 1960 at paragraph 7.

7 PRO File IR63/251, page 919.

had advised a claimant as follows:

> "In the end the cardinal question must be with what view Mr X has been engaged in his farming activities. What was his objective? This is essentially a matter of intention, formed in his own mind. If he asserts that his objective was profit earning his answer to the question must, in my opinion, be conclusive of the whole matter unless circumstantial evidence shows the answer to be incredible."[8]

The case had involved losses of over £10,000 a year for more than ten years without any sign of improvement. The taxpayer sent a copy of the opinion to the Revenue which decided that "in the light of this opinion, which accorded with our view of the attitude of the Special Commissioners to a case of this kind, we had no alternative but to drop the case".[9] By this time it was clear to the Revenue that unless something was done their success rate before the General Commissioners would soon be much reduced.

Revenue Action

On 17th February 1967, the Chairman of the Board of Inland Revenue submitted a four page paper to the Chancellor entitled "Hobby farmers – tax relief for losses".[10] After briefly explaining how trading losses could be set against other income, the Chairman referred to the "abuse" of this relief which "occurs in practice almost wholly in the field of farming and market gardening".[11] At that time the after tax cost of a loss could be as little as one shilling and nine pence (8%) in the pound. This was forcefully brought to the Chancellor's attention together with the fact that "the hobby farmer is normally prepared to go on incurring losses even if he sees no prospect of getting out of the red, either because the farm is part of his way of life, or because of the prestige it gives him, or because his land is a hedge against inflation on which his estate will qualify . . . for a sizeable relief from estate duty".[12]

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8 PRO File IR63/246, page 119.

9 *Ibid.*

10 PRO File IR65/251, pp 917-920.

11 *Ibid*, para 2.

12 *Ibid.*

The paper briefly set out the history of the 1960 provisions and claimed that they had been "by no means wholly ineffective"[13] on the basis that relief for taxpayers engaged in agriculture, horticulture or market gardening had reduced from an average of just over £12m per annum in the five years to 1959/60 (about £182 million in current terms) to an average of £10¾m in the five subsequent years (about £139 million in current terms). However, no specific examples of successes with the existing legislation were presented and no statistics were provided of the total disallowed loss relief. The weakness in the existing provisions was highlighted by reference to three cases heard by the Special Commissioners involving "annual losses of £46,000 (pedigree cattle breeding), £19,000 (stud farming) and £12,000 (normal farming) respectively [which] were not exceptional losses . . . but were generally typical of the activities in question".[14] The Chairman then gave the Chancellor the following warning:

> "The hobby farmer who is well advised can escape any restriction of tax relief in respect of his losses by lodging an appeal to the Special Commissioners. In this way, many of the biggest fish have already escaped our net; and as knowledge of the situation spreads, what success we have had . . . is likely to be jeopardised".[15]

Having made out the case for action, the following three alternative solutions were put forward.

1. The substitution of the words "with a reasonable expectation of profit" for the existing "with a view to the realisation of profits".

2. A requirement for the taxpayer to demonstrate that his activities were likely to show a specific degree of profitability (measured by reference to the profitability of other similar undertakings run on a truly commercial basis) within a specified period.

3. An entirely objective test such that relief would cease after losses had been made for five consecutive years.

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13 *Ibid*, para 6.

14 *Ibid*, para 8. These amounts convert to approximately £520,000, £215,000 and £136,000 respectively in current terms.

15 *Ibid*, para 9.

The Chairman of the Board dismissed the first possibility as he believed it left open an element of motive while the second was both too difficult to draft and would leave the Revenue "largely at the mercy of expert witnesses"[16] on any appeal. The third approach was also thought to be open to criticism as being too generous in giving relief for five years of losses to hobby farmers while being too harsh on farmers who deliberately accepted a series of losses in building up what subsequently became successful businesses. Furthermore, it was realised that such an approach could be represented as being unfair to the farmer who did his best to make profits but who had a run of bad years or was simply not very efficient.

The Inland Revenue did not make any suggestions as to how the matter should be resolved and merely pointed out that any really effective legislation was bound to be highly controversial. The Chancellor was also warned that the Ministry of Agriculture might have reservations about more stringent legislation and ought to be consulted in advance of any action being taken. Rather surprisingly, the Chairman concluded by recommending against legislating in 1967 as he thought the need to do so was neither immediate nor urgent.

Ministerial Reactions

Both the Chief Secretary and the Financial Secretary to the Treasury were much more enthusiastic than the Revenue about taking immediate action. One advised the Chancellor that he preferred the reasonable expectation of profit approach while the other suggested that there was a need for further discussion and clarification but that some action "would provide people with the feeling that we are moving in the right direction".[17] The Chancellor indicated a preference for holding the matter over until the following year but asked the Chief Secretary to call an appropriate meeting.

The Chief Secretary quickly arranged a meeting at which it was decided that farming losses should be debarred from set-off against general income once they had continued for more than *three* years (five in the case of new farmers) subject to a let-out for exceptional cases where profitability was, on any reasonable view, expected to be deferred for a longer period. However, the Revenue were instructed at the meeting to discuss these proposals with officials of the Ministry of Agriculture.

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16 *Ibid*, para 10.

17 PRO File IR63/251, page 291.

The Ministry's representatives made three main points. First, they regarded the three year period as too short because it was likely to catch many genuine profit seeking farmers who were merely going through a bad spell. In their view the *minimum* acceptable period was five years. Secondly, they did not feel confident that a letout could be devised which would not be open to abuse, particularly by pedigree cattle breeders and stud farmers where it was generally accepted that starting from scratch they could not expect to become profitable in less than ten years. Thirdly, they drew the Revenue's attention to the National Agricultural Advisory Service (NAAS) which had given free advice to farmers for many years but had only recently revised its reports so as to analyse precisely which crops or activities showed a profit or loss and to indicate the course to be followed to obtain better profits. The Ministry suggested that if appeal commissioners had these reports brought to their attention together with a statement of the farmer's follow up action, the Revenue might be more successful in showing that the farm had not been operated on a commercial basis with a view to profits.

In their report back to the Chief Secretary, the Revenue agreed that a five year limit would probably be the best way forward. As regards the difficulty with a let-out, they advised that the only way to prevent abuse would be to have no let-out at all but suggested that this was politically impossible. As regards the NAAS reports, as there was no compulsion on farmers to consult NAAS, the Revenue doubted that these would be much help. In any event, Inspectors were already under instruction to enquire whether the service had been consulted and, if so, to obtain copies of any reports in all cases taken to appeal. By 31st March 1967 the Chief Secretary had accepted the Revenue's suggestions and agreed that a five year period should be initially used which could be reduced if necessary in later years. Furthermore, with only 11 days to the Budget Statement, he requested that "we should try to include it in this year's Finance Bill - but no need to break necks".[18]

The Ministry of Agriculture had asked that their Minister should be given an opportunity to comment before any final decision was taken, but given the shortness of time the Revenue immediately gave drafting instructions to Parliamentary Counsel. It is not known what the Minister of Agriculture had to say on the matter, but the draft legislation took the form proposed by the Inland Revenue. In sharp contrast to the position when the 1960 legislation was introduced, the 1967 provisions involved no discussion in Parliament and there is no indication on the Revenue or Treasury files that any representations were made. As a result, the Revenue acquired a new weapon of which they were the chief designers and they got the power to use it earlier than they thought due to the clear political advantage

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18 *Ibid.* page 298.

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in a Labour Government being seen to take action against hobby farmers.

Conclusion

At the time this legislation was introduced, the top rates of income tax had for many years been more than double those we have now become used to and in such a high tax rate environment dealing with extreme cases was probably necessary. However, it should be remembered that the Ministry of Agriculture did suggest that a five year period was a *minimum* acceptable period as otherwise it would catch those who were merely going through a bad spell. The last few years has seen widespread hardship for farmers and thankfully the Inland Revenue have introduced a limited concession to temporarily relax the severity of the five year period. Instead of a concession, maybe the time has come to give serious consideration to the regular Budget representations calling for the abolition of section 397 so that farming losses are dealt with in the same way as losses of other trades. It could be argued that even though generous inheritance tax reliefs are available, with a top income tax rate of 40%, there is now far less attraction to "hobby farming" than there was 40 years ago. It may well be "beyond question that in the vast majority of farming businesses the concept of hobby farming is totally inappropriate"[19] as has been urged upon the Chancellor by the Institute of Chartered Accountants of Scotland. Alternatively, maybe there are still people who are prepared to go on making losses for the various reasons put forward by the 1955 Royal Commission: the prospect of a capital profit, the amusement of indulging in their hobby or as a hedge against inflation. But these reasons now look a little thin so perhaps it is time to consider abolishing such discrimination against farmers. It might then be necessary to tighten up the general restriction on setting off losses against other income. If so, the substitution of the words "a reasonable expectation of profit" for "a view to profit" in sections 384 and 393A TA 1988 would provide an objective basis for the disallowance of all sideways loss relief against other income. That was, after all, what the Revenue suggested to the Chancellor as the appropriate way to deal with the problem in 1960!

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[19] Page 7 of ICAS Budget representations on the Finance Bill 1996.