HM Revenue
& Customs

Income Tax: Extension of averaging period for farmers

Summary of Responses
9th December 2015

Contents

On request this document can be produced in Welsh and alternative formats including large print, audio and Braille formats

Foreword

Volatility, in yields, prices and incomes, is an inherent feature of the agricultural industry, and we can expect more volatility in the future. Part of the answer is the growth and increased use of important private sector market mechanisms for managing risk. This will be an important feature of the ambitious 25 year plan for food and farming that we are preparing, as we look to build on the excellent global reputation of UK food and drink.

In parallel, the government wants the tax system to accommodate the realities faced by farmers by increasing the period over which they can average their profits in a way that is simple to understand and use.

At the March 15 Budget, the government announced that it would extend the period over which self-employed farmers can average their profits for Income Tax purposes from two years to five years from April 2016 and that it would engage with interested parties on the design and implementation of the extension.

We are grateful to all those who have contributed to the consultation both through responses and attendance at meetings. These contributions have been constructive and have significantly informed decisions on how the extension should be delivered to support our objectives for the industry.

The key messages that have emerged from the responses to the consultation is that the current two-year averaging regime delivers significant relief and is well understood and that an extension must balance providing more flexibility to achieve the best outcome for farmers with simplicity of approach to keep costs down and encourage use. We have listened to the views expressed and have decided that simply replacing the two-year averaging regime with a five-year regime will not strike the right balance. We will therefore retain the two-year averaging regime but in addition will also provide an alternative for farmers to choose to average over five years.

Elizabeth Truss MP
Secretary of State, Department for Environment, Food and Rural Affairs

David Gauke MP
Financial Secretary to Treasury

1. Executive Summary

1.1 At Budget 2015, the Government announced that it would extend the period over which self-employed farmers can average their profits for Income Tax purposes from 2 years to 5 years, with effect from April 2016.

1.2 To consider the design of 5 year averaging, a consultation entitled 'Income Tax: Extension of averaging period for farmers' was published on 8th July 2015 and ran until 7 September 2015.
https://www.gov.uk/government/consultations/income-tax-extension-of-averaging-period-for-farmers

1.3 The Government received 26 responses to the consultation. HMRC and HMT officials also met twice with representatives from the agricultural sector and the tax advisory profession.

1.4 The Government would like to thank respondents for their contributions and for taking time to respond and attend meetings. This document summarises the content of the responses received. It also sets out how the Government intends to proceed regarding the extension of averaging for farmers.

1.5 Overall opinion was divided. Several respondents highlighted the importance to the industry of giving farmers maximum flexibility with regard to averaging of profits. However, a significant number of responses emphasised that the current 2 year averaging regime is well understood and already delivers considerable flexibility; further flexibility would mean additional complexity and increased costs.

1.6 The Government has decided that the optimum balance between flexibility and simplicity will be achieved by retaining the existing 2 year averaging regime and providing an additional option that will give farmers the choice of averaging over a 5 year period or a 2 year period. Legislation will therefore be introduced in Finance Bill 2016 to provide 5 year averaging for individuals carrying on a trade of farming, market gardening or the intensive rearing of livestock or fish.

1.7 The Government considers that two alternative averaging periods will not be disproportionately complex. There will be a significant degree of symmetry between the 2 year and 5 year alternatives, which farmers and tax practitioners will be familiar with.

1.8 The Government has also identified an opportunity to simplify the regime by removing the marginal relief for averaging over 2 years. Marginal relief will not feature in the 5 year averaging option.

.

2. Introduction

Background to the consultation

2.1 Farmers typically have volatile profits, due to factors such as weather, disease outbreaks or fluctuating global prices. The Government wants the tax system to accommodate the realities faced by farmers and averaging assists farmers by allowing them to spread profits over consecutive years to offset the volatility of profits. Increasing the period over which farmers can average their profits provides additional assistance in managing the volatility they face.

2.2 Averaging can be applied to profits earned from farming or market gardening in the UK, whether carried on alone or in partnership. It can also be used for profits from the intensive rearing in the UK of livestock or fish on a commercial basis for the production of food for human consumption.

2.3 The extension to 5 year averaging is intended to benefit more farmers, who will be able to claim to average their profits during periods of extended volatility. It is estimated that the number of farmers averaging from 2016/17 will increase to 28,000.

The proposals

2.4 The consultation presented two methods of delivering an extension:

- Option A built on the existing framework. It required annual claims for averaging relief to apply over the current and preceding 4 years. Claims remained subject to a qualifying condition [volatility test] requiring a minimum level of volatility of profits over that period.
- Option B offered a new framework. It removed the ‘volatility test’ as a barrier to entry. This framework moved away from an annual claim to one were farmers could opt-in on an irrevocable basis for a period of 5 years, averaging automatically each year.

3. Responses

The responses

3.1 The Government received 26 responses to the consultation. Of those responses 12 were received from the tax advisory profession and 6 from their representative bodies. There were 5 responses from industry representatives and 3 responses were also received from individuals. A full list of respondents is included at Annex A.

3.2 HMRC and HMT officials also met twice with representatives from the agricultural sector and the tax advisory profession

Overview of responses

3.3 Most respondents considered that the current regime, which facilitates averaging over a period of two years, was well understood and served its purpose very effectively.

3.4 However, several industry representatives considered that the final framework should provide a more flexible approach by allowing averaging over a range of periods between 2 and 5 years, rather than the fixed period of 5 years set out in Options A and B.

3.5 While acknowledging the desire for additional flexibility, other respondents cautioned against too much choice around the length of the averaging period, as this would inevitably add complexity and increase the cost of advice and compliance.

3.6 Almost without exception respondents considered that Option B would not achieve the aims of the measure. The key drawback being the irrevocable nature of the opt-in which was likely to deter many farmers from opting-in.

3.7 There was mixed opinion among respondents as to the need for a volatility test under Option A. On the one hand it was acknowledged by some that it was a barrier to averaging relief and an additional complication in terms of administration. It was equally suggested that the volatility test ensured that only genuinely volatile profits were averaged, preventing insignificant adjustments occurring on an annual basis.

Specific responses to the consultation questions

Question 1
Are there any other aspects of the current rules that should be retained?

3.9 Paragraph 3.5 in the consultation set out a number of aspects of the current regime which the extension would retain. The clear view among respondents to this question was that the existing regime was well understood, familiar, effective and not unduly complex:

> *"The retention of the aspects of the current regime as detailed in paragraph 3.5 is welcome. The basic principles of the current relief are familiar and well understood. We see no reason to change them".*

3.10 There were seventeen respondents who considered that the existing 2 year regime should be retained, in addition to a framework providing an extension to 5 years:

> *"we think there may be a case for the current 2 year averaging period being retained as an option, as well as introducing an extended 5 year averaging period. HMRC will need to consider the evidence it receives and balance this against the additional complexity having more than one option would bring"*

3.11 Although not part of the current 2 year averaging regime, a sizeable number of respondents took the opportunity to suggest that averaging should be available in the years of commencement or cessation of farming. However the view was not universal:

> *"we believe the decision not to allow averaging in the first and last year of participation in a trade should be reviewed. The need for this exclusion is no longer clear in policy terms. With the advent of high initial capital allowances as a feature of the recent tax system, permanent cessation is often now giving rise to a high relative taxable income in final periods as a result of balancing charges as there tends to be very little pool value left. This is a time when averaging is more vital than ever"*

> "*while we sympathise with the suggestion to extend averaging to the years of commencement and cessation, we believe this would create added complication given that opening and closing years are often based on the profits of part years and that the interaction with overlap relief would be an additional complicating factor."*

3.12 Government response: The Government recognises the value in retaining the fundamental features of the existing averaging framework, to minimise the changes being introduced. Incorporating the same features within a new 5 year regime will help farmers and advisors to understand and take full advantage of the options available from 2016/17.

3.13 Extending averaging to the years of commencement and cessation, would be a move away from the familiar aspects of the current regime and also add complexity. The Government does not believe such a change would be appropriate.

Question 2
Do you agree the proposed methodology for applying the volatility test under Option A, if not please explain your reasoning?

3.14 A small number of respondents questioned the need to retain a volatility test. It was felt that averaging claims would only be made in practice if the level of volatility was sufficient to warrant a claim:

> *"we question whether there is a need for such a test. The concept of profit averaging was introduced when the relevant calculations had to be made manually by the farmer or their agent and checked manually by HMRC. It was therefore appropriate as a matter of cost-efficiency to confine the application of averaging to those situations where there was material volatility".*

By contrast, a similar number of respondents saw merit in the principle of a volatility test, to target relief in a cost effective manner:

> *"This will also assist with compliance costs as computations would only need to be carried out if the volatility test was satisfied"*

3.15 In terms of the proposed methodology, there was general acceptance among most respondents that it was sensible to apply the volatility test, in such a way as to address volatility during the period for which profits were to be averaged. However concerns were raised by some that anomalies would occur and potential claimants may fail the test in common situations:

> *"The volatility test as set out in the consultation document would mean some taxpayers could not average whereas under the current rules they could (those where there is a substantial change between the current and previous years, but not a significant change when compared to the previous 4 years)".*

3.16 Respondents were overwhelmingly supportive of the proposal to deem the volatility test as having been met if a loss arose in any of the five years.

3.17 **Government response:** The Government remains of the view that the volatility test is an essential feature of an annual claim framework. It provides a first basic check as to the potential costs and benefits of any claim for averaging and in policy terms ensures that relief is targeted at volatile farming profits.

3.18 The responses to Question 2 indicate that respondents were divided on the need for a volatility test. Some concerns were also raised that the proposed methodology of the 5 year volatility test might exclude claims that were related to shorter periods of volatility.

3.19 The Government acknowledges the concerns raised in relation to the volatility test under Option A. However these concerns are substantially overcome in the context of retention of the 2 year averaging regime. If volatility is sufficient, but relatively short term, then the 2 year averaging regime will remain available. On that basis the Government considers that the volatility test as proposed under Option A remains the most appropriate measure of volatility for 5 year averaging.

Question 3
Do you agree that a marginal relief should be omitted from the new rules?

3.20 With one exception, all the respondents were in favour of removing marginal relief. The overwhelming view was that this would deliver a welcome simplification.

3.21 Several respondents suggested that averaging relief should continue to be available if the level of volatility reached 75%, but attracting full averaging relief rather than marginal relief.

3.22 **Government response:** The Government has decided that marginal relief will not be included in the 5 year averaging regime and that the volatility level will be set at 75%. Marginal relief will also be removed from the existing 2 year averaging regime.

Question 4
Would Option A (including transitional arrangements) achieve the aim of delivering the 5 year extension to averaging while reducing complexity in the way that the relief works?

3.23 Many respondents liked the approach taken in Option A as it was familiar and allowed farmers to consider, on an annual basis, whether it was advantageous to make a claim:

> *"We prefer Option A as it is based on the current rules which are widely understood and will give both farmers and their advisors comfort that they will be better off if they choose to make an averaging claim".*

3.24 While most respondents took the view that 5 year averaging would assist the industry, by addressing the volatility that can arise over a period beyond 2 years, concerns were often raised that there was a need to retain some flexibility by allowing claims to be made for shorter periods of volatility:

> *"Extending the averaging period to a 5 year period could be disadvantageous for some taxpayers. By making repeated 2 year averaging elections over a period of several years the taxpayer, in many*

cases, would not get an outcome materially different to that proposed through 5 year averaging. We prefer option A whereby a farmer can decide on a year by year basis whether or not to average. In order to assist people in the industry we would suggest that the 2 year rule is maintained and that a five year rule is offered as an additional option".

3.25 There were a range of suggestions as to what level of flexibility was desirable and how that might be delivered. At one end of the spectrum it was suggested by several respondents that the existing 2 year framework was all that was required and that any change to 5 years would be unduly complex. Several others suggested that farmers should benefit from the flexibility to average any period between 2 and 5 years.

3.26 However, most respondents raised concerns about the degree of additional complexity and cost of administration that increased flexibility would create. Many respondents highlighted that additional calculations would be required in respect of each different period of averaging, to determine the eligibility to claim and decide whether a claim would be beneficial:

"In general, our comment is that whatever is introduced will increase complexity of the existing system (and so the consequent cost of review). Therefore our preference is to retain the simple two year averaging period currently available, but build on this in a way which is as simple as possible to understand and to operate for longer periods of volatility".

"If further averaging claims are made for subsequent tax years, the tax liability of any one tax year may be need to be recalculated 5 times before the final liability is determined under these proposed provisions"

3.27 **Government response:** The Government is committed to delivering a framework that will provide the facility for qualifying farmers to average their profits over 5 years. However, the case for recognising that volatility may be confined to a shorter period has been well made. It is also apparent that farmers may not wish to routinely incur the professional fees that might be associated with assessing the impact of a 5 year averaging claim.

3.28 Option A has met with a positive response, delivering the objective of 5 year averaging in a package that is familiar. However there was a common sentiment among many respondents that the option to average over a fixed period of 5 years does not provide sufficient flexibility for shorter periods of volatility

3.29 On this basis the Government will retain the existing 2 year framework in addition to the introduction of the 5 year averaging framework under Option A. It is accepted that having two regimes inevitably brings some further complexity, however it is considered that the similarity and synergy between the two regimes will mitigate that complexity.

3.30 Retention of the 2 year option will further serve as a proxy for transitional relief under Option A. On that basis, and by way of simplification, transitional relief will not be available under the 5 year option. Farmers will be able to choose annually whether to average over 2 or 5 years, or not at all.

Question 5

Would Option B (including transitional arrangements) achieve the aim of delivering the 5 year extension to averaging while reducing complexity in the way that the relief works?

3.31 There was a clear consensus among respondents that Option B did not offer a viable framework. The irrevocable nature of the 5 year opt-in was seen as a significant drawback and farmers and agents alike would be slow to commit to averaging when the future was uncertain.

3.32 It was also observed by some respondents that while averaging over a longer period would provide a smoother level of profits, some farmers also had non-farming income and so averaging over a longer period would not always lead to a tax saving:

> *"We are not sure that we would want to lock any of our clients into an irrevocable prospective five year election. It is not just changes in rates or bands that may have an impact over a five year period. There are all sorts of other tax and non-tax considerations that may be relevant."*

> *"An irrevocable election for a future period would impose on the taxpayer the administrative burden of carrying out the computations, even if there turns out to be no benefit."*

3.33. **Government response**: The Government has noted the views of respondents and accepts that it is not possible to predict whether averaging over 5 years will be advantageous in all circumstances. The Government notes respondents concerns that Option B may be unattractive to farmers or deter them from taking advantage of the benefits of averaging. On that basis the Government has decided the framework outlined as Option B should not be implemented.

3.34 Although some responses suggest that Option B might be presented on a revocable basis, it is considered that in practice this would amount to an annual claim framework. Without any form of volatility test the Government considers these revisions could commonly lead to compliance costs that were disproportionate to any tax saving.

Question 6 We would welcome your views on the two alternative frameworks. What are (a) the advantages and disadvantages of Option A, and what are (b) the advantages and disadvantages of Option B?

3.35 Respondents were overwhelmingly supportive of Option A as it delivered the facility to average over 5 years, within a framework that was familiar and would be understood by taxpayers and practitioners. However most respondents felt that further flexibility was required to allow farmers to average over a shorter period of volatility. Many respondents were also concerned that further flexibility would inevitably add complexity in requiring additional calculations covering 5 years:

> *"Option A has the advantage of not being too dissimilar to the current system but it is unnecessarily rigid and may fail to give relief, at the time it is needed, for a short sharp period of volatility".*

> *"We do not believe the proposals reduce complexity. Averaging operates at partner, not partnership, level. Reviewing averaging decisions typically involves reworking tax figures for 2 years and comparing the results to see if it is advantageous. Doing this over 5 rather than two years will significantly increase the work load."*

3.36 Option B was welcomed by several respondents for its simplicity and consistency of approach for many farmers, but the major disadvantage highlighted by most respondents was the irrevocable nature of the 5 year opt-in:

> *"We think that committing to an irrevocable choice when the relevant variables were wholly unknown would discourage averaging claims. From an agent's perspective, it would be impossible to provide advice on the implications of the action. Simply stated, there would be too many 'unknown unknowns".*

3.37. **Government response**: The Government has noted the responses and will implement a revised version Option A, in addition to retaining the existing 2 year averaging framework.

3.38 The revisions to Option A will exclude transitional relief for new farmers and reduce the volatility test to 75%.

Question 7
Do you consider that there are circumstances in which the options would give rise to outcomes inconsistent with the policy objectives outlined in paragraph 1.6 and, if so, in what circumstances and how might these situations be addressed?

3.39 The high level objectives set out in the Consultation (paragraph 1.6) were:

- Extend averaging to farmers to 5 years
- Ensure that no profits fall out of charge
- Keep the rules as simple as possible to understand and operate

3.40 Most respondents felt the options delivered the first two policy objectives. However concerns were again raised by several respondents that the move to 5 year averaging would bring additional cost and complexity.

3.41 Several comments were also received that in some circumstances 5 year averaging under Option A may not be financially advantageous over a shorter averaging period and most respondents felt Option B was unlikely to be an attractive option for farmers.

3.42. **Government response**: The Government considers that the final framework will meet its policy objectives. The additional complexity inherent in having two distinct periods of averaging is mitigated by the similarity between the two options.

Other issues

3.43 A number of other issues were raised in relation to averaging of farming profits.

3.44 Nine respondents highlighted the difficulties averaging posed to the calculation and administration of pension contributions for farmers:

> "*We believe that farmers profit averaging does currently affect net relevant earnings for pension purposes. However with five year farmers profit averaging this will make pension contribution planning more difficult, particularly for those who find it necessary to make lump sum pension contributions as cash flow allows. We would therefore suggest that in future Net Relevant Earnings for pension contribution purposes should be based on profits arising in the tax year regardless of an averaging claim".*

3.45 **Government response:** The Government is currently considering responses to the consultation on pensions tax relief which was published at the Summer Budget. The Government will respond to this consultation at Budget 2016.

3.46 Two respondents suggested that the profits to be averaged should be the profits before capital allowances are applied. One respondent suggested that the current approach of averaging profits after capital allowances be retained.

3.47 **Government response:** The Government does not consider there to be any clear advantage to altering the current basis of the profits being averaged.

4. Next steps

Implementation

.

4.1 The Government is announcing these changes today, in advance of their introduction from 6th April 2016.

4.2 Draft legislation was published on 9 December 2015 for technical consultation. We would welcome any comments you have on the draft legislation. The consultation will run for 8 weeks.

4.3 If you have any comments on the draft legislation, please send them to Mark Bingham by email if possible to: fa.consultation@hmrc.gsi.gov.uk

4.4 Alternatively, comments may be sent by post to the following address:

Mark Bingham

HMRC

Level 2

Dorchester House

52-54 Great Victoria Street

Belfast

BT2 7WF

.

Annexe A: List of stakeholders consulted

The following representative bodies and professional advisors formally responded to the consultation:

1. Allen Sykes Chartered Accountants
2. Armstrong Watson Chartered accountants
3. Association of Taxation Technicians
4. Central Association of Agricultural Valuers
5. Chartered Accountants Ireland
6. Chartered Institute of Taxation [CIOT]
7. Country Land and Business Association
8. Deloitte LLP
9. EQ Accountants
10. Farmers' Union of Wales
11. Grant Thornton UK LLP
12. Harold Smith Partnership
13. Institute of Chartered Accountants in England and Wales
14. Institute of Chartered Accountants of Scotland
15. John Ashley Chartered Accountants
16. Johnston Carmichael LLP
17. Landtax LLP
18. National Farmers' Union
19. Nevill Hovey Chartered Accountants
20. Old Mill LLP
21. Sage UK
22. Tenant Farmers Association
23. Ulster Farmers' Union

There were also three responses from individuals.