

[2016] UKFTT 47 (TC)

TC04842

Appeal number: TC/2014/06037

TC/2014/06038

Income Tax – losses – sideways loss relief – s 68(3) ITA 2007 – reasonable expectation of profit – time when test applied – application of test to farmer accepted as competent – held – milk price main component in profitability – outside farmer’s control – no reasonable expectation of losses for loss period – appeal dismissed.

FIRST-TIER TRIBUNAL

TAX CHAMBER

Bryan Scambler

Appellants

&

Rebecca Scambler

- and -

**The Commissioners for Her Majesty’s
Revenue & Customs**

Respondents

**TRIBUNAL: JUDGE Rachel Short
William Haarer (Member)**

**Sitting in public at Exeter Magistrates’ Court, Heavitree Road, Exeter on 7 December
2015**

Mr Andrew Gotch for the Appellants

**Mr Colin Brown instructed by the General Counsel and Solicitor to HM Revenue and
Customs, for the Respondents**

DECISION

1. This appeal concerns the availability of losses to Mr Scambler of £149,649 to set against chargeable gains and income tax for the 2010-11 tax year and the availability of losses to Mrs Scambler of £149,649 to set against chargeable gains and income tax for the 2010-11 tax year.
2. The Tribunal issued a direction on 2 December 2014 that these cases be joined and heard together.

3. HMRC issued closure notices on Mr and Mrs Scambler on 17 July 2014 amending their self-assessments by refusing to allow the losses claimed by both Appellants against capital gains tax and income tax for the 2010-11 tax year. HMRC refused to allow the losses because of the restrictions on “sideways loss relief” contained in s 67 Income Tax Act 2007 (“ITA 2007”). The Appellants requested a review of that refusal. HMRC confirmed their view in a review letter dated 13 October 2014. The Appellants appealed to this Tribunal on 10 November 2014.

Background facts

4. Mr Scambler was a dairy farmer. He worked initially on his parents’ dairy farm (Bocombe) and then, when he got married in 2003, acquired his own farm on neighbouring land (Melbury) in partnership with his wife, with bank financing of £970,000. He also continued to farm at Bocombe.
5. By 2003 Mr and Mrs Scambler had a dairy herd of 460 cows at Bocombe and Melbury in their dairy business. The milk produced at the Scambler’s farms was sold under an exclusive contract to Dairy Crest. Under that contract Dairy Crest could change the price paid for milk on one month’s notice. The partnership was profitable until the 2005-6 tax year although in 2004-5 it only made a small profit.
6. Milk prices started to decline in 2004 from a peak of 23 pence per litre in 2004, dropping from 18 pence to 17 pence per litre in 2006.
7. In 2006 Mr Scambler’s parents wanted to retire from farming and so Mr and Mrs Scambler bought them out of their farm at Bocombe, taking on further bank borrowings of £240,000 to do this
8. In 2007 the Scambler’s farming business made losses and so they sold some of their land at Melbury and the milking herd based there. It was decided to invest in a robotic milk shed on the land at Bocombe to increase yield and reduce losses. It was estimated that this would bring a 25% increase in production.
9. During 2008 the Scambler’s re-built the dairy herd to make up for the losses in 2007 and paid off some of their debts leaving them with approximately £600,000 of debt.
10. In 2009 the robotic milking shed was constructed at Bocombe for which borrowings of £350,000 were needed. This project suffered from delay and financial problems which meant milk production was not increased as quickly as had been anticipated. As a result further borrowings of £315,000 were needed in 2010 and more land was sold at Melbury which allowed the Scambler’s to repay £273,000 of their borrowings. A farm consultant concluded in 2010 that with the sale of this land at Melbury it was realistic to bring the farm back into profit.
11. By 2011 things were financially more positive. Losses were made in 2011 but the herd size was increased to improve production. Nevertheless, due to health issues and the financial strains of the business Mr and Mrs Scambler decided to sell the business in 2011.

The law

12. S 67 Income Tax Act 2007: This sets out the circumstances in which “sideways loss relief” is restricted for farming trades:
 - “1) This section applies if a loss is made in a trade of farming or market gardening in a tax year (“the current tax year”).

- (2) Trade loss relief against general income is not available for the loss if a loss, calculated without regard to capital allowances, was made in each of the previous 5 tax years (see section 70).
 - (3) This section does not prevent relief for the loss from being given if-
 - (a) the carrying on of the trade forms part of, and is ancillary to, a larger trading undertaking,
 - (b) the farming or market gardening activities meet the reasonable expectation of profits test (see section 68), or
 - (c) the trade was started, or treated as started, at any time within the 5 tax years before the current tax year (see section 69 below, as well as section 17 of ITTOIA 2005).
13. S 68(3) ITA 2007: This sets out the reasonable expectation of profits test:
- “The test is met if –
- (a) a competent person carrying on the activities in the current tax year would reasonably expect future profits (see subsection (4)), but
 - (b) a competent person carrying on the activities at the beginning of the prior period of loss (see subsection (5)) could not reasonably have expected those activities to become profitable until after the end of the current tax year”
14. S 68(5) defines the “prior period of loss” as
- “(a) the 5 tax years before the current tax year, or
- (b) if losses in the trade, calculated without regard to capital allowances, were also made in successive tax years before those 5 tax years (see section 70) the period comprising both the successive tax years and the 5 tax years”.
15. For our purposes the “beginning of the prior period of loss” is April 2005. The current tax year is the 2010-11 tax year.

Evidence

16. We saw a written witness statement of Mr Scambler dated 7 April 2015. Mr Scambler gave oral evidence to the Tribunal and was cross-examined by Mr Brown. Mr Scambler’s witness statement set out the history of his and the partnership’s dairy farming business. He said in that statement:
- “By the start of the 2006 year, particularly with the borrowing costs of expansion, we knew there was no prospect of making a profit with the farm as it was, because our costs were fixed (and in the case of feed, labour and fuel they were going up) and the milk we could produce was not enough to produce a profit unless farm gate prices rose a lot and there was no sign or guarantee that they would ever rise to profitability at that time”.
17. At the Tribunal Mr Scambler explained that the milk price fluctuated over time and he had no way of predicting the milk market. It was hard for him to take any action in a short time frame to protect himself against these fluctuations.
18. We saw a written witness statement of Mrs Jewell of R T Marke & Company Limited Chartered Accountants. Mrs Jewell gave oral evidence to the Tribunal and was cross-examined

by Mr Brown. Mrs Jewell was Mr and Mrs Scambler's accountant in 2005. Mrs Jewell's witness statement described a meeting which she had with Mr and Mrs Scambler in March 2005 when it became clear that their business was struggling:

"We agreed that with milk prices as low as they were, he and Becky (Mrs Scambler) could no longer cover their farm overheads and would make losses in future, particularly following their expansion to acquire Melbury the previous year.

Bryan (Mr Scambler) did not envisage an increase in the milk price, so we discussed whether he could achieve higher productivity by buying more cows. However, he pointed out that due to lack of facilities at the farm he was unable to increase the herd size to a level that would produce a sufficient increase in volume.

In the end it was agreed that although they would run at a loss, Bryan and Becky would do what they could to increase volume and would "weather the storm" in the hope that milk prices rose, despite the fact that they were unable to control it".

19. Mrs Jewell confirmed to the Tribunal that Mr and Mrs Scambler's margins were comparable to those of other dairy farmers.
20. At the request of the Tribunal after the hearing the Appellants provided data from DEFRA giving details of the average UK farm gate milk price per litre paid to producers from 1995 to 2009. This showed the average price per litre reaching a high of 25.02 pence in 1996, declining to 16.93 pence in 2000 followed by a gradual increase to 18.47 pence in 2005, a drop in 2006 but then a significant increase back to levels above 25 pence per litre by 2008.
21. Mr and Mrs Scambler also provided information about the farm gate price which they had actually been paid for their milk for each month from 1998 to 2006. This showed prices moving significantly from month to month, in 2004 the price fluctuated between a low of 14.948 pence per litre in June to a high of 22.735 in October with a similar fluctuation in 2005, in June 2005 prices were 14.814 pence per litre, by December they were 22.439. For the whole period the highest price paid was 22.900 pence per litre in August 1998 and the lowest was 14.085 in May 2000.

Agreed matters

22. It is agreed between the parties that s 68(3)(a) ITA 2007 is satisfied.
23. It is agreed that Mr and Mrs Scambler are "*competent farmers*" for the purpose of s 67 and s 68 ITA 2007.
24. The quantum of losses claimed by Mr and Mrs Scambler is agreed as £ 149,649 each.
25. There is no material dispute about the factual background of this appeal.
26. The issue in dispute between the parties is whether Mr and Mrs Scambler can rely on s 68(3)(b) ITA 2007 for the 2010-11 tax year to take them outside the rules in s 67 which would deny them "sideways loss relief" for that year.

Appellants' Arguments

27. On behalf of Mr and Mrs Scambler Mr Gotch pointed out that his clients were not "hobby farmers" or the type of farmer to whom s 67 is intended to apply. On the contrary, as is clear from the evidence, they had done everything possible to ensure that their farming business was profitable.

28. Mr and Mrs Scambler satisfy the condition at s 68(3)(b); in April 2005 there was no prospect of them, or a competent farmer undertaking those activities, making a profit from the farm business as it then was.
29. If Mr and Mrs Scambler are competent and if they had a reasonable basis for expecting that no profits could be made from the business as it was in 2005, the statutory test in s 68(3)(b) is satisfied. The only way in which they could fail that test is if those (lack of) profit expectations were not reasonable.
30. Mr Gotch also said that s 68(3) is a relieving provision and so should not be construed restrictively.

Interpretation of s 68(3)(b): “the activities”.

31. According to Mr Gotch, the activities referred to in s 68(3)(a) ITA 2007 are the activities carried on in 2010 (the year of the loss claim). The activities referred to in s 68(3)(b) are the activities which were actually carried on in 2005 (the start of the loss period).
32. In applying the test in s 68(3)(b) the activities which are the subject of that test are the activities of Mr and Mrs Scambler which were being carried out in 2005, before the sale of Melbury and before the acquisition of the robotic milking parlour. It was not reasonably conceivable that a profit could be made from those activities before 2010.
33. Any changes to the business or events which occurred subsequent to 2005 are not relevant to the test at s 68(3)(b).
34. HMRC are incorrect to argue that “the activities” which are the subject of the test are the activities being carried on in 2010-11. This is supported by the decisions in *Christopher John French and Margaret Alexander French v HMRC* ([2014] UKFTT 940(TC)) and *Peter Silvester v HMRC* ([2015] UKFTT 532 (TC)) both of which applied the test in s 68(3)(b) by reference to the farmer’s activities at the start of the loss period, or in this case, what Mr and Mrs Scambler were doing in 2005-6. HMRC’s interpretation leads to a legal nonsense; it would never be possible to satisfy both the test in s 68(3)(a) – the 2010 activities are profitable and s 68(3)(a) – the 2010 activities were not expected to make a profit if carried on for five years starting in 2005.
35. In Mr Gotch’s view there is no ambiguity in this legislation; it is crystal clear. HMRC cannot revert to older versions of the re-written legislation to support their case. Mr Gotch relied on the FtT decision in *Shirley* to support this position; it is only legitimate to consider earlier versions of consolidated legislation if “there is a real or substantial difficulty in interpreting the literal words of the statute” (*Shirley v HMRC* [2014] UKFTT 1023 (TC)). There is no difficulty in identifying and applying the proper construction of s 68 in this case.

HMRC’s arguments

36. Mr Brown said that the correct approach to the test in s 68(3)(b) is to ask whether the 2010 activities, if carried on by a competent farmer in 2005 could reasonably have been expected to realise a profit within five years; the answer to that must be yes.
37. The onus is on the taxpayer to demonstrate a specific reason why profits would not be made within five years on this hypothesis; the Appellants have not provided that evidence. None of the actions taken by the Appellants subsequent to 2005 can be relevant to this test, which can only look at what was known and what had been done by April 2005.

38. The aim of s 68(3)(b) is to allow losses where activities are such that an extended period of time is needed to bring the business to fruition and profitability.

Interpretation of s 68(3)(b): “the activities”

39. According to Mr Brown, there is some ambiguity in how the test in s 68(3)(b) should be applied, as demonstrated by the conflicting tribunal decisions in *French* and *Neil Erridge v HMRC* ([2015] UKFTT 89(TC)). In *Erridge* the tribunal applied the test by reference to the activities carried on by Mr Erridge at the time when the losses were claimed and took account of changes to the business made during the loss period. For that reason, it is permissible to look at earlier versions of the legislation as an aid to interpretation; the earlier versions of the legislation refer to “those activities”, suggesting that the activities referred to in s 68(3)(b) are the same as the activities referred to in s 68(3)(a); the 2010 activities.
40. The Appellants’ interpretation of s 68(3)(b) would mean that it served no useful purpose because the test would be applied to activities which might well have ceased by the year when the claim for losses was made, for example if the business had changed significantly in the intervening years. Whether a trade which was no longer carried on could have been profitable within five years should not be a relevant consideration in deciding whether losses are available in the year of the claim, 2010-11 in this case.

Decision

41. On the basis of the evidence provided to us we make the following findings of fact;
- (1) The main factor which influenced the profitability of the Scamblers’ farming business was the farm gate price of milk.
 - (2) The Scamblers had little means of controlling the price which they received for the milk which they produced.
 - (3) The average farm gate price of milk for the five years prior to 2005 varied significantly but was higher in 2004 and 2005 than it was in all but one of the four previous years. The price paid by Dairy Crest to Mr and Mrs Scambler showed a similar pattern.
 - (4) In 2005 Mr and Mrs Scambler believed that the farm gate price of milk was likely to stay low, but could not predict what would actually happen to the farm gate price of milk.

Interpretation of s 67 and 68 ITA 2007:

42. We do not agree with the Appellants that there is no ambiguity in the drafting of s 68(3) and would not describe that provision as giving rise to no difficulty in interpretation. This is reflected by the length of time which the tribunal spent considering the correct interpretation of s 68(3)(b) in *French*. We accept HMRC’s argument that there is some ambiguity in the wording of s 68(3)(a) and (b) and that it is permissible to refer to earlier versions of the legislation as an aid to its interpretation.
43. Despite that, our view is that the Appellants’ interpretation of the application of s 68(3)(a) and (b) is the only one which gives rise to a sensible result; that the activities referred to by s 68(3)(b) are the activities carried on by Mr and Mrs Scambler in 2005, the start of the loss period. As stated in *French*: “By locking the actual activity of the actual farmer to that of the notionally competent farmer, it (the test in s 68(3)(b)) then ensures there is a level playing field comparison between their progressions to profitability” paragraph 42. Equally, if the activities referred to in s 68(3)(a) and (b) are the same activities (in this case the 2010 activities) it is hard to see how both of those tests could ever be passed at the same time.

44. Applying s 68(3)(b) to the activities as carried out by the Scambler in 2005, the question is whether a competent farmer in their position, would reasonably not have expected to make a profit before 2010. Our answer is that such a notional competent farmer would not have reasonably expected no profits until 2010.

Competent farmers and reasonable expectations

45. The point was made in *French*, and we agree, that if the farmer in question has been accepted as competent, as Mr and Mrs Scambler have been, it makes it more difficult to see how they could fail the test at s 68(3)(b). At first glance, it seems to us that the concept of competence in this context must incorporate a sensible approach to profitability over the medium term (five years in this case) test period and that the two aspects of s 68(3)(b) must stand or fall together; only an incompetent farmer would carry on a business which had no reasonable prospect of making profits within five years. However, we think that there are two objections to the suggestion that all that needs to be demonstrated here is competence.
46. The test in s 68(3)(b) envisages that it is possible for a competent farmer, in at least some circumstances, to not reasonably expect profits for five years. Although the Appellants resisted this approach, we have to agree with HMRC that those circumstances only seem likely on the part of a competent farmer if there is some established long term strategy envisaged for the business, within the farmer's control, which is going to take a period of time to come to fruition and generate profits. The Appellant pointed to the specific provision for start-ups in s 67(3)(c) to suggest that s 68(3)(b) could not also be applying to that type of situation, but we think that there are situations other than start-ups where investment is required in a farming business which will take time to bear fruit.
47. The other objection is that the test in s 68(3)(b) is set out in two stages; as Mr Gotch pointed out, there has to be evidence both of competence and of the reasonableness of the profit expectation. Therefore it is possible for a farmer to be competent but nevertheless have an unreasonable expectation of profits. The question for us is whether it was reasonable for Mr and Mrs Scambler, as competent farmers, to have no expectation of making profits for the next five years.
48. One of the reasons why this test is difficult to apply is that an expectation over a five year time period is difficult to sustain however much knowledge might be available in year one to a competent farmer. There is bound to be an element of uncertainty. In addition, it is hard to avoid the line of reasoning which suggests that if a competent farmer thought that he was going to make losses for the next five years, he would have done something about it, as indeed Mr and Mrs Scambler did. Nevertheless, while the actions taken by Mr and Mrs Scambler in the intervening years might influence a conclusion about their competence as farmers, they cannot, as both parties accepted, have any influence on the s 68(3)(b) test which rests entirely on expectation.
49. HMRC said that the Appellant needed to show a specific reason why profits would not be made for the loss period, despite the business being run on a competent basis. We agree with this approach. Did the Appellants provide this explanation? We do not think that they did.
50. Mr Scambler's oral and written evidence, supported by Mrs Jewell, established that there were a number of pressures on his farming business in 2005: the milk price was going down, debts needed to be serviced and costs were going up. Mr Scambler said that this meant that it was impossible to predict how his business would fare from one year to the next. He was tied to the price paid by Dairy Crest and so he could not be certain that he would make profits for the next five years. He also told us that his costs (mainly feed and labour) were increasing and that this impacted his profits. He said that "the milk we could produce was not enough to produce a

profit unless farm gate prices rose a lot and there was no sign or guarantee that they would ever rise to profitability at that time”.

51. It is difficult to apply the test in s 68(3)(b) to a farming business such as this where such a significant component of the business’s profitability (the milk price) is outside the farmers’ control. Mr Scambler made it clear that he could neither set the price nor very easily move to a different buyer to change the price which he received, which even then would not have made more than 1-2 pence difference in the price paid. On his milk yield (9 thousand litres per cow a year, or 1.8 million litres a year, which we calculated as 25 litres per cow per day) each 1 penny decline in the milk price meant an annual drop in income of £18,000. It was this to which both Mr Scambler and Mrs Jewell pointed to demonstrate the issues with predicting a profit stream for the Appellants’ business in 2005.
52. We do not think that this is sufficient to pass the test at s 68(3)(b); The Scamblers’ business profits were uncertain because the farm gate price of milk was volatile as shown by the DEFRA and the Scamblers’ own figures for the 2000-2005 period. The future milk price was unknown, but that did not mean that it was reasonable to expect no profits for the next five years; it was, on Mr Scambler’s evidence, equally possible that the milk price would go up at some stage in the next five years. We were not provided with any evidence about Mr and Mrs Scambler’s margins, or at what farm gate milk price they would break even.
53. While no competent farmer might confidently have predicted profits for the next five years, neither would any competent farmer have confidently predicted a loss for each of the years until 2010. The best that could be said in 2005 was that Mr and Mrs Scambler, like many other dairy farmers at this time, were vulnerable to changes in the farm gate price of milk along with their fixed feed and labour costs and their financing charges.
54. In this respect we consider that Mr and Mrs Scambler were in a similar position to the farmer in *Silvester*, although engaged in a different type of farming activity. Mr Silvester was accepted to be a competent farmer, the reasons why he was not able to make a profit for 11 years were circumstances outside his control (sheep rustling and foot and mouth disease) which could not have been known in 2000 (the start of his loss period) and losses could not therefore have reasonably been expected.
55. The Appellant attempted to argue that an “expectation of profit” must be more than a mere hope for the purpose of s 68(3)(b) and in these circumstances, no competent farmer would have been able to be sufficiently certain of profits in view of the Scamblers’ business in 2005 to fail the test in s 68(3)(b). We do not agree that the hurdle is as high as Mr Gotch suggested; an expectation applied to a five year period is bound to have an element of uncertainty, but it can amount to more than a “hope” if it is based on reasonable assumptions.
56. We do not consider that an assumption that the milk price was only likely to move downwards over the next five years was a reasonable assumption in these circumstances. The only reasonable assumption, based on the Scamblers’ knowledge of the milk market in the UK supported by the DEFRA figures which we saw, was that the price of milk was volatile and could move either up or down over that period.
57. For these reasons we agree with HMRC that a competent farmer carrying on the activities of Mr and Mrs Scambler as they were carried on in April 2005 would not have had a reasonable expectation that no profit would be made for the next five years.

HMRC’s approach to “activities”

58. Although we have agreed with the Appellants’ interpretation of the activities to which the test in s 68(3)(b) should be applied, if we are wrong about that, we have also considered whether

our answer would be different if we applied the test to the activities carried out by Mrs and Mrs Scambler in 2010 transferred back to 2005, as HMRC suggested we should. The main differences between the Scamblers' business activities in 2005 and 2010 are:

- (1) The acquisition of Bocombe in 2006
 - (2) The sale of all of the land at Melbury
 - (3) The installation of a robotic milking parlour
 - (4) Business debts fluctuated significantly between 2005 and 2010 and by 2010 the level of indebtedness was slightly but not significantly lower than in 2005.
59. To an extent the 2010 activities have, as Mr and Mrs Scambler intended, given them a more efficient business and one which might be more able to cope with changes in the farm gate price of milk; a robotic milking parlour has been installed, some debts have been paid off by selling assets and the farm has reduced in size. It is impossible for us to gauge on the information which we were given to what extent this would have protected their margins against changing milk prices from 2005 to 2010, but it seems fair to assume that they would have been less likely to be making losses and this is supported by the opinion of the farm consultant in 2010.
60. However, our view is that the answer to the s 68(3)(b) test must be the same whether the 2010 or the 2005 activities are considered for the loss period; if the main variable in predicting losses is the milk price, and that itself is essentially unknown as Mr Scambler told us, it is impossible to conclude that there was a reasonable expectation of nothing but loss for the five year loss period whether one looks at the activities which were being carried on in 2005 or 2010.

Purpose of the legislation

61. In conclusion we have asked ourselves whether, in denying losses to Mr and Mrs Scambler, our decision is in line with the purpose of s 67 and 68. To the extent that this purpose can be divined, Mr Gotch argued that it was to exclude from sideways loss relief those who were involved in farming with no intention to generate a profit (true hobby farmers) or those who were incompetent. This is in line with the interpretation suggested in *French* that the statute's purpose is to preclude loss relief unless the farm, in the right hands, is capable of generating a profit, is not an everlasting loss maker or if there is any suspicion that the farmer is a hobby farmer.
62. Mr and Mrs Scambler clearly do not fall into either of the categories suggested by Mr Gotch. They fall into a category of farmer which was probably not envisaged at all when this legislation was first introduced in 1967; farmers whose profitability is dependent on a global, or at least European, wide market in commodities which significantly influences their business but over which they have no, or very little control.
63. While we sympathise with the position of Mr and Mrs Scambler, our view is that there is nothing in the legislation which suggests that they should be given the additional protection for losses provided by s 68(3).
64. For these reasons this appeal is dismissed and HMRC's amended assessments as stated in the closure notices issued to Mr and Mrs Scambler on 17 July 2014 are confirmed.
65. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must

be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to “Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)” which accompanies and forms part of this decision notice.

Rachel Short

TRIBUNAL JUDGE

Release Date: 26 January 2016