Quota Tips And Traps

JULIE BUTLER FCA considers the quirks of quotas.

AFTER ONE OF the wettest Augusts on record, the plight of the arable farmer has been the subject of nationwide coverage. But what of the dairy farmer, who needs the summer rain to produce the lush grass for the dairy herd in order to produce a good volume of milk?

Milk quotas were introduced by the Council of EEC Agriculture Ministers on 2 April 1984 as a means of curbing excess milk production and reducing expenditure on the disposal of surplus milk and milk products.

Wholesale quota is held by milk producers who deliver milk (produce of the milking cows) to a purchaser (generally a dairy or intermediary co-operative). Direct sales quota is held by producers who sell their milk directly to the market without going through a purchaser, or who sell products other than milk, e.g. cream, butter, yoghurt and cheese. Milk producers can hold one or both types of quota.

Quotas can be transferred either temporarily or permanently:

Temporary transfers

Milk producers may lease quota in or out throughout the milk quota. Quota that is leased stays with the lessee until the beginning of the following quota year (1 April), when it then reverts back to its original owner.

Permanent transfers

There are three ways in which quota can be permanently transferred from one producer to another:

- A producer wishing to obtain milk quota may lease some land which is used for milk production, and therefore has milk quota attached to it, for a minimum period of ten months in England and Wales. At the end of the lease, the land reverts back to the original owner, but the milk quota stays with the lessee.
- Through a permanent transfer of land, e.g. sale or inheritance, with milk quota attached to it.
- Without land, due to scaling down, restructuring or cessation.

End of a tenancy

Community regulations establish a bond between milk quota and the area used for milk production. As a consequence, departing tenants cannot generally take the milk quota attached to their tenanted land at the end of the tenancy. In the event of a tenancy that began after 1 September 1995, the provisions of the Agricultural Tenancies Act 1995 may provide for compensation if the quota remains with the landlord and certain other criteria, e.g. the giving of notice, are met.

What kind of asset?

Does a milk quota comprise of an interest in the underlying land or should it be treated as a separate asset for capital gains tax purposes? The decision in *Faulks v Faulks* [1992] 1 EGLR 9 concerned a dispute between a surviving partner and the widow of a deceased former partner over the amount of compensation due to the estate. Comments made suggested that a quota was indistinguishable from the underlying land. This approach, if well founded, could imply that the disposal of a milk quota should be treated as a part disposal of underlying land, with the need to apportion expenditure attributable to the acquisition cost. However, the capital gains tax case of *Cottle v Coldicott* [1995] STC (SCD) 239 has cast doubt on this treatment, where it was held that milk quota is a separate asset.

With regard to whether or not quota is a fixed capital asset, the Revenue's *Business Income Manual* at para BIM 55305 describes quotas as follows:

> 'A farmer holds a quota primarily in order to make a profit from carrying on the particular farming activity which it covers. She or he does not ordinarily buy and sell quota in the course of the farming trade. The quota has the character of an enduring asset of the farmer's business similar to the buildings or farm machinery. Quota is normally therefore a fixed capital asset of a farmer's business.'

Where herds are sold before the quota, it has been Revenue practice in the case of dairy farmers to combine the value of quota with the value of the agricultural land for agricultural property relief (APR) purposes. In any event APR (and business property relief) will not be due on milk quota where dairying activities cease, that is, the quota is held without a trading activity.

As the quota is normally a fixed capital asset of a farmer's trade, such purchases and sales normally have no income tax consequences for the farmers concerned. In particular, there can be no question of farmers who have bought quota claiming a deduction for the amount of any expenditure such as levies or leasing charges, which they would have incurred if they had not bought it. That is, the sale is a capital gains tax disposal and the purchase represents the capital gains tax base cost for a future sale. The cost of leasing quota should achieve income tax relief.

When leasing quota, the cost to the purchaser is a trading expense. If it is the lease of temporary surplus, it will be treated as Sch D, Case I. However, if the enterprise has sold the herd, then the leased out income is Sch D, Case VI. Care must be taken with the income tax computation and the possible matching of quota.

Limited companies

With effect from 1 April 2002, agricultural quotas for new companies, but not partnerships or sole traders, come under the new rules for the taxation of intangible assets contained

in FA 2002, s 84 and Schs 29, 30. These treat amortisation properly charged in the profit and loss account of farming companies as an allowable deduction, with sales being taxed as income.

Transitional rules ensure that assets held at commencement will be taxed on the old (chargeable gains) basis. However, disposals thereof will not qualify for capital gains rollover relief except where reinvestment under the capital gains rules has taken place before 1 April 2002 and within the twelve-month period prior to the disposal.

Receipts from the leasing of quota which is temporarily surplus to the requirements of a particular activity carried on by a farmer may be regarded as part of the farming income within Sch D, Case I.

Also from 1 April 2002 new quota owned by a company will qualify for write off against profits either at 4% or at a preferred rate. As the future of quotas is not guaranteed beyond 2008, it could be prudent and tax efficient to write it off over a period to that date. This could have large benefits to farmers trading through a company. There are a number of anti-avoidance provisions including the exclusion of relief on quota purchased from a connected party.

However, income from leasing of quota which is not required because the activity to which the quota relates has ceased or substantially reduced should be dealt with under Sch D, Case VI.

Where quota is leased out by a non-farmer, including an ex-farmer who has retained quota, the income is chargeable under Case VI. It is highly unlikely that there would be evidence to justify Case I treatment.

The tax consequences of selling quota or leasing quota should be considered when looking at the commercial alternatives. For unincorporated businesses with the ability to use the fungible asset rule, the use of annual exemptions, etc., the tax advantage of disposals should be built in when trying to weigh up disposal or leasing.

The intangible rollover trap

As mentioned above, from 1 April 2002 there is a change in capital gains tax treatment of intangible assets, e.g. quotas. The gain on an intangible asset will only be allowed to be rolled over into another intangible asset. The gain on a tangible asset will not be allowed to be rolled over into an intangible asset. This will affect the practical tax planning on quotas.

From a tax planning point, potato quota now has £nil value, therefore a claim for the capital loss should be considered under TCGA 1992, s 24(2). The timing of the claim, as in all such claims, should be made, where possible, in the year of a gain above the annual exemption for capital gains tax. The future value of milk quotas will be £nil and similar tax planning should be contemplated for milk quota in due course. It currently has a value but, with a future life due to terminate in 2008/2012, tax planning should be considered. The current dairy market shows the best performing farmers are those with high input and high output, and purchasing quota has to be considered.

Planning the 'fungible' asset rule

The Revenue takes the view that milk quota is a fungible asset. It is worth considering what benefit this could have to the farmer and what traps could be encountered.

The *Capital Gains Manual* at para CG77821 states:

> 'A producer primarily holds milk quota to produce and sell milk profitably and not to run the risk of a financial penalty for over production. Such producers do not ordinarily buy and sell quota in the course of their day-to-day trade. Quota is an enduring capital asset of their business in the same way as buildings or farm machinery.'

Thus, where some of a producer's quota was allocated without cost in 1984 and some was subsequently purchased, the Revenue originally considered that the acquisition cost should be apportioned under TCGA 1992, s 52(4) by reference to the total holding, i.e. not matched by reference to each element of quotas owned.

This could seem unreasonable to the producer who has had to buy and sell quota to reach production targets. The result could be a high sale price matched with a relatively low acquisition cost. The *Capital Gains Manual* at para CG77901 confirms that milk quotas are regarded as fungible assets, under TCGA 1992, s 104(3), and the same identification rules will apply as for shares and securities. For milk quota disposals before 6 April 1998, it could be said that the share pooling rules may be analogous with the apportionment rule in TCGA 1992, s 52(4), but disposals on or after that date should be identified with acquisitions under the share identification rules.

It could be argued that the application of TCGA 1992, s 54(4) was unfair on those producers who, from time to time, had to purchase and dispose of quota, in that the disposal was matched against the much reduced cost due to the inclusion in the apportionment of the 1984 allocation with £nil base cost. In these cases, the disposal proceeds largely represented the gain, which was produced by what could be said was transitional, and better matched with the purchased quota. It is hoped that applying the current, fungible asset rules will help to present a more equitable position and also a clearer representation of the correct position.

Farmers could use both methods. The original method could produce gains to offset against any unused annual exemption, while keeping the base cost higher for future disposals. However, the latter treatment could produce gains, which would not otherwise have been taxed. There are times when both methods have advantages, but consistency must be used. The fungible asset rules do not apply to limited companies. ■

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