Farming for the environment

Andy Case and Julie Butler consider the accounts and tax treatment of the receipts from ecosystems and 'farming for the environment'.

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With the move away from the area-based subsidy regime in the UK, such as the basic payment scheme (BPS), to the environmental land management schemes (ELMS), consideration has to be made towards the correct accounts, tax and bookkeeping of such receipts.

Spring Budget announcement

The Spring Budget brought the announcement of a consultation on the tax treatment of ELMS for farming, including a call for evidence on how the production and sale of ecosystem service units should be taxed, aiming to understand the commercial operations of these land uses and areas of uncertainty on income and corporation tax treatment.

One of the key questions is how the tax system should account for the timing difference between upfront payments and ongoing project management and delivery costs.

However, it is fair to say that the majority of the focus from farmers and farm advisers has been on the inheritance tax (IHT) treatment of the changes as these subjects are significant.

With an increased focus on the environment rather than traditional farming, do these new schemes meet the definition of 'agriculture' and qualify for agricultural property relief (APR), and will it be deemed a trade for business property relief (BPR) as a back-up if APR is denied? As receipts from ELMS are not seen as farming trade income, farmers may struggle to set farming losses against environmental income and this will have negatives for BPR.

Key points

- The Spring Budget brought the announcement of a consultation on the tax treatment of environmental land management schemes (ELMS) for farming.
- The focus of the consultation is the extension of the definition of APR to include environmental projects.
- ELMS are varied and tax planning must be tailor made.
- All tax planning should be undertaken before the contract is signed.

We understand that the focus of the consultation is the extension of the definition of APR to include environmental projects and in the gap before the findings of the consultation the eligibility for BPR must be decided. It is important to go back to basics as to what is the accounts and income tax/ corporation tax treatment. The area based annual payments were relatively straightforward in accounts terms. There was some complexity through purchased entitlements, but principally it was ensuring the correct allocation of annual income to the correct year. However, questions have been raised as to possible capital gains tax (CGT) of such income.

Environmental land management schemes

ELMS are varied and tax planning must be tailor made. First, the schemes are all very different in themselves and the farmland they apply to also differs hugely. Secondly, the schemes are generally reimbursement of monies paid so there must be identification of costs and the matching of this expenditure. Thirdly, ELMS can be for long-term agreements, 'carbon contracts' as they are often called, where the life of the contract must be considered in the context of accounting for a long-term contract.

The VAT treatment of income from ELMS is another area where clarity is needed. Aligning the treatment with other farming receipts, at zero rate, seems to be the most sensible approach but if they are to be exempt this leads to partial exemption. Such quirks could arise given the tax-free nature of woodlands, for example where the woodland creation is part of a larger overall woodland operation where the income is treated as tax free.

Possible capital gains tax

There is an argument that receipts from any land entered into a conservation covenant should be treated as capital on the basis that the covenant would restrict the future use of the land and in so doing devalue the land. However, the Central Association of Agricultural Valuers (CAAV) has reported that valuation is difficult.

HMRC's guidance on capital sums derived from assets also direct to the receipts being chargeable to CGT – see its *Capital Gains Manual* at CG12940P, for its view on TCGA 1992, s 22(1). However, any management fee received in return for providing the service of creating and maintaining habitat would be subject to income or corporation tax. Another area of tax debate is how to treat the costs associated with maintaining habitats in the future over the length of the contract.

Principles need to be agreed which confirm whether receipts from selling ecosystem services would be charged to income tax or CGT. Likewise, whether the activity was deemed to be trading and how income and expenses should be matched over the period of an environmental contract. It would be very difficult for a tax adviser to treat carbon contract income as a CGT receipt until the results of the guidance are made clear.

In the meantime, it will be important, if the CGT route were to be taken, that there is evidence that the land was devalued by the contract and all the nuances of the matching of future costs of the contract and base cost are thought through meticulously.

Plan in the gap before consultation results

Until more guidance is given following the consultation, here is the suggested step-by-step proposal of how to treat the ELMS receipts in the accounts and for tax purposes. Ideally all tax planning should be undertaken *before* the contract is signed – see 'Starting well', *Taxation,* 16 March 2023.

Where there is no planning in advance:

1) Obtain a copy of the ELMS agreement with DEFRA so the terms of the receipts and payments are understood. Pass to the tax team to identify any specific tax concerns on initial assessment.
2) Forensic analysis of all expenditure that relates to ELMS and ensure there is an understanding with farm bookkeepers of how to record – ideally specific nominal ledger accounts for the ELMS receipts and repayments with further breakdowns. The grants towards capital equipment should be treated accordingly.
3) Forensic analysis of all receipts is required on both an initial and an annual basis. Ensure the correct disclosure/allocation to the correct year/accounting period. Where monies are paid in advance for any future costs and maintenance then ensure the correct provision is made in the accounts and disclosures are clear.
4) Ensure there is a clear accounting policy for all environmental grants.
5) Consider ELMS 'enterprise accounts' within the main body of the trading accounts for more complicated undertakings.
6) Review stock and work in progress together with the correct accounting policy
7) Assess income tax/corporation tax treatment following on from step 1 with the tax team.

The consultation should help with the matching of income and costs.

Example: landscape recovery scheme

The landscape recovery schemes aim to reverse declines in nature, improve the landscape and tackle climate change on a large scale.

The government wants to support projects that require collaboration across a large area and where the outcomes will take a long time to deliver, such as with peatland restoration or woodland creation. The idea is that groups explore the potential for securing private funding by selling carbon credits and other ecosystem services during the development phase of their project, and then negotiate with DEFRA about filling any funding gaps. Accounting between the group must be explored. This means that every agreement will be bespoke and follow different business models. Some projects might need capital payments to ensure it starts; others need ongoing maintenance payments.

The second round of pilot project applications for landscape recovery are now open until midday on 21 September, with a focus on projects across at least 500 hectares hitting net zero, protected sites and wildlife-rich habitats. Applicants or agricultural pioneers may therefore commence on projects before further guidance is received. The simple explanation of accounts and tax considerations as set out above shows the potential twists and turns for the accounting thoughts process and application to quality accounts. Phrases such as long time to deliver, collaboration, sale of carbon credits and capital payments should immediately flag that accounting and tax skills will be required.

Business property relief in the gap

Again, the individual and bespoke nature of ELMS will need careful understanding. While we await the Budget 2023 consultation on the extension to APR at agricultural value etc, the farm tax adviser must try to defend all such claims with BPR at market value.

If farmers die (or have died) in the interim period, we must rely on BPR and assess the availability of BPR at every level. This would include reviewing partnership and non-partnership property in the context of 100% BPR/50% BPR and also trust registration for evidence of partnership property (see 'Clear as mud', *Taxation,* 30 March 2023). It may also be worth considering whether the mixed-use estate could be viewed as a single composite business overall and s 105(3) – the so-called Balfour test (see *CRC v AM Brander (as executor of the will of the late fourth Earl of Balfour)* [2010] STC 2666).

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