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# TAXATION OF ENVIRONMENTAL LAND MANAGEMENT AND ECOSYSTEM SERVICE MARKETS CONSULTATION AND CALL FOR EVIDENCE ON SELECTED TAX ISSUES

**Response by Association of Taxation Technicians**

## 1 Introduction

1.1 The Association of Taxation Technicians (ATT) is pleased to have the opportunity to respond to the HMT and HMRC consultation document on *Taxation of environmental land management and ecosystem service markets: Consultation and call for evidence on selected tax issues* ('the Consultation') issued on 15 March 2023[1].

1.2 The primary charitable objective of the ATT is to promote education and the study of tax administration and practice. We place a strong emphasis on the practicalities of the tax system. Our work in this area draws heavily on the experience of our members who assist thousands of businesses and individuals to comply with their taxation obligations. This response is written with that background.

1.3 This has been a challenging consultation to respond to, given the range and breadth of both the types of scheme and the different ways in which schemes are structured. There is no consensus on the treatment of some quite fundamental questions.

1.4 The main requests from contributors were for certainty and consistency of treatment across different projects in order to ensure landowners are not discouraged from entering the schemes. We agree that certainty would be welcome, but think that - other than for IHT where consistency is essential, as land could be more than one scheme at any given time - consistency may be challenging to achieve and is less important than certainty.

1.5 There was also a desire for guidance (i.e certainty) as a matter of urgency on the income/capital position for the sale of credits. There are time pressures both from the proposed introduction of Biodiversity Net Gain (BNG) later this year and because the first tranches of pending issuance units generated from the Woodland Carbon Code have now been verified and landowners are looking to sell their first Woodland Carbon Units.

[1] https://www.gov.uk/government/consultations/taxation-of-environmental-land-management-and-ecosystem-service-markets

1.6 Although VAT was noted as specifically out of scope of this consultation we have made some comments below in section 18.

1.7 Finally, as the UK strives to reach the net zero target, clear and possibly favourable taxation of these schemes could become an incentive for more landowners to become involved, making it easier for the UK to achieve this target.

1.8 We look forward to discussing these issues further with HMRC and our contact details are included in section 19.

## 2 Introduction

2.1 This response includes evidence not just from our members, but also from various legal and other professionals advising in this area, together with information and evidence gathered from meetings of the Natural Capital Working Group, which we cofounded last year. There have been a range of opinions expressed and we have tried to reflect all the views we have heard in this response.

2.2 We understand that the aim of this call for evidence is to understand the commercial operations and the areas of uncertainty in respect of taxation and we have included examples of scenarios we have been presented with wherever possible.

2.3 A common thread in all the feedback we received was that uncertainty around the tax position is reducing the pool of individuals and businesses willing to engage with these schemes. People *are* engaging with the schemes, but a number of respondents commented that it was generally those with a more robust attitude to risk, or entities such as charities where the tax considerations discussed below are not always relevant. This is clearly unhelpful given the Government's ambition (as stated in the Consultation document) for 75% of farmers to be engaged in low carbon practices by 2030.

2.4 The most commonly raised concerns centred on the uncertainty of the position for Inheritance Tax. The sort of comments we heard included 'demand is there, but it is hard to step up in the dark', 'uncertainty is the killer' and that clarity was needed so that the tax costs could be factored in before taking decisions which have very long term consequences. That HMRC, HMT and DEFRA are engaging seriously in these issues is therefore to be welcomed.

2.5 In addition to certainty, a number of people we spoke to were keen for consistency of treatment across the range of schemes. It is possible for some of the schemes to overlap, with the potential for landowners not just to have different parcels of land in multiple schemes, but for a single parcel of land to be in more than one scheme (so called *stacking*). At the same time, many were keen to retain the woodlands exemption, which immediately introduces differences between the Woodland Carbon Code (WCC) schemes and all the others.

2.6 We agree that there are similarities between the schemes - they all involve long term, permanent land use change which are seeking to put a financial value on environmental benefits. However, there remain significant differences between the schemes both in terms of the type and nature of management and their duration. The minimum period is 30 years for peatland and biodiversity schemes - which could allow one individual to see a scheme through to maturity - while some woodland schemes can run for 100 years, and nutrient neutrality schemes up to 120 years. As more of these types of schemes evolve, it may not be

possible to achieve absolute consistency across the board unless the Government seeks to regulate the underlying schemes themselves so that they have key, common features.

2.7 Therefore, while we think that ideally tax rules would be consistent across the schemes to keep things simple and to ensure that one scheme is not favoured over another, this may not be possible in practice. The only place where consistency is truly required is with IHT, given that land may be in more than one scheme at a time. Consistency of IHT treatment will also help to facilitate Balfour-style planning and to ensure farmhouse reliefs are preserved. Unless woodland reliefs are changed, income and capital treatment will inevitably vary with the type of scheme.

2.8 The other major area of concern, which is specifically excluded from this Consultation, is VAT. Everyone we spoke to regarding VAT to expressed the view that HMRC's existing guidance[2] stating that voluntary credits were outside the scope of VAT was out of date. There was a hope that credits could be considered taxable, ideally zero-rated. We note with interest that in February, a DEFRA consultation[3] stated that 'biodiversity units will be subject to VAT when they are sold' and we look forward to further commentary from HMRC on this area. We have included some further detailed comments in the final section of this response in section 18.

2.9 Finally, this has been a challenging Consultation to respond to for a number of reasons including:

- The breadth of subject matter. We have only commented on four schemes - the Woodland and Peatland Carbon schemes, Biodiversity Net Gain (BNG) and Nutrient Neutrality, but a number of further, similar schemes are under development. As noted above, the schemes share similarities but are not identical and the commercial agreements can vary greatly.
- A lack of consistent commercial agreements. As yet there is no common approach to any given scheme. While commercial norms will grow up in time, it is still early days, which has also lead to difficulties in getting details of actual schemes, due to commercial sensitivities. More than one contributor referred to a 'wild west' in terms of the range of different approaches and interests.
- A lack of clarity over the obligations which those entering the market to provide credits may be taking on. One of the ways in which we draw conclusions about fair or reasonable tax and accounting treatments comes from consideration of the obligations and liabilities of the parties but this is not always clear - and some specific scenarios do not yet appear to have arisen or been tested. For example what happens if units are created but not sold, can schemes be subdivided if land is split for example following a divorce? What if schemes do not generate the credits expected? How are restrictions on the resale market intended to work?
- There seems to be limited certainty on what happens when schemes mature. We understand that the intention for all the schemes is for permanent land use change. However, apart from for woodland (where existing laws would prevent felling without a licence once the trees have reached a certain minimum size), unless further steps are taken to designate areas which have been in these schemes as protected (eg as Sites of Special Scientific Interest or SSSIs) there doesn't seem to be any obvious legal protection beyond the life of the scheme.
- While there are clearly a number of projects in progress for woodland and peatland schemes, most of the examples we saw of BNG and nutrient neutrality were still at the planning stage.

[2] https://www.gov.uk/hmrc-internal-manuals/vat-supply-and-consideration/vatsc06584

[3] https://www.gov.uk/government/consultations/consultation-on-biodiversity-net-gain-regulations-and-implementation/outcome/government-response-and-summary-of-responses#government-response-part-2-applying-the-biodiversity-gain-objective-to-different-types-of-development – see section 5.3.

**Part 1**

## 3 Q1: What has been, or would be, the effect of ecosystem service payments on existing business models, such as farming or commercial timber production?

3.1 We received a wide range of comments relating to this question, largely relating to farming businesses. While some existing landowners have already signed up to schemes, or are significantly advanced in projects, we also heard that the lack of certainty around both the tax and legal aspects is discouraging many smaller landowners from proceeding at the current time (3.2), impacting on the type of scheme chosen (3.3) or influencing the choice of business structure (3.4).

3.2 For those who are holding back, concerns expressed to us were mainly around Inheritance tax and the ability to transfer the farm down the generations. The risk of loss of Agricultural Property Relief (APR) on either or both of the land and farmhouse is a major disincentive to engage with schemes. For estates which are already diversified, a related concern is the impact that ecosystem payments might have on their Business Property Relief (BPR) position and their ability to meet the *Balfour test*. In brief, the estate of the Earl of Balfour was able to obtain 100% BPR on an estate comprising both investment and trading activities run as a single composite estate in which the trading activities predominated. For estates which are relying on Balfour principles as part of their IHT planning, their concerns centre on ensuring that ecosystem schemes will not be counted as investment activities.

3.3 We understand that the current tax rules can form part of the decision for existing businesses over the type of scheme in which they are prepared to consider. Habitat restoration to species-rich grassland, for example, might be preferred rather than woodland or scrub creation as it can still be mowed for a grass or seed crop and/or grazed (albeit at a lower stocking density) and therefore preserve APR. Tax is not the sole driver here, as such an approach also gives more flexibility in future land use and is more likely to complement an existing farming business, but it would be helpful if tax concerns around APR did not limit the potential range of habitats that landowners were prepared to consider.

3.4 We received a couple of examples where the uncertainty around whether income from credit sales should be treated as income or capital has led to a decision to transfer land into a company before proceeding with the project. This resolves issues around the tax rate (if not necessarily the timing of the tax charge) as the rate of corporation tax is the same for income and gains. However, it does so at potentially considerable additional upfront tax costs and adds administration.

3.5 For individuals, income tax rates are significantly higher than capital gains tax, and at least one respondent expressed concern that applying income tax rates could make projects unviable.

3.6 For woodland and peatland schemes where Pending Issuance Units (PIUs) are generated following the initial validation of the scheme, we have heard that a number of landowners were opting to hold onto their PIUs, rather than sell, due to uncertainties around the tax treatment. One woodland manager reported to us that, as yet, none of their clients have sold their PIUs due to lack of a suitable template/agreement for sale. There are therefore a number of other, non-tax factors influencing decisions including:

- Cash flow issues, and whether or not the landowner has a need for cash at that early stage in the project.
- A concern among some landowners that they may, in time, need to use any carbon credits themselves (so called *insetting*) and therefore they are choosing to hold onto any PIUs generated and also the resulting Woodland Carbon Units (WCUs) and Peatland Carbon Units (PCUs) as an insurance policy.

- The reduction of risk by waiting to sell credits which have been verified, rather than pending issuance units which have not.
- The volatility in the price and potential for higher prices for WCUs in the future compared to PIUs prices now.

3.7 The cost of WCUs, PCUs, BNG and nutrient credits is expected to vary depending on the location and features of the schemes, which may mean that the incentives to engage with schemes will vary regionally. We understand that for larger BNG or nutrient projects it may take several years to sell enough credits to make the site viable and that one of the challenges is in predicting supply and demand locally. One respondent noted that not all credits created will necessarily be sold, which could presumably also be the case for other schemes, but we assume that market for nutrient neutrality will be the most limited of the ecosystem schemes, as developers need to find offsets within the same catchment area that they are trying to develop.

3.8 Examples of the sorts of scenarios which have been shared with us during discussion include :

- Biodiversity Net Gain – Farmer A has agreed a 30 year Farm Business Tenancy with an intermediary who will arrange the necessary survey work, draw up the binding agreement with the local planning authority and arrange the sale of the credits to developers. The intermediary will, in turn, contract the farmer to carry out day-to-day site management under a separate management agreement. The farmer will then receive two income streams – rental and management fees – for the 30 year duration of the lease. As ongoing agricultural activities such as light grazing and/or mowing for a hay crop can continue on the land, the farmer expects to retain APR as the land should remain in agricultural use.

- Nutrient neutrality – Landowner B wishes to set aside land for a wetland for a nutrient scheme. Initial costs of flooding the site and other associated works will be in the region of £1m, and income will be obtained by the sale of credits to the local planning authority, via long term (80-120 year) agreements. Sale of units should, if agreed, generate an upfront lump sum, but the landowner will then be committed to managing the site over a number of generations. There will be some ongoing management costs to ensure habitats develop as intended. To manage the risk, the landowner is considering transferring the intended site into a separate legal entity such as a company, despite the potential SDLT costs of making the transfer.

- Nutrient neutrality – we have received two examples where credits have been created by stopping farming. In one case a pig unit was purchased with a view to closing it down, and in another case a dairy farm was able to generate nutrient credits by selling the dairy herd. There may be wider implications here around food security from these sorts of decisions.

3.9 Beyond existing businesses, many respondents noted that a major effect of the new market has been to encourage a number of new investors into land markets, driven specifically by potential for profits from carbon and other credits and/or by environmental concerns. These include both individuals and institutional investors. As a consequence, we have heard a number of concerns about the impact of the schemes on the price of land, particularly in Scotland.

3.10 By way of example, two large projects which have received some publicity in recent years include Aviva Investors and Par Equity who have acquired an estate at Glen Dye moor[4] and Brew Dog's purchase of an

[4] https://glendyemoor.com/

estate at Kinrara (branded 'The Lost Forest'). Income from carbon credits has also been used as an income source to allow community purchase of land in Scotland. Some of these schemes have involved substantial initial costs – into the millions. Other examples that were shared with us include a purchase of a farm by someone not currently engaged in farming, with a view to turning part of the farm into a wetland to generate income through the sale of nutrient credits with a view to contract farming the remaining land.

3.11 We received limited feedback on the impact of the schemes for timber production, although an expert in the industry reported to us that it is not helpful to think of woodland creation for carbon credits as necessarily separate from felling. While some schemes are being carried out purely for the income from carbon credits, depending on the type of the trees planned and subject to the relevant permissions, there is no reason why, once the scheme is complete, that commercial species such as Sitka or Spruce could not be felled for timber sales and the site replanted. From a carbon capture point of view, once a wood has matured, it becomes a carbon store rather than a carbon sink. Felling and replanting provides an opportunity to sequester more carbon on the same site, while harvested wood products lock in carbon and can be used in place of other, less environmentally friendly materials.

## 4 Q2: What are the main areas of uncertainty in the taxation of trading income for income tax and corporation tax in relation to the production and sale of units generated by ecosystem service markets? Please provide evidence and scenarios, including the relative scale of the concern by explaining where decisions have and have not been influenced by the uncertainty of the tax treatment.

4.1 By way of context, we have set out some brief background on the structure of the various schemes in appendix 1, and more detail on the Woodland Carbon Code in appendix 2.

4.2 The uncertainties for direct taxes tend to arise with lump sums and are linked to uncertainties around accounting treatment (discussed in the next section) and also issues around what is actually being sold. In the majority of cases, we hear that upfront lump sums are being treated as capital disposals with some respondents expressing a strong preference for a capital approach. However, we have also heard the view that it is not so much a sale of an intangible asset as a long-term agreement to manage land in a given way for a period of time which is effectively the provision of a service. This could then lead to a different accounting and tax analysis.

4.3 Uncertainties arise around the following points, which we have expanded below with examples.

- Whether the sale of credits is trading income or a capital gain
- In either case:
    - What costs can be offset – the cost of establishing the new habitat, the costs of validating and verifying credits or the loss in value of land
    - What tax relief is available for ongoing maintenance costs.
- If sales of credits are treated as income, where there is a lump sum payment, is HMRC willing to accept an accounting treatment which defers receipts to be recognised over a number of decades?
- Where credits are considered to be trading income, is this farming income eligible for farmers averaging?

https://www.avivainvestors.com/en-gb/about/company-news/2021/12/ai-par-equity-scottish-woodlands-natural-capital-project/

- Where the receipts are income, and in respect of woodlands, would woodlands exemption apply for income tax and corporation tax purposes?

4.4 We also need to consider the position for those who are not intending to sell credits but using them for internal off-setting (carbon credits) or to facilitate development (nutrient neutrality, BNG). There is uncertainty over how and when costs incurred in creating and then maintaining the changed habitat might be offset. For woodlands/peatlands, the point at which WCUs/PCUs are retired would seem the natural point at which relief could be sought on the costs of establishing the underlying woodland or restoring peatland, but there is no equivalent 'retirement' for nutrient credits or BNG and the cost would have been incurred to facilitate a development. Ideally, costs of generating BNG or nutrient credits in house, could be relievable with other development costs.

4.5 **Capital or income**

Of the various uncertainties, most stem from the capital/income divide. This is of most concern for unincorporated businesses due to the significant differences in tax rates between income tax and CGT. There is also the complication that those selling woodland credits may wish for receipts to be considered trading income to benefit from the woodlands exemption. We have set out some examples below.

4.6 **Scenario 1:**

*A 45 hectare site is planted up with a native broadleaf scheme with a 75 year project duration. After validation, there are 18,000 PIUs of which 3,600 are placed in a buffer and the remaining 14,400 are available for sale. All 14,400 are sold, up-front to three local companies looking to offset future $CO_2$ emissions. If all the units are sold at £20 each, there would be an upfront receipt of £288,000 from the three contracts.*

The question is whether this is a trading or capital receipt.

If the proceeds are treated as a trading, then the tax treatment would generally follow the accounting treatment, but there is also no guidance or certainty here. Recognition of income from the contracts would need to follow existing IFRS rules in the first instance. We are not accounting experts, but we understand that there is an argument that, as the landowner has undertaken to maintain the wood for next 75 years, that income from the contract could be deferred and recognised only as performance obligations are met. In this case, the performance obligation is to convert the PIUs to WCUs. Income could be recognised as verification takes place and PIUs are converted to WCUs over the life of the project. The first verification would normally occur in year five with subsequent verifications every ten years after that.

A key question is whether or not woodlands exemption would apply. If it does, then there would be no relief for costs of establishing or maintaining the woods. If the woodlands exemption does not apply then consideration needs to be given to what costs can be offset against income. In addition to the costs of establishing the wood (some of which may be covered by grant income) there will be annual maintenance costs and insurance costs.

All of this is further complicated if the wood is then felled at the end as if there is a different tax treatment between credit sales and timber sales we might look to apportion costs between the two activities. However, since one is so intrinsically linked to the other, this may not be meaningful.

4.7 The alternative view is that this would be a capital transaction either because:

- A disposal such as this will devalue the underlying land and therefore there should be a capital element to the tax treatment,
- The proceeds fall within s22 TCGA 1992 as a capital sum derived from an asset.
- The sale of PIUs themselves is the sale of an intangible asset.

If capital, then woodlands exemption would not be in point as this is an income tax relief, and the s250 TCGA reliefs from CGT on the sale of timber would also not be relevant as no trees are being felled.

A capital treatment allows access to favourable tax rates at the cost of an upfront bill, but consideration needs to be given again to what is being disposed of and what costs can be offset. There are the costs of establishing the woodland itself (although there may well be grant funding), the cost of validating the credits and also a likely diminution in value of the land following the change of use and sale of all the potential carbon credits which has now burdened the land. The actual interpretation will depend on the terms of the contract between the landowner and the purchaser of the credits. As yet, no standard template for a sales agreement has been developed or agreed.

Finally, there is not an obvious route to relief for ongoing maintenance costs, unless HMRC was prepared to accept these as ongoing losses from a trade, although again the costs are connected to the growing of trees which is generally excluded by the woodlands exemption.

4.8 *Scenario 2:*

*In this scenario, the position is as above, other than the landowner decides to keep their PIUs until they mature and as each vintage of WCUs matures, units are sold off in instalments with a few sold every few years following verification.*

Again the uncertainty is whether this is a series of smaller, capital disposals, or more akin to a trade and the sale of stock, in which the stock are the WCUs. Again, the question arises regarding what costs of establishing the wood, credits and ongoing maintenance can be offset and whether the woodlands exemption applies.

4.9 ***Scenario 3:***

*A farmer decides to set aside 150 acres of an 850 acre farm as a wetland. There are substantial costs in establishing the wetland and the farmer enters into an agreement with the local authority who will sell on the credits to developers looking to build in the area.*

Again, as for the woodland, this is a single upfront lump sum payment with a substantial upfront cost, and then an ongoing obligation to maintain the land. We understand that such agreements may also involve the creation of a sinking fund, to ensure that funds are set aside for future maintenance.

In this situation it could be argued that what is happening here is not an actual 'sale' by the landowner but more of a compensation for a change of use. Some respondents have reported treating income in these cases as farming profits in the year of payment.

4.10 It has also been suggested that lump sums such as this could be treated this as a capital item under s22 TCGA 1992 *Disposal where capital sums derived from assets.* s22 applies where there is a disposal of assets by their owner notwithstanding that no asset is acquired by the person paying the capital sum. Examples include a capital sum received in return for forfeiture or surrender of rights, or for refraining from exercising rights, or where a capital sum is received as consideration for use or exploitation of assets. The idea is this reflects the nature of the agreement in which the purchaser does not acquire an interest in the

land, but the landowner is required to carry out certain activities (and refrain from certain agricultural uses) having received the sum. It is less clear that s22 would apply if the landowner themselves were selling the nutrient credits to the developers, as it would be clearer that the purchaser was receiving an asset in the form of intangible credits. Again, HMRC's view on this point would be welcome.

4.11 We have previously submitted comments to HMRC on the woodlands exemption and have included them here.

4.12 **Woodlands exemption**

As previously noted, there is no current guidance on the direct tax treatment of the sale of PIUs or WCUs. The only available guidance applies to those opting to sell their Woodland credits under the Woodland Carbon Guarantee[5], which says:

*"Currently, profits arising from the commercial occupation of woodlands are not chargeable to* Income Tax & Corporation Tax *and the value attributable to trees is exempt from* Capital Gains Tax*. The sale of voluntary carbon credits is not currently chargeable to* VAT*. However, you should always seek professional independent advice based on their specific circumstances before making any long-term investment decisions."*

It would be helpful to know if this guidance applies to non-guarantee sales.

4.13 Under existing law[6], where a woodland is operated *commercially*, any profits generated from the occupation of such woodlands is outside the scope of both income tax and corporation tax.

Commercial occupation is defined by reference to the management of the woods:

*"For this purpose the occupation of woodlands is commercial if the woodlands are managed—*

*(a) on a commercial basis, and*

*(b) with a view to the realisation of profits."*

There is no specific requirement that the income is generated from the sale of timber in the terms of the exemption above. The existing exemption would appear to apply to income generated from credit sales where the management is carried out commercially and with a view to profit and capital treatment does not apply.

4.14 The consequences of being within the existing woodland exemption are that the income is outside the scope of tax, but so equally are the costs, including planting/preparation costs and any machinery costs as no capital allowances are permitted. To an extent therefore, this reduces the issues around reporting obligations as there are no tax consequences.

4.15 It is necessary to note at this stage some aspects of the WCC which might impact the decision about whether a woodland is 'commercial'. One of the conditions for qualifying for the WCC, is that the project meets the additionality test. Broadly, woodland will only qualify for WCC (and thus generate PIUs/WCUs) if the project is additional and would not have gone ahead without the benefit of carbon credits. According to WCC guidance "Under the financial consideration [test], a project is only 'additional' if it requires

[5] https://www.gov.uk/guidance/woodland-carbon-guarantee
[6] See s768 ITTOIA 2005 and BIM67701.

carbon income to turn it from a project which is not financially viable/worthwhile (in its own right, or compared to an alternative non-woodland use) to one which is financially viable.

4.16 The net present value of a project as calculated for additionality purposes, may not necessarily be positive even after including the carbon income. This raises the question whether a project with a negative NPV would be considered to be being carried out with a view to realisation of profits. However, it should be noted that such NPV calculations are based on a number of estimates of the value of future PIU/WCU values and looking at discounted cash flows over many decades, which are inherently uncertain. Therefore we could not consider a negative NPV should directly result in a project being considered non-commercial.

4.17 The benefits of existing woodland exemptions applying to income from carbon credits are:

- It is a simple and straightforward approach giving consistency with the treatment of income and expenditure for woodlands where the trees will be felled.
- Without the exemption, there would be increased need to consider the accounting position more carefully. Where the woodland is likely to be felled at the end of the scheme, then it becomes very difficult to know how to apportion costs between credit income and timber sales, given both arise from growing and maintaining the trees.
- If income from carbon credits from woodland are within the scope of tax, then tax relief will need to be available for the costs incurred in growing and planting the trees.
- The tax free treatment is a further incentive for engaging in these schemes which is consistent with Government's stated net zero goals.
- Without the same incentives, in the future there may be more incentives to fell and replant rather than retain the wood as a carbon sink, together with the natural benefits of an established wood.

4.18 Reasons against extending the tax treatment for woodlands to carbon credits might include

- This treatment provides a benefit for woodland carbon schemes which is not currently available to other similar carbon credit schemes which may lead to distortions in the choice of scheme. However, ensuring the right project is done in the right place is probably best managed by ensuring scheme rules themselves prevent woodland schemes on land where woodland would not be the best use.
- The position for insetting is unclear, but if the woodlands exemption applies, it would appear that a business which choses to 'grow their own' carbon credits, would not necessarily be able to get tax relief for their costs, whereas we would expect them to get relief for purchasing credits from a third party.

4.19 One of the reasons that commercial woodland was exempted from income tax in the Finance Act 1988[7] was in order to prevent landowners getting tax relief for the costs at the start of the project and offsetting against other income, when income sales of timber would be some decades off. At the time, it was considered that income tax receipts would, counter-intuitively, increase by taking woodlands outside of tax. The position for carbon credits is a little different, as it is possible to realise funds from the sales of WCUs as they are verified every 5 to 10 years – i.e before the trees have reached maturity, but there is still a substantial time gap between incurring planting costs and recovering income.

[7] See Hanard, Finance Bill 1988 - https://hansard.parliament.uk/Commons/1988-03-15/debates/d8dab897-21f2-4146-8343-bfb0bbb5ce66/IncomeTax

## 5 Q3: Should the tax system account for the timing difference between the upfront and ongoing project costs, with the delay in receiving income generating units – for example, should the tax system provide tax certainty in respect of timing mismatches, which may require an override to the accounting treatment?

5.1 At the moment there is a lack of clarity over the accounting treatment for the generation and sale of carbon and other credits. We have been advised by accounting experts that the key issues around income recognition should be based on the existing five step revenue recognition process but we understand that it will be some time before definitive guidance from the standard setters will be available. In fairness to those looking at this, it is also made more difficult by a lack of access to examples of projects, given the commercial sensitivities involved, and the sheer range of different projects and structures.

5.2 In the absence of clear accounting rules, it would be very helpful to have clarity on the tax position, even if that does result in a mismatch. While it would be far simpler if the tax could follow the accounting position, the question of what tax to pay - and when - is more important for decision making than the accounts disclosure. It is reasonably common for accounting and tax treatment to diverge and agents and taxpayers should be able to deal with this. It would therefore be helpful if the tax system could provide certainty.

5.3 In brief, from an accounting perspective we understand that there are uncertainties around:

- How to classify and measure the initial costs of the project in any relevant accounts, and account for subsequent, ongoing maintenance costs.
- Whether any credits, or PIUs can or should be recognised separately in the accounts and, if so, at what point that would occur.
- How to recognise the income from contracts – while we understand that the principles are well established, the range of different agreements and lack of access to agreements has made analysis difficult by policy teams.

It should be noted that grant income will also need to be accounted for but we have not heard of any difficulties with the usual accounting rules for income recognition here.

5.4 So far, there appears to be a consensus emerging that costs of establishing a woodland, peatland or new habitat/ecosystem can potentially be recognised an asset (an asset being, for accounting purposes, a present economic resource controlled by the entity as a result of past events). Where uncertainty remains is over the *classification* of that asset, which may vary depending on the intentions of the project.

5.5 For example, we have heard of a case where the decision has been made to capitalise all the costs of establishing a woodland as an intangible asset, representing the costs of generating the PIUs which have been validated. This has been done because there is no intention to use the woodland for anything other than the production of carbon credits. But other respondents have reported classifying upfront costs for creating a woodland within as property, plant and equipment (PPE) as they view these costs as representing the cost of creating a tangible asset. Others have suggested that PIUs should be viewed as stock.

5.6 There is also no agreement on whether PIUs can, or should, be split out and recognised separately from the costs of establishing a woodland or peatland and, if so, how they should be valued. These are all accounting questions best addressed by others.

5.7 We assume that the idea of deferring the tax on large lump sums over many decades is unlikely to be attractive to the Government. We have also received feedback from some respondents that capital treatment would be preferred, given the more favourable rates and potential for CGT reliefs if what is sold is viewed as a business asset. However, this doesn't give an easy mechanism for relief for ongoing costs, unless the losses in the years with no credit sales could be viewed as trade losses and offset against other farming or trade income. However, that would lead to a differential in that loss relief would then be available at higher, income tax rates. For woodlands, the existence of the woodlands exemption might also preclude relief for the costs of maintaining the wood given that some schemes may well be felled in the future.

5.8 We have heard it suggested that future costs could be estimated and deducted against lump sums, with subsequent adjustments to correct the position when costs become known. This is possible, but again the duration of the schemes could mean ongoing adjustments for many years.

5.9 An alternative approach might be to provide for taxpayers to split lump sum payments into income and capital elements to reflect the mixed nature of the disposal, using rules similar to those for splitting lease premiums.

## 6 Q4: How could greater clarity be provided in these areas (e.g. guidance, law changes)?

6.1 We think that there needs to be a mix of guidance in the short term and new legislation in the longer term.

6.2 In the short term, guidance to clarify HMRC's view of how the current schemes interact with existing legislation would be welcome. This should go some way to fix some of the more obvious tax barriers by removing some initial uncertainties as set out in section 4.

6.3 The first tranche of PIUs have now been verified under the Woodland Carbon Code, and landowners are looking to sell their first WCUs, so prompt guidance here will help to reduce the number of clearance/opinion requests.

6.4 In terms of the existing law, it would be helpful if HMRC could confirm if

- s22 TCGA 1992 is considered to apply to lump sum payments connected to these schemes and, if so, which schemes and under what sort of circumstances.
- Whether or not the woodlands exemption as s768 ITTOIA 2005 and s980(1) CTA 2009 would apply to the sale of PIUs/WCUs.

6.5 For the capital/income split, it would be helpful if HMRC could provide some guiding principles to illustrate how they think the position should work, particularly around lump sum payments. We would be happy to work further with HMRC on this, as this is not an easy ask.

6.6 At this stage the market is still evolving quite rapidly and it is likely that further legislation and guidance may be needed once commercial norms are established. Introducing more legislation earlier on may be a way of influencing the way the market develops if the Government has a preference for some scheme structures over others.

6.7 Finally, given that the language of the existing woodlands exemption legislation is very broad, if the intention is to exclude income from carbon credits from the exemption then we consider that legislative change would be needed to ensure legal certainty rather than just a statement in guidance that HMRC does not consider it to apply.

## 7 Q5: Are there any other areas of uncertainty in respect of the broader taxation of the production and sale of units generated by ecosystem service markets? Please provide evidence and scenarios, including the relative scale of the concern by explaining where decisions have and have not been influenced by the uncertainty of the tax treatment.

7.1 Given the duration of the projects, capital taxes are highly likely to be an issue for most projects involving private landowners, as there is a high chance that there will be one (or more) of a sale, gift, exchange on divorce/separation, exchange of joint interests or inheritance at some stage. Clarity around the availability of valuable reliefs such as roll-over relief, hold-over relief and Business Asset Disposal Relief would be welcome.

7.2 Roll-over relief is available to defer the gains arising on the disposal of qualifying business assets, which includes land and buildings used in a trade or where the taxpayers is occupying commercial woodlands and managing them commercially to make a profit. It would be helpful if HMRC could confirm that they would be prepared to accept land subject to one or more schemes as either a business asset (or commercial woodland in the case of the WCC). We note that HMRC has recently updated its IHT guidance at IHT25253 to say the following.

"*HMRC are of the view that the activities necessary to create, manage and maintain the land for the purposes of generating credits for use or sale will mean any business undertaking these operations will, in general, not be mainly involved in the holding or making of investments*"

This would suggest that HMRC may be prepared to consider that land within a scheme which is being actively managed is a business asset.

7.3 Hold-over relief applies to defer gains when business assets, or agricultural property is gifted. Where land is subject to one of these schemes, we assume that any unsold credits, and the associated obligations of the scheme would transfer to the new owner with the land. Again, it would be helpful to understand HMRC's view about whether land subject to the schemes has the potential to be a business asset. Guidance here would be welcome, and of course the position may be affected by any changes to APR.

7.4 For WCC schemes, s250 TCGA 1992 may also be relevant, as this provides for an exemption from CGT from the sale of standing trees provided that the woodland is commercial. While the intention in most cases will be to grow and not fell trees during the life of the scheme, there may well need to be thinning operations, and the wood could be felled (and replanted) once the scheme has completed. Again, it would be helpful if HMRC could confirm if woodlands grown entirely or partly for credits will be accepted as commercial for the purposes of s250 when/if any felling occurs.

7.5 SDLT

To the extent that carbon credits affect the value of the land and/or are valued separately, there may be implications for the various land transaction taxes in England and Northern Ireland (SDLT), Scotland (LBTT) and Wales (LTT). We have restricted our comments to SDLT, as the LBTT and LTT are devolved taxes.

7.6 Although SDLT is an issue for the purchaser of land, when buying land in one or more schemes the question arises as to whether any unsold PIUs or credits constitute a chargeable interest for SDLT. We note that Single Farm Payment entitlements were not subject to SDLT and confirmation of whether similar treatment would be apply here would be welcome.

7.7 A query has also been raised with us around the position for SDLT relating to property investment partnerships (PIPs). SDLT is payable when an interest in a PIP is transferred. A property investment partnership is defined as a partnership whose sole or main activity is investing or dealing in chargeable interests, whether or not that activity involves the carrying out of construction operations on the land in question. Farming and commercial forestry partnerships are not usually PIPs, but it is unclear whether holding land with a view to generating carbon credits would be considered more akin to farming than investing in land. It has been reported to us that a lot of new projects using partnerships only have a small or very limited farming element, with the main focus on generating income through the sale of credits. For peatland in particular the level of any farming activity may be low to non-existent. We have been asked if HMRC would be willing to provide guidance or clearance, if a specific clearance application was made, on this point.

7.8 **Purchases of credits**

In addition to guidance for landowners and tenants, it would be helpful if there could be guidance to confirm the tax position for businesses purchasing units under the various schemes. We would expect that although businesses purchasing Woodland or Peatland credits to offset their emissions are doing so on a voluntary basis, that such costs would be deductible for tax as wholly and exclusively relating to offset of $CO_2$ emission from the trading activities as the units are 'retired' and offset. Similarly, for developers purchasing BNG or nutrient credits, we would expect the costs incurred to be part of the cost of the development, and dealt with in line with other costs of planning consent. However, guidance to confirm these points would be welcome.

7.9 For Woodland and Peatland credits which have not been 'retired' and which are being held by the business, plus PIUs which represent a future offset which is not yet guaranteed, we think consideration should be given as to whether or not it is reasonable to expense these costs immediately. Until the units are converted to WCUs and then retired, there is an argument that the cost of a PIU is an intangible asset on the businesses' balance sheet. Similarly, a WCU which has not yet been retired would also be an asset, until such time as the decision is taken to retire/offset the create.

## 8 Q6: How could greater clarity be provided in these areas (e.g. guidance, law changes)?

8.1 Provided HMRC is happy to accept land within the schemes as being a business asset, or having the potential to be a business asset for the purposes of the CGT reliefs above then guidance should be sufficient. If there is a risk that existing beneficial reliefs that are available to agricultural land might be lost, then there may be a need for a change to legislation to ensure that landowners are not disincentivised from taking part in the schemes.

**Part 2: Consultation on agricultural property relief from inheritance tax and environmental land management**

**9 Q1: What are the areas of concern in respect of agricultural property relief and environmental land management? Please provide evidence and scenarios, including the relative scale of the concern by explaining where decisions about land use change have and have not been influenced by the scope of agricultural property relief.**

9.1 Most of those we talked to raised concerns about the potential loss of IHT reliefs as a real barrier to engaging with schemes. While HMRC's recent guidance on BPR is welcome, BPR would not be available for landlords who may have previously qualified for APR. BPR is also either not available or restricted to 50% in certain circumstances again where APR may have previously been available. This might be because the land is held personally by the partners outside of the farm partnership and restructuring is not possible, or the farming operations are run through a company but the land is held outside of the company. Again in these scenarios APR may have previously been available.

In respect of the current APR position we heard the following concerns:

9.2 **Risk of loss of APR on the farmhouse**

APR covers not just the agricultural value of the land but also any farmhouse and buildings occupied ancillary to the land. The concern is that as more land is moved into schemes, this could put APR at risk on the farmhouse because buildings must be of a nature and size appropriate to the farming activity that is taking place. Loss of APR on a farmhouse could be a significant disincentive to put large amounts of land into schemes which might otherwise be beneficial for wider society. On the other hand, it is very unusual to get relief on a residential property in the manner available to farmhouses. Such an outcome could be argued to be compatible with the intention of APR, as if the nature of the farming operations is reduced, then there may not be the same need for the farmer to be 'on hand' in the farmhouse in the same way.

9.3 **Choice of scheme**

We received a number of examples of BNG schemes where individuals were proceeding with habitats where agricultural use was still possible - eg hay meadows where there is potential for grazing or to take a crop in order to preserve APR entitlement. The risk here is that the creation of equally valuable habitats such as scrubland or wetland say, where agricultural use is either very limited or excluded, might be limited if there is a loss of APR.

9.4 **Equality of treatment**

Given the potential for stacking more than one scheme on a piece of land, it would be helpful if the IHT reliefs could be the same for all schemes.

9.5 **Impact for tenants**

This is a complex area, but unless tenants can enter schemes without affecting the APR position for their landlords, there will be further restrictions on tenant farmers entering schemes and a risk of land being taken back in hand. Given the amount of tenanted land, this will severely affect the Government's desire to get 75% of farmers into low carbon practices by 2030.

9.6 **Impact on land values prior to entering schemes**

We didn't receive any specific evidence of this, but concerns were expressed about the effect on land values prior to entering schemes. The concern is that the capacity to take part in some schemes could increase the value of otherwise marginal or low value land to above what would be considered agricultural, and this might not be covered by APR. While 'hope' or development value is covered by BPR, as noted above there are landowners who are relying on APR and not BPR for their IHT reliefs. It would be helpful to understand whether any enhancement to value because a land would be a good fit for a scheme would fall within the agricultural value.

9.7 As an alternative to expanding the definition of APR, we have previously discussed that another approach would be to introduce 'CPR' – or 'Conservation Property Relief' in addition to the existing APR/BPR reliefs. While a separate relief does introduce some additional complexities, it could help to remove disincentives from loss of IHT reliefs. Equally, a separate 'CPR' could be helpful to encourage landowners to retain land purely for conservation purposes and may provide reliefs for land which remains as a carbon or nutrient store after the schemes have been completed

9.8 By separating the requirements from existing reliefs, Government would have more control over what types of non-agricultural, non-commercial land use was desirable for social and environmental reasons. The relief would also need to be carefully drawn to exclude situations such as gardens or land associated with residential property which is managed for conservation benefits. One simple approach might be to set a *de minimis* area.

## 10 Q2: Do you agree that the qualifying conditions for relief would need to be underpinned by live undertakings and ongoing adherence to those undertakings at the point of transfer?

10.1 We agree that the qualifying conditions need to be tied to robust schemes and we think it makes sense at this stage for APR to be available only where there are live undertakings.

10.2 We have had sight of the Chartered Institute of Taxations (CIOTs) response and would agree with their comment that the test should be less strict and perhaps relief should be withdrawn only when the majority of undertakings have been breached?

10.3 In the longer term, consideration will need to be given to what status land in schemes has at the end of the scheme and how it can be used. If land comes to the end of the scheme and then falls out of the protection of APR, this could incentivise landowners to bring the land back into agricultural use and result in a loss of some or all of the ecological benefits. If this was looking like it might be a problem, then APR could be reviewed at this point, and/or the merits of a Conservation Property Relief (CPR) explored. This could have different conditions to APR and apply for land which has been out of agricultural use for some period of time, but is providing an ecological benefit. CPR could be at lower rates than APR, or be subject to a minimum level of activity sufficient to maintain the established habitat.

10.4 A couple of respondents commented that they are working on the assumption that land within these schemes will likely be designated as a Site of Special Scientific Interest (SSSI) which would potentially limit any change of use once a new habitat has been established. Woodland is already protected by the need for a felling licence.

10.5 At this stage it is too soon to say what might be needed in the future. There is a risk that if there was no need for active management or an active scheme, but land still qualified for APR that it might result in the

creation an asset which had value purely as an IHT shelter. However, there is also a risk of such land being a burden - having some value but with no IHT protections, and obligations to maintain it but limited ability to generate future income. Then again, it may be that land is simply rolled over into whatever new schemes are available at that time, or that the enhanced biodiversity of some areas of land on an estate could provide benefits for the rest of the farmland – for example, enhancing pollinators or providing opportunities for diversification (beekeeping, holiday cottages etc). This would mean that, even if outside a live scheme, that land was still contributing to the farming business.

**11 Q3: Do you agree with the potential proposed approach to the list of Environmental Land Management Schemes that could qualify for relief where the activities covered relate to land being taken out of agricultural use?**

11.1 We agree that listing the accepted schemes is a sensible approach as it provides clarity and should help to ensure that IHT reliefs are restricted to high quality, genuine schemes.

**12 Q4: Could the government remove the list of existing enactments for land habitat schemes in the existing legislation? Are you aware of any land continuing to qualify for relief now under any of the existing enactments?**

12.1 We did not receive any feedback in response to this question.

**13 Q5: What agreements that meet high verifiable standards and have robust monitoring could be added to any list of qualifying Environmental Land Management Schemes? Please explain, including any potential unintended consequences or tax planning opportunities that might need to be considered and how they could be addressed.**

13.1 We did not receive any further suggested schemes to include, although we understand that a number are in progress including land-based carbon sequestration activities such as soil carbon enhancement, marine based sequestration (blue carbon) and hedgerow creation schemes.

13.2 We think that it will be important for the legislation to stay up to date as new schemes are developed in order to avoid future issues around disincentives. One approach might either be to do a catch all clause in which all schemes approved by certain bodies (for example Natural England) are automatically added, or HMT is given the power to add schemes through secondary legislation as new schemes reach maturity.

**14 Q6: How could the government achieve its intention not to expand the scope of relief beyond agricultural land that was being used for agricultural purposes? What would the practical challenges be for those claiming relief and how could they best be overcome?**

14.1 We understand that the concern here is that schemes are not exclusively open to farmers but could also be on wasteland (for example ex-landfill sites), pony paddocks, golf courses or other land not necessarily currently in agricultural use. The concern is that extending APR to cover all land within the scheme, regardless of previous use, would increase the cost to the Exchequer.

14.2 In response, we would suggest that where land is being tied up for the long term then it may be helpful to have incentives such as APR to encourage private owners into the schemes. We also think more work is needed to understand the extent of the risk here. While we agree that credits can be gained through restoring landfill sites and similar areas which are not currently eligible for APR, we wonder how big an issue this might be. Where land is held by large corporates, the fact it could become eligible for APR by virtue of

being in a scheme is unlikely to affect the IHT position of the company shareholders. Land such as a golf courses or caravan park may also already be covered by BPR so there would be no loss of tax to the Exchequer by extending the definition of APR. Equally, a pony paddock could be always converted into agricultural use in order to achieve APR, subject to the relevant timelimits.

14.3 It will certainty be much simpler to assess whether or not land is an approved ecosystem scheme at the date of death or gift, than whether or not it was in agricultural use at either a fixed point in time, or prior to the commencement of the scheme.

14.4 The concern from our members is that it could be quite challenging to prove active farming at a point in time especially for marginal land which is often best suited to this sort of scheme.

14.5 One simple approach to exclude claims by private individuals with small areas of previously not agricultural land might be to set a minimum acreage that must be held before APR could be claimed.

14.6 We note that APR is already subject to minimum periods of ownership.

## 15 Q7: How could the environmental land be valued most appropriately? What would the practical challenges be and how could they best be overcome?

15.1 This is not an area we are able to comment on.

## 16 Q8: Are there any other design issues that would need to be considered if the government decides to update the land habitat provisions in agricultural property relief?

16.1 We have not received any feedback from members on this point.

## 17 Q9: What would the impact be of restricting 100 per cent agricultural property relief to tenancies of at least 8 or more years?

**Q10: What exclusions would be necessary and how could these be defined in legislation if the government pursued this approach?**

17.1 We received limited feedback on these questions. Those that did comment were unsure of the merits of the proposal and were concerned that the changes would restrict the ability of landlords and tenants to make commercial decisions. Concerns were expressed that it would be unfair for landlords to lose APR purely due to an inability to acquire tenants willing to enter into longer tenancies. We did not receive any comments in support of the measure.

## 18 Other comments

18.1 For completeness, although not related to tax, during our discussions with interested parties, we received feedback from a number of legal professionals that the lack of legal certainty was causing issues, even before tax matters were considered. For BNG in particular there was a concern that secondary legislation has not yet been issued and the register for the credits has not been made available for testing.

18.2 On page 9 of the Consultation, there is an explanation of pending issuance units (PIUs) and a comment that these are 'not guaranteed to the same standard'. We think this is a slight misunderstanding in that PIUs are not guaranteed to *mature* into Woodland or Peatland credits, but in the meantime, the woodland/peatland from which the PIUs have been sold must still be held to the same standard.

18.3 **VAT Issues**

Although VAT is out of scope of this Consultation, for completeness we have included some comments as it came up a number of times in discussions with contributors. We note that DEFRA have recently said that biodiversity units will be subject to VAT when they are sold[8] but that HMRC guidance has not been updated.

18.4 As a transaction tax, the VAT aspects are often the first tax issues to arise. At it currently stands, HMRC has issued guidance to say that income from voluntary carbon markets is outside the scope of VAT as sales of voluntary credits do not meet the conditions to be consumption of the type envisaged by the VAT system. This is set out in HMRC's manuals at VATSC06583 and VATSC06584.

18.5 HMRC's manuals set out their reasoning for this position based on concerns about the lack of audit trail and risk of double counting of credits when used for offsetting purposes. While some codes are still undergoing development, the woodland and peatland codes are now much better established than when HMRC's guidance was issued, with a public audit trail of credits (and record of retired credits) on the UK Land Carbon Registry. We would question if the arguments advanced in the manuals are still valid for these codes, and suggest that this position should be reconsidered and the guidance updated.

18.6 In the current environment, where many organisations are committed to meeting net zero obligations in the next decade, the ability to demonstrate this by the purchase of unregulated carbon credits has increased, and businesses have evolved to meet this need. The application of normal VAT principles, including recent HMRC guidance, to supplies of unregulated carbon credits indicates that where there is consideration and a benefit then there is a supply in the course of business, which is treated as a supply of services in the absence of any goods being involved. This conflicts with the HMRC guidance referred to above.

18.7 For businesses which are generating this revenue it is important that they have up to date guidance from HMRC on the correct VAT treatment of their supplies in order to avoid the risk of a future challenge that their activities are beyond the scope of the current guidance. In the absence of such guidance, a business is likely to conclude that the safest way forward is to account for VAT on this income, although this position is unlikely to be consistent across all such businesses.

18.8 Viewing carbon credits as outside the scope of VAT effectively means activities designed to bring credits into existence are being considered a non-business activity by HMRC, which does not sit comfortably with the direct tax position, where the same activities are likely to be taxable as a business activity. It also creates issues around VAT recovery and the need to apportion overheads between VATable farming activities and credit generating activities. Where a separate entity is created to manage credit schemes, some contributors have expressed concerns that the current position makes it difficult for VAT grouping.

18.9 Other comments we received relating to VAT include:

- Contributors tell us that the UK's current position on VAT is out of step with other jurisdictions which is clearly unhelpful.
- A member advising on a nutrient neutrality scheme noted that while there was no mention of VAT in the agreement between the farmer who had agreed to leave their land fallow and the Council, the Council were charging VAT on the sale of nutrient credits to developers. It would seem unfair if the farmer was unable to recover VAT, but the Council could.

[8] See section 5.3 of https://www.gov.uk/government/consultations/consultation-on-biodiversity-net-gain-regulations-and-implementation/outcome/government-response-and-summary-of-responses#government-response-part-2-applying-the-biodiversity-gain-objective-to-different-types-of-development

- In the event that HMRC does change their position, will there be scope for it to have retrospective effect, or for those who have followed the current guidance to make error claims.
- One member highlighted potential complexities as a result of barter type transactions, particularly with charitable organisations engaged in generating credits. They were concerned that these arrangements might be seen as non-business activities.

## 19 Contact details

19.1 We would be pleased to join in any discussion relating to this Consultation. Should you wish to discuss any aspect of this response, please contact our relevant Technical Officer, Helen Thornley on 07773 087125 or hthornley@att.org.uk.

**The Association of Taxation Technicians**

## 20 Note

20.1 The Association is a charity and the leading professional body for those providing UK tax compliance services. Our primary charitable objective is to promote education and the study of tax administration and practice. One of our key aims is to provide an appropriate qualification for individuals who undertake tax compliance work. Drawing on our members' practical experience and knowledge, we contribute to consultations on the development of the UK tax system and seek to ensure that, for the general public, it is workable and as fair as possible.

Our members are qualified by examination and practical experience. They commit to the highest standards of professional conduct and ensure that their tax knowledge is constantly kept up to date. Members may be found in private practice, commerce and industry, government and academia.

The Association has more than 9,500 members and Fellows together with over 5,000 students. Members and Fellows use the practising title of 'Taxation Technician' or ‘Taxation Technician (Fellow)’ and the designatory letters 'ATT' and 'ATT (Fellow)' respectively.

## Appendices

### Appendix 1: Background to the schemes.

For woodland and peatland carbon schemes, the two schemes are reasonably similar, although technically woodland is sequestering (absorbing) $CO_2$ and equivalent greenhouse gases from the atmosphere whereas peatland schemes are about the reduction in emissions which would otherwise be made by an unrestored bog. The schemes are registered, then validated, at which point the Pending Issuance Units (PIUs) can be listed on the UK Carbon Registry. These cannot be offset against emissions and are effectively a 'promise to deliver' future sequestration or emission reduction. There is a process of verification every 5 to 10 years at which PIUs can be converted to Woodland or Peatland Carbon Credits (WCUs/PCUs). The risk that PIUs do not mature into WCUs which can be used appears to rest with the purchaser. WCUs/PCUs can be offset against emissions for reporting purposes, at which point they are 'retired'.

Sales of either PIUs or WCU/PCUs can occur at any stage of the project, or they can be retained for offsetting against the owner's own emissions (insetting). Once PIUs are sold, the landowner has an ongoing obligation to maintain the wood or peatland until the terms of the contract are satisfied. Once matured WCU/PCU credits are sold it is less clear whether any obligation to maintain the woodland or peatland continues as arguably the benefit of sequestration/reduction has occurred at that point. Further detail on Woodland Credits and the lifecycle of scheme has been set out in the appendix.

For BNG and Nutrient Neutrality schemes, there does not appear to be the same concept of a PIU and instead credits are issued to the landowner once the scheme has been validated at the start. In most examples we have seen, these credits are then sold for a lump sum upfront to developers rather than retained for future sales. The landowner is then required to abstain from farming and/or develop alternative habitat for a period of 30 years (BNG) to 120 years (Nutrient Neutrality). The obligation to maintain the habitat is regulated under a s106 agreement with the local authorities. The developer is not involved in ensuring that the scheme is successful. We understand that the plan in future is to replace s106 agreements with conservation covenants, which will be between the landowners and a responsible body who will enforce the terms of the scheme. Responsible bodies may include local authorities but could include conservation bodies/charities. We are not clear on the position if at the end of the scheme the habitat development does not result in the expected number of credits. We also understand that landowners may be required to put aside a sinking fund out of the upfront sales proceeds to ensure there are funds available for maintenance over the life of the project.

We have also seen some BNG schemes where, instead of an upfront cash payment, the landowner enters a lease with an intermediary company who pays rent. This company will enter the land into a scheme, obtain verification of the credits and market them to third parties. The intermediary will then contract with the farmer to maintain the land in accordance with the scheme, for which the farmer will receive a separate payment. The tax here seems to be rather more straightforward, with the farmer accounting for tax on their annual rental receipts, and income from a maintenance contract.

**Appendix 2: Notes on Woodland Carbon Credits**

**Carbon credits**

A single unit of carbon credit is generated by taking an action that removes 1 tonne of $CO_2$ emissions from the atmosphere permanently (e.g. by planting trees) or avoids a tonne of $CO_2$ emission (e.g. by restoring peatland).

Projects only generate units of carbon credit if the removal is permanent and it would not have happened but for receipt of the credit income. Verified Woodland Carbon Units (from the Woodland Carbon Code) or Peatland Carbon Units (from the Peatland Code) are registered on the UK Land Carbon Registry and recognised in the UK Government's Environmental Reporting Guidelines.

The codes are both voluntary, but help to provide assurance to purchasers that the credits being sold represent real, quantifiable, additional and permanent removal of carbon by setting out to quantify and audit the amount of carbon captured in any given scheme. The codes set out requirements for land suitability, soil conditions, project length, on-going management, and confirm that the project would not have happened without financial support.

When a business who has purchased units wishes to formally recognise those units as offsetting their emissions, the credits are then 'retired' and cannot be resold/passed on.

**Woodland Carbon Credits**

A Woodland Carbon Unit (WCU) represents a tonne of $CO_2$ emissions which have been sequestered in a Woodland Carbon Code (WCC) verified woodland.

Prior to the issue of a WCU it is possible to purchase Pending Issuance Units (PIUs), which are a promise to deliver the removal of 1 tonne of $CO_2$ based on future growth. Once the growth has been achieved and verified – a process which occurs in stages every 5 years - a PIU can be converted to a WCU and then retired for offsetting purposes. At present, it appears there are far more PIUs available to purchase than WCUs but this should shift as early projects start to mature.

Sales of WCUs can be made to individuals, businesses and Government (for the latter see Woodland Carbon Guarantee.)

A Woodland Carbon Unit (WCU) represents a tonne of $CO_2$ emissions which have been sequestered in a Woodland Carbon Code (WCC) verified woodland.

Sequestration does not occur evenly over the life of the project as the capacity of a growing tree to sequester carbon depends on its age. Initially, the creation of a project will result in carbon emissions (for example due to ground disturbance planting trees) then, as the trees grow, $CO_2$ will be taken up by the tree, and as part of the biological processes of tree growth, carbon is stored in the timber and structure of the tree. In general, sequestration should peak between 16-25 years into the project and then decline thereafter. Sequestration effectively ceases once the woodland is matured, at which point the woodland can be considered a store of carbon. During the growth period it is a carbon sink[9].

As it takes time for trees to grow and sequester $CO_2$, prior to the issue of a WCU, the landowner can opt to sell Pending Issuance Units (PIUs), which are effectively a promise to deliver the removal of 1 tonne of $CO_2$ based on future growth. At the start of the project, an estimate is made of the potential of the scheme to sequester carbon by following established procedures. The number of validated potential units are then listed on the registry. A number

[9] https://carbonstoreuk.com/wp-content/uploads/2021/06/CarbonStore-User-Guide.pdf

of PIUs will be held in a buffer – i.e. will not be available for sale – to reflect inherent uncertainties in the process of estimating PIUs for a given project.

All PIUs and WCUs are recorded on the UK Land Carbon Registry. At present, there are more PIUs available to purchase than WCUs, but this should shift as early projects start to mature.

As growth is achieved and verified – a process which occurs after the first 5 years and then every 10 years thereafter- PIUs can be converted to WCUs. When listed on the registry, PIUs are allocated a 'vintage' – which is an indication of the 10 year window in which the PIU is expected to mature to a WCU. This allows purchasers to plan ahead and purchase PIUs to offset future emissions. Each PIU/WCU has its own unique serial number to identify it with a specific project and the time period during which it is expected to mature. PIUs and WCUs are not therefore entirely fungible – see below.

The lifespan of a typical woodland project can vary but will be a minimum of 35 years up to a maximum of 100 years. These are therefore long term schemes with significant implications for capital taxes as land could well be sold or passed to a new generation during this time.

Purchasers of PIUs or WCUs can include individuals, businesses and Government (for the latter see Woodland Carbon Guarantee.) All transfers of units are recorded on the UK Land Carbon Registry. As yet, there is no standard contract for the sale of PIU or WCUs.

A purchaser who wants to offset their carbon emissions can do so by 'retiring' the WCUs they own on the register. Once the credits have been 'retired' they cannot be sold on or used by any other entity for offsetting. It is key that retired credits cannot be reused or this would result in double counting of offsets. It is not possible to 'retire' PIUs – they cannot be used for offsetting until they have matured into a WCU.

At present, landowners can sell their units either to an end user (who anticipates offsetting the credits against their emissions) or to an intermediary. The intermediary can only hold the benefit of any credits purchased for a limited time before moving them on to the end user. Entities wanting to trade or buy/hold units then need to be authorised by FCA.

Landowners can also opt to retain their PIUs and subsequent WCUs to offset against their own emissions. This is called in-setting.

Project owners who choose to sell, can sell any quantity of PIU/WCUs units at any time. We understand that due to uncertainties on tax, as well as concern about selling too early, as demand for offsetting is expected to increase, that many landowners are currently holding onto their PIUs.

The price of an individual PIU/WCU is affected by factors including:

- Location – projects which are closer to populations can have more value for local businesses looking to visit the site or place advertising on site.
- The nature of the project – Native, mixed broadleaved schemes are perceived as more valuable than plantations consisting of a single species.
- Vintage – the earlier the vintage (the estimated date when the PIU is due to mature), the closer to conversion it should be so the lower the risk for the purchaser.
- The current stage of project and thus certainty with which it will proceed.
- Extra benefits (see below) – a project may also bring additional benefits such as increasing biodiversity, slowing water flow or filtering water, or community benefits if the land allows access. Some purchasers may value these benefits more than others.

**Additionality**

In order for any project to qualify for carbon credits it must satisfy an *additionality* requirement – i.e. projects should be providing additional sequestration which would not otherwise have happened. The aim of this test is to restrict the issue of PIUs to projects which would not be viable absent the carbon credit income.

The additionality tests have changed since the WCC was launched in 2011. Since October 2022, there have been two tests – a legal test and an investment test.

In brief, the legal test requires that the new woodland is not already required by law, while the investment test requires the landowner to demonstrate that the scheme would not be viable without the income generated from the carbon credits.

The investment test starts by calculating the net present value (NPV) of the cashflows over the life of the scheme using a template with standardised costs and income projects. The NPV of future cashflows with the scheme in place must either be:

- less than the base line NPV if the use of the land is unchanged;
- be negative, but become either positive, or less negative, once income from carbon credits is taken into account.

For an example cash flow of a woodland contract prepared for the purposes of establishing the NPV of the project to assess additionality, see appendix 1.

Unlike some previous grant schemes, there is no minimum size of woodland that is eligible[10]. We are unsure at this stage if this might cause issues around commerciality (discussed below) and whether there are specific issues for small woodlands is something which should be considered.

**Wider benefits**

It should also be noted that the planting of a woodland can create wider benefits including:

- Increasing biodiversity by providing new habitats for wildlife
- Better management of water including reductions in flood risk and allowing for filtration of pollutants such as phosphorous and nitrogen
- Reduction in soil erosion and stabilisation of slopes
- Benefits for local people if access to the woodland is permitted

At present, these benefits are 'bundled' together into the carbon credits. It is possible that in future, as further credit schemes are developed, that the planting of a woodland could create not just woodland carbon units, but also income from further credits schemes relating to biodiversity, soil or water and nutrient management. This is called 'unbundling'.

The reverse of unbundling is stacking, in which the same piece of land can be placed in multiple schemes. At the present time, there are limits to how many schemes can be applied for on the same piece of land.

As the benefits and features of each project are different, and each unit is separately identified, while units within a given vintage can be considered fungible, units of different projects are not identical and a purchaser may not view units from one project as equivalent to units from another.

[10] See Point 6.5 https://www.gov.uk/government/publications/woodland-grants-and-incentives-overview-table/woodland-grants-and-incentives-overview-table#woodland-carbon-code-wcc

**Life cycle of a woodland project:**

**Stage 1: Registration and planning**

Landowner identifies an area of land for tree planting.

Planning and calculations are carried out to design the planting scheme and confirm it will meet the scheme requirements. Decisions are made about the mix of species, exact location and area, and project length. This could be 35- 100 years depending on how long the trees are expected to take to reach maturity. The estimated number of PIUs that the woodland could sequester is calculated.

Schemes must be registered with the WCC before planting can begin.

**Stage 2: Planting**

Once the scheme is registered, planting can begin.

**Stage 3**: **Validation**

Once planting is complete the scheme must be validated. Paperwork produced by the project must be audited.

Once validated, the credits are recorded on the registry as PIUs, subject to a retention of a certain percentage of credits to reflect both uncertainties in the estimation process and the risks that the wood does not grow as expected. Once on the register, the PIUs could be sold at this point to generate an initial income for the landowner, or retained.

**Stage 4: Verification**

Projects are reviewed or verified at least every 10 years following initial verification to assess how much tree growth has occurred and therefore how much carbon has been sequestered. The initial PIUs recorded at the start of the project will mature into WCUs over the life of the project. Following verification, PIUs are converted to WCUs.

We understand that there is the possibility that in future, verification could occur more frequently than every 10 years, which would accelerate the recognition of verified units.

**Stage 5: Project completes**

At the end of the project term, the trees should be at maturity and the project is completed. What happens at this point is not entirely clear and there are questions over whether or not there are ongoing obligations after the scheme has completed to retain the woodland which is created, given that land use is intended to be permanent.

In terms of the WCC, at the start of the scheme, landowners agree to a statement which says that the change of land use to woodland will be permanent, to ensure that the benefits of the carbon sequestration achieved is not lost. The legal basis of this obligation should be considered and further work is needed here. In any event, the Government has a general policy against felling woodland without restocking which is delivered through the felling licence regime. A felling licence is required before trees can be removed and it is a standard condition of a felling licence that the site will be restocked, so regardless of whether any obligations entered into when signing up to the WCC are specifically enforceable or not, the landowner will usually be required to retain or replant the woodland.

The schemes are voluntary so in theory the landowner could also choose to drop out of the scheme at any point. It's difficult to say what sort of circumstances would prompt this, but if the income from felling trees was greater than that from credits, that could be a consideration. Where PIUs had been sold, it is presumed that there would need to be some form of compensation for purchasers depending on the terms of the contract entered into. Presumably, a

landowner could, subject to the terms of any sales contracts, deal with any sales through any breach of contract provisions. Again, there is no standard contract, so it's not clear what such provisions might be. It is not clear that compensation would be required if WCUs had been sold, as it is not clear that there is necessarily an enforceable ongoing obligation. Again, more work is needed here.

**Sales/disposals of units**

The landowner can either

- Sell PIUs post validation (after stage 3 in the cycle above) or later.
- Sell WCUs as they mature during the various verification cycles at stage 4
- Hold WCUs to offset against their own carbon emissions (this is called insetting, as opposed to offsetting which relates to a third party purchasing units)
- Dispose of the underlying land, subject to any existing contracts for sales of PIUs/WCUs.

We have been told that many landowners are holding onto their PIUs or selling only a percentage to generate some upfront cash.

Further tax issues (not considered here) will also arise for projects on tenanted land.

Credits can only be transferred via the UK Land Carbon Registry. There are limits restricting transfer, so they are not saleable as freely as, say, stocks or shares or cryptoassets. There is a limit to the number of times that units can be sold on, with a limited role for aggregators/intermediaries between the project owner and the end user who will be looking to claim offsets against their emissions. Further work to understand the nature of the trading market is required. We are not clear how robust or legally enforceable the measures to prevent active trading in credits are.

At present, we understand that there is no standard contract for the sale of PIUs/WCU and there is natural caution from those involved in sharing copies of contracts which have been developed so far as they are commerciality sensitive. We have seen extracts of the key terms for the sale of a small number of PIUs from a peatland project but no contracts for sales of PIU/WCUs from woodland schemes.

**What happens once WCUs are verified?**

Once the WCUs have been verified, or if the vendor waits until they have WCUs to sell rather than selling PIUs, it is not clear what, if any, ongoing obligations the vendor will have and to whom. It is not obvious that the vendor has ongoing obligations to the purchaser/end user of a WCU as if the project fails after the sale of WCUs, there is a WCU 'buffer' on the registry - to ensure that WCUs which have been sold do not have to be cancelled or repaid.

As a separate issue, we are not aware of any guidance on opting out of the WCC, but we understand that it is possible to opt out of the WCC and that this has been confirmed as possible by the Peatland Code in respect of peatland units. While opting out doesn't seem like an immediate concern, these are long term projects and there are all sorts of factors such as obtaining planning permission, compulsory purchase or an opportunity to profit from timber harvesting that may mean that some landowners could look to opt out at a future date. It would also be necessary to consider if this had any effect on the initial upfront grants.

Where the vendor remains in the code, the code does set certain requirements around permanence of the removal of $CO_2$ and project owners are asked to sign an agreement when a project is verified that confirms they will commit to the rules of the WCC and this commitment includes a statement that land change to woodland should be permanent – i.e. continue beyond the duration of the project[11]. The landowner may have contractual obligations to

[11] https://woodlandcarboncode.org.uk/standard-and-guidance/2-project-governance/2-3-management-of-risks-and-permanence

retain woodland if they have sold PIUs, and there may be legal obligations to retain the woodland under the Environmental Impact Assessment Regulations (1999) and the Forestry Act (1967) which requires landowners to obtain permission before felling can commence.

Further work is needed to clarify the position on the ending of a project as this may have further tax implications.

Where a project is split, and perhaps some land is removed from the scheme or sold, then the project will need to be re-verified and again, there may need to be compensation from the landowner depending on what units have been sold, and what units the remaining area can potentially generate. If a landowner is envisaging a future sale of land at the time that a sale is known or contemplated, it may be simpler for separate projects to be created from the start.