

## VAT focus

# Green and pleasant land? VAT and Natural Capital

## Speed read

With the growing world population and the constant need for more housing, we must protect our ecosystems. Natural Capital is a framework for those elements of the living world that produce a value or benefit to humanity. The implications thereof are felt both by landowners and developers, whether this is in respect of carbon, nutrients, water, woodlands, or peatland. Credits or biodiversity units can be created, sold and purchased. What are the VAT implications? Basic principles should be followed, but it would be good for HMRC to update its guidance or publish new guidance to cover the plethora of new environmental credits.



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Much like the English countryside itself, the current legal landscape for Natural Capital is a patchwork of the national and the local, the intentional and the accidental.

There are two recent developments, however, which have the potential to transform this legal patchwork: first, the newly introduced biodiversity net gain (BNG) rules; and, second, the drive to scale up private investment through nature markets. Both of these related developments trace their evolution back to the government's 2018 25 Year Environment Plan.

These developments have implications, of course, for the natural environment we all live in. For certain rare breeds, however, engaging questions of VAT also arise.

## BNG

Schedule 14 of the Environment Act 2021 introduced into the Town and Country Planning Act 1990 a condition for planning permission that developments must result in a BNG of at least 10%, as measured by a prescribed 'biodiversity metric'. The rules apply to major developments from 12 February 2024, to small developments (less than ten dwellings in the case of residential developments on a site less than 0.5 hectare) from 2 April 2024, and to nationally significant infrastructure projects from late 2025.

The required BNG must be realised according to a hierarchy of:

1. Onsite mitigation or enhancement of habitats.
2. Offsite biodiversity gains allocated to the development. These can be enhancements made to other land held by the developer or the developer can purchase biodiversity 'units' in respect of land where such enhancements are being made. In either case, the gains must be maintained for at least 30 years.
3. As a last resort, the purchase of statutory biodiversity credits by the developer.

Onsite BNG significant enhancements for a developer will be agreed either via a Planning Condition, Conservation Covenant or a section 106 Agreement with the Local Planning Authority, with annual management and reviews and likely detailed reports every five years to the local authority.

For offsite BNG, there would be a Unit Purchase Agreement showing the developer buying biodiversity units from the landowner, who will then need to enter into a Conservation Covenant or section 106 Agreement with the Local Planning Authority (if they have not done so already); or a habitat bank provider is inserted between the developer and the landowner.

## Scaling up of nature markets

In March 2023, the government published *Nature markets: A framework for scaling up private investment in nature recovery and sustainable farming*. This framework sets out core principles and rules for the functioning of nature markets, with the goal of attracting private investment of more than £1bn a year into nature markets by 2030.

There are a number of existing nature markets. Some of these are purely voluntary; others exist to facilitate the compliance of developers and other land users with their legal obligations.

As to voluntary markets, the most prominent are those which allow firms to purchase carbon credits to compensate for carbon emissions. The credits are generated through woodland creation or peatland restoration, under the auspices of the UK Woodland Carbon Code and the UK Peatland Code respectively.

As to compliance markets, there is an existing market for nutrient credits where these are required for local planning purposes and now an emerging market for BNG offsite biodiversity units. In both of these cases, the credits or units are created and sold by private vendors to the developers who need them. Such credits or units can be sold directly by the landowner to the developer or else through an intermediary, meaning that there is a secondary market.

In addition to private vendors, Natural England sells nutrient credits under its Nutrient Mitigation Scheme in the Teesmouth and Cleveland Coast catchment area and will be the seller of statutory biodiversity credits. The funds raised through these sales are used in Natural England's environmental work.

## Existing VAT guidance

HMRC have set out their view on the VAT treatment of carbon credits in their *VAT Supply and Consideration Manual* (at VATSC06581–VATSC06585).

The manual draws a distinction between 'compliance' carbon markets and 'voluntary non-compliance' markets. It takes the position that while compliance market credits are 'capable of consumption of the type envisaged by the

VAT system, voluntary market credits are not, with the consequence that the former is a standard-rated supply of services while the latter is outside the scope of VAT (VATSC06584).

It should be noted, however, that, at the time of writing, this guidance in the manual has not been updated since February 2022, and so the manual does not expressly consider biodiversity units or nutrient credits.

Looking to more recent sources, DEFRA's guidance on the new BNG rules clearly envisions that statutory biodiversity credits will be taxable supplies. This guidance also sets the prices of statutory biodiversity credits to be applicable from the date BNG becomes mandatory, which are dependent on the type of habitat. These prices are significantly higher than market trading prices.

Furthermore, in March 2023 HMRC published a consultation on the taxation of environmental land management (Environmental Land Management Schemes having replaced the CAP) and nature markets (called 'ecosystem service markets' in the consultation). While the consultation does not address VAT generally, it does note that "[t]he government is also seeking views on other areas of uncertainty in respect of broader taxation, *with the exception of VAT*, of the production and sale of units generated by ecosystem service markets" (italics added). This could suggest that HMRC has a settled view on the VAT treatment of nature market credits and units. If so, it would be helpful to know what it is.

## Natural Capital leads to a variety of transactions that were not envisaged when VAT was first introduced back in 1973

### Issues for developers

VAT will need to be considered by developers for (at least) the following transactions.

First, the purchase by a developer of biodiversity units or nutrient credits from a private vendor. Extrapolating from HMRC's current guidance would lead to an expectation for such 'compliance' market supplies to be treated as subject to standard-rated VAT. Accordingly, sale agreements entered into between a developer and a seller of biodiversity units or nutrient credits should take VAT into account.

If, as expected, this is HMRC's view on the purchase of biodiversity units and nutrient credits, then it would seem tricky to challenge.

The rationale given for treating 'compliance market credits' as subject to VAT in HMRC's current guidance on carbon credits is that '[t]he businesses "consume", in a VAT sense, the compliance credits so that they can engage in economic activity without penalty and meet their regulatory commitments' (VATSC06584). In like manner, biodiversity units can only be allocated once by a developer, as recorded on the biodiversity gains sites register: in that sense they, too, are consumed.

VAT Notice 742 indicates that the provision of goods or services by a developer pursuant to a section 106 Agreement entered into with the Local Planning Authority 'is not a supply for consideration' (para 8.4). The situation with biodiversity units, however, is quite different: it is the landowner that enters into a binding obligation (registered as a local land charge) with the Local Planning Authority to enhance the land, which, once registered, creates the 'unit' which is then purchased from the landowner by the developer by way of a separate supply.

For this same reason, it would be difficult to make any sort of argument that a biodiversity unit ought to be exempt as an 'interest in or right over land' (VATA 1994 Sch 9 Group 1 item 1). What the developer is purchasing is not any sort of right to the offsite land, but rather the registered 'unit' which represents the services the landowner is obliged to deliver in enhancing the land.

As for statutory biodiversity credits, DEFRA's guidance and the terms and conditions for their purchase clearly indicate an intention to charge VAT for their supply by Natural England. This would entail that a view has been taken that the supply of biodiversity credits (and so presumably nutrient credits as well) is made in the course of business by Natural England according to the test in *Wakefield College v HMRC* [2018] STC 1170 and that VATA 1994 s 41A does not operate to disturb this. This could be because Natural England is not 'engaged as a public authority' (s 41A(1)) in supplying the credits or because, if it is, either s 41A(2) or s 41A(3) applies. It would be interesting to know DEFRA's reasoning in this regard.

Finally, there is the voluntary purchase by a developer of other credits, such as carbon credits pursuant to the UK Woodland Carbon Code. In contrast to credits in a 'compliance' market, HMRC's guidance currently suggests that voluntary credits should be outside the scope of VAT as '[t]here is ... no consumption' because "[n]o service is being provided ... which is capable of forming the cost component of the activity of another person in the commercial chain".

While this appears to be the current position, however, it is worth keeping an eye on it. This analysis may come under pressure from the fact that, as shown by the 2023 framework, voluntary markets are increasingly expected to abide by the same standards and principles as compliance markets. Additionally, it may be noted that enhancements made for the sake of carbon credits cannot also be used for biodiversity units or nutrient credits, which arguably makes it appear that such voluntary credits have been 'consumed'.

### Issues for landowners and farmers

Once upon a time, the VAT position for landed estates and farmers was quite straightforward: they would either farm in hand or have tenant farmers – one was taxable, the other exempt (at least until the introduction in August 1989 of the election to waive exemption, aka option to tax when the latter could be taxable by choice). Then diversification became an economic necessity for many landed estates and farmers, from letting surplus cottages, converting disused barns into workshops or offices or holiday accommodation, running events (who has not heard of Glastonbury) and courses, weddings, livery, to opening the house and grounds to the public. Some of these are taxable and some exempt so VAT compliance became more complicated and businesses often could no longer recover all the VAT on their expenditure.

Demand for greener energy has led to the construction of wind and solar farms, from obtaining planning permission to developing the site, with the landowner either entering into a joint venture with a developer or power company, or granting a lease for a fixed rent. Again, taxable versus exempt (subject to the option to tax) for VAT.

Those, as well as Natural Capital projects, require land use change with potential tax and VAT implications. Furthermore, the schemes tend to involve a long-term commitment for the current landowner but potentially also future generations, as schemes are for a minimum of 30 years and can easily be for 80 years. And they have to be commercially viable, i.e. landowners should not have to go

into the red in order to be green.

In the consultation issued in March 2023, HMRC refers to the three Environmental Land Management Schemes (ELMS) of Sustainable Farming Incentive (SFI), Countryside Stewardship (CS) and Landscape Recovery whereby payment will be made to farmers for protecting and enhancing the natural environment alongside farming and food production. In the same way that receipts of Single Payment and Basic Payment Scheme were outside the scope of VAT, these ELMS payments are also expected to be outside the scope of VAT as no supply is being made by the farmer.

Landowners now also have the potential to create and enhance habitats to support more biodiversity or establish nutrient neutrality in affected river catchments. They can then trade the units or credits generated to local developers. The natural capital markets include biodiversity units and nutrient credits both of which are compliance markets. As noted above, these units / credits once sold are 'retired' from the market and hence consumed by the purchaser, and so the supply of these units / credits is likely to be subject to standard rated VAT in line with HMRC's guidance at VATSC06584.

Landowners may incur VAT on creating or enhancing habitats pursuant to its obligations under a section 106 Agreement or Conservation Covenant entered into with the Local Planning Authority. A real life example is achieving mains water use nutrient neutrality for a residential development whereby the landowner builds a roof over cattle yards etc. to collect rainwater to recycle through its dairy enterprise – the input VAT would be reclaimable as the construction costs are used in the landowner's taxable farming activities. The payment received from the developer for the 'offset' credit should be subject to VAT as the credit would be consumed by the developer.

## It would be good for HMRC to update its guidance or publish new guidance to cover the plethora of new environmental credits

An alternative is the use of a Habitat Bank (HB), whereby the landowner grants a 30+ years Farm Business Tenancy (FBT) to the HB, who grants a sub-Farm Business Tenancy of 30+ years (less one day) to the landowner. A Habitat Management Agreement would also be put in place. The HB would be responsible for the capital costs to create the new habitats, and the landowner will manage the habitat in return for management payments. Rent payments under the FBT would be exempt from VAT subject to an option to tax having been made; the habitat management payments would be consideration for a taxable supply of services.

### Where does this leave us?

Natural Capital leads to a variety of transactions that were not envisaged when VAT was first introduced back in 1973. Following basic principles, where biodiversity units and other environmental credits sold are 'consumed' by the purchaser, they should be subject to standard rated VAT. This follows the guidance published by HMRC on carbon credits, but it would be good for HMRC to update its guidance or publish new guidance to cover the plethora of new environmental credits.

It remains to be seen whether such guidance will be forthcoming. It also remains to be seen how BNG and other Natural Capital policies will transform the English countryside. Locking up land for 30+ years is a significant move by any landowner; at the very least, it seems unlikely that the land will ever return to its original use. But government policy, like the countryside, can be ever-changing. ■