Consultation Response

Taxation of environmental land management and ecosystem service markets

Date: 5 June 2023

Introduction

1. The Country Land and Business Association (CLA) is the membership organisation for owners and managers of land, property and business in rural England and Wales. Our 27,000 members own or manage around half the rural land in England and Wales. As well as agriculture and forestry, our members operate nearly 250 different types of business located in the rural area.

2. Governments across the UK have made ambitious long-term commitments to address climate change and a wide range of environmental outcomes including biodiversity, water and air quality. For example, in England the government has targets to deliver 5,000-6,000 ha of biodiversity net gain (BNG) per year; 7,000 ha of new trees (out of 30,000 ha across the whole UK) and 280,000 ha of restored peatland by 2050. In addition, the Food Strategy document suggests around 200,000 ha of agricultural land will be managed for nature. That could be through the government's Environmental Land Management schemes (ELM) in England or private agreements with funding through Nature Credits (biodiversity units not related to BNG). Achieving these targets will require changes in land use and land management for carbon sequestration or habitat creation, and changes in practices to reduce farming impacts on water and air.

3. Government has a number of levers to support the transition in land use and land management, including the agricultural transition plan in England and the Sustainable Farming Scheme in Wales. However, the Green Finance Institute estimated that even with this and other public funding for environmental targets, there is a significant shortfall in funding. It is expected that private sector environmental markets will help address this gap, through mandatory offsetting such as BNG in England from November 2023, as well as voluntary markets for carbon, nature, and other environmental benefits.

4. The government is looking to leverage a minimum of £500 million per year of private sector funding by 2027 and £1 billion per year by 2030. The markets for ecosystem services have developed over the last decade and are now starting to become established. However, from the land supply side, there are a number of barriers to entry. Some of these will be resolved by innovation in contractual arrangements and improved understanding of the market, but the taxation issues need to be resolved so that the market for ecosystem services is not restricted to corporates or charitable landowners that do not have to worry about the loss of inheritance tax relief. As such, the CLA welcomes this call for evidence and consultation.

General comments

5. The CLA supports the proposals to extend agricultural property relief (APR) to land being used for environmental land management. This will remove the concerns of

farmers and land managers of all sizes that entering into long term environmental management agreements could affect the future viability of the holding for next generations. There are, however, concerns around whether the scope of the relief will be wide enough to fully mitigate the inheritance tax (IHT) barriers:

- The proposal only deals with APR. The extension of this relief is essential to enable tenanted land to be used to deliver ecosystem services, since it is available to the landlord. However, many agricultural and landowning businesses are already diversified and so rely on business property relief (BPR) to cover other parts of their land and buildings. Without certainty that environmental land management will be treated as trading activity, there is the risk that even if the environmental land itself qualifies for APR, the whole business may lose the availability of BPR, meaning that assets not qualifying for APR would be fully subject to IHT, and any market value of assets above the agricultural value would be subject to IHT.[1]

- The government proposes to limit this relief to only land that was previously in agricultural use. This would mean the loss of IHT relief would still serve as a barrier to putting non-agricultural land that currently qualifies for BPR into environmental use.

    - For example, large scale landscape recovery schemes will often require collaboration between several neighbouring landowners. If a crucial part of the overall land package is currently being put to a non-agricultural business use (for example, as a golf course) then the loss of IHT relief for that one landowner may deter them from participating and prevent the whole project from proceeding. For instance, we are aware from discussions with the Royal Society for the Protection of Birds that they are engaged in landscape recovery pilot projects, one of which involves twenty different landowners with different types of land, including non-agricultural land.

    - Another unintended consequence would be that only agricultural land is used to deliver ecosystem services, instead of encouraging the right land in the right place to be used for this purpose. For example, it may be better for land such as brownfield sites and former quarries to be used for environmental delivery, rather than productive agricultural land. Achieving the government's targets for environmental delivery will require significant changes in land use, so this opportunity should be taken to encourage all types of land to be used for the benefit of the environment.

6. Extending APR to all land used for environmental land management and ecosystem services will be tax neutral for HM Treasury where that land currently qualifies for relief from IHT, due to APR and/or BPR. As such we see no reason to limit relief to land that was previously in agricultural use as proposed.

7. In this response we use the following terms:

    - ecosystem service payments (ESPs) – these are payments for the production and sale of units generated by ecosystem services markets.

[1] This issue is discussed further in paragraphs 92-96

- ecosystem service units – these are the units generated by action taken on the land by a landowner/manager. They can include biodiversity units, carbon units (including pending issuance units, woodland carbon credits, peatland carbon credits and any credits created by carbon codes under development), nutrient mitigation units or nature units.

Part 1: Call for evidence on the taxation of ecosystem service schemes

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

Impact on farming businesses

8. Many farming businesses are already participating in government funded agri-environment schemes as part of their farming operations, but we expect that a much higher proportion of their income will be from environmental management in the future, not least because the removal of BPS (in England by 2028) will reduce farming profitability.

9. The impact on the farming side will vary depending on the particular ecosystem service payments (ESPs) scheme. Some ESPs will be for changes to management rather than land use changes (e.g. low input, regenerative or mixed farming systems), where farming will still be the main activity. However, most ESPs will be for land use change with a primary focus on ecosystem services delivery, although some limited farming activity on the same land might be possible (e.g. low density grazing). For some farming businesses this will be a relatively small proportion of the land as a way of building resilience. Others may decide to make more significant land use changes, with ecosystem service delivery accounting for a more significant part of business income. This may be through larger-scale environmental projects, such the Defra Landscape Recovery scheme. If payments for ecosystem services are significantly higher than profits from traditional farming or timber production, landowners may opt for maintaining or restoring ecosystems rather than cultivating crops or harvesting timber.

10. Businesses could be receiving ESPs from several different organisations – this could be a combination of public funding, different private funding for carbon/biodiversity units and payments from water companies, for example. Payments for different schemes will be made at different intervals (some in advance, others ongoing either annually or perhaps every 5-10 years). They may generate a mixture of capital and revenue and will not necessarily align with expenditure. There is increasing innovation in the structure of contracts being offered to land managers including leasehold and management contracts with varying requirements.[2]

Impacts of changes

11. Ecosystem service units can lead to the creation of new markets, such as carbon market, where companies and individuals can purchase carbon credits to offset their emissions. This can provide a new revenue stream for businesses that can generate these credits, such as farms or forests that sequester carbon. However, there is an expectation that the credits/units may be used internally by the producers to achieve their own carbon neutrality.

[2] Some examples are provided in at paragraph 40

12. Diversification of income streams through ESPs can make businesses more resilient to market volatility. However, for this to happen, it is important that the tax system should deem ecosystem services as a *trading* activity so that farmers and timber producers can effectively manage their businesses as a single economic unit and not worry about losses being restricted.

13. On the downside, participating in ESP markets is likely to increase costs for some businesses. These could include the costs of monitoring and verifying compliance with the relevant codes, standards or contractual terms, or the opportunity costs associated with foregoing certain activities (e.g. clearing land for cultivation or timber extraction).

14. However, the net impacts would depend on the specifics of the ecosystem services in question, and the local context, among other factors. And the shift in land use and/or management may not happen if the current taxation approach is not changed.

Effect of current taxation approach

15. Landowning businesses often regard themselves as the multi-generational custodians of their properties and are generally motivated by long-term business interest. They could be hesitant to make changes in how they use their land without some degree of certainty. This would affect uptake, which in turn would affect the Government's ability to deliver its long-term commitments to address climate change and a wide range of environmental outcomes including biodiversity, water and air quality and meet the targets outlined in paragraph 2.

16. In particular, tax uncertainties could dissuade these businesses from participating in ecosystem service markets or affect their decisions about transaction structuring. For instance, they might opt for structures or partners that minimise tax risks, even at the expense of efficiency or profitability.

Taxation barriers – Types of Income and Sideways Loss Relief

17. The classification of income from environmental activity is particularly crucial in relation to the current rules on sideways loss relief. Farming income is treated as a distinct form of trading income. In general, relief of farming income losses against general income is not available where a farmer incurred losses before capital allowances in each of the five preceding tax years.[3]

18. At present, income received under the Basic Payments Scheme (BPS) is classed as farming trade income. This is important because often in a farming business the cost of production exceeds the receipts made from agricultural sales, and it is only the funding from BPS that makes the farming business profitable. This means that the farmer's net farming income will be the sales plus BPS payments, less costs.

19. The BPS is being phased out and farmers will need to replace it with funding from ELMS and private ecosystem services markets. It is important for these forms of income to be treated as farming income. Otherwise, any loss made on the farming side of the business, after five years, will not be set off against the environmental income. This will result in less funds to be available to be used within the business.

[3] Income Tax Act 2007 sections 66 and 67 and for farming companies Corporation Tax Act 2010 sections 48–49 – usually referred to as the 'hobby farming' rules.

This can make a difference to the ongoing viability of the business which could lead to decisions to undertake less profitable agricultural activities or delay investment to improve productivity.

20. As an example, take a farmer who currently relies on BPS to support their farming operations (these figures are taken from a real-life example of a non-diversified farm):

Income from farming sales:	£175,000
Subsidy:	£60,000
Farming costs:	£193,000
Total net farming profit:	£42,000
Income Tax at 20%:	£8,400
Post-tax profit:	£33,600

21. Once BPS is gone, if the farmer was to make up the BPS payments with income from ecosystem services, but that income was not regarded as farming income, and the current hobby farming rules remain in place:

Income from farming sales:	£175,000
Farming costs:	£193,000
Total net farming loss:	£18,000
Environmental income:	£70,000
Environmental costs:	£10,000
Trading profit:	£60,000 (The farming loss cannot be offset against environmental income due to the hobby farming rules)
Income Tax at 20%:	£12,000
Post-tax profit:	£30,000

22. This illustrates how farmers could be disadvantaged. One solution to this would be legislation deeming income from ecosystem services to be farming trade income. Another solution would be to abolish the rule that currently limits sideways loss relief for those deemed to be hobby farmers.

23. The hobby farming rules were first introduced in the 1960s to address concerns that taxpayers were farming for recreational purposes and not for commercial reasons to enable them to offset losses against other sources of income. The expectation at that time was that this would not impact genuine commercial farmers. In a Finance Bill Parliamentary debate on 24 May 1960 Anthony Crosland MP said “it is impossible to believe that farming is growing less and less prosperous every year so that genuine farming losses are growing. On the contrary, common sense suggests the conclusion that farming is prosperous, that genuine farming losses are not on the increase and that what has been on the increase in recent years are hobby farming losses”.

24. Yet much has changed for farming since these hobby farming rules were introduced so that they are now outdated. This is because the rules fail to recognise that British agriculture is often dependant on diversification to bolster the agriculture operations. The unfair impact of the hobby farming rules on genuine farmers attempting to make a

long-term investment in organic farming is illustrated in the recent case of *Naghshineh v HMRC*.[4]

Taxation barriers – Types of Income and Accounting

25. The need to report different types of income also has an administrative burden. A diversified farm will often already have farming trade income, furnished holiday let trade income (for example, from farm cottages converted into a holiday let) and property income (for example, from farm cottages let out on residential tenancies). Unless environmental income is deemed to be farming income, this will add an additional source of income to report. When accounts are produced for a diversified business, they provide data which is useful management information but when they are amended to reflect the need to make multiple tax reports they become less useful for business owners. The farmer will need to apportion the time they and their staff spend between all the activities for tax purposes. This can make an element of the business appear to be loss-making and uncommercial once a share of fixed costs has been deducted, despite the fact that when the whole business is viewed in the round in the management accounts it makes a positive income contribution to the overall financial health of the business.

26. This administrative burden is likely to be compounded by introduction of Making Tax Digital for income tax. There is a requirement to provide quarterly updates of income and expenses to HMRC via accepted software, and this will have to be provided for each source of business and property income.

27. If the ESP income is not classed as farming income, a diversified business with farming income and income from ecosystem services, a furnished holiday let and a residential let will have to submit 16 quarterly returns, four end of period statements and a final declaration each tax year. This is incredibly burdensome for an SME, particularly if there is a lack of clarity around how to apportion business costs between different aspects of the business. Business overheads are typically shared across these multiple different activities and not separated out in the business management accounts. The processes that businesses will need to adopt to be compliant with making tax digital for income tax will be time consuming, impact on business efficiency and productivity. SME business owners are likely to need to pay for support from their accountants to assist them to comply with their reporting obligations, thus increasing their business costs.

The Single Business Unit

28. A more radical – and more effective - approach to addressing these issues involves moving to our proposed Single Business Unit approach (SBU – previously referred to as the Rural Business Unit). The essence of our proposal is that a qualifying business may elect for all elements of that business to be treated as a single business entity, the SBU, for all tax purposes. This would mean that all the economic activity undertaken by that one business entity would be treated for tax purposes as a trade. This would apply to any diversified rural business regardless of whether the land and assets utilised by the business are owned or rented. There would be rules to ascertain which businesses can qualify as an SBU to prevent the exploitation of the new system by those that only carry on non-commercial, investment or personal activities.

[4] *Naghshineh v Revenue and Customs Commissioners* [2022] EWCA Civ 19

29. If the business chooses to be treated as an SBU, that business would be able to undertake a single computation for income tax purposes (in a similar way as a VAT registered business would do for VAT reporting) that looks at all the income generated by the various activities, deducts all the expenses incurred without the need to apportion them between different types of activity to arrive at the taxable profit figure. By consolidating all activities within the SBU, once qualified, as a single trade, landowners will be able to confidently adopt ESP schemes without fearing unintended tax consequences. The consolidation also simplifies the administrative burden for businesses and for HMRC, aiding the adoption of Making Tax Digital for income tax in near future.

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.

30. **Lack of clarity on tax treatment of the sale of ecosystem service units:** There has been debate within the accounting profession on whether the sale of a carbon unit, or a pending issuance unit, would be subject to taxation as income or a capital gain. This has resulted in great uncertainty over the tax treatment of this activity, which discourages businesses from entering the market. Similar issues arise in relation to payments for other ecosystem service units.

31. **Whether upfront payments will be treated as income or capital:** Concerns have been raised regarding the classification of payments received by landowners for the provision of ecosystem services. Specifically, there is uncertainty about whether an upfront lump sum payment should be treated as a capital receipt or an income receipt. While some practitioners suggest that the current treatment of lease premiums could potentially serve as a useful model to be adapted for ESP, we believe this approach is not suitable.

32. The lease premium rule essentially serves as a statutory formula that determines the split between the capital portion and income portion of the lump sum payment. However, unlike a lease, the characteristics of an ESP can vary greatly, influenced by factors such as the nature of the services provided, the length of the agreement, and the allocation of funds. Likewise, the costs associated with providing ecosystem services—for instance, maintaining or enhancing the land—could be subject to an arbitrary division based on this capital-income distinction. In some cases, there may be no capital works that are required to be undertaken by the landowner (for example, where payment is received in return for ceasing particular activity on the land, such as committing not to put down fertiliser in the future). In these cases, it would not make sense for part of the payment to be apportioned to capital.

33. **Will income from woodland carbon units fall within scope of existing exemptions for commercial woodland**: There is also uncertainty as to whether income generated from the sale of woodland-based carbon units or pending issuance units would fall within the scope of the existing exemptions for the commercial occupation of woodlands. Income arising from the commercial occupation of woodlands is outside the scope of income and corporation tax.[5] The occupation of woodlands is considered commercial if the woodlands are managed on a commercial basis, with a view to the

[5] Section 768 ITTOIA 2005 and section 980 Corporation Tax Act 2009

realisation of profits. Sequestration of carbon through afforestation requires the management of woodlands. Where this management is done as part of a business plan to profit from the selling of carbon offsets, this would be on a commercial basis, with a view to the realisation of profits. It is therefore a form of commercial management of woodlands, separate but analogous to growing timber for sale. However, given that the relief has only previously been applied to woodland managed for timber forestry, there is some uncertainty over whether a claim for relief would be accepted in this context. This is despite the fact that the statutory definition of commercial woodlands for does not specifically require that the income is generated from the sale of timber.

34. If the relief does apply to the commercial management of woodland for carbon sequestration, this would mean that the income from the sale of carbon units (or pending issuance units) and expenditure on the management of the woodlands will be outside the scope of both income and corporation tax. This should make carbon sequestration through afforestation more appealing and so encourage landowners to pursue it, helping the government to achieve its climate change goals. However, payments issued under other codes, such as the Peatland Carbon Code, will still be taxable as they do not relate to the management of woodland.

35. As illustrated, the classification of income generated from the sale of ecosystem service units may be ambiguous. This categorisation can impact the tax rate applied and deductions permitted. For example, if income from carbon units is considered equivalent to income from commercial woodland, then associated expenses (such as the cost of tree maintenance and preservation) could potentially be non-deductible. Given the central premise of these ecosystem service schemes is to enable landowners to diversify towards a sustainable and resilient business model, the simultaneous application of an array of different tax rules would only serve to complicate and confuse matters. This could result in unnecessary and arbitrary apportioning of costs between different activities, solely for tax purposes. Once again, we propose that our SBU concept be recognised as a method of simplifying these issues and providing landowners with certainty and confidence when entering these schemes.

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?

36. Where businesses enter into an ESP agreement to sell ecosystem service units, such as carbon units or biodiversity net gain units, the costs for generating these may typically have been incurred in the years prior to the sale. These costs should be recognised as trading expenses, and so deductible against trading receipts arising in prior tax years, or else generating a trading loss that can be set against the trading profit generated once the carbon units are sold.

37. Once any carried-forward trading losses have been exhausted, a trading profit generated by the sale of carbon units will be taxable. Given the way verification schemes operate, carbon units are likely to be generated infrequently (for example, every ten years under the Woodland Carbon Code). This will therefore result in spikes in profit in certain tax years. The majority of landowners operate their businesses through unincorporated structures such as partnerships, trusts or as sole traders. To avoid unfairness in the taxation of this income, an **averaging scheme** should be made

available, similar to that available for farming income. This would allow for the income generated upon verification and sale of carbon units in certain years to be spread over a wider period for income tax purposes.

38. The sale of pending issuance units should be governed by section 23 of Financial Reporting Standard 102. If the sale of pending issuance units is treated as the provision of a service, as we believe it should, then the seller should be able to recognise a percentage of the revenue in each reporting period based on the completion of the contract. If it is instead considered to be a sale of goods, it should be possible to postpone the recognition of the revenue on the basis that the seller retains significant risks, since they still need to ensure that they do whatever is required for the pending issuance units to be verified or else they will be liable to the buyer.

39. At a recent meeting between the Agricultural Representative Bodies Group, HM Treasury, HM Revenue & Customs, and the Department for Environment, Food & Rural Affairs, it was agreed that it would be helpful for discussions between government and the representative bodies to continue with the aim of reaching an agreed analysis of the tax treatment of various different example scenarios. Guidance could then be published. This would be similar to the June 2005 Special Edition Tax Bulletin dealing with the consequences of the Single Farm Payment scheme.[6]

40. We have set out below examples of different ways we have seen agreements structured which could be included as common scenarios analysed in this guidance.

- *An agreement made between a landowner and a local authority in relation to nutrient mitigation*. Every six months, for three years, the local authority would purchase from the landowner a tranche of credits, each representing 1kg of nitrogen discharge reduction every year, for a specified price plus VAT. Upon each purchase, the landowner would designate a specific area of land linked to those credits. The landowner covenanted that, once land had been designated in relation to credits purchased by the local authority, it would manage that land in accordance with a nitrates management plan, for a period of 130 years.

- *An agreement between a landowner and a highway authority in relation to biodiversity net gain*. The landowner covenanted to carry out specified biodiversity works and maintain them for a period of 30 years. The highway authority promised to pay the landowner a sum for legal fees, plus three further payments staggered over three years. The first was specified to provide funding for planting, seedings and initial capital works costs. The second was specified to provide funding for capital, management and maintenance works. The third was specified to provide the remaining cost for 30 years of management and maintenance.

- *An agreement between a landowner and a company in relation to biodiversity net gain and other environmental mitigation.* This involved a headlease of the land from the landowner to the company, and a sub-lease to the landowner. These are for a term of 33 years. The company would pay to the landowner a specified sum of rent every year. The landowner covenanted that, if required, it would enter into a planning agreement (such as an agreement under section 106 Town and Country planning Act 1990 or similar, or a conservation covenant, as required to have the land registered as a habitat bank on a biodiversity net gain register). The parties

[6] https://webarchive.nationalarchives.gov.uk/ukgwa/20090606024838/http://www.hmrc.gov.uk/bulletins/tb-se-june05.htm

agree that any form of environmental units arising from the property (including biodiversity net gain, carbon, and nutrient) would belong to the company.

- *Agreements with the Highways Agency under section 253 of the Highways Act 1980 to provide mitigation for the adverse effect which the construction improvement existence or use of a Highway has on its surroundings*. The agreements are usually for the period of 25 years. They bind successors in title and are registerable with the local authority as a Local Land Charge. In the first three years the Highways Agency has the right to establish the mitigation measures which involve changing the land from agriculture by planting trees, shrubs and other plants. After the initial three year period, the landowner takes over the management of the land for either a commuted lump sum or periodical payments.

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

41. We recommend that HM Revenue & Customs could issue guidance confirming that a business generating units for ecosystem service markets, or carrying out other forms of environmental land management for payment, is engaged in a trade for the purpose of income tax.

42. It would also be helpful if HM Revenue & Customs could issue guidance confirming that the commercial management of woodland for carbon sequestration will be regarded as falling within the existing income tax/corporation tax exemption. In the interests of a level playing field, legislation to expand the exemption to other forms of carbon sequestration/emissions avoidance (for example, peatland management) might be considered. The definition of commercial woodland (referred to in paragraph 33 above) does not appear to be drafted in a way to limit the exemption from tax to income from felling timber. If it is the government's intention that commercial management for woodland for carbon sequestration falls outside the scope of the exemption, it is our view that legislation would be required to specifically exclude it.

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.

VAT

43. There is currently uncertainty around the treatment of carbon and other ecosystem units for VAT purposes, as well as around the VAT treatment of government payments for environmental land management. We understand that these issues are not being considered as part of this call for evidence, but we will be happy to provide further information and discuss if this would be helpful.

Capital gains tax

44. It will be important to have clarity on the application of capital gains tax (CGT) reliefs to land used for environmental land management and ecosystem services. It is essential to ensure that these reliefs remain available for such land so as not to further deter landowners from converting land to this use. Agricultural or commercial assets tend to be held for a long period before any transfer of ownership. HMRC CGT statistics

published on 4 August 2022 indicate that in 2020-21, 65% of disposals of non-residential land related to property that had been owned for over 10 years.[7] We consider it important to ensure that long-term ownership of land is not penalised as those who hold assets for the long term are likely to be taxed on inflationary gains. Long-term land ownership is going to be particularly important to the delivery of environmental outcomes, which will typically involve land being committed for many years. Private market agreements for ecosystem services tend to be long term agreements, typically a term of 30 years for biodiversity net gain agreements or 125 years for those to deliver nutrient neutrality.

45. If environmental land management is not a qualifying use of land for the purposes of CGT reliefs, CGT may act as a disincentive for farmers and landowners considering entering environmental schemes. Reliefs on gifts enable assets used in a trading business to be handed down so that CGT does not stop them from being passed on. Existence of reliefs do influence decisions to pass on assets, and it is in the interests of the wider economy for them to be passed on at the right time for investment decisions to be made.

46. Ensuring succession of the family enterprise and sustainability is a primary objective of our members, often in priority to maximising income and capital returns in the short term. Land-based rural businesses tend to be cash poor and so the ability to make lifetime gifts of land/assets to the next generation to ensure it is in the hands of the right person to maximise productivity, etc cannot be achieved without the availability of reliefs for business assets and principle private residence relief for the main home.

47. The relevant CGT reliefs are:

- Business asset hold-over relief.[8] This is helpful for enabling business owners to transfer business assets to the next generation in their lifetime. Without it, there will be a dry tax charge which may disincentivise the timely transfer of assets. As well as applying to assets used for a trade, profession or vocation, the relief is currently also available on assets to which APR applies. Therefore, provided the scope of APR is expanded as currently proposed, this will cover land used for qualifying environmental purposes.

- Business asset roll-over relief.[9] This provides an important mechanism for businesses that dispose of assets for reinvestment in their business without a tax charge that limits this investment. It applies to assets used for the purpose of a trade, though the meaning of this is extended by section 158 to cover various other situations including “the occupation of woodlands where the woodlands are managed by the occupier on a commercial basis and with a view to the realisation of profits”. As discussed in our response to question 2 above, there will be ambiguity whether this applies to the commercial management of woodlands for the purpose of carbon sequestration. To resolve this ambiguity, and to avoid the loss of CGT reliefs deterring changes of land use to environmental purposes, we would recommend that land qualifying for APR on the basis of environmental land use should be included in section 158.

[7] https://www.gov.uk/government/statistics/capital-gains-tax-statistics
[8] Section 165 Taxation of Chargeable Gains Act 1992
[9] Section 152 Taxation of Chargeable Gains Act 1992

- Business asset disposal relief.[10] This provides for a reduced rate of CGT on certain qualifying business disposals. It only applies to businesses that are a trade, profession or vocation. Therefore, to avoid the loss of CGT reliefs deterring changes of land use to environmental purposes, we would recommend that businesses carrying out environmental land management should explicitly qualify for the relief.

48. Our recommended changes to enable land used for environmental land management and ecosystem services to qualify for CGT reliefs would be neutral to the Exchequer, as the bulk of the land that would already qualify for relief where it is used in an agricultural or other trading business.

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

50. We believe that in order to clarify the position on VAT, there should be an amendment to the Value Added Tax Act 1994 to provide for supplies of environmental land management and ecosystem services to be zero-rated for the purpose of VAT, in the same way that agricultural supplies are zero-rated. There should then be a VAT notice to accompany this change and provide guidance on how it applies.

51. In relation to the CGT reliefs mentioned above, we believe that changes to the Taxation of Chargeable Gains Act 1992 would be best to make fully clear that the delivery of ecosystem services will benefit from business asset rollover relief and business asset disposal relief. No change to that act would be necessary in relation to business asset holdover relief provided that the scope of APR is extended to cover land used for ecosystem services. Alternatively, a general provision could be made in legislation that the delivery of ecosystem services should be regarded as a trade for all purposes.

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

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.

52. The tax system should be aligned with the government's environment and climate change objectives. This requires land used for environmental land management or ecosystem services to be within the scope of agricultural property relief. Otherwise, the landowner may in some cases lose agricultural property relief both on the land used in a carbon project, as well as on the farmhouse, which will be a significant deterrent to entering the market.

53. Professional members (land agents, accountants, legal firms) with clients who are farmers and smaller landowners regularly confirm to us that the lack of clarity about the treatment of land under environmental management was making it difficult for them to advise their clients on the IHT complications. They had noticed that landowner clients have scaled back their environmental land management due to uncertainty about the tax position, so it was affecting the delivery of schemes with some more ambitious

[10] Sections 169H to 169V Taxation of Chargeable Gains Act 1992

projects getting deferred or cancelled. With larger-scale schemes, such as landscape recovery in England, that rely on co-operation between multiple landowners, it would only take a couple of participants to withdraw for tax reasons to cause the scheme to fail.

54. Some examples of where the lack of certainty that IHT reliefs are available and act as a deterrent to increased environmental and ecosystem services delivery can be found in Appendix 1.

55. We have provided below some examples of common scenarios and how they will be impacted.

Scenario 1 - Farm with no non-farming diversification

56. An average sized farm of 215 acres with a farmhouse and agricultural buildings is farmed in-hand. Assuming the house and buildings meet the character appropriate test, under the current rules the farm will qualify for APR on the agricultural values of the land, farmhouse and buildings. As the farming is undertaken in-hand, any difference between the market value and agricultural values of the land and buildings will qualify for BPR.

57. If land is put into an environmental scheme or biodiversity net gain arrangement that involves the land being taken out of agriculture, then under the current rules the land will no longer qualify for APR. If too large a proportion of land is taken out of agricultural use, then the house and buildings may no longer be of a character appropriate. IHT will be chargeable on the value of the house.

58. The impact on BPR will also depend on the amount of land used for environmental schemes or biodiversity net gain and whether the environmental activity is regarded as trading or investment activity. If only a small proportion of the land is taken out of agricultural use, then the value of the land and buildings should still qualify for BPR if the business as a whole meets the 'wholly or mainly' test. But this still leaves the potential for a large IHT bill to pay if the farmhouse does not qualify for APR.

59. If too large a proportion of the land is taken out of agriculture and the environmental delivery/biodiversity net gain is not regarded as a trading activity, then the risk is that the whole business does not qualify for BPR. In this case IHT will also be payable on the non-agricultural value of the farm land and farm buildings as well as on the market value of the environmental land. This could be a substantial sum for the business to find.

60. For most businesses, these IHT charges cannot be accommodated out of cashflow and would therefore lead to the sale of assets, which in turn would affect future business viability.

Scenario 2 - Farm with diversification

61. A farmer owns and farms a 175 acre sheep farm with a farmhouse & traditional farm buildings. To support the farming enterprise, he lets a stone barn to a neighbouring farmer for storage. He also lets 2 small 2-bedroom cottages on the farm as holiday lets.

62. Whilst the whole of the land is being farmed it would be entitled to 100% APR on the agricultural value of the land, farmhouse, and farm buildings. His diversified farm is run as a single enterprise and satisfies the 'wholly or mainly' test so that it qualifies for BPR.

63. He is considering putting some land into environmental management that involves taking it out of agricultural use. He is alco considering planting 20 acres of broadleaf woodland for carbon sequestration, generating carbon credits under the UK Woodland Carbon Code.

64. As in scenario 1, if land is taken out of agricultural use for environmental delivery, biodiversity net gain or carbon, etc then under the current rules the land will no longer qualify for APR. If too large a proportion of land is taken out of agricultural use, then the house and buildings may no longer be of a character appropriate, and APR will not be available. IHT will be then chargeable on the value of the house.

65. Whether the business continues to qualify for BPR under the 'wholly or mainly' test will depend on whether taking land out of the farming business (i.e. the trading side of the business) for the environmental delivery is regarded as trading or investment. If it is treated as an investment activity then if too large a proportion of the land is taken out of agriculture, there is a risk that this will be detrimental to the assessment of the whole business under the 'wholly or mainly' test.

66. If the woodland planted to generate carbon credits is regarded as commercial woodland, then under the current rules it will qualify for BPR and may help the whole business to continue to qualify for BPR. But if it is not regarded as commercial woodland and is regarded as an investment activity then this together with any land taken out of agriculture for environmental activity will mean that the whole business no longer qualifies for BPR.

67. If the business does not qualify for BPR then IHT will also be payable on the value of the land used for environmental delivery and carbon sequestration; on any non-agricultural value of agricultural land and buildings and on the full value of the let barn and holiday cottages. This will be substantial sum for the business to find.

68. As with scenario 1, a large IHT bill on death that cannot be accommodated out of cashflow would lead to the sale of assets which in turn would affect future business viability.

Scenario 3 - Estate with a combination of let farms and in-hand farming

69. The landowner owns 2,015 acres, which includes 4 let farms (farm A = 275 acres, farm B = 300 acres, farm C = 375 acres, farm D = 225 acres) which total 1,175 acres. The landowner's remaining land consists of 840 acres of which 805 acres are farmed in hand, and 35 acres consist of several small areas of ancillary woodland.

70. The estate currently qualifies for APR on the agricultural value of the let farms and the in-hand acres (including the ancillary woodland). The estate is run as a single business, but as the let farms as a proportion of the whole exceeds 50% the estate, it will not qualify for BPR. With the reduction in BPS payments all the tenants want to take some land out of agriculture for government environment schemes, biodiversity net gain or carbon sequestration.

71. Under the current rules, the land the tenants take out of agricultural use will not qualify for APR. If too much land on each let farm is taken out of agricultural use, the accompanying farmhouses and farm buildings will no longer meet the character appropriate test and will also not qualify for APR.

72. The executors faced with a substantial IHT bill are more likely to sell one or more of the let farms than reduce the land occupied by the in-hand farming business (because of efficiencies of scale within their own business).

Scenario 4 - Single let farm

73. A divorced farmer has a non-organic arable farm of 215 acres. The son and daughter have non-farming careers and do not want to take over the farm. On retirement the farmer moved into a small, rented bungalow in a nearby village at a time when the grandson who is going to take over the farm was just starting agricultural college. After graduating, the grandson intends to work on another farm to gain experience before taking on the family farm. The whole farm was therefore let on a 10 year tenancy. The tenant wants to take a substantial amount of land (100 acres) out of agricultural use for environmental management, so that the payments replace some of the BPS that is being lost.

74. The land occupied for agriculture is reduced to 115 acres. The land still in agricultural use will qualify for APR on the agricultural value, but under the current rules, the land taken out of agriculture for environmental management will not. This will also have an impact on the availability of APR for the farmhouse as it will probably no longer meet the character appropriate test with the reduced amount of agricultural land.

75. If the landowner dies before the grandson has taken over the occupation and management of the farm, and the land use has been changed by the tenant, this will give rise to a substantial IHT bill leading to the sale of land. Do the executors sell the environmental land or the land still in agricultural use? Either option will impact on the viability of the tenant's business if the tenant remains in occupation or on the grandson's ability to establish a viable and productive business when he takes over the farm.

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?

76. The conditions for the relief would need to account for the distinction between public and private funding. In the case of public funding, such as ELMS, the recipient will enter into an agreement with the government to undertake certain activity on the land. The impact of a failure to comply with the terms of an agreement will vary, as seen in the guidance published for the Sustainable Farming Incentive.[11] This explains that where the Rural Payments Agency (RPA) confirms that a breach has taken place, it will assess various factors, including the seriousness of the breach, whether there were good reasons for the breach, and whether it can be rectified. Based on these factors, the RPA may take no action, or require action to be taken to address the breach, or in some cases require repayment of payments already received. The

[11] *Sustainable Farming Incentive: full guidance*, sections 11.3 to 11.9 https://www.gov.uk/government/publications/sustainable-farming-incentive-full-guidance/sustainable-farming-incentive-full-guidance

position is similar under the guidance published for the Countryside Stewardship Scheme Higher Tier.[12] If the Rural Payments Agency identifies a breach, it may ask for the breach to be corrected, or for more serious breaches reduce payments or require repayment. Again, it recognises that there may be good reasons for a breach.

77. In the case of private funding, the recipient will have entered into an agreement with another party or other parties, which may include public bodies. This agreement will likely involve contractual obligations on some or all parties, some of which will relate to the environmental actions to be undertaken on the land, but the terms of these agreements will depend on what is agreed by the parties and so may vary widely. In one example we have seen, entered into with a highway authority under section 253 of the Highways Act 1980 in order to deliver biodiversity net gain, there is provision for payments to be withheld or repaid in the event of a breach of a failure to deliver the required biodiversity works. However, this only applies if the landowner has failed to rectify failures within a reasonable period and does not apply where the failure arises from a force majeure event.

78. In light of this, we do not believe that it would be appropriate for all breaches of the agreements to automatically prevent APR being claimed on the land, as this would be disproportionate and unfair, especially when the breach may be minor, rectifiable, or occur for reasons outside the landowner's control (for example, due to illness, severe weather, third-party actions, disease or supply chain issues).

79. This will be a particularly significant issue in relation to let land. If it is the tenant who has the agreement with government and is responsible for compliance, then the landlord may be unable to prevent the tenant from breaching these undertakings. It would therefore be unfair for the landlord to be penalised through a loss of APR for breaches by the tenant, and the risk of losing APR due to their tenant's behaviour is likely to deter many landlords from granting tenants permission to take land out for agricultural use for environmental delivery.

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?

80. We do not agree that schemes within the Sustainable Farming Incentive should be excluded from the list of qualifying environmental land management schemes. Even if all the current options can be carried out without taking land out of agricultural use, there is no reason why further options introduced by the government in the future will necessarily not involve taking part of the land out of agricultural use (for example, field corner management, shelter belts, or hedgerows). If Sustainable Farming Incentive schemes are excluded from the expanded definition of agriculture, there may be future uncertainty over the availability of APR to new options, and farmers may be deterred from pursuing these options. If Sustainable Farming Incentive schemes do all involve the land remaining in agricultural use, then the land would anyway qualify for APR under the existing definition, and so no government revenue would be lost as a result of including them in the new wider definition.

[12] *Agreement holder's guide: Higher Tier grants 2023*, sections 6.5.8 to 6.5.10 and section 6.11 https://www.gov.uk/government/publications/higher-tier-grants-2023-countryside-stewardship/agreement-holders-guide-higher-tier-grants-2023

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?

81. We are not aware of any land still subject to these regulations. We would expect the RPA/Natural England to know if any land is still subject to these regulations, particularly if payments are being made.

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.

82. We have prepared a draft clause as an example of how environmental land management could be effectively brought within the scope of APR. This includes a list of the agreements which we believe should qualify and are set out in the draft clause in Appendix 2.

83. We agree that land subject to a conservation covenant, or on the biodiversity net gain register, or being used for delivering nutrient mitigation, or on a carbon register should be able to benefit from APR.

84. In addition, we believe that land subject to a written agreement with a regulated water company, (to which a local authority may be party to) to provide specified environmental management actions should benefit from the relief. Such agreements are going to be required where land use change is needed for the purpose of flood mitigation and may mean that land needs to be taken out of agricultural use (such as where it will need to be flooded). In addition, a water company may enter into an agreement with a land manager for water quality purposes that requires them to stop farming identified areas of land or to change land use to plant riparian buffer strips to protect water quality.

85. It is going to be important that it is clear which land qualifies for APR on the basis of its environmental use. In some cases it may be clear, such as where land is registered on a carbon register, or subject to a conservation covenant, or registered on the biodiversity register (once available). However, we have seen that public authorities are currently making use of statutory agreements[13] to ensure that land is used to provide biodiversity gain or nutrient mitigation. We understand that this is likely to continue once conservation covenants are available, since public authorities have more experience in this mechanism. Some method will therefore be needed to distinguish which land subject to such agreements is being used for qualifying environmental purposes (and so qualifies for APR) and which is being used for other purposes. We propose that public authorities who enter into these statutory agreements with landowners to use land for qualifying environmental purposes should be required to ensure that the land is recorded on a suitable publicly accessible register. This would allow both HMRC and the owner (or their personal representatives after death) to verify that it qualifies for relief.

86. We also believe that the relief should apply to land that is prevented from being used for agriculture because it forms part of an environmentally protected area. This would help to avoid landowners from being deterred from making environmental

[13] For example, under section 106 Town and Country Planning Act 1990, or section 253 Highways Act 1980.

improvements to their land, including entering into environmental land management schemes, by the concern that doing so may lead the land to be designated in the future. At present, there is legitimate concern that if land is designated, it may no longer be available for agricultural use even after the end of an environmental land management scheme, and even if no other environmental schemes are available at that time.

87. Similarly, where land has been in a long-term scheme, such as 30 year agreement to improve biodiversity, even not designated, the landowner may find that the land is no longer eligible for a government environmental scheme and cannot be used for a ESP agreement. To avoid the sudden loss on IHT relief at the end of this period, a landowner may wish to return the land to agricultural use. This will lead to the environmental/carbon benefits being lost, which may be detrimental to the government's climate change and environmental outcomes (referred to in paragraph 2 above). To avoid this, consideration should be given to drafting the relief in a way so that relief is not lost by those that have spent many years managing their land for environmental or other ecosystem benefits.

88. Defra is funding a 3 year project with the British Standards Institute (BSI) to set out principles and processes for nature investment standards to ensure they are high integrity. This, along with other International Standards Organisation (ISO) standards (BSI is a member), that meet the requirements could be recognised as a verifiable standard. It is expected that the Defra BSI project will have interim consensus on key issues at an early stage in the project. To future proof the draft clause in Appendix 2 we have included a provision to enable land in schemes with BSI or ISO standards to qualify for relief.

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?

89. We understand the government's desire to avoid a loss of revenue by allowing for land not in agricultural use to be put into environmental land management and therefore qualify for agricultural property relief. However, any restriction on the previous use of land must allow for the relief to apply to land that was previously in agricultural use but had been changed to environmental land management prior to the change in the law. Otherwise, the legislation would penalise those who acted earlier to put their land to environmental use.

90. We suggest that there is no need for the legislation to limit relief based on the previous use of the land. The existing rules of APR will require a minimum period of qualifying use before land can qualify for the relief (two years where occupied by the landowner, and seven years otherwise). If the land has already been in agricultural use for the necessary period when it is changed to a qualifying environmental use, then it would continue to qualify for APR. If non-agricultural land is put into qualifying environmental use, this use would need to continue for the minimum period before APR would apply to the land.

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

91. We believe that valuation of environmental land will not present difficulties, its value would be based on open market value, given the use, or potential uses that that land could be used for (this potential could be for agriculture, environmental offset or housing).

92. Assuming that the definition of agricultural land is widened for the purpose of APR to encompass land in qualifying environmental land management schemes (as it is in our proposed clause at Appendix 2) this would consequentially expand the definition of agricultural property in clause 115(3) Inheritance Tax Act 1984. As a result, the valuer is still required to determine an artificial agricultural value based on the assumption that the land is subject to a perpetual covenant prohibiting its use otherwise than as agricultural property. Where the land use has changed away from agriculture for environmental and ecosystem service delivery, it is difficult to see how the land can be valued using this assumption of such a perpetual covenant.

93. Valuing land according to the rule in section 115(3) purely for the purposes of IHT makes little sense when a valuation for any other purpose would just be on an open market basis. To simplify matters, we consideration is given to removing the definition in section 115(3). Doing so would reduce valuation costs for taxpayers and prevent the time-consuming disputes over probate valuations that personal representatives of estates have with HMRC and the Valuation Office Agency. This would also represent a cost saving for government. At the very least it should not apply to land used for environmental delivery or ecosystem services.

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?

94. Even if agricultural property relief is made available, there will need to be consideration of how environmental land use would interact with business property relief from inheritance tax.

95. In the modern day it is very frequently necessary for farms to diversify in order to remain financially sustainable – 68% of farm businesses in England have some diversified activity.[14] This may take the form, for example, of residential let property, holiday let property, commercial lets, camping and glamping sites, farm shops, agrotourism, and other ventures that can take place on parts of the farmland. The income from this diversified activity is often essential to subsidise the agricultural operations on the farm.

96. The land and buildings utilised in this diversified activity would not qualify for agricultural property relief, and so in order to enable the viable succession of the farm to the next generation, it is necessary for the owners to ensure that the business will qualify for business property relief. This means ensuring that the business as a whole is not carrying out wholly or mainly investment activity. As many of the diversified activities mentioned in the previous paragraph would be classed as investment activity, this will require careful consideration by farm owners of the factors discussed in the

[14] Department for Environment, Food & Rural Affairs, *Farm Accounts in England*, Chapter 5: https://www.gov.uk/government/statistics/farm-accounts-in-england/chapter-5-diversification

Balfour case to ensure that the business remains mainly trading. This is a major consideration for a majority of our members who take advice on inheritance tax.

97. For many farming businesses, the financial pressures to diversify mean that they are already finely balanced under the *Balfour* test. It is at present not clear whether all forms of environmental land management will be regarded as trading activity, which therefore means that there is a risk to farm owners that converting part of their land from agriculture to such use could cause the business to become mainly investment. The result of this would be to lose business property relief on the whole business, not just the land being converted to environmental land management use. This would therefore be a major deterrent to many farmers from entering this market.

98. HM Revenue & Customs has recently published guidance confirming its view that the generation of carbon units under the Woodland Carbon Code and Peatland Carbon Code would not "in general" be classed as investment activity, although "Ultimately, however, the availability of business relief in any individual case will be decided on the specific facts of that case"[15] The guidance on agri-environment schemes more widely is still vague on whether these will be regarded as investment activity or not.[16] The availability of the relief will therefore come down to an individual HMRC officer's assessment of the facts and so there is the risk that a particular land use may be assessed to involve too little activity for it to qualify as trading activity (for example, where the activity was required at the outset, and now the land simply needs to be maintained in its new state). To avoid this uncertainty in the law, ensure a consistency of approach, and to avoid deterring farming businesses from entering land into environmental land management, there should be confirmation in legislation that where land is occupied by the owner for uses that would qualify for agricultural property relief, it will not be deemed to be investment activity for the purpose of business property relief.

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

99. The CLA would oppose such a measure, as it would damage the tenanted sector reducing the amount of land on offer in the future. It would also hamper new entrants, those leaving the industry and those gradually seeking to expand whilst offering no increase in productivity or efficiency.

100. The Tenancy Reform Industry Group has discussed this issue on many occasions over the last decade and there has been no support for such a change, with the exception of one organisation.

101. Limiting APR only to tenancies of over 8 years duration will negatively impact on freedom of contract (which is at the heart of the FBT concept), harm landlord and tenant relations and be a disincentive to let land, whereas in the past APR has encouraged letting land.

102. By way of background, and part of the debate about tenancy length, it is important to consider the history of the legislation. Post war Agriculture Acts gave security of

[15] HM Revenue & Customs Inheritance Tax Manual at page *IHTM25253 - Other relevant business property: Land used under the Woodland and Peatland Carbon Codes*
[16] HM Revenue & Customs Inheritance Tax Manual at page *IHTM25252 - Other relevant business property: Agri-environment schemes*

tenure to tenants for the duration of their lifetime. In the late 70s this was increased to 3 generations. However, there were many shorter-term agreements that worked as good “get-arounds" to avoid the security of tenure that came with the acts - grazing/cropping agreements, *Gladstone v Bower* and tenancies approved by the Ministry of Agriculture and Fisheries. The Agricultural Tenancies Act 1995 bought in the Farm Business Tenancy which offered much more flexibility than was hitherto the case and bought all those shorter term and seasonal agreements under that umbrella. This is why the consultation identifies an average tenancy length of less than 4 years, which reflects the impact of many of these short-term tenancies, often of small areas of bare land. These short-term agreements dilute the average tenancy length considerably and mask the very real opportunities that are current being offered for longer term tenancies of whole farms or larger blocks of equipped land.

103. The CLA carried out a survey in the summer of 2022 to test the engagement of landowners with their tenants on the new environmental schemes – it showed a very high level of engagement despite so little being known about the scheme detail at the time. One of the questions asked about tenancy length. The survey result came back with the average tenancy length of 8 years, confirming that many CLA members are letting for the longer term.

104. At the current time, there is still uncertainty over much of the ELM scheme detail which will mean that longer term agreements are more difficult for landlords and tenants to enter into, as land use and income changes are more difficult to judge going forward more than a few years.

105. The premise of the proposal seems to be that if you move APR so that it can only be applied to tenancies of over 8 years, the market will move to 8-year tenancy periods. That is unlikely to be the case. Most businesses who let/rent on short term agreements do so because it is mutually convenient for both of their businesses. Being tied into long term agreements can be unattractive for tenants as they cannot just leave an FBT, in the same was as they could an AHA agreement; they are bound into the agreement, and the rent for the duration – very unsettling at a time of great change.

106. It is also necessary to qualify what is defined as an eight-year tenancy. Is this a tenancy agreement with a minimum of eight years? What is the role of break clauses in the tenancy agreement, whether they are to accommodate the requirements of the landlord or the tenant, development, death of either party or the benefit of schemes. What is the position of a landlord who has already let land to the same tenant for over 8 years but on shorter term agreements? Another scenario may be a landowner who let land out last year for 6 years (to avoid the need for land registration or SDLT) who could, if these proposals are implemented lose out on APR.

107. There is a very real risk that rather than encouraging longer term letting, the proposal to limit APR to tenancies of 8 years or more will drive those who would otherwise let for the short term to look for other business models. This will permanently remove this land from the tenanted market.

108. Since the Tenants Working Group started to take evidence in Spring 2022, there is anecdotal evidence of greater hesitancy to offer new FBTs. Some of this is because of the threat of removing APR for short term lets and also fear that FBT legislation could be reformed further harming the landlords’ interest.

109. Our membership is concerned that the impact of this change would be to vastly reduce the area of land available for letting, as landlords would take back land in hand to farm themselves or through contract farming. We have also received feedback from our membership that rents on short FBTs would need to be increased in order to ensure that the landowner will have sufficient cash available to meet the IHT liability on the land.

110. Shorter tenancies have benefits both for landlords and tenants. Both parties can benefit from the opportunity to bring tenancies for an end for a variety of reasons, whether commercial or personal. Tenants will also be subject to more stamp duty land tax when being granted a longer tenancy.

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

111. If this was pursued, a large number of exemptions and exclusions would be needed in order to prevent this from being a real obstacle to normal farming practice. Therefore, the proposal to change the tenancies that can qualify for APR will limit flexibility for farming businesses. This is important in a changing market where businesses have to restructure to remain viable and many need to use shorter term tenancies to do so.

112. The number and variety of these exemptions in itself provides a signal that the proposal is flawed. For example:

- Grower requirements for crops (not just specialist cropping) e.g. potatoes, carrots, peas etc.
- New entrants – where the landlord wishes to take this risk of a new entrant with untested experience, this could also apply to a young/inexperienced successor. A short term FBT would give him a chance where otherwise the risk for the landowner in the initial stages would be too great.
- Gradual incremental expansion of farming units by renting in additional land.
- There may be cases where a tenant wants a short-term tenancy to take them into retirement.
- Short term grazing or cropping, taken on as additional land.
- Changes to government schemes.
- Land that could come forward for development, or non-agricultural uses.
- Cases where land becomes unexpectedly vacant and there is a need to reach some short-term transitional agreements either before the land is offered for let or sale.
- Instances where land will be in time well placed for amalgamation into another unit to retain its viability into the future and a short term let may assist with this transition.
- Temporary mitigation – a tenant may lose land temporarily to a scheme or development and the landlord may wish to offer a short-term tenancy during that time.

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Appendix 1 - Examples of impact of uncertainty that IHT reliefs will apply

Member with 2,015 acres
Participating in the Biodiversity Net Gain (BNG) pilot working with Natural England to build a pipeline of Units to ensure day 1 operability for BNG. For them the uncertainty about taxation, capital, revenue and VAT is a very real blocker in their ability to cost, plan for and ultimately sign up to BNG contacts. In their view, the same will become true for ELM. They are looking at the potential for significant areas of their holding to be put forward for a Landscape Recovery pilot, involving permanent, and long term (30+ year) changes to land use including woodland creation, BNG habitats and agroforestry. However, it may be that due to the uncertainties around taxation risk, that they decide not to put in a proposal. If these concerns were allayed soon, then a significant blocker to their habitat creation plans, and therefore the Government's supply of BNG unit backed statutory BNG Credits would be unlocked.

So far, they have only delivered land use change in areas where it did not affect APR (for example in a woodland setting). This was a key factor in deciding site location. Tax concerns was a key factor in their decision making alongside revenue flows and valuation risk (although it forms part of both of these) and they understand that amongst the other BNG pilot sites under private ownership tax is a common concern.

Member with 270 acres
Concerned about loss of APR if put majority of land into Countryside Stewardship (CS). After advice reduced amount of land put into CS to 20 acres.

Member with 1,520 acres
Sought advice when considering 5 year CS application and effect on inheritance tax reliefs if put more land into CS by changing land use away from agriculture. After advice restricted land in CS to 295 acres.

Member with 162 acres
Considering entering into 5 year CS agreement but concerned about impact of agreement on availability of IHT reliefs. No application for CS made.

Member with 320 Acres
Concerned about impact of entering HLS on availability of IHT reliefs.

Member with 50 acres
Sought advice about impact on IHT reliefs if land put into CS scheme.

Professional member – Rural Consultant
Concerned about potential loss of IHT reliefs if clients entered environmental schemes that took land out of agricultural use and wanted a solution so clients could enter CS and future ELM schemes without concerns about loss of IHT relief.

Member with 30 acres
Small traditional farm considering entering into mid-tier CS but concerned about losing IHT relief.

Member with 158 acres
Considering mid-tier CS agreement but concerned about losing IHT reliefs.

Member with 3,000 acres
Estate was trying to be environmentally responsible and was considering putting more land into environmental management which involved less agricultural use but concerned about impact on IHT reliefs.

Member with 3,600 acres
Estate, mainly tenanted, is being deterred from taking land out of agriculture for environmental schemes due to the tax implications. In particular they had planned to enter into a landscape recovery scheme, linking up land along the banks of the Severn, which is considered important for eels and acts as a flood plain with curlews and rare grasses. They now think this may not be possible due to the tax consequences. They were also prevented from allowing a tenant to put land into BNG due to the tax consequences.

Member with 395 acres
The farm is currently in a HLS/ELS scheme and the member intended to convert this to mid-tier CS. 54 acres are in various conservation scheme options (Corn Bunting, Nectar and Pollen etc) and 123 are grassland in the low input option. If the land does not qualify for APR the member would leave the schemes and revert to arable farming, as the land is good for growing wheat.

Member with 370 acres
Currently 7 acres has entered into a hay meadow option under HLS. The member will not risk taking any further land out of agricultural production due to concern about the Balfour balance for BPR.

Member with 5230 acres
The estate has a policy of supporting tenants entering into agri-environment schemes, but recently refused permission to an AHA tenant to enter a portion of a field into an English Woodland Creation Offer as it would be devalue the land, and also because it would be managed by the tenant and so neither qualify for APR nor count as trading activity for BPR purposes for the estate.

Member with 1123 acres
322 acres are already covered by CS. The partnership is debating entering water meadows into CS, but may be deterred by the risk to APR.

Member with 500 acres
Member not taking land out of environmental use due to the risk to APR.

Member with 450 acres
Might put up to 25% of land into environmental schemes if APR was not a barrier.

Member with 1705 acres
Would not take land out of environmental use due to risk to APR

Member with 1000 acres
20% of the farm is currently in environmental schemes which mostly come to an end at the end of this year. As the owners are in their late 80s, they are debating whether the land should be put back into CS/ELMS next year, due to the IHT risk.

Member with 2623 acres
An application has been submitted to place the majority of the land into higher tier CS. Limitations on APR will restrict how much land is taken out of agricultural use.

Member with 1500 acres
The member thinks 200 acres would ideally be used for ecosystem services, but is concerned by the tax position as important to be able to pass the estate on to his son.

Member with 140 acres
Member is open to the possibility of putting considerable land into ecosystem services, but this would be massively constrained if APR not available.

Member with 160 acres
Land is held on trust and subject to 10 yearly anniversary IHT charges. Would not go into any scheme that put APR at risk.

Member with 460 acres
Member would put all arable land and temporary grassland into CS so long as APR was available.

Appendix 2 - Draft clauses proposed for a Finance Bill

A clause to ensure land in environmental land management will qualify for agricultural property relief

Insert new section 124D into the Inheritance Tax Act 1984

(1) For the purposes of this Chapter, where any land is managed for natural capital and eco-system services —

(a) the land shall be regarded as agricultural land;
(b) the management of the land to deliver natural capital and eco-system services shall be regarded as agriculture; and
(c) buildings used in connection with such management shall be regarded as farm buildings.

(2) For the purposes of this section land is managed for natural capital and eco-system services if —

(a) an application for financial assistance under one of the enactments listed in subsection (3) below has been accepted in respect of the land and the land is described in the agreement document and identified on the agreement map(s);
(b) the land is subject to a conservation covenant under the Environment Act 2021;
(c) the land is included on the Biodiversity Net Gain Register established in accordance with section 100 of the Environment Act 2021;
(d) the land is included on a recognised UK Carbon Registry;
(e) the land is subject to a written agreement with a regulated water company to provide specified environmental management actions;
(f) the land is subject to a written agreement under section 253 of the Highways Act 1980 that is registered as a local land charge;
(g) the land is used to deliver biodiversity net gain, nutrient neutrality or other environmental mitigation measures pursuant to a written agreement entered into under section 106 Town and Country Planning Act 1990;
(h) the land is managed in accordance an established scheme with standards verified by the British Standards Institute or International Standards Organisation;
(i) agricultural use is prevented because the land is:
    (i) part of a mitigation scheme under the Conservation of Habitats and Species Regulations 2017 (as amended);
    (ii) in a Water Protection Zone and subject to controls under the Water Environment (Water Framework Directive) (England and Wales) Regulations 2017;
    (iii) subject to a statutory designation that it is a Site of Special Scientific Interest, a Special Area of Conservation, a Special Protection Area, or a Ramsar Site.

(3) Those enactments are

(a) Section 1 of the Agriculture Act 2020, if the undertakings to which the acceptance relates have neither been terminated by the expiry of the period to which they relate nor been treated as terminated;
(b) The Agriculture (Financial Assistance) Regulations 2021;
(c) Section 98 of the Environment Act 1995;

(d) Countryside Stewardship (England) Regulations 2020 and Countryside Stewardship (England) (Amendment) Regulations 2022;

(4) The Treasury may by order made by statutory instrument amend the list of enactments in subsection (3) above. [NOTE: this will be necessary to include any environmental support schemes introduced in the devolved nations]

(5) The power to make an order under subsection (4) above shall be exercisable by statutory instrument subject to annulment in pursuance of a resolution of the House of Commons.

A clause to ensure that occupying land in environmental land use will be classed as non-investment activity for the purpose of business property relief

Insert new section 105(4B) into the Inheritance Tax Act 1984

(4B) For the purpose of subsection (3) above a business shall not be considered to be dealing in securities, stocks or shares, land or buildings or making or holding investments to the extent that it consists of managing land for natural capital and eco-system services as defined in subsection 124D(2) below.