Law Society of Scotland

Consultation Response

Taxation of Environmental Land Management and Ecosystem Service Markets

16 June 2023

Introduction

The Law Society of Scotland is the professional body for over 12,000 Scottish solicitors.

We are a regulator that sets and enforces standards for the solicitor profession which helps people in need and supports business in Scotland, the UK and overseas. We support solicitors and drive change to ensure Scotland has a strong, successful and diverse legal profession. We represent our members and wider society when speaking out on human rights and the rule of law. We also seek to influence changes to legislation and the operation of our justice system as part of our work towards a fairer and more just society.

Our Tax Law sub-committee welcomes the opportunity to consider and respond to the HM Treasury and HM Revenue & Customs consultation: *Taxation of environmental land management and ecosystem service markets*.[1] The sub-committee has the following comments to put forward for consideration.

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?

We believe that it is essential that such payments are simply treated as part of the trading income of such farming or commercial timber operations, rather than as a differentially taxed income stream.

This is particularly sensitive in relation to the income tax treatment (exemption) for commercial forestry. We consider that any differential treatment would distort business models currently in use and in particular may drive operators/recipients to attempt to ring-fence different activities. The comparison with agricultural "subsidies" of various kinds over the years seems persuasive. This is clearly also relevant to inheritance tax.

[1] Taxation of environmental land management and ecosystem service markets - GOV.UK (www.gov.uk)

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.

As indicated, certainty as to the tax treatment falling within "normal" activities would be extremely welcome, along with confirmation as between income and capital treatments – although it is appreciated that there may be different views depending on the method by which economic value is extracted from the units in question. Notably, the question of whether and when receipt of value from such schemes is liable to capital gains tax as involving a disposal – as opposed to income tax as involving exploitation of the land asset – would be welcome.

As adverted to above, confirmation that woodland carbon units should be treated simply as another form of receipt from commercial forestry and subject to the same rules as cropping trees would be very welcome. There is a clear overlap between such receipts and other forestry receipts.

The position is less obviously comparable in relation to peatland carbon credits. However, as both forms of economic value derive from active use of the land (admittedly less obviously active in the case of peatland), analogous tax treatment might be expected. Such confirmation would be an obvious economic lever encouraging such land use.

This desired treatment would also carry over into inheritance tax. The key for that tax is that receipt of credits should not be treated as carrying a business into the realms of being treated (for this reason) as "making or holding investments". There is a welcome and encouraging explanation of current views in paragraphs 3.36 – 3.27 of the consultation paper and we hope that those views can be formalised further in due course.

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?

We would defer to accounting practitioners in relation to this question, although with a general comment that we generally support tax treatment following accounting treatment.

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

This is a fast moving and developing area. In general, we tend to support tax treatment being set out in clear legislation rather than general legislation which then requires guidance and ultimately often court decisions. Because of the variety of and developments in the relevant schemes, in this case it may be preferable to have a general legislative framework supplemented by clear guidance that particular forms of receipt from different schemes are (in the view of HMRC, supported by clear Government policy statements) within or outwith the particular tax treatment in the legislation. This comment applies whether one is dealing with the applicability of existing legislation to new schemes or (and preferably) any new tax legislation which deals with the generality of such schemes.

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.

It may be too early to say, although there is some evidence of earlier transfers of land than might otherwise have been contemplated, on the basis that such land may not in future qualify for any favourable tax treatment which currently applies before any receipts arise from such schemes.

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

As adverted to above, clear general legislation on the subject followed by clear and example-driven guidance as to HMRC's view of specific scenarios would be welcome.

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.

There are a number of fundamental points to highlight here, with overlaps also relevant to what may be different policy drivers.

Firstly, we would point to the need for tax policies and treatment to be integrated with and take account of the policies of the Scottish Government wherever possible. When one is dealing with undevolved taxes such as capital gains tax and inheritance tax, there should be no scope for less favourable treatment to apply to Scottish payers of such taxes simply because the non-tax legal framework within which such taxpayers are operating may differ – unless those differences are absolutely fundamental (and indeed in some cases even if such differences were fundamental).

Secondly, as noted above, the statements made within the consultation – in relation to terms such as "agricultural purposes" and "agricultural value" within inheritance tax legislation – on the treatment of land affected by some schemes are generally very welcome but require to be formalised and probably extended.

Thirdly, we note the points in relation to agricultural property relief on let land. The terms of a tenancy may restrict what a tenant farmer can do in terms of environmental initiatives. The landowner should not be prejudiced in their own eligibility for relief by agreeing to intended environmental initiatives by the tenant (although a broader definition or guidance on when the tenant is still engaging in "agricultural purposes" may assist here also). There is a broader concern on the effects of encouraging diversity of activity by agricultural tenants and possible prejudice to the landlord's position.

The final fundamental point involves the very basis of agricultural property relief for tenanted land; and this is one which clearly drives activity. There is reasonable fear among landlords that the relief may be withdrawn or restricted in future, and hence a wish to bring tenanted land in-hand (giving rise to the possibility of business property relief as well as agricultural property relief) and/or not to offer new land for tenancies.

The encouragement of land for new tenants and new entrants to farming without the capital to buy land is a particular concern in Scotland. Therefore, and in conjunction with more general consideration of the effects of environmental schemes on

agricultural relief, there lies the possibility of enhancing or at the very least not further discouraging the attractiveness to landowners of offering tenancies and including in such tenancies full scope for sharing in environmental scheme benefits.

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?

This would be a new development, as current reliefs are generally assessed at the point of transfer (often death), looking only backwards rather than future use of and/or conditions attached to the land. Although the particular qualities of land being used in schemes may be a reasonable justification – in something akin to conditional exemption as applies to heritage property.

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?

We agree with this, provided that this list can be readily amended as new initiatives develop, particularly if those initiatives derive from the devolved Governments rather than Westminster.

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?

We are unable to provide specific information on this point. As an indication from a small pool of consulted members whilst preparing this response, such members are not aware of any such continuing eligibility – although that is, of course, not to imply that such land will not exist.

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.

We have no comments on this question.

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?

This may involve some contradiction between a wish positively to encourage the desired environmental activities (or indeed inactivity) and an understandable fiscal

caution about extending a valuable relief beyond its current parameters. If the latter trumps the former, it could be achieved by only permitting the relief to be available where the land in question would qualify "but for" its participation in the scheme(s); or a condition that the land would actually have qualified before entering the scheme(s) in question. We would note, however, that this should only be based on a theoretical qualification – not having actually qualified on a previous occasion. We are cognisant that such additional conditions would introduce additional complexity and increased compliance costs.

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

We cannot comment on this aspect, beyond reiterating what is said above about the definitions of agricultural purposes and related terms.

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?

We have no comments on this question.

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

We are highly concerned about the proposal, which could be extremely detrimental in Scotland. The standard "short" agricultural tenancy in Scotland is a Short Limited Duration Tenancy ("**SDLT**") of up to 5 years. An agricultural tenancy of 8 years is a legal (or at least practical) impossibility in Scots law, as after an SLDT the minimum period jumps under a Modern Limited Duration Tenancy ("**MLDT**") to 10 years.

SLDTs can be used in effect as provisional arrangements and are very important to encourage landowners to let land for productive agricultural use. Any suggestion that such tenancies would remove the landlord's APR would simply cause them not be used at all – and resultantly would be unlikely to lead to longer tenancies, but rather more land taken in-hand or used for contract farming.

The point is a perfect illustration of the absolute need to consider the different legal, and to some extent practical, land-use background in Scotland as compared to other jurisdictions in the UK.

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

We do not favour such an approach in any circumstances.

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