Taxing Matters

Navigating the complexities of the tax world

Season 3

Episode 5 – Nature's wealth: unlocking the power of natural capital with Daisy Darrell

Alexis: Hello and welcome to Taxing Matters, your one-stop audio shop for all things tax brought to you by RPC. My name is Alexis Armitage and I'm a Senior Associate in RPC's Tax Disputes team. I will be your guide as we explore the sometimes hostile and ever-changing landscape that is the world of tax law and tax disputes.

Taxing Matters brings you a roadmap to guide you and your business through this labyrinth. In case any of you miss any crucial information or just want some extra bedtime reading, there is a full transcript of this and indeed every episode of Taxing Matters on our website at www.rpclegal.com/taxingmatters.

I'm delighted to be joined today by Daisy Darrell, a Senior Associate in Birketts' Agricultural and Estates team. Daisy deals with a variety of work within the agricultural property sector, acting for rural landowners, tenants, institutions, and agribusinesses in relation to general estate matters, refinancing, disposals, and tenancy matters.

Daisy also deals with matters relating to Ecclesiastical property. However, a significant proportion of Daisy's practice is related to natural capital and one of Daisy's latest projects has been for a large estate in North Yorkshire committing 177 hectares to environmental enhancement. Daisy is part of Birketts' natural capital team and has extensive experience in acting for landowners on a national basis in settling complex biodiversity net gain arrangements which allow for the improvement of biodiversity through the regeneration of habitats and landscape recovery projects which involve acting for farming clusters to enhance farmland at scale. As well as acting in the BNG sector, Daisy is instructed by landowners across the country in relation to sales of farmland to government bodies as part of major infrastructure projects. Welcome Daisy and thank you so much for joining me today.

Daisy: Thanks for having me on.

Alexis: So today, Daisy and I are going to be discussing all things natural capital. So, to start, what is natural capital?

Daisy: Essentially, natural capital is the planet's natural wealth and the idea that the world has a stock of natural assets which provide ecosystem services like clean air, fertile soil and pollination of crops. It's a really exciting time in the natural capital space with the World Economic Forum predicting that the global demand for biodiversity units is going to reach approximately $2 billion by 2023, and $69 billion by 2050.

Alexis: So what are some of opportunities for landowners do you think in the natural capital space?

Daisy: There are lots of different vehicles coming forward at the moment which allow farmers and other landowners to monetize the ecosystem services that they have on their land. Obviously, it's a challenging time in agriculture at the moment and diversification of any sort can be a really good way of insulating against some of these unwelcome changes in the agricultural sector.

So perhaps, leading from the top, the one that is probably most well-known is biodiversity net gain. Now this is the idea which is now enshrined in statute, which requires any development in England and Wales, unless it's exempt, to have an overall gain in terms of biodiversity of at least 10%. And so, if a developer is going to be developing out a site, they will need to either look to enhance a section of land on that development site to ensure that the biodiversity there improves by a minimum of 10% or look for an offsite option.

This provides an opportunity for local landowners to assess their own land holdings and see if any units can be generated on their land and provides a potential source of income over a 33-year period. And I'll discuss a bit more on that later.

Nutrient Neutrality – this is an idea of mitigating nitrate and phosphorus pollution in certain protected or designated habitats. Again, whether your site is suitable will depend on the location or whether you fall within a specific catchment area. But from the deals that we've seen coming to the fore, the investment available is quite high in the areas which are suitable for this.

Another potential option is carbon. Again, this is much talked about at the moment. There's two types of carbon credit which can be generated. Firstly is a permanence credit - this will be new tree planting or peatland restoration. Again, peatland doesn't cover the UK completely, so this will be only available in certain areas. The Fens are a good example, Scotland has a lot of peatland restoration projects at the moment. These sorts of deals will generate the highest values and then there's also emission reduction credits, which although they're not as lucrative are still potentially good sources of income. So this is an idea of a farmer or an estate reducing emissions potentially through changing what sort of fuels they're using, or even just how you feed livestock.

Another scheme is around water neutrality. That's a new concept which is being brought forward to try and protect certain water stressed habitats by looking at whether the demand for water by a new development can be offset in the existing community. So if a development is going to generate X amount of demand for water, you can see if you can get someone else to use X amount less. It's tricky, but it might be worth looking at for landowners for that solution. Again, it's not relevant to certain parts of England and Wales, but I'm mentioning it because it's really important to show that there are new investments and new concepts coming along all the time.

Other opportunities can arise through ESG, and this is environmental, social and governance. And these are the three main areas that certain businesses over a certain size and revenue are expected to report on now. The environmental element of ESG is interesting to landowners because businesses are approaching landowners to invest in projects which are bringing about environmental change over an extended period of time. Big businesses are willing to invest in that, and we are certainly seeing that, I have recently worked on a project for an estate in North Yorkshire, committing 177 hectares of land at the estate to a nature shares project over a period of 30 plus years. And the idea with Nature Shares is that unlike BNG units, which are generated under statute, this is a voluntary market and it's a voluntary investment model, but we'll see big companies wanting to improve their ESG credentials and the market for Nature Shares is really starting to grow and gather pace. So, there's no statutory obligation that compels investment, but they are becoming a key consideration in global companies' ESG models. The idea is to create a market for these shares, allowing investors to directly invest in the preservation and enhancement of natural capital. The mechanism behind Nature Shares involves the identification, so determining the natural assets to be included in the share offering. Evaluation - so the assessment of any economic value of the ecosystem services provided by those assets. Issuance, so creating shares that represent the stake in the natural asset, which can be bought and sold in the financial markets. And management, using the funds raised from the sale of the shares to manage and protect the natural assets.

Also, we're seeing some philanthropic interventions in the natural capital markets. So effectively its free money entering the marketplace where people are willing to give money for the feel-good factor of helping the environment. And then finally it's worth including the public funding here in terms of investment in relation to DEFRA because there are environmental land management schemes in place at the moment and as part of those schemes some of the SFI options look very appealing to landowners and are directly competing when entering the private marketplace. So there are things like landscape recovery schemes which I'm working on at the moment and these involve clusters and collaborations of farmers, landowners at scale to bring about real environmental change which are supported initially by DEFRA seed money and then through the life of the project over the 20 years, they will be going to the private market for additional funding during the 20 year period.

Alexis: That sounds fantastic. Obviously we've discussed the opportunities. What do you think some of the risks would be for landowners in this area?

Daisy: So I think first and foremost, as it's a tax podcast, I'd say taking tax advice, it's really key for farmers, landowners and estates to make sure that the projects will work for them from a tax perspective. So the tax treatment is key. And I'll elaborate a little bit more on that later. But also the life of some of these arrangements is not to be sniffed at; Biodiversity Net Gain, projects are for a minimum of 30 years plus. And in the farming world, that will probably mean at some point that will involve a succession in the farm. So you have to think, are the next generation on board with the project? Are they going to be happy to carry on the implementation of the obligations under some of these arrangements. Landscape recovery projects are for a minimum of 20 years, again not to be sniffed at, it's a long time.

If you're a farmer or a landowner, you have to think, am I happy to get in bed with these people for that long? What happens if I want to leave? What happens if I die during the project? So these are all big considerations that you have to think about. Using biodiversity net gain, BNG, as an example if I can just discuss the two different types of ways of selling the units that you generate to the market that will tease out the potential risks in that setting.

Thinking about a direct sale of BNG units which you as a landowner have generated to the market. The scenario is this, you're a landowner and you're approached directly by someone wanting to acquire an environmental outcome for you. And that might be a unit, so a BNG unit or some other kind of quantifiable outcome. You will, as you would expect, enter into a direct contractual relationship with the buyer of that environmental outcome. And the contract will include the price and your obligations to deliver or enhance the habitat over the length of time. There might be a broker that forges that relationship for you. So that's all as you might expect but if you're selling the units for BNG or Nutrient Neutrality you're most likely going to need to enter into a Section 106 agreement, so that's a planning agreement, or a conservation covenant with a planning authority or a responsible body and that will be for at least 30 years. So you have to think, as I said, before about potential changes in ownership in the family and succession generally.

So from a risk perspective, it's an interesting concept because you're going to be paid by the buyer, but covenanting with the local planning authority or responsible body. So if the buyer stopped paying you, you'll still be obliged to deliver the habitat. And that's a risk, so commonly you'll see landowners ask for much more money upfront, or in escrow, to ring fence the money's required for the requisite period. If you were going to be bringing in a third party, acting with a Habitat Bank provider, your relationship would be one where you would have a lease with the Habitat Bank provider where you'd be paid a rent or a revenue share in exchange for you being obliged to provide certain habitat deliverables. It will then be the Habitat Bank provider who enters into the unit sale agreements to sell the units to the buyers. But just like before, it would be most likely the underlying landowner who needs to enter into the planning agreement or the conservation covenant. So we've got the same issues as before. The landowner is also ultimately responsible for delivering the change in the land or the habitat enhancement. So thinking about the risks, I would say as a headline, planning agreements and conservation covenants, these are for a minimum of 30 years, if not more. So you have to make sure as a landowner that you're comfortable with that arrangement.

The lifetime of the arrangement itself is for a very long time. Any changes made to the land also under the arrangement will be permanent, most likely. You need to think about what happens if the buyer stops paying you during the life of the arrangement but you'll still be under covenant even if you aren't receiving payment for the arrangement. So you have to be comfortable that you've either had the money upfront or that there's some kind of insulation protecting you.

And then another consideration would be additionality and stacking. So the idea of several different types of natural capital project running together in relation to the same land, so an ecologist would be the best person to speak to. You might have a river running through your land where you were already using the land for carbon, there might be something you could do with the water aspect of the land also. You'd need to speak to an ecologist about the potential of stacking these projects on top of one on top of another. Tenancies is also a consideration for any landowner or farmer, is the land offered up already under tenancy? We would recommend that you make sure that you consider your tenants and how you might deal with any tenancies. In our experience, there's often been commercial negotiation resulting in some kind of share in the revenue based on what kind of security of tenure the tenant benefited from.

And then land value and lending. So if you sell your natural capital, what impact does that have on your underlying asset value? Is it going to decrease it initially? But will it make it pick up and increase again? Potentially higher, we're not sure. It's a valid consideration for those who might be considering transferring any land in the future. And lenders, obviously, if your land is already subject to a legal charge, you need to engage your lenders early because you're most likely to require their consent. We are seeing that lenders are getting better as they're becoming more familiar with these sorts of natural capital projects in providing consent in a reasonable amount of time. But it may take some of the smaller lenders or the ones that are unfamiliar with natural capital projects a lot longer to review documents, and issue consent. There might be additional questions they have which need to be settled. So it's really best to engage them at very early doors.

Alexis: Brilliant. Thank you. Can you give us like a real-life working example of one of these situations? Obviously, I know they can be quite complex, but just so that people listening can get an idea -, so say you've got a client that rings you, new client, they're thinking about how they can get into the natural capital space, they don't know anything about it, you go to their farm. What do you do? What are you looking for?

Daisy: So BNG, biodiversity net gain, is probably the one that I can speak to the most effectively that requires land that effectively is not scoring particularly well in terms of biodiversity to be enhanced. So first and foremost, I'd always advise get an ecologist to come out and do a baseline survey. There are not many ecologists at the moment and those that are active are busy, but there are certain companies that are good. Or if you're slightly more risk averse, approaching a habitat bank provider to start a conversation would also be a good way of kicking off the process. And obviously if you're entering into a partnership with a Habitat Bank provider, one of the benefits of that for farmers and landowners is that the whole process is largely de-risked – the Habitat Bank provider sits in the middle and has the obligation of selling the units on the open market and not the farmer. So that takes away a headache and the extra admin from the process. Have a survey, so if you've got any land that is not prime land effectively. A good example would be I'm acting for a client again in Yorkshire at the moment sheep farming, the land is really overgrazed and so it's going to score pretty low on the DEFRA BNG metric, which is great for a BNG project. What's going to happen there is that I think the amount of sheep that are going to be on the land will be reduced quite significantly, allowing certain flora and fauna to return. I think they're creating some ponds and some wetland there as well.

Essentially, you would need an ecologist to review what you're looking at, to sort of confirm that your suspicions as a farmer that the land is not performing that well and to look at other options. And then once that's been rubber stamped, then you can start thinking about habitat management plans, and that's something that would be done in tandem with an ecologist to put a plan in place to regenerate, enhance the habitat there.

Lots of farmers sort of say that generally the habitat management plans are in line with the farming practices that they're already implementing. So it's generally not a significant amount of change. I have another client down in Cornwall whose land is going to have, I think as the first phase, some native pigs are being reintroduced to his land to sort of essentially free up the soil, burrow, aerate it, and that will start a process of regeneration. Their muck will regenerate the soil and that sort of thing. So it really is a completely different process for each location. Each habitat will require a different approach and that's where ecologists will be best placed to advise. Take advice from an ecologist early doors and then see what you've got. And once you do know what you've got, then you can start thinking about what kind of projects would be appropriate for you and what you can do with your land, and also the location is also quite key for certain projects like Nutrient Neutrality.

Alexis: Brilliant. And you mentioned clusters earlier. It sounds like there's an opportunity for different landowners, different farmers to work together?

Daisy: Absolutely, yeah. So on some of the landscape recovery projects that I'm acting on at the moment, we've got ones nationally, but some of them are really quite large. And I suppose the benefit of working together is that you can commit quite a significant amount of land to a project and therefore increase the amount of investment that comes forward from the private market potentially and again working together will help to insulate a project from any potential pitfalls.

There are some considerations around working in a cluster. A corporate entity would need to be created with its own considerations around governance and potentially a steering group to be set up amongst the cluster members as well. You might need to think about rights to step away from the cluster if, say, the project wasn't something that you wanted to enter your land into. So there are lots of considerations to think about when acting as part of a cluster, but the benefits can be quite significant in comparison to acting on a solo basis. But obviously, it depends on a case-by-case basis. But that's where early advice and having these discussions early on are really, useful because it can tease out any potential risks and pitfalls at an early stage.

Alexis: Thank you, that's really helpful. I think that was just really useful for anybody that has not considered getting into this space before. And actually it sounds like there might be a lot of people out there with land and they're already kind of doing this stuff but they just don't realise what else they could do to enhance the opportunity.

Daisy: Exactly. Yeah, monetizing things that they're already doing effectively. Yeah.

Alexis: Absolutely, absolutely, that's really useful, thank you. So we've already talked a little bit about ESG, is there anything else you want to say on the potential impacts of ESG on natural capital markets?

Daisy: ESG is really interesting because we are seeing more and more big companies looking to invest. But I think also it's a really great PR exercise for some of these global companies to say "look, we've invested in reforestation of wherever" or, " we're investing in a project of reintroduction of beavers". It makes their consumers feel happy. It's a win-win effectively. And I think we'll see more and more of that going forward. And that's really exciting. And if, you know, if a landowner can have a slice of that, then so much the better at the moment, as I said, diversification is a great way of insulating farming businesses against all these changes that are coming through. So natural capital should definitely be something that they consider.

Alexis: Definitely. How long would you say that the natural capital space has been in existence?

Daisy: I would say I've been doing it solidly for three years, Birketts as a firm have been doing it for a lot longer. It's been talked about for a lot longer by ecologists and sort of environmentalists you'll probably know Knepp, they were the figurehead of rewilding a good few years ago. It's all kind of flowed from that I think, I mean Ecologists and environmentalists will know much better than me, but in terms of acting for landowners, for farmers who are really interested in either just bringing about change for environmental purposes or just monetizing what they're already doing, it's certainly gathering pace. A couple of years ago, it was still a very new concept and a bit of a gamble in the same way that solar was about 20 years ago.

It's really taken hold and gained momentum now I'm seeing real potential financial investment as well from the financial markets.

And certainly the projects that involve scale and clusters will attract some serious investment because of what they're doing, how they're doing it, and the size of the projects. So it's definitely coming to the fore now.

Alexis: Yes, absolutely. So what are some of the key tax considerations when thinking about natural capital?

Daisy: Tax is an interesting one. It's the single most important explanation given by clients for not proceeding with natural capital projects. So what I would say is, from the amount of clients that we have coming forward to say, yes, I'd like to go think about a project. I'd like to speak to an ecologist and get cracking, sometimes, well, more than sometimes, the tax review means that it's not right for the business or for the farm or for the estate for various reasons. So it's really important to take tax advice early to prevent any unforeseen occurrences or to stop the project completely. Also, as a sideline, once you have got an offer on the table, make sure you take good advice to benchmark the offer to make sure that you're getting market value because again some of the markets in their infancy so without having a good agent who is experienced in the natural capital space advising you, you can be quite exposed so we would always say take good tax advice, take good agents advice before kicking off on these projects.

So going back to your question. Thinking about from a landowner perspective, if your land doesn't qualify for APR, then you need to try and think about qualifying for business property relief. So to qualify for business relief at its maximum rate of 100%, it's important that you're actively managing and using your land as part of your trading business and taking a commercial risk.

If you're leasing your land to a Habitat Bank provider or selling units but not actively managing the land, then you might still qualify for business relief but you need to take great care that this doesn't spoil your balfour balance. So definitely take specific advice on your individual circumstances, and obviously inheritance tax in the agricultural world is a hot topic at the moment. We would say take advice around IHT as well in relation to natural capital. In the event that you have got a natural capital project in situ and you're well on your way to receiving payments for any units that you're generating, you're going to want to know how that payment is going to be treated. So if you're an individual, is it going to be taxed as capital, which would be taxed at capital gains tax rates, which are currently 20%, or is it income, which is going to be taxed at income tax rates, which is up to 45%, or is it a combination of both?

That's another point where we would advise taking specific tax advice in relation to your circumstances to make sure that you're fully aware of the tax treatment so you can plan accordingly.

Thinking about other types of tax, stamp duty land tax, this is primarily a point for the developers in a BNG setting. The question is whether you're going to pay SDLT on the purchase of BNG units. SDLT is payable on the acquisition of interest in land or the benefit of obligations or restrictions affecting the land. So it's important that you take specialist advice to ensure that this has been considered at an early stage.

VAT is another consideration. That's going to need to be considered on an individual basis in relation to your estate, farm or business. The VAT position is going to depend on what's going to be done and sold. But unless it's deemed to be an exempt supply, we would expect that the provision of habitat management services by a trading business to be a VATable supply.

Business rates is again something else to think about. That's an interesting one and has not been widely discussed, but business rates are payable on non-domestic premises, but there are exemptions for agricultural land and buildings. So again, something to think about and something to ask your tax advisor for further information on. There's also a definition of agricultural land within the statutory exemption and the question is whether a non-grazed BNG habitat would fall within that definition. I can't give you an opinion on that one other than to say that your negotiations, legal documents and your financial modelling should factor these in so that you're clear on who pays them at the end of the day.

Alexis: You've already given us a few tips of how to sort of navigate this situation, but have you got any further tips for landowners thinking about moving into the natural capital space?

Daisy: I would say first and foremost, don't panic. These are opportunities, so view them as such. If you do get approached by a company, a broker, anything like that, and you did want to consider it, then take your time, and take some good agents and tax advice first. Don't dive into the first opportunity that's presented to you, because if someone has identified that your land might have potential, then chances are it's got lots of potential.

So, do some research, speak to the right people and then take it slowly and see what's available, benchmark the offers to make sure that you're getting the best in the market at the current time. And first and foremost, approach an ecologist to have a baseline survey. So the sooner that you know what you have in terms of biodiversity, the sooner you can take advice on how to quantify the opportunities available.

Alexis: Well, I'm afraid that's all we have time for today, folks. Thank you again to Daisy for today's podcast.

Alexis As ever, a big thank you goes to RPC's in-house team for the production, music and sound editing of this episode.

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