Can money grow on trees?

Inheritance tax and trusts   Personal tax

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Julie Butler considers the commercial and tax strategy of woodland

Key Points

What is the issue?

HMRC has been looking very closely at how woodlands are used for inheritance tax (IHT) purposes.

What does it mean for me?

Woodlands are often used for lifestyle activities and ‘forgotten’ about by the farm and woodland tax advisers, when they should be used to make a contribution to overall profitability.

What can I take away?

All farmers and landowners, together with their advisers, have to embrace the opportunities and ensure the correct recording in the accounts of both farmers and ‘woodland investors’.

Woodlands are currently potentially more profitable than they have been previously, possibly more so than they have been in ‘living memory’. It is essential therefore for all tax advisers to understand their tax position. HMRC's approach to woodlands HMRC has been looking very closely at how woodlands are used for inheritance tax (IHT) purposes at many levels. HMRC is perhaps taking advantage of the fact that woodlands are often used for lifestyle activities and are 'forgotten' about by the farm and woodland tax advisers at a time when farm woodland should be used to make a contribution to the overall farm's profitability, as well as being closely reviewed for tax purposes.

Woodlands are deemed commercial for tax purposes where trees are grown in order to sell as timber; i.e. with a profit motive. The commercial occupation of woodlands in some cases is not classed as a trade and so the owner does not receive tax relief, pay tax on the profits (ITTOIA 2005 s 11(1)), or claim tax relief on the losses. However, the traditional model of commercial woodlands has now progressed to much greater productivity through improved harvesting methods. Profits can be made from harvesting wood, as well as there being the future potential for improved subsidies.

The tax protection required for woodlands is to ensure there is forensic analysis of their use, especially where the woodland is combined with the farm or other trades. Whilst the sale of the timber can be 'outside the scope of income tax', the reality of the operation must be considered in tax terms. If the holding is, for example, woodland attached to a farm, then the overview of the operation must be understood to protect agricultural property relief (APR) and, where applicable, business property relief (BPR) for inheritance tax.

Inheritance tax: APR and BPR

Woodlands can benefit from APR where they are ancillary to farmland, such as 'shelter belts' (a protective barrier of trees and shrubs), and areas where firewood and fencing are taken or the activity of 'short rotation coppice' is carried out. However, once woodlands are managed on a commercial basis and have been owned for the two-year minimum time of ownership, they can benefit from 100% BPR. The reality is that on many farms, the woodland income has now become a positive part of diversification and profitability.

As part of tax protection and planning, the farm accounts must clearly reflect the exact nature of the business activity of any woodland and, furthermore, any 'barter' transactions involving the woodland must be accurately recorded. A large number of tree surgeons clear woodlands and fallen trees in return for the value of the wood, but both sides of such transactions are needed. Woodland maintenance can also be exchanged for woodland shooting rights.

In practice, HMRC will ask about the activities taking place in the woodland when it tries to verify APR (and BPR) and it will be necessary to provide evidence with detail from the farm books and accounts of any such transactions. Where barter of woodland activity is unrecorded and the accounts show no woodland income, it is more difficult to argue that the inheritance tax reliefs are due. A practical point is therefore to ensure that the trading activity around woodlands is correctly recorded in the accounts and tax returns.

Consideration should be given as to what inheritance tax relief needs to be claimed (APR or BPR) on the woodlands depending on the requirements of the landowner. If there is a greater need for relief on the farmhouse, then a claim for APR could be made on the woodland to increase the agricultural activity associated with the farmhouse. Alternatively, if there is a greater need for trading activity, then a claim for BPR could be made to improve the 'Balfour Matrix' (the relative value of trading and investment elements) by moving away from the investment line or the spectrum of investment. The Office of Tax Simplification's review of inheritance tax suggests that the trading mix should match with CGT; i.e. increase from 50% to 80%.

Woodland goals

Tax advisers for both farm and woodland investors must consider all woodland tax strategy in terms of the short, medium and long term goals.

1. Short term goals

- Ensure that APR and BPR are protected for all potential probates.
- Protect tax reliefs by ensuring that barter is correctly disclosed in the accounts, and that the accounts show evidence of commercial and agricultural woodland.
- Assess the future subsidies and benefits under the Agriculture Bill.
- Take professional advice on both maximising income and overall tax relief.

2. Medium term goals

- Follow the short term strategy to continue to maximise income streams, especially subsidy eligibility, as more is understood about the Agriculture Bill.
- Consider opportunities of planting more trees on marginal farmland.
- Assess the agricultural value versus the woodland value of land as greater understanding of profitability and farmland values emerges following the recent election result and the impact of Brexit, and their impact on subsidies in the Agriculture Bill.

3. Long term goals

It is difficult to predict revenues with so many uncertainties. Advisers must keep monitoring income potential, subsidies and input on land values, and the interaction of succession planning. It is also important that advisers understand the latest developments in the woodland industry.

Environmental issues

Environmental campaigners have emphasised that the UK must ‘plant more trees’. This statement is something farmers must embrace both from a farm strategy viewpoint and also to help the environment. The generic problem of tree planting can be that agricultural value of land has remained higher than woodland value. Planting trees on quality agricultural land can reduce the capital value of the land and therefore have an overall financial negative effect, despite the very attractive subsidies on offer.

Woodland Carbon Guarantee Scheme

The environment ethos is that farmers and landowners in England can currently plant trees to ‘sequester’ or capture carbon (carbon sequestration) and assist with climate change. The Woodland Carbon Guarantee Scheme (WCGS) gives successful land managers the option to sell their ‘captured carbon dioxide’ in the form of ‘verified carbon credits’, called woodland carbon units (WCUs), to the government for a guaranteed price every five or 10 years which continues up until 2055/56. The plan is that the government’s guaranteed price will be set by auction and help to form the market; landowners are free to sell their credits privately as well. Subject to certain exceptions, it is possible for woodland managers to combine participation in the WCGS with other woodland grants, but more information is awaited.

Natural capital

Marginal land is farmland that does not produce strong agricultural returns, so that other uses need to be considered. ‘Natural capital’ is the stocks of natural assets that include geology, soil, air, water and all living things. It is from these assets that the UK derives what have been known as ecosystem services, such as carbon sequestration, water purification and soil fertility.

'Natural capital' opens up new earning opportunities for farmers through subsidies that may mitigate the loss of payments as a result of leaving the EU Common Agricultural Policy (CAP); for example, following Brexit the Basic Payment Scheme (BPS) is being phased out between now and the end of 2027 under the Agriculture Bill.

Ash dieback

Ash dieback (also known as Chalara or Hymenoscyphus fraxineus) was discovered in East Anglia and Kent in 2012 and has been causing irrecoverable damage to the UK's native ash trees. For many centuries, ash has been planted on a wide range of sites due to qualities such as fast growth, excellent timber and its form of growth. Due to the impact of this species specific disease, the UK will no longer see ash in the UK woodlands for many years to come. The woodland strategy can be to maintain a thinning programme for ash trees by focusing on their removal, while restocking with different species. The felling and removal of ash trees is needed not only to realise their economic value and ensure the species change process, but also to remove dying wood which can become the breeding stock for more deadly fungal infection, such as honey fungus. The tax position of these changes must be considered, and all tax advisers must understand the extent of the ash dieback problem.

Woodland changes

Current certainties for tax advisers are that woodland can no longer be 'forgotten' about. All farmers and landowners, together with their advisers, have to embrace the opportunities and ensure the correct recording in the accounts of both farmers and 'woodland investors'.

Many positive changes face the woodland industry, such as the WCGS, 'natural capital' and increased profit potential as hardwood and softwood prices increase, yet these rest against a background of problems such as ash dieback. In order to maximise the opportunities for more profit, the tax adviser must embrace and understand all woodland activity, whether as part of the farm or as a standalone 'woodland investment'. The tax reliefs can be very beneficial and decisions of 'inside' or 'outside' the scope of tax must be very clearly understood.