

Note on Green finance - biodiversity net gains (BNG)

Charity Tax Group

Executive Summary

Many charities will be interested in engaging with the BNG scheme. In most cases, the income received from such contracts will be subject to VAT and treated as trading income for corporation tax purposes.

Where a charity is an environmental charity or has 'the advancement of environmental protection or improvement' as one of its objects, HMRC have confirmed that this income should be primary purpose income. In other cases, this trading income may be subject to corporation tax. Some charities may wish to explore the use of a subsidiary trading company to shelter this income from corporation tax.

Because the corporation tax charge is driven by the accounting treatment, it is important that charities consider this in order to evaluate the possible corporation tax costs.

Charities should ensure that they understand the accounting treatment and tax costs, including any corporation tax and the potential costs of using a trading subsidiary to generate BNG income, before they enter into such contracts. Failure to do so may result in the charity (and potentially a trading subsidiary) sustaining an economic loss on such contracts.

In this note we look at the accounting and potential corporation tax issues. VAT is not covered.

Background

There are a number of schemes now embedded into the planning system with the aim of protecting or enhancing the natural environment. Charities may be considering how they can benefit from these schemes and how to treat any income that is generated from their land.

The most common / well-developed of these schemes is Biodiversity Net Gains (BNG). BNG is an approach to development. It makes sure that habitats for wildlife are left in a measurably better state than they were before the development.

In England, BNG is mandatory under [Schedule 7A of the Town and Country Planning Act 1990 \(as inserted by Schedule 14 of the Environment Act 2021\)](#).

Developers must deliver a BNG of 10%. This means a development will result in more or a better quality natural habitat than before development.

In this note we consider the emerging best practice for accounting and tax and specifically what charities should be considering if they are looking at contracting with a developer or contributing land to a biodiversity scheme.

Although outside the scope of this note, there may be situations where a charity is itself a developer and has obligations to meet under Schedule 7A. Advice should be taken on these separately.

Direct engagement

A developer who cannot provide the requisite gains on their own land can contract with someone to do this for them. The agreement between the developer and the charity is likely to be a contract for services and not a grant as there is a legal agreement which meets the definition of a contract.

HMRC have confirmed verbally that income from a contract to provide BNG on a charity's land would be treated as trading income. They will publish formal guidance on this shortly. Income from BNG will be income from a long-term contract and so to decide on the tax implications of receiving the income, we must first consider the accounting treatment.

A contract is an exchange transaction recognised under the accounting principles in [FRS 102](#) (specifically [section 23](#)). Each contract will need to be reviewed to assess the requirements it places on both parties and any conditions on the recognition of income.

A charity must decide if 'performance obligations' exist within the contract and each contract will need to be assessed on its merits. If there are 'performance obligations,' being obligations that the provider has to the other party then there may be an argument for deferring the income and only recognising it to the extent that those performance obligations are met. This would require the recipient of the BNG funds to actively track its performance of the obligations and the expected stage of completion so that any profit within the contract was recognised proportionally to the stage of completion.

However, emerging commercial practice appears to favour agreements that place obligations on the recipient of the funding to maintain land and increase biodiversity but no direct performance obligations in accordance with FRS 102.

If this is the case, then it is likely that the whole of the income will be recognised on receipt.

However, there are obligations within the contract, and it is often therefore appropriate to recognise a provision for costs expected to be incurred over the life of the contract. A provision can be recognised in accordance with section 21 of FRS 102 when:

- a) the entity has an obligation at the reporting date as a result of a past event;
- b) it is probable (ie more likely than not) that the entity will be required to transfer economic benefits in settlement; and
- c) the amount of the obligation can be estimated reliably.

This can present challenges to those in receipt of BNG to demonstrate that they can reliably estimate the costs. However, regardless of the accounting requirements, as a charity entering into such an agreement it would be prudent to have an estimate of costs when setting the contract value.

When calculating a provision, the accounting requirement is to include it in the financial statements at the best estimate of the amount required to settle the obligation. Where the obligation is arising over 30 years it is likely that the time value of money will be material and so this should be factored into the calculation. In subsequent years costs can be charged against a provision to the extent that they relate to expenditure originally included within it and the provision should be remeasured each year and adjusted based on the current estimate of the amount required. All adjustments to the provision go through profit and loss.

Charities must ensure the price offered to developers includes an appropriate estimate of costs. If a trading subsidiary is used, those costs should include the costs of operating the contract through a subsidiary and any corporation tax charge. Failure to do so would result in a loss arising from the activity.

Tax

Receipts from BNG will be considered receipts from contracts and as such will be subject to VAT (although VAT is outside the scope of this note)

The accounting and corporation tax treatment of BNG are interlinked because the starting point for the taxable amount will be the income (profit) that is recognised in accordance with UK generally accepted accounting practice (FRS102 in most cases). So, the accounting treatment will determine when income is taxed and expenditure relieved.

For a charity, where the BNG income arises from a contract for services, it will be treated as trading income and will be taxable if the trade is not a primary purpose trade. HMRC have confirmed verbally that environmental charities, or charities that have 'the advancement of environmental protection or improvement' as one of their objects, should be able to enter into such contracts as part of their primary purpose, or ancillary to their primary purpose, and account for the income (and expenses) as part of that activity, and so the income should not be taxable. Other charities that own land from which they wish to generate BNG income may find that the income generated would be non-primary purpose trading income and so potentially taxable.

In that situation, if the income from BNG is likely to be material, the charity could consider setting up a subsidiary trading company, to mitigate the tax liability. It may also be possible to use an existing subsidiary trading company. The subsidiary trading company would need to have an interest in the land ie the charity would need to enter into a lease or similar agreement with it, sufficient to allow it to fulfil the obligations under the BNG agreement. Rent paid by the subsidiary trading company to the charity should be able to qualify for the income from property exemption available to charities and be a deductible expense in computing the profit of the subsidiary.

The profits or surplus generated in the subsidiary trading company could be paid over to its parent charity under corporate Gift Aid to mitigate corporation tax.

Charities would need to take professional advice before entering into arrangement through a trading subsidiary as there are a number of complexities. A problematic issue is that the charity may need to provide funding to the subsidiary to undertake the activities, and the charity must ensure that this funding is a qualifying investment (whether provided by way of subscription for shares or loans to the subsidiary). If at a future date it transpires that the costs of fulfilling the BNG obligations had been underestimated, the subsidiary may not have sufficient cash or reserves to cover costs to deliver the contract and may need to make a cash call on the parent charity. As with the initial investment, the charity must ensure that any further funding is a qualifying investment.

Therefore, the calculation of the provision for future costs becomes ever more important. The cash needs of the subsidiary will need to be evaluated to see whether it has sufficient reserves and cash to meet its obligations under the BNG contract and where there is a profit or surplus, sufficient reserves and cash to make a Gift Aid payment to the parent charity. Note that the amount of Gift Aid that a subsidiary can pay may be restricted if its distributable reserves are less than its tax-adjusted profits.

In summary, charities should consider their motive around why they are entering into such contracts. Environmental charities should be able to enter into such contracts as part of their primary purpose. But other charities would be doing so to raise funds for the charity and may need to use a trading subsidiary and corporate Gift Aid to mitigate tax.

Indirect engagement

Contracting indirectly to access green finance, for example selling units into a habitat bank, may not be as straightforward and the terms of any agreement would need to be considered.

Specifically predicting the costs of providing the service may be harder to reliably estimate at the time of sale. The details of each agreement would need to be considered on its merits but the principles on trading income are likely to be broadly similar.

Charities may be considering generating funds through signing up to a conservation covenant or becoming a responsible body, contracting with a landowner in receipt of BNG to assist them in fulfilling their obligations. Each of these transactions is likely to generate contractual income. The same steps would be relevant in that each contract would need to be considered on its own merits asking the questions:

- Is this income generated from a trade that could be considered primary purpose trading?
- Does this contract include performance obligations that must be met in order to demonstrate entitlement to this income?
- Does this contract obligate the charity to incur future costs that meet the definition of a provision?

Conclusion

With these three questions answered the charity should be able to establish the accounting treatment and, where the primary purpose trading exemption is not available, calculate the tax-adjusted profits. These could be profits in the charity (that undertakes the activity itself) or in a trading subsidiary. In the case of a trading subsidiary, that profit will be the starting point for working out what amount can be paid to the parent charity as Gift Aid subject to having sufficient distributable reserves and available cash or the corporation tax exposure where it is not possible to pay up Gift Aid.