Comment

Green tax incentives: an opportunity or a threat?

Speed read

As the world moves towards net zero, the development of new environmentally friendly technology is increasing in importance. The introduction of green tax incentives in the United States is beginning to impact where green tech developers locate their businesses and where investors spend their capital. The EU has reacted with its own Green Industrial Plan. The UK should respond by introducing targeted incentives for both investors and developers, which are simple to operate and internationally competitive, if it wishes to meet its ambitious net zero commitments and entice green tech developers.

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The past couple of years have seen a shift in the environmental strategy of businesses. Rather than just offsetting their carbon emissions, businesses increasingly want to be actively involved in solving the world's environmental problems. This shift is not merely due to an enhanced awareness of net zero targets, but also reflects the growing importance of the environmental component of businesses' ESG policies to stakeholders, such as customers and employees.

Innovation of green technology requires huge capital investment and businesses will be attracted to jurisdictions where there are tax reliefs to mitigate the impact of these costs. With businesses looking to make long term decisions as to where to locate these activities, governments have a window of opportunity to attract green investment to their jurisdictions.

We will examine how UK green tax incentives for businesses could be structured, as well as considering the role that tax reliefs could play in changing consumer behaviour.

Approach to environmental taxation

Tax can be a useful tool to help change and drive business behaviour. While businesses are ever more focused on their environmental credentials, they are ultimately still motivated by the bottom line and therefore aiming to reduce their tax burden where it is possible to do so. Green tax incentives can therefore be a good motivator to drive businesses towards more environmentally friendly behaviour and to help achieve the government's net zero target.

There are two ways that tax can be used in this manner: either as a stick by way of increased taxation of environmentally damaging activities or as a carrot by providing tax incentives to businesses for actively being more environmentally friendly. To date, the UK has generally focused on the 'stick' approach with various taxes applying to environmentally damaging behaviours (for example, climate change levy, landfill tax and, more recently, the plastic packaging tax). While there are some more 'carrot' like features in the UK tax system within the environmental sphere, these have been relatively limited, including enhanced capital allowances for certain forms of environmentally friendly expenditure, mainly focusing on low or zero emission vehicles, land remediation relief and limited time VAT zero rating for the installation of certain energy saving material in domestic properties.

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What are other jurisdictions doing?

In 2022, the US introduced the Inflation Reduction Act (IRA 2022), a multi-billion dollar package of environmental incentives for US businesses and consumers. The incentive package is a combination of grants, loans and tax credits covering a whole raft of environmental activities. Tax credits are available under IRA 2022 for (among other things) manufacturing of wind turbines, solar panels, batteries and biogas, developing renewable technologies and electric vehicle manufacturing capabilities and developing green hydrogen and other alternative sustainable fuels. Many of the tax credits provided for in the bill are direct pay and will therefore provide a cash incentive even in circumstances where the business' tax liability is relatively low. Further, several of the tax credits have been put in place for a period of ten years providing ongoing certainty to businesses operating in these sectors. Another interesting feature is that some of the tax credits can be transferred to unrelated parties in exchange for cash on a tax neutral basis, enabling the original recipient to monetise the tax relief.

Another significant element of IRA 2022 is that it incentivises businesses to use the US domestic supply chain to develop and manufacture products, thereby helping to boost the US economy by motivating businesses (and indirectly) investors to spend in the US.

It is also worth noting the social aspects of IRA 2022 as well as the environmental: many of the tax credits will only be available to businesses which meet the requisite wage and apprenticeship standards.

Finally, in addition to business level incentives, IRA 2022 also provides tax credits and rebates to individuals and households for the purchase of electric vehicles and for retrofitting housing to run with energy efficient appliances.

The EU has now reacted to IRA introducing its own Green Industrial Plan which is intended to 'enhance the competitiveness of Europe's net-zero industry and support the fast transition to climate neutrality'. The plan is based on four pillars: a predictable and simplified regulatory environment; faster access to sufficient funding; skills; and open trade for resilient supply chains. The plan itself, being EU wide rather than jurisdiction specific, does not contain any specific tax incentives but does set out the policy to ease state aid rules to provide additional flexibility for certain environmental measures – which should pave the way to allow EU member states to more easily introduce their own green tax incentives.

Many other jurisdictions have some form of green incentives with the majority focusing on grants and subsidies. Generally, most jurisdictions also have some form of 'stick' type taxation of environmentally harmful practices. In light of the movements in the US and EU, it would not be surprising for tax incentives to start becoming more common worldwide.

Forms of incentive

Tax incentives can be targeted at various points in the supply chain and investment structure. A jurisdiction wishing to incentivise the development of environmental technology could offer enhanced tax deductions or tax credits to the developer. Alternatively, the jurisdiction could introduce investor level tax reliefs – such as lower rates of taxation on returns and gains – to make it more attractive to invest in high risk, capital intensive green technology development businesses. Finally, jurisdictions will also need to incentivise the take-up of environmentally friendly technology by consumers and other businesses. Customer level tax incentives could be used as a lever to encourage this.

Jurisdictions will need to determine the objective of green tax incentives before deciding where to focus the incentives. Green tax incentives could support the following aims:

- encourage high tech businesses to set up in the UK, providing highly skilled jobs for UK workers;
- attract foreign and UK investment in UK green tech businesses; and
- meet UK's net zero targets.

The UK government's net zero commitments are ambitious and will require major shifts in consumer behaviour. For example, the government aims for all cars on the road to be zero emissions capable by 2035.

Possible forms of green tax incentives

Company level incentives

The core aim is to encourage high tech green businesses to establish themselves in the UK. Investor level tax incentives alone cannot do this, as the UK's residence-based tax system means such reliefs could only be granted to UK tax resident investors. To attract the necessary foreign investment, reliefs would need to be offered at developer level, minimising the upfront capital costs and making the developer entity an attractive investment.

As development of new technology is often capital intensive, resulting in losses during the start-up period, any tax relief will need to provide the developer with immediate cash flow benefits, as opposed to merely increasing the amount of carried forward losses.

One option would be an enhanced rate of R&D relief for the development of environmentally friendly technology. To ensure that the relief achieves the objective of producing jobs for UK workers, the relief would need to be limited to UK activities. From 1 April 2024, existing R&D relief will generally be restricted to UK activities, meaning that it would be easy for an enhanced rate of relief for green R&D to be UK focused.

The UK will need to ensure that any new tax relief is compliant with BEPS Pillar Two, so that the effect of the incentive is not undermined by subsequent top-up taxes. Although Pillar Two only applies to groups with annual revenue of €750m or more (so most businesses in start-up mode would be out of scope), the relief needs to be future proofed so that the benefit of it does not fall away when the business becomes profitable or is acquired by a larger group.

To be respected under Pillar Two, R&D relief would need to be structured as a qualifying refundable tax credit. If the relief was structured as a super-deduction, it would potentially result in top-up taxes, as the extra portion of deduction would not be reflected in the entity's adjusted profits (UK equivalent of 'GloBE income'). By contrast, qualifying refundable tax credits are treated as income, increasing the entity's adjusted profits (which will increase the entity's effective tax rate).

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A 'qualifying refundable tax credit' is defined in the Finance (No. 2) Bill 2023 as a tax credit which is payable in cash within four years (unless used to discharge a tax liability). Although the UK's RDEC is potentially payable in cash, features of the RDEC may need tweaking to meet this definition. In particular, capping the payable tax credit at the amount of company's PAYE and NICs liability may limit the effectiveness of the relief from a Pillar Two perspective (as only the portion of the tax credit used to discharge tax liabilities or payable in cash would qualify), and is also unlikely to be internationally competitive.

Investor level incentives could be introduced in addition to a developing entity tax credit to attract domestic investment into green tech. Whilst dividend returns and gains on disposal made by a corporate investor may qualify for the dividend exemption and SSE, a more generous regime than EIS/SEIS could be introduced for individuals investing in UK green tech companies.

Another option could allow both individual and corporate investors the ability to access tax losses of the developer entity to set against their income and gains (for corporates, at a lower ownership threshold than is permitted under consortium relief). This could incentivise crowdfunding of new technologies that are likely to be loss-making for a period.

Consumer level incentives

Some VAT incentives already exist at consumer level in the form of zero rating for the supply and installation of energy saving materials such as insulation, solar panels, wind turbines and heat pumps. The category could easily be expanded to catch further energy saving items such as double, or triple, glazing and electric car charging points. A zero rate could also be introduced for new electric cars.

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Housing is one of the areas in the UK responsible for the highest emissions; to create a competitive advantage for energy efficient homes a lower rate of SDLT could be introduced. This could apply to any new homes which have been using low carbon material or to existing homes which have installed energy efficient heating systems. This could help encourage homeowners to make their homes more energy efficient with the potential of a higher price on a future sale thanks to the lower SDLT rates.

A more radical approach could entitle individuals to income tax deductions for expenditure improving the energy efficiency of their homes.

Conclusion

In the Spring Budget, the chancellor stated that he would respond in the Autumn Statement to the challenges created by IRA 2022. He will also need to respond to the EU's Green Industrial Plan. Brexit arguably enables the UK to be nimbler than its European neighbours: the UK will not need to consider state aid issues, does not need to comply with fundamental freedoms and has flexibility to introduce new reduced and zero rates of VAT.

To prevent capital flowing into other jurisdictions and entice green tech developers to establish themselves in the UK, any new UK incentives will need to be internationally competitive. Key to this will be the generosity of the reliefs, their simplicity to operate and the certainty of the regime. ■

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