



Tax Faculty

## TAXREP 5/06

### GREEN LANDLORD SCHEME

*Memorandum submitted in February 2006 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales in response to an informal consultation published by HM Treasury in August 2005*

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## GREEN LANDLORD SCHEME

### INTRODUCTION

1. Following an announcement in Budget 2005 on the Green Landlord Scheme, the Government has continued the informal consultation which began in August 2005 with representatives from the private rented sector (PRS). The consultation document can be found at <http://www.hm-treasury.gov.uk/media/726/37/greelandord010805.pdf>. The proposals would reform the existing Wear and Tear Allowance (W&TA) for furnished residential property by:

- making it conditional on the energy efficiency level of a property
- possibly extending it to unfurnished property in the future.

The ICAEW was not asked to take part in the informal consultation when it began. Since a key aspect of the proposals involved tax changes, we are keen to comment on them. Our comments are given below, with specific reference to the informal consultation document on the Green Landlord Scheme published by HM Treasury in August 2005.

### KEY POINT SUMMARY

2. We are concerned at yet another attempt to use the tax system to influence behaviour. We accept the need to encourage energy efficiency. But we are not convinced that the proposed change to the tax system is the right way to influence behaviour, nor even that it will be effective. It will add another complication to an already over-complex tax system, further adding to the burden of administration and the financial costs imposed on business, including private landlords. Our key points are:
  - The extent to which the Landlord's Energy Saving Allowance was taken up in 2004/05 will indicate the success or otherwise of the publicity surrounding its introduction. We urge HMRC to work more closely with Chartered Accountant business advisers in seeking to raise the profile of the latest energy saving measures.
  - Recent research commissioned by the ICAEW into the attitude of smaller businesses indicates that the greater fiscal incentives given for research and development do encourage additional investment, but that these incentives must be significant.
  - We support the whole house approach to any new relief on the grounds of simplicity.
  - The wear and tear allowance was introduced as a means of simplifying tax relief for the cost of renewing furnishings and fittings etc in residential furnished lettings. This simplification benefits taxpayers, their representatives and HMRC officers and is a model which should be extended rather than complicated by having additional constraints attached. We do not think that

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adjusting the current W&TA will encourage landlords to invest in energy efficiency.

- We recommend that the W&TA should be used as a model for a new and quite separate 'Energy Saving Allowance', which would be extended to apply to unfurnished lettings and to corporate bodies.
- Consideration should be given to the mechanism for giving tax relief for the cost of obtaining the new Energy Performance Certificate.
- The earliest date from which the new scheme could be implemented is April 2007. Changes will be needed to self assessment tax returns for individuals, partnerships, trusts and possibly also companies.

## GENERAL COMMENTS

3. Firstly, we recognise that climate change is one of the greatest risks facing the world in modern times. As such, we support moves to combat the detrimental impact of CO<sub>2</sub> emissions on climate change and welcome moves to reduce the UK's emissions levels by improving energy efficiency in the private rented sector.
4. We have restricted our comments in this response to the tax consequences of the proposals in the informal consultation document on the Green Landlord Scheme published in August 2005. Extracts from the discussion paper are shown in italic type in the paragraphs which follow, with the questions to which we are responding highlighted in bold.
5. Successive governments have long used the tax system in an attempt to influence behaviour. Whilst we accept that this can have beneficial effects, it can also lead to complication of an already over-complex system, further adding to the burden of administration and the financial costs imposed on business.
6. The small business rental sector includes many individuals who may only let one or two properties. We are concerned that there should be no additional burdens placed on this sector since this may cause market failure as the costs of renting begin to outweigh the benefits and the stock of rental property falls as a result.
7. The paper states at paragraph 11 that  
*'there is currently a lack of incentive for PRS landlords to invest in the energy efficiency of their property. The main reason for this is that the benefit of that investment currently flows to the tenant (in the form of lower energy bills) rather than to the landlord.'*
8. Most tenants will adopt the energy supplier used by the previous occupants and are unlikely to change supplier for what may only be a short term rental. Prospective tenants will even accept a property fitted with pre-payment meters, although these cost more than payment by monthly direct debit. The suggestion that a lower Energy Efficiency rating will have a significant influence other than at the margin needs further research. We are concerned that the administrative costs of EPC certificates will be borne by landlords, further reducing the return on their investment.

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## SPECIFIC COMMENTS ON THE CONSULTATION DOCUMENT

### Landlords Energy Saving Allowance (para 13)

9. We should be interested in the HMRC analysis of Tax Returns for 2004/05 which will indicate the extent of take up of the £1,500 relief for capital expenditure on loft, cavity wall and solid wall insulation. We are not aware that this has been widely publicised and it is likely that many landlords will only have become aware of this when they saw Box 5.36C on their Tax Return 2005. If they only turned their attention to completing this in, say November 2005, it will be too late to spend anything in the 2004/05 tax year, and very likely be too late also for 2005/06. This means that the allowance has been available for two years without the majority even becoming aware of its existence.
10. Giving relief by means of a tax deduction is of little use to landlords whose expenditure already exceeds income. This can easily happen in the early years of letting a property when interest on the loan used to buy the investment, together with other costs, may already create a tax loss. In such cases a grant which is unconnected to the tax system is more useful incentive. Similar considerations will apply to the suggestions in the current consultation.

### Reasons why landlords invest to improve their property (para 17)

- *Do landlords take tax into account when deciding what to spend (and when), or is it only factored in after the event?*
11. If a landlord is working to a pre set expenditure budget for maintaining a number of properties, then tax will be taken into account, both in terms of how much to spend and when this should be. They are more likely to include plans to make the property more energy efficient either to enhance the property's rental or resale potential if they are treating the let as a proper business rather than if it is a one-off or temporary arrangement. Any extra incentive will increase the rate of return on the investment.
  12. If expenditure is driven by necessity, such as a broken window, the landlord is more likely to choose the cheapest and quickest option without regard to the tax consequences.
    - *Would a fiscal incentive for energy efficiency change landlords' attitudes towards investing in energy efficiency?*
  13. This would probably depend on the size of the incentive. Recent research commissioned by the ICAEW into the attitude of smaller businesses towards the research and development tax credit, showed:

*Substantial capital allowances, however, do seem to generate increased investment. For example, the 100% first year allowance for computers offered in the past and incentives for energy-saving investments.*

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[The Role of Tax Incentives in Capital Investment and Research and Development Expenditure Decisions by Small and Medium Enterprises, Mohsen Derregia and Francis Chittenden 2006]

14. It is perhaps worth noting the considerable marketing by the computer industry of the availability of reliefs for expenditure on computer equipment that has accompanied recent changes to the tax treatment of IT equipment in recent years.

## **Whole house or targeted measures**

*Incentives could be offered that are targeted at specific areas of improvement in energy efficiency (eg LESA). Alternatively, a more 'whole house' approach could be taken whereby an annual tax relief allowance would reward landlords of properties that meet a certain level of energy efficiency (para 18).*

15. We support the whole house approach on the grounds of simplicity. Although more focused incentives are better targeted, they are inevitably more complex and more difficult to administer. In particular, record keeping requirements would be more onerous.

## **Incentive mechanism**

*A possible way to incentivise landlords would be to adjust the W&TA so that landlords would be eligible for a greater level of additional allowance if their property met a certain level of energy efficiency. The Government would be interested to hear stakeholders' views on the use of the W&TA as a vehicle for incentives (para 21)*

- *Would adjusting the current W&TA to include an incentive encourage landlords to invest in energy efficiency?*
- *If so, what level of incentive would need to be offered to make a landlord act upon this thought?*
- *Would it be appropriate to extend the scope of an allowance based on energy saving to cover unfurnished as well as furnished properties?*
- *What other routes, be it existing or new measures do landlords feel the Government should consider as a vehicle for incentivising landlords to invest in energy efficiency of their property? How do landlords envisage this working in practice?*

16. The wear and tear allowance was introduced as a means of simplifying tax relief for the cost of renewing furnishings and fittings etc in residential furnished lettings. This simplification benefits taxpayers, their representatives and HMRC officers and is a model which should be extended rather than complicated by having additional constraints attached.
17. We do not think that adjusting the current W&TA will encourage landlords to invest in energy efficiency any more than the existing allowance encourages them to replace the beds more frequently. Expenditure in a business is driven by necessity, not tax relief. It may alter the nature and timing of the purchase, but will not be the main driver.

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18. Nevertheless, as a system, the W&TA works well. We would therefore recommend that it could be used as a model for a new 'Energy Saving Allowance' (ESA). This would be quite separate from the W&TA and so could easily be extended to apply to unfurnished lettings and to corporate bodies, but calculated on the same basis.
19. Labelling the new ESA as such, would also make it easier to market and would link it to its purpose in the public's mind.
20. Introducing a separate ESA would also allow those taxpayers using the Renewals basis to continue to claim for the exact level of expenditure they incur using that method and there would be no need for transitional provisions.
21. A range of ESA percentages of say between 5% and 10% based on the Energy Performance Certificate (EPC) rating could be awarded. There would be an incentive for landlords to achieve a higher rating because their rate of ESA would increase.
22. We have not yet seen any suggestion of how tax relief may be given for the cost of obtaining the EPC. In the most straightforward case it may be that a landlord applies for the certificate at the same time as he first offers the property for let. Some letting agencies may offer the certificate as part of their letting service. In either case, the cost would be wholly and exclusively for the purposes of letting and so presumably tax deductible. Where the certificate was obtained for a property partly owner occupied, the expense would not be wholly and exclusively incurred and a special provision will need to be made to remedy this.

## W&TA or use the Renewals (para 22)

- ***What are the reasons that determine whether landlords claim the W&TA or use the Renewals methods? (para 22)***
23. The main reason for using the wear and tear allowance is simplicity. From informal research amongst our members, we believe that around 95% of represented taxpayers use this option. However, this will depend on the type of letting, perhaps as a professional let or as student lets.
    - ***Do landlords know if they lose out or benefit financially on the exact cost of replacement furniture and fittings because they claim the 10% W&TA, and to what extent?***
  24. Although an accountant will assess the cost/benefit arising from the choice of method initially, the main reason for using the wear and tear allowance is simplicity. There is no free choice as to method on a year by year basis. Once the method is adopted, it must be used consistently.
    - ***Could adding a conditional element to the W&TA encourage landlords to change to the Renewals method of claiming for expenditure incurred? At what point would making the allowance dependent on energy efficiency cause landlords to switch to using Renewals?***

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25. The main reason for using the wear and tear allowance is simplicity. We would strongly recommend leaving the existing W&T allowance unchanged; it works, is simple and cheap to administer and is readily understood.
26. Any change to the existing W&TA rules will inevitably lead to transitional rules, with all the associated complexities these bring.
27. Indeed it is difficult to see how landlords' behaviour would be influenced in the short term since they cannot switch methods for any one let once they have chosen one or the other. If the new W&TA became more complicated or conditional, the likelihood is that for new lets, landlords would choose Renewals regardless of the financial implications if it looked like being simpler and more easily understood than WT&A.
- ***How do landlords rank the priorities of financial gain and administrative simplicity when choosing between using the W&TA and the Renewals method?***
28. See paragraph 23 above.

## **Energy Performance Certificates**

*The introduction of Energy Performance Certificates (EPC) is planned. These certificates will be a requirement for all landlords entering into new leases of their property, and will need to be presented to potential tenants. Each certificate will set out the energy efficiency level of a property, and what this means for fuel bills. EPCs will provide more information to landlords and tenants on the issue of energy efficiency, and the Government is interested to hear how this might influence the behaviour of landlords. (para 25)*

- ***Would a fiscal incentive be an effective complement to EPCs and encourage a positive reaction to the certificates?***
29. See paragraphs 17 to 21 above, noting in particular the problem of tax relief for the costs of obtaining EPC certificates.

## **Operational issues**

*The ease of use of a measure can shape the level of incentive effect it would have. It is important to make sure that a measure is accessible, straightforward to use and easy to administer. The Government is interested in the views of landlords, agents and tax practitioners as to the key issues that would need to be covered to ensure that a new measure would be effective. (para 26)*

- ***How long would be needed to ensure a smooth introduction of a scheme, in order to prepare landlords and to maximise its impact?***
30. Tax relief is given by reference to expenditure incurred in a tax year. In order to achieve this, it will be important to plan for a publicity campaign during the year

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ahead of the new scheme taking effect. EPC ratings will also need to be determined before the scheme could be introduced. The earliest that it could be implemented is April 2007, and April 2008 is probably more realistic.

- **How should a scheme be handled on the Self-Assessment form?**

31. An additional box will be needed on the Land and Property pages of the Tax Return, with suitable guidance being included in the notes.
32. A separate box will also be needed on the trusts and the partnerships tax returns, with suitable guidance being included in the notes.
33. A separate box will also be needed on the corporation tax return. Although we do not have statistical information about the number of companies which let residential property, there seems no reason why the new ESA should not also be available to companies.
  - *What extra guidance would be needed for landlords on any additional allowance?*
  - *What publicity would be appropriate to ensure maximum take up by landlords?*
34. We would urge the Government to make more use of the qualified accountancy profession. Many landlords are advised by Chartered Accountants for their tax and business affairs. Suitable publicity material should be disseminated through the professional bodies to their members, who would in turn advise their clients. This would achieve an efficient and timely information flow. Accountants like to give their clients good news and the new ESA which we have suggested would be welcomed. One of the most common questions will be 'How do I get the allowance and what do I have to do?'

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## WHO WE ARE

1. The Institute is the largest accountancy body in Europe, with more than 123,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.
2. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry (DTI) through the Accountancy Foundation. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy (which includes taxation).
3. The Tax Faculty is the focus for tax within the Institute. It is responsible for technical tax submissions on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter 'TAXline' to more than 11,000 members of the Institute who pay an additional subscription, and a free weekly newswire.

## THE TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. **Statutory:** tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. **Certain:** in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. **Simple:** the tax rules should aim to be simple, understandable and clear in their objectives.
4. **Easy to collect and to calculate:** a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. **Properly targeted:** when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. **Constant:** Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. **Subject to proper consultation:** other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. **Regularly reviewed:** the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. **Fair and reasonable:** the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. **Competitive:** tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99; see [http://www.icaew.co.uk/taxfac/index.cfm?AUB=TB2I\\_43160,MNXI\\_43160](http://www.icaew.co.uk/taxfac/index.cfm?AUB=TB2I_43160,MNXI_43160)