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RELIEF FROM THE 40% TRUST RATE FOR SERVICE CHARGES AND SINKING FUNDS IN THE PRIVATE SECTOR

PURPOSE AND INTENDED EFFECT

Policy Objective

6.1 The proposal will provide relief from the 40% rate of taxation applicable to income from the investment of service charges and sinking funds held on trust, in the private sector. Because such funds are commonly held on bank deposit, they will instead be subject to income tax at the lower rate of 20%. Because most forms of investment income are taxed at source, no further tax will be payable.

6.2 Finance Act 2006 provided relief from the 40% trust rate of tax to income arising from the investment of service charges and sinking funds held on trust in the social housing sector. Extending this relief to the private sector will place it on the same footing as the social housing sector. This measure will be deregulatory on private landlords. Landlords of properties with service charges and sinking funds held on trust will no longer be required to complete and submit an annual tax return for this income, and HMRC will not have to process them.

6.3 Collecting service charges from tenants to cover the day-to-day repairs and maintenance costs of the property and holding them on trusts is only a statutory requirement for landlords in England and Wales. However, the proposal to extend the tax relief would also apply to the income from service charges and sinking funds held by landlords in Scotland and Northern Ireland who are voluntarily operating trusts in the same way.

Background

6.4 Service charges are collected from tenants of leasehold property. They cover the day-to-day repairs and maintenance costs of the property. In order to provide funds for long-term dilapidations and repairs, a portion of the charges is saved up – this portion is called a “sinking fund”. Service charges and sinking funds in the private sector are required to be held in trust funds for the tenants (Section 42 of the Landlord and Tenant Act 1987) which ring fences them from the landlord and ensures that the tenants are entitled to any surplus in the funds over the cost of repairs etc. The purpose of this requirement is to ring fence these funds from the landlord’s own monies, so that residents’ contributions are protected in the event of landlord insolvency. Sinking funds are normally invested in interest bearing bank accounts or other similar investments. They are chargeable to tax at the special trust rates.

6.5 In Finance Act 2006, an exemption from the full rate of 40% was provided for the first £1,000 of trust income. The exemption was intended to benefit small trusts including those holding service charge and sinking funds. The first £1,000 is taxed at the basic (20%) or lower (10%) rate of tax instead of 40%. More significantly in relation to the present proposal, Finance Act 2006 legislated for an exemption from the 40% rate, for service charges and sinking funds held in the social housing sector.

Rationale For Government Intervention

6.6 In short, this measure is deregulatory and supportive of the Government's wider housing agenda for increasing the supply of affordable and sustainable housing.

6.7 It is considered good management practice for the management companies of leasehold blocks to maintain sinking funds. Sinking funds are a provision against future liabilities. The Government supports sinking funds as they help to ensure that sufficient funds are available for the upkeep and repair of properties containing residential units and help even out annual service costs. The use of sinking funds prevents properties falling into disrepair, potentially leading to a decline in local communities and neighbourhoods.

6.8 Many private sector leaseholders have similar affordability issues to social sector leaseholders. Finance Act 2006 provided relief from 40% trust rate of tax to income arising from the investment of service charges in the social housing sector. Extending this relief to the private sector will place it on the same footing as the social housing sector; especially given that sinking funds are a statutory requirement on the private but not on the social housing sector.

6.9 All residential properties will, over time, require repairs and maintenance. Many homeowners will budget to fund such work and will put savings on deposit. (The income from these savings could be tax-efficient if they were to be held in an ISA). However, leaseholders, through their leases are generally required to "save" and are required to hold the savings for maintenance purposes in trust which is taxed at the higher 40% rate. Therefore, even though the majority of these homeowners would only be liable at the 20% savings rate of tax on any other savings they might have, they are taxed at the higher rate for their 'maintenance savings'. Leaseholders with a private sector landlord will therefore enjoy the same benefit as ordinary homebuyers from this measure.

6.10 A variety of rights for leaseholders and obligations for landlords have been introduced by Government. In doing so, it has been policy to ensure that, unless there was a practical reason why it was not possible, the rights and obligations prescribed applied equally to leaseholders and landlords irrespective of whether the landlord was from the social or private sector. Extending tax relief to the private sector landlords would be consistent with this approach.

6.11 The intention in specifying that service charges and sinking funds were to be held on trust was to protect residents' investment in their homes, providing an incentive to save in order to meet future costs. However, a disproportionate tax burden has been created that is detrimental to housing affordability. Sinking funds can only be spent on a given purpose, yet are more heavily taxed than savings which are freely available to their investors.

6.12 Government supports sinking funds as they provide increased returns on the savings within them, and by doing so help to reduce the long-term need for grants to cover renovations and increases in service charges to cover any shortfall. There is also an indirect connection with housing benefit costs. Some of those who rent in the private sector are in receipt of housing benefit. The cost of housing benefit (which will cover costs such as service charges) would be lower in the long term as service charges need to be lower to reflect less tax being paid.

6.13 HMRC is also committed to reducing tax related administrative burdens on business. This measure is consistent with that objective. It is also consistent with the Treasury objective of promoting a fair, efficient and integrated tax and benefit system with incentives to work, save and invest.

CONSULTATION

6.14 We have carried out an informal consultation on the draft legislation within Government (Department for Communities and Local Government (DCLG); Scotland Office; Scottish Executive; Northern Ireland Office; and Northern Ireland Executive). Overall, there was contentment with the legislation as drafted especially in its applicability to Scotland and Northern Ireland where service charges are not a statutory requirement.

6.15 Housing sector bodies (Association of Residential Managing Agents (ARMA) and the Association of Retirement Housing Managers (ARHM)) have provided valuable information and data to enable the Treasury and HMRC to assess the costs and benefits of this measure.

Options

6.16 The following options have been considered.

Option 1: Do nothing

6.17 Would save the Exchequer the tax cost and would keep the tax rules simple. But would mean that private sector landlords would continue to face a regulatory burden through tax compliance (as would HMRC) as well as continue to incur a higher tax cost than their counterparts in the social housing sector. Overall, this option provides no benefits to business (i.e. private sector landlords).

Option 2: Exemption from higher trust rates of tax

6.18 All income from service charges and sinking funds held by private sector landlords is taxed at basic (20%) or lower (10%) rates of income tax. Private sector landlords will face lower tax and administrative costs under this option.

COSTS AND BENEFITS

Benefits

Option 1: Do nothing

- No Exchequer costs (loss in tax revenue) - an estimated £1 million to £1.5 million per year.
- Keeps tax rules simple by avoiding a special rule.
- HMRC will not be required to publicise any changes as part of their Budget change publicity, and guidance for Trusts and Settlements pages of the self-assessment tax return will not be required to be updated in time for the 2008 return issue.

Option 2: Exemption from higher trust rates of tax

- Financial benefits to private sector landlords from paying less tax – an estimated £1 million to £1.5 million per year.
- As long as the fund receives only taxed income such as UK bank interest, it would have no further tax obligations. Landlords will no longer be required to submit an annual tax return and HMRC will not have to process them. Estimated annual administrative savings to private sector landlords of between £580,000 and £725,000 per year.
- More sinking funds will be available to prevent properties falling into disrepair, and avoid leading to a decline in local communities and neighbourhoods.
- Some of those who rent in the private sector are in receipt of housing benefit. The cost of housing benefit (which will cover costs such as service charges) would be lower to reflect no tax being paid.
- All residential properties will over time require repairs and maintenance. Many homeowners will budget to fund such work and will put savings on deposit attracting at most the basic rate of tax (The income from these savings could be tax-efficient if they were to be held in an ISA). Leaseholders with a private sector landlord would enjoy the same benefit as ordinary homebuyers.
- Extending the relief will place private sector leaseholders on the same footing as those in the social housing sector especially taking into context that sinking funds is a statutory requirement on the private but not on the social housing sector.

Costs

Option 1: Do nothing

- Private sector landlords will continue to pay tax at 40% on income from services charges and sinking funds in excess of £1,000 – an estimated £1 million to £1.5 million per year
- Private sector landlords will continue to incur administrative and regulatory cost of completing and submitting an annual tax return to HMRC – estimated annual administrative cost to private sector landlords of between £580,000 and £725,000 per year.
- HMRC will also continue to incur costs in processing these tax returns.
- Tenants and landlords may be deterred from making adequate provision for the future major repairs through sinking funds by the 40% tax rate.
- Fewer sinking funds will be available to prevent properties falling into disrepair, potentially leading to a decline in local communities and neighbourhoods.
- Sinking funds can only be spent on a given purpose, yet are more heavily taxed than other forms of savings which are freely available to their investors

for a host of purposes which could include refurbishment and acquiring capital assets.

- Private sector leaseholders will be at a disadvantage compared to those in the social housing sector who enjoy relief from the 40% rate of tax; especially when viewed within the context of the statutory requirement placed on private sector landlords to hold service charges and sinking funds on trust.
- All residential properties will over time require repairs and maintenance. Many homeowners will budget to fund such work and will put savings on deposit which would attract at most the basic rate of tax. (The income from these savings could be tax-efficient if they were to be held in an ISA). Leaseholders with a private sector landlord will continue to be at a disadvantage compared to the benefit ordinary homebuyers currently enjoy.
- Some of those who rent in the private sector are in receipt of housing benefit. The cost of housing benefit (which will cover costs such as service charges) would continue to be higher than otherwise as service charges need to be higher to reflect tax being paid at 40%.

Option 2: Exemption from higher trust rates of tax

6.19 Exchequer costs (loss in tax revenue) - estimated £1 million to £1.5 million per year.

6.20 HMRC will be required to inform landlords and their own staff about the change, but implementation will not have significant impact on HMRC.

Sectors Affected

6.21 The sector affected by the measure would be those who are managing private sector housing on behalf of tenants. This could be an individual member of the public, or a company managing leasehold flats. In terms of the market as a whole it is estimated that there are some 1.5 million leasehold flats, of which some 900,000 are professionally managed. There is no information on the ownership of the freeholds, however, there is information on who has control of the management. Figures from ARMA¹ members indicate over 65% of blocks they manage are lessee controlled. Given members manage over 80% of the 900,000 it would be reasonably safe to say the figure is greater than 65% once self-managed properties are taken into account.

6.22 It is estimated that 4,000 to 5,000 trusts and 225,000 leaseholders might benefit from this measure. Private sector landlords will no longer be required to complete and submit an annual tax return to HMRC.

SMALL FIRMS IMPACTS TEST

6.23 The majority of private sector landlords of leasehold properties affected by this measure would be considered small businesses (although there are some landlords with larger portfolios of leasehold property). This measure will have a positive financial impact on all private sector landlords with leasehold properties irrespective of size.

¹ Association of Residential Managing Agents

They will pay less tax, and incur less administrative costs from not having to complete and submit an annual tax return to HMRC.

COMPETITION ASSESSMENT

6.24 Finance Act 2006 provided relief from the 40% trust rate of tax to income arising from the investment of service charges in the social housing sector. Extending this relief to the private sector would place it on the same footing as the social housing sector. There is no competition impact within the private housing sector.

ENFORCEMENT, SANCTIONS AND MONITORING

6.25 The tax relief is within the self-assessment system and we expect it to be self-policing. It is a tax relief and levels of compliance are likely to be high. No new sanctions are required.

IMPLEMENTATION AND DELIVERY PLAN

6.26 The new tax rules will take force for income arising in the relevant service charges and sinking funds from 6 April 2007. They will need to be taken into account in making tax returns after the end of the 2007-08 tax year by the deadline of 31 January 2009.

POST IMPLEMENTATION REVIEW

6.27 DCLG will monitor the development of sinking funds and evaluate the success of the policy in 2009.

SUMMARY AND RECOMMENDATION

6.28 11.1 We recommend option 2 – providing a relief from the 40% trust rate of tax to income arising from the investment of service charges in the private sector.

6.29 11.2 Sinking funds support sustainable communities, create an equitable system, and address disparity in tax treatment between social and private sector leaseholders. It is estimated that 4,000 to 5,000 trusts and 225,000 leaseholders might benefit. Private sector landlords will no longer be required to complete and submit an annual tax return and therefore, HMRC will not be required to process them. In short, the measure is deregulatory and supportive of the Government's wider housing agenda of increasing the supply of affordable and sustainable housing.

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REGULATORY IMPACT ASSESSMENT

Relief From The 40% Trust Rate For Service Charges And Sinking Funds In The Private Sector

Statement of Ministerial Approval

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:

Dawn Primarolo MP
Paymaster General

Dated: 22 February 2007