

# 14

## REGULATORY IMPACT ASSESSMENT FOR RELIEF FROM THE 40% TRUST RATE

### RELIEF FROM THE 40% TRUST RATE OF TAXATION FOR SERVICE CHARGE AND SINKING FUNDS IN THE SOCIAL HOUSING SECTOR

#### Purpose and Intended Effect of Measure

##### *The Policy Objective*

**14.1** The proposal will provide relief from the 40% rate of taxation applicable to trusts service charge and sinking funds in the social housing sector. They will instead be subject to income tax at the basic or lower rate. Because most forms of investment income are taxed in this way at source no further tax will be payable.

**14.2** The measure will de-regulate Registered Social Landlords (RSLs) and others in the social housing sector and will reduce the administrative burden on HMRC.

##### *Background*

**14.3** 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 charge and sinking funds in the private sector are required to be held in trust funds for the tenants (section 42 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. Section 42 does not apply in the social housing sector, but RSLs have on advice been holding service charge and sinking funds in trust to benefit the tenants of their properties.

**14.4** The measure proposed here is mainly of relevance to sinking funds as service charges are normally spent during the year.

**14.5** Sinking funds are normally invested in interest bearing bank accounts or other similar investments. Following changes to trust taxation in 2004 the rate of income tax applicable to trusts was increased to 40%, and the dividend trust rate to 32.5%. The intention was to deter the use of trusts for tax avoidance purposes, but a consequence was that sinking funds attracted the special trust rates even though they are not used for tax avoidance.

**14.6** In Finance Act 2005 an exemption from the full rate of 40% was provided for the first £500 of trust income. The exemption was intended to benefit small trusts including service charge and sinking funds. The first £500 is taxed at the basic or lower rate of tax instead of 40%. Another exemption was also introduced for trusts for the vulnerable. In those cases the income is taxed taking into account personal allowances and rates bands for the beneficiary instead of at the special trust rates.

**14.7** In the social housing sector, RSLs have been collecting money on behalf of tenants to pay for sinking funds. There is no statutory requirement that this money is held on trust but it is wise for the RSL to do so. Interest and other income arising on these trusts is taxable at 40% unless the income is less than £500. We have discovered that many of the funds in the social housing sector are very large and therefore derive little benefit from the £500 standard rate band.

**14.8** There is also some doubt that RSLs are aware of their tax obligations as trustees, exposing themselves to the risk of HMRC action to recover undeclared tax. We have been told that some RSLs may have been advised that their sinking funds are not trusts, but the view of HMRC is that this is not the case.

**14.9** It could also increase the long term need for grants to cover renovations by reducing the returns on sinking fund savings, unless service charges increase to cover any shortfall.

**14.10** There is also an indirect connection with housing benefit costs. Many of those in social housing are in receipt of housing benefit, and the cost of the housing benefit (which will cover costs such as service charges) would be greater in the long term if service charges need to be higher to compensate for additional taxation.

### ***Rationale for Government Intervention***

**14.11** The Office of the Deputy Prime Minister (ODPM) is the Government Department with primary responsibility for social housing. The Housing Corporation, an agency of ODPM, regulates and funds RSLs, the main providers of new social housing. They are concerned that the imposition of the 40% rate on RSL sinking funds is a regulatory burden and that it could be seen as unfair to tax social housing tenants at the same rate as wealthy tax avoiders. ODPM/Housing Corporation encourage sinking funds to ensure that sufficient funds are available for the major repair or properties and to help low cost home ownership purchasers sustain home ownership.

**14.12** Current tax yield from sinking funds in the RSL sector might be just under £5m (HMRC data does not allow a precise estimate) and this measure will forego about half of that costing about £2.4m a year in lost tax income.

**14.13** This measure has no EU implications.

## **Consultation**

### ***Within Government***

**14.14** Consultation within Government was across HM Treasury, HMRC, and ODPM.

### ***Public Consultation***

**14.15** Consultation has been conducted by approaching the Housing Corporation, The National Housing Federation, The Association of London Government, the Local Government Association, and the executives of the other nations. These are all bodies with an interest in social housing.

**14.16** Consultees either did not respond or welcomed the proposal.

## **Options**

**14.17** We have considered a range of options.

### ***1. Do Nothing***

**14.18** This option would save the tax cost but would mean that RSLs continue to face a regulatory burden through tax compliance. It would also keep the tax rules simple by avoiding a special rule. However, residents and social landlords may be deterred from

making adequate provision for the future major repairs through sinking funds by the 40% tax rate.

**14.19** This option requires no delivery planning.

## **2. Complete Exemption**

**14.20** This option would provide that RSL and local authority sinking funds are completely free of tax and could recover tax suffered through deduction at source. This has been requested by the Housing Corporation and ODPM. It would maximise the benefits to RSLs by minimising the exposure of the sinking funds to tax. But it would mean that these trusts have to submit claims to tax repayments as most types of investment income are taxed at source. It would therefore not be deregulatory for RSLs or HMRC.

**14.21** Checking claims for refunds would place an administrative burden on HMRC. It would cost also about double the estimate for option 4. Exemption would look inconsistent with rules on trusts for the vulnerable and other types of trust, which might also be considered to be not for tax avoidance. It would also raise many “me too” requests, for example from tenants in the private sector.

**14.22** This option would require RSLs to be informed how to claim refunds of tax, and HMRC to train its staff to process them. It would also require additional operational staff in HMRC.

## **3. Extension of the £500 threshold for RSLs**

**14.23** A £500 threshold for all trusts was introduced in 2005. This provides that the first £500 of income is taxed at basic or lower rate and that the 40% rate only applies to income in excess of £500. An extension of the threshold for the sector was rejected as some RSL sinking funds have considerable income and evidence suggests that wherever the line was drawn some would be over it. This option therefore has little to offer in advantages except that it had a reduced tax cost to other options.

**14.24** This option would involve RSLs being informed about how the provisions work and also HMRC would examine returns to ensure the conditions are met and the threshold not breached. It will require more policing than option 4.

## **4. Providing basic or lower rate taxation for all income of RSL service charge and sinking funds**

**14.25** This would go further than option 3 by providing that all of the income of RSL sinking funds is taxed at basic or lower rate. This option has the best regulatory outcome as it would mean that as long as the fund only receives taxed income such as UK bank interest it will have no further tax obligations. It will also mean that HMRC will not have to process returns.

**14.26** This option requires HMRC to inform RSLs and their own staff about the change, but implementation will not have significant impact on HMRC (and will be simpler than options 2 and 3).

**14.27** This option is the preferred option. The Government propose that where an RSL holds funds on trust for the maintenance etc. of a property, the income from the fund is exempt from the charge to tax at the special trust rates under section 686 ICTA 1988, but

instead charged at the appropriate income tax rate depending on the nature of the income.

**14.28** For this purpose RSLs will be defined by reference to the definition in the Housing Act 1996. 'Service charge' and 'sinking funds' will be defined by reference to the definitions in LTA 1987.

## **Costs and Benefits**

### ***Sectors Affected***

**14.29** The business sector affected by the measure would be those who are managing social housing on behalf of tenants. This sector is mainly local authority or charitable.

**14.30** The proposal has no race, NI or equality impacts.

## **Benefits**

### ***Benefits to the Exchequer and Administrative Burdens***

**14.31** The measure clarifies the tax treatment of sinking funds in the social housing sector for those in doubt.

**14.32** There is scope for reduction of demand on public finances either through grants or increased housing benefit to top up service charge and sinking funds. This cannot be quantified.

**14.33** It will reduce the administrative costs of HMRC and will marginally reduce the risk that public grant will be needed to help pay for repairs to social housing in the future.

**14.34** The proposal will reduce the bureaucracy and administrative costs of RSLs by removing the obligation to make annual tax returns (unless the RSL is in receipt of untaxed income).

### ***Environmental and Social Benefits***

**14.35** None. But there is a small indirect benefit in making it easier for social housing to be maintained to a high standard through increasing the returns of sinking funds.

## **Costs**

### ***Costs to the Exchequer***

**14.36** The proposal will cost less than £2.5m. While this is based on scaling up a small sample the assumptions used to do that were chosen cautiously.

**14.37** The proposal could increase calls for other types of trust to be taxed in a special way.

### ***Other Costs***

**14.38** The proposal has no additional environmental, social or economic costs.

## Small Firms Impacts Test

**14.39** For the purposes of this RIA we assume that the charitable RSL sector will qualify as small businesses.

**14.40** We have not approached any RSLs directly about the proposal although we have spoken to ODPM and the Housing Corporation. The measure is intended to reduce taxation and remove a burden, as requested by the Housing Corporation and ODPM. It will benefit both small and large RSLs; the benefit to smaller RSLs may be disproportionately more valuable.

## Competition Assessment

**14.41** The tax aspects of this proposal will benefit individuals and not businesses.

**14.42** It will only affect businesses to the extent that the tax and administration costs of the current regime get passed from RSLs onto tenants and leaseholders

**14.43** The regulatory aspects will benefit the grant funded RSL sector. Arguably this will marginally improve the regulatory burden on that sector compared with private landlords, but on the evidence we have these markets are distinct and have little overlap. In the private sector where such service charge and sinking fund trusts exist they are normally managed by tenants and not landlords (depending on the terms of the lease).

## Enforcement, Sanctions and Monitoring

**14.44** For all options the measure is a tax relief 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.

**14.45** No new sanctions are required.

**14.46** No additional costs are imposed except for Option 2 above where full refunds would have to be claimed.

## Implementation and Delivery Plan

**14.47** The new tax rules will take force for income arising in the relevant sinking funds from 6 April 2006. They will need to be taken into account in making tax returns after the end of the 2006/7 tax year by the deadline of 31 January 2008.

**14.48** HMRC will publicise the change as part of their Budget change publicity, and issue instructions to staff within 3 months of the Budget announcement.

**14.49** HMRC's Trusts, Settlements and Estates manual will be updated by 5 April 2007. The guidance for the Trusts and Settlements pages of the Self-Assessment tax return will be updated in time for the 2007 return issue. Changes to the return itself will not be needed. Internal guidance will be made public.

**14.50** Trust tax returns It will remove the obligation on social housing sinking funds to notify chargeability to HMRC. ODPM will monitor the development of sinking funds in England and evaluate the success policy measure in 3 years time.

**14.51** ODPM will publicise the change through the housing corporation.

## Post-implementation Review

**14.52** ODPM will monitor the development of sinking funds in England and evaluate the success of the policy in 3 years time.

## Contact Point

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## REGULATORY IMPACT ASSESSMENT

### Relief from the 40% Trust Rate for Service Charge and Sinking Funds in the Social Housing 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  
Paymaster General

Dated: 7 March 2006