TAXATION OF PRIVATE LANDLORDS

The Tax Position of the Small Private Landlord

- The private rented sector is possibly the only sector of the economy where the tax and regulatory systems work to prevent the growth of small and medium-sized enterprises into larger businesses.

- This is the consequence of several discriminatory anomalies which exist within the tax system in the way that private landlords are treated compared with other businesses.

- *The Anomaly of Trading Status*

    - Property letting is one of the few business activities which is not treated as a trade for tax purposes.

    - Income from property is taxed under Schedule A as investment income, regardless of whether the income is generated from pure investment or from a property ownership and management business. Tax is now charged under Schedule A on annual profits arising from a business carried on for the exploitation, as a source of rents or other receipts, of any estate, interest or rights over land in the UK (Finance Act 1998 Schedule 1). The profits of a Schedule A business are computed in the same way as a trade (Finance Act 1998 Schedule 4).

    - However, a Schedule A business is not a trade. It simply adopts Schedule D Case I rules on the computation of profits. Section 74 of the Income and Corporation Tax Act 1988 states 'in computing the amount of profit or gain to be charged under Schedule D Case I, no sum shall be deducted in respect of any disbursement or expense not being wholly or exclusively laid out or expended for the purposes of a trade, profession or vocation'.

    - The Inland Revenue explained this by saying that '*property letting is seen primarily in the nature of the investment. That is, the return to property owners derives essentially from the property itself rather than from services provided*'. From this flows the conclusion that property letting is primarily an investment rather than an entrepreneurial activity.

    - Property does not produce a return simply by existing; it must be managed and worked to produce an income stream. How can those who themselves market and manage the properties which they own can be said to deriving the return solely from the investment?

- *The Anomaly of Relief on Management Costs*

    - Because this form of business is not regarded as a trade, a landlord managing his own property is not able to claim the costs of managing his property and lettings business against tax. However, he would be able to claim these costs if he were using the services of a managing agent.

- *The Anomaly of Capital Gains Tax Rollover Relief*

    - Unlike other businesses, because they are not regarded as a trade, lettings businesses are unable to claim rollover relief from capital gains tax when they sell a capital asset with the intention of reinvesting the funds realised in their business. Under section 152 of the Taxation of Chargeable Gains Act 1992, rollover relief applies for 'consideration which a person carrying on a trade obtains for the disposal …of his assets used, and only used…for the purposes of a trade… and is applied by him in acquiring other assets, which, on acquisition are taken into use and used only for the purposes of a trade….'.

    - This severely limits the flexibility, mobility and above all the efficiency of investment, particularly amongst the smaller investors, since the decision to sell to reinvest carries with it the same tax penalty as the decision to sell to take the profit. Landlords continue to hold property which does not perform as well as alternative property investments because the impact of capital gains tax renders selling and investing elsewhere a less attractive or even unviable option.

    - It also limits the potential for growth (see Appendix 1 for worked example)

- *The Anomaly of Earned Income*

    - Full-time landlords, whose sole activity is managing their property and their lettings business, and who have no other source of income, cannot contribute to personal pension schemes, because the tax relief on contributions is only permitted on "earned income", and excludes "investment income" (sections 639(1) and 644 of the Income and Corporation Taxes Act 1988).

    - It may be argued that the property holdings offer a more than adequate substitute for a pension fund. However, this implies that the owner will sell the portfolio on retiring, thereby preventing the business passing from one generation to the next. Even if the portfolio is sold, the landlord will still face a substantial capital gains tax liability on the proceeds.

    - Although a landlord is not able to qualify for a private pension scheme, he is required to pay National Insurance contributions.

- *The SIPPS Anomaly*

    - Some landlords have generated Schedule D income (usually through trading properties), and have used this to contribute to Self-Investment Personal Pension Schemes.

    - The SIPPS rules allow investment in commercial property, and allow it to be let, but expressly forbid direct investment in residential property or land connected with such an investment, except where commercial property includes a residential element which is either occupied by an employee as part of the job or is an integral part of the business premises and is occupied by a person who had no family connection with the owner.

- The result has been that professional residential landlords have bought commercial properties, often shops with flats above them, and have been compelled to leave the flats vacant, despite their having a residential lettings business, because of the potentially adverse impact on the pension arrangements. (This restriction is equally frustrating for small pension fund investors who are looking principally to invest in the commercial property, and are frustrated from making the most effective use of their funds because the flat above a prospective investment is tenanted).

- *The Anomaly of VAT*

    - Residential rented property is an exempt supply for VAT purposes, and so any payments of VAT made to suppliers of goods or services, for example, building contractors or managing agents, are irrecoverable. This increases the cost to a landlord and, when combined with the tight margins under which many smaller landlords operate, can act as a disincentive to repair.

    - The additional cost of VAT on management expenses may discourage those landlords who lack the skills, the time or the inclination to manage their lettings from engaging an agent.

    - On the other hand, some very small landlords are able to make use of the partial exemption rule and the de minimis limit. It is also possible to recover VAT where service charges are charged separately from rents.

Stamp Duty

- Since the present Government came to power in 1997, stamp duty on property transactions has quadrupled from 1% to 4%.

- When the rate of stamp duty was set at 1%, investors were prepared to accept the tax as part of the incidental costs of a transaction. However, the greater cost of the tax liability once the threshold is crossed is now having an effect on investment decisions. The rate of return required by the institutions takes no account of the tax leakage. By reducing the level of funds available for actual investment, the increases in stamp duty have made it more difficult to achieve the required level of return.

- The purchase of multiple properties as a portfolio, the individual components of which might all be priced below the stamp duty threshold, is treated as a single transaction, which exceeds it. Thus if 10 flats, each valued at £50,000, are sold individually, the stamp duty payable is nil. If the same 10 flats are bought together, for the same price, the Treasury now receives a windfall gain of £20,000.

- The new stamp duty reliefs which were introduced for registered social landlords in the 2000 Budget means that it now appears that stamp duty acts directly as a tax on investment in the private residential rented sector.

Incentives to Invest

- Speaking to the Social Market Foundation on 2 August 2001, the Secretary of State, Stephen Byers MP repeated the Government's willingness to continue the dialogue with investors on tax issues to encourage investment.

- The BPF believes that tax reform to remove these anomalies would prove more effective in encouraging investment than tax breaks.

- The case for a tax-transparent securitised property investment vehicle remains strong.

- Housing Investment Trusts were introduced in 1995. No one has launched one successfully to date. Few now believe they will ever be used.

- The structure which was put in place did not appeal to investors for several reasons:

    - The rules were too complex;
    - The valuation limits meant that it was difficult to acquire properties of a suitable quality;
    - The restrictions on capital growth were unacceptable;
    - The Stock Exchange insisted on listing them as Investment Trusts, which meant that they would trade at a discount;
    - The loss of relief on Advance Corporation Tax credit meant that there was not sufficient tax transparency to make them an attractive investment opportunity.

- The Government rejected the case for a tax-transparent securitised vehicle for indirect property investment following the 2000 Budget. The Housing Green Paper refers to the Government's willingness to explore other tax-related measures.

Recent Initiatives

- *Capital Allowances on Costs of Conversion of Flats over Shops*

    - The 2001 Budget introduced 100% capital allowances on spending to create flats to rent above shops and commercial premises. The scheme is complex and includes many restrictions on the types of buildings which will qualify.

    - The Government does not wish the allowance to be used to create high value flats, so all applications will be subject to the test of a notional rent limit. The conversion will only qualify for the allowance if, on the date when expenditure is first incurred, it can be reasonably expected that the flat would let for less than a specified figure. These limits are "notional" because the Government recognises that the market may move between the commencement of a scheme and the flats actually being let. It is not clear how this will be policed.

    - The general response from the industry has been that, while any tax concession is to be welcomed, it is unlikely to be used widely or make a significant contribution to increasing the sector.

- *VAT on Housing*

- The 2001 Budget also reduced VAT to 5% for the cost of:

    - Renovating sinvle household dwellings that have been empty for 3 years or more;
    - Changing the number of single household dwellings in a building (eg, converting a house into flats);
    - Converting a non-residential property into a single household dwelling or number of single household dwellings;
    - Converting a single household dwelling or house in multiple occupation into a care home or other qualifying "relevant residential" use (or a care home into a single household dwelling); and
    - Converting a housing in multiple occupation (eg, bedsit accommodation) into a single household dwelling (or vice-versa).

- *Ending of the Extra-Statutory Concession on Improvements*

    - The Inland Revenue ended its extra-statutory concession whereby a notional amount may be deducted from expenditure on improvements (which is regarded as capital expenditure, and therefore non-deductible), to allow for the element of cost on repair and maintenance (which as revenue expenditure is deductible) which is made unnecessary by the improvement from 1 April 2001 onwards.

    - The Revenue is now expected to take a much stricter approach towards interpreting the distinction between improvements and repairs and renewals. This will problems for all landlords. An essential repair can sometimes be so extensive that it could be argued as an improvement. Problems might also arise where the advances in standards or technology mean that maintenance to modern standards appears to be an improvement, for example in replacing timber framed single-glazed windows with UPVC double-glazing.

Is There A Case For Tax Breaks?

- Tax breaks are essentially devices intended to bridge a financial gap in order to render an uneconomic activity commercially viable. But would such devices be sustainable in the long run?

- *We do not want artificial tax breaks that distort investment choices and do not tackle the problems faced by the sector*

Housing Green Paper 2000

- *Concessions of this sort tend to be transient and, during their brief existence, to stimulate investment which would never have been justified under normal commercial criteria.*

Nick Raynsford, BPF Residential Symposium 1999

- The Government insists that the tax system should be tenure-neutral, so as not to favour one form of occupation over another.

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APPENDIX 1: EXAMPLE OF POTENTIAL FOR CAPITAL GAINS TAX ROLLOVER ALLOWANCE

An investor buys a property to let in 1990 at purchase price	***£500,000***
Gross rental yield of 8% pa	£ 60,000
Income tax payable @ 40%	*£ 24,000*
He holds it for ten years£ then sells because of poor performance	£750,000
Gross profit	£250,000
Indexation allowances @ 25% of original purchase price	- £125,000
Net capital gain	£125,000
Capital Gains Tax payable @ 40%	*£ 50,000*

Assume rollover relief were granted up to a maximum of £100£000 in any one tax year (assuming indexation allowances abolished to reduce net cost to the Exchequer)

Purchase price of investment 1990	£ 500,000
Sale price 2000	£ 750,000
Capital Gain	£ 250,000
Tax liability if taxed @ 40%	*£ 100,000*

Rollover Relief enables landlord to use proceeds from sale to gear up to double his original investment

New investment project completed value	£1,500,000
Gross yield on completion of 12% pa	£ 180,000
Tax payable @ 40%	*£ 72,000*
Net increase in taxable revenue (New gross yield - original gross yield)	£ 120,000
Net increase in tax payable (New liability - original liability)	£ 48,000
Stamp duty on sale of original investment @ 4%	£ 30,000
Stamp duty on purchase of new investment @ 4%	£ 60,000
Total stamp duty payable	*£ 90,000*
Total tax expenditure	*£ 100,000*
Total tax yield (year 1)	*£ 162,000*
Net increase to Exchequer (year 1)	**£ 62,000**
[(Stamp Duty + Income Tax) – reduction in CGT liability]	
Net increase to Exchequer (subsequent years)	**£ 48,000**
[Net increase in income tax]	