NLA Budget Submission
September 2017

Introduction

The National Landlords Association (NLA) is the UK's leading organisation for private-residential landlords. It works with almost 78,000 landlords, of which over 38,000 are paying members, ranging from full-time landlords with large property portfolios to those with just a single letting.

NLA membership helps landlords make a success of their lettings business by providing a wide range of information, advice and services. The NLA campaigns for the legitimate interests of landlords by seeking to influence decision-makers at all levels of government and by making landlords' collective voice heard in the media.

It seeks to raise standards in the private-rented sector while aiming to ensure that landlords are aware of their statutory rights and responsibilities. Based at its head office in central London, the NLA currently employs over 30 full-time staff and has a network of more than 35 regional representatives and branches throughout the UK.

Summary

The NLA's submission is broken down into three sections, each containing a number of practical and cost-effective recommendations.

Our recommendations ahead of the Autumn Budget 2017 are:

(i) Embark on an immediate review of the removal of finance cost relief for private landlords.

(ii) Introduce a package of Capital Gains Tax reduction measures to encourage the sale of:

   a. Poorly performing investment properties.
   b. Properties where the proceeds of the sale will be entirely reinvested into the lettings business.
   c. Properties invested in, and utilised, for a period of more than 10 years.
   d. Properties that are eligible and suitable for sale to existing tenants.

(iii) Introduce measures to facilitate the tax-efficient movement of a letting portfolio into a corporate structure.

(iv) Establish a government-backed investment vehicle to allow the sale of properties into a managed fund.

(v) Reintroduce the Landlords' Energy Saving Allowance (LESA), and establish a level sufficient to improve the tax efficiency of carrying out relevant works.

(vi) Set LESA at a level sufficient to improve the tax efficiency of carrying out works

(vii) Fund the expansion of Help to Rent nationwide

(viii) Establish a national deposit guarantee scheme for the private rented sector

(ix) Remove the Capital Gains Tax surcharge for property sales

(x) Introduce Capital Gains Tax tapering and business asset rollover relief for private residential property which is let.

(xi) Abolish the Stamp Duty Land Tax levy on additional property

(A) Supporting Investment

(a) Taxation of landlords' income (S24)

The Finance Act (2) 2015 removed income tax relief for landlords' finance costs, partially replacing this with a 'tax reduction' in line with the basic rate of tax. This is currently being introduced over an extended period to allow for transition.

The NLA commissioned Capital Economics Ltd to model the outcomes and costs of this policy on landlords, households, and the wider economy.

Using this analysis, we are concerned that the additional cost to an 'average' landlord once the policy of reducing mortgage interest rate relief is fully implemented by 2020, will be £850 per year. That is to say, following withdrawal of tax relief reduction, for a typical £122,000 buy-to-let mortgage with a 3.5 per cent interest rate, a landlord paying income tax at 40 per cent will have to pay an extra £850 in tax.

At a 4.8 per cent gross yield, and assuming some maintenance costs, the landlord would have pre-tax income of £4,370. Post-tax income would be £2,622 a year, falling to £1,768 following the removal of tax relief; a significant reduction of nearly one-third to the landlord's bottom line.

Landlords who are paying tax at the additional rate face an even larger reduction in profit as they will have to pay an effective tax of 25 per cent of their mortgage interest payments. Given an equivalent property and mortgage as above, their net profit would fall from £2,400 to £1,330 per year; a reduction of nearly 40 per cent.

As a consequence, the withdrawal of mortgage interest relief will create a precarious position for those who have highly leveraged portfolios; they will face larger losses as a result of the policy change. Some landlords will have profit margins wide enough to withstand it, whereas the change will push others into the red.

For example, a landlord with a property bought for £200,000, achieving a 4.8 per cent gross yield and with a 3.5 per cent cost of finance will see profits fall by £1,250 per year if leveraged at 90 per cent – making the property barely profitable.

These highly leveraged investors represent an additional risk to the sector within the context of rising interest rates. As interest rates rise, so will the risk that the cost of finance will exceed gross rental income for some landlords.

The withdrawal of interest rate relief will only exacerbate this, with rises in interest rates leading to an increase in costs 20 per cent larger than it would have been, had the relief been left in place.

This will reduce landlords' ability to weather interest rate hikes. For example, a £200,000 property leveraged at 70 per cent and with a gross yield of 4.8 per cent will become loss-making at an interest rate of 5.2 per cent.

Previously, this threshold would not have been reached until interest rates reached around seven per cent.

The impacts of this policy are likely to be wider than landlords' profitability. In December 2016 The Council for Mortgage Lenders published a profile of the private rented sector, in which they asked landlords how they would cope with deterioration in cash flow. The question does not specify the magnitude or the reason for the deterioration, but it nonetheless gives us a useful idea of how landlords may respond to deteriorating returns as interest rate relief is withdrawn.

By far the most common response would be to increase rents for new and existing tenants. A sizeable proportion also suggested they would engage in some sort of deleveraging, either by selling some or all of their properties or reducing their reliance on mortgage debt.

In addition, answers to this survey question highlight that businesses supporting the private rented sector may suffer, with eight per cent of landlords saying they would reduce their reliance on lettings agents and seven per cent saying that they would spend less on property maintenance.

In order to mitigate these impacts, the NLA therefore makes four practical recommendations ahead of the 2017 Budget.

(i) **Embark on an immediate review of the removal of finance cost relief for private landlords.** The transition period, during which time the existing relief will gradually be replaced with the restricted 'tax deduction', provides an opportunity to pause the implementation at 25 per cent to review the impact. This will allow HM Treasury to benefit from increased revenue from the 2017/18 tax year, while reviewing the impact that full implementation is likely to have.

(ii) **Introduce a package of Capital Gains Tax reduction measures to encourage the sale of:**

   a. **Poorly performing investment properties.** Performance criteria could be established, taking into account energy efficiency performance, suitability for letting, void history, etc., in order to reduce the potential for disrepair and empty properties.
   b. **Properties where the proceeds of the sale will be entirely reinvested into the lettings business.** In common with the disposal of capital assets in other forms of business, landlords should be able to 'roll over' gains which are used to fund the business.
   c. **Properties invested in, and utilised, for a period of more than 10 years.** This would differentiate between investors set on 'flipping' property for short-term profit and long-term landlords who invest in properties and communities.
   d. **Properties that are eligible and suitable for sale to existing tenants.** When landlords must sell properties, they should be encouraged to consider selling to their tenants.

(iii) **Introduce measures to facilitate the tax-efficient movement of a letting portfolio into a corporate structure.** Many landlords have grown their letting portfolios gradually, and as such hold numerous assets as private individuals. These landlords and their customers would in many cases be better served by being able to envelop their properties in a commercial vehicle by means of incorporation. At present the cost of incorporating includes significant SDLT charges (including the 3 per cent levy) and liability to Capital Gains Tax on disposal. This should be reduced in order to allow landlords to restructure appropriately.

(iv) **Establish a government backed investment vehicle to allow the sale of properties into a managed fund.** This could take the form of a residential REIT and be managed in line with legal standards and agreed industry best-practice in order to ensure that stock remains available and of decent quality.

(b) Investing in energy efficiency (LESA)

The Energy Efficiency (Private Rented Property) (England and Wales) Regulations 2015 set out the requirement for domestic private rented properties in England and Wales to have a minimum Energy Performance Certificate (EPC) rating of E.

- From 1st April 2018, landlords will be prohibited from granting new tenancies for properties with an EPC rating below E. This includes extensions and renewals of existing tenancies, or a tenancy becoming a statutory periodic tenancy following the end of a fixed term shorthold.

- From 1st April 2020, this restriction on landlords letting out sub-E rated properties is to be extended to cover all existing tenancies for properties within the scope of the Regulations.

Local authorities will enforce compliance. Non-compliant landlords could face a financial penalty of up to £4,000.

Following the practical failure of the Green Deal initiative to incentivise and fund energy efficiency improvements, landlords are left with very limited options in respect of funding potentially costly renovation. The likely effect of this is that a considerable number of landlords will simply seek exemptions, or, where these are not available, exit the market completely.

The NLA is making two recommendations, aimed at reducing the cost of carrying out the required measures.

(v) **Reintroduce the Landlords' Energy Saving Allowance (LESA)**

The NLA is calling for the reintroduction of the Landlords' Energy Saving Allowance (LESA) that ran from 2007 until it was ended in April 2015, in order to minimise the extra financial burdens being imposed upon landlords. LESA should run until 2020 at the very earliest, as this is when the second phase of the Minimum Energy Efficiency Standard (MEES) regulations will prohibit the letting of any properties rated at F or G, rather than just in the case of new tenancies.

LESA encouraged landlords to invest in energy efficiency improvements by permitting them to offset up to £1,500 per dwelling against income tax or corporation tax for installing efficiency measures. The actual take-up of LESA by landlords was low; the Energy Saving Trust estimates that roughly 18,000 landlords took up the offer over its lifetime.[1] HMRC estimated that the cost of the scheme

[1] http://www.energysavingtrust.org.uk/blog/give-landlords-new-lesa-life

was quite small, at around £5m per year (doubling to £10m in 2013/14 and 2014/15).[2] This was largely due to landlords having had little incentive to make energy efficiency improvements (as it is tenants who benefit from fuel bill savings). In addition, the allowance was poorly promoted to both landlords and their accountants.

It is in this context that the NLA is calling for the reintroduction of LESA, and on more favourable terms. The advantage of a tax allowance such as LESA is that it explicitly leverages private sector finance, in the form of landlords investing in their properties. This in turn ensures an economic multiplier, firstly through private sector investment, and secondly through the wider economic benefit that comes from tenants spending less on imported energy and more on local goods and services.

The reintroduction of LESA could, if not restricted to those properties with an EPC rating of F or G, see further improvements in the whole of the PRS stock. The Government has already set out an ambition to see every property achieve a C rating in the future. Allowing all landlords to take advantage of LESA could see tenants across the whole sector benefiting from warmer homes now, instead of waiting five or more years for further regulations.

(vi) Set LESA at a level sufficient to improve the tax efficiency of carrying out works

When deciding the level at which LESA should be set, the Government should take into consideration the other financial pressures that landlords are currently facing, as previously discussed. Many landlords who will be financially harmed by the Section 24 tax changes could take advantage of the allowance to upgrade the energy efficiency of their property. This will not only alleviate some of the damage but also allow tenants to benefit from lower bills and warmer homes.

Restrictions could be placed on the allowance to ensure that it is not abused, for example by capping the total amount each landlord can claim.

In a 2014 research paper conducted by Parity Projects for the WWF and UK Green Building Council, 3,000 properties rated as EPC band F or G were examined, and a model was built of the improvements that would be required in order for EPC band E to be reached.[3]

It found that:

- more than 70 per cent of properties were able to reach band E for less than £1,000;
- more than 86 per cent of properties were able to reach band E for less than £4,000;
- the average cost to upgrade from G to E was £3,732, and;
- the average cost to upgrade from F to E was £943.

We therefore propose that the cost cap be set at an initial level of £3,500 per property, which is the estimated cost of upgrading 75% of F and G-rated PRS properties to EPC Band E. This research,

[2] www.gov.uk/government/uploads/system/uploads/attachment_data/file/579727/Dec_16_Minor_Reliefs_Final.pdf
[3] *Analysis for WWF and UK-GBC: achieving minimum EPC standards in housing,* May 2014, www.ukgbc.org/sites/default/files/Minimum%2520EPC%2520standards%2520report%2520WWF%2520%26%2520UK-GBC.pdf

conducted by the Energy Saving Trust in 2011 shows that this level would also enable 74% of properties rated E, F and G to reach a D rating.[4]

(B) Homelessness Reduction

The number of homeless people, and households, is increasing. So too is the reliance on the private rented sector to provide suitable accommodation.

The NLA supported the campaign orchestrated by Crisis, the homelessness charity, which ultimately assisted in the passage of the Homelessness Reduction Act. However, we remain concerned that without adequate funding the new law's provisions will not have the required impact. Consequently, we are backing Crisis' following two recommendations.

(i) Help to Rent

Help to Rent projects match tenants with landlords while providing financial guarantees for deposits and rent. This greatly reduces private landlords' exposure – and, crucially, perception of risk – when working with vulnerable or homeless people.

Inexperienced landlords can receive training and support as necessary regarding the complexities of managing associated tenancies, and a named point of contact is provided should difficulties occur.

Unlike many other schemes, the tenant also receives personalised and structured support throughout the tenancy, rather than only during the establishment of the tenancy agreement.

As part of the DCLG-funded Private Rented Sector Access Development Programme, Crisis started 153 Help to Rent projects. Over its four-year duration the cost was £9.8m, which helped 8,123 people into private tenancies – 90 per cent of which lasted longer than six months.

Using the HMT Green Book methodology, WPI Economics has modelled the costs and benefits of expanding the Private Rented Sector Access Development Programme into every local authority in England. It is estimated that at a cost £24.1m annually, national operation would support approximately 32,000 people, amounting to an aggregate saving in local authority budgets of between £175m and £595m.[5]

(ii) National rent deposit scheme

One of the most significant impediments to homeless or vulnerable individuals and families accessing the private rented sector is their inability to raise a security deposit.

---

[4] *Which Way up – Advance Headline Findings*, a report by the Energy Saving Trust for WWF and Friends of the Earth, February 2011 https://www.foe.co.uk/sites/default/files/downloads/which_way_up_advance.pdf
[5] WPI model, available from Crisis

At present, access schemes frequently offer bonds or guarantees to facilitate access to landlords' properties, but this ties up funds which could otherwise be used to support tenancies. It would represent a significant saving if local authorities and independent schemes were able to access a central, national rent deposit scheme administered by government.

WPI Economics has also modelled the cost of establishing such a national resource. It is estimated that £6.7m would establish a national scheme able to underwrite guarantees of up to £20m, whilst also covering mediation costs and claims.

(C) Addressing Disparity

(a) Capital Gains Tax

(i) Rate

In March 2016 Capital Gains Tax rates were cut significantly from 28 and 18 per cent to 20 per cent and 10 per cent respectively. However, landlords were excluded from this cut, establishing a *de facto* eight per cent surcharge on property transactions.

This move was described as an incentive to invest in companies over property, ignoring the positive contributions made by landlords and property companies. Real estate activities, including those associated with the private rented sector, account for more than 366,000 jobs in the UK and contribute around £40bn annually to the economy.

Inflating the tax liability of property transactions relative to other asset types puts this investment and activity at risk. Landlords face a disincentive to structure their portfolios efficiently, courtesy of the additional CGT levy, leading to poor allocation of resources. Additionally, poorly-utilised property is kept off of the market by such liabilities, thus restricting access to potential owner-occupiers.

The NLA recommends that CGT rates for property be unified with those relating to other types of investment.

(ii) Taper

Introducing a CGT cut or taper would help facilitate the disposal of poorly-performing property and diversify people's financial investment portfolios.

In a recent survey of 977 private landlords, 35 per cent said they had 'delayed' selling property because of the implications of CGT, and 29 per cent added that they feel unable to retire because of the CGT they will have to pay.[6] This is shown clearly below.

The NLA believes that this situation benefits nobody. Property is retained by landlords who would rather release the equity they have built up, and the wider economy suffers because this money cannot be spent.

[6] NLA Q2 2015 Landlord Panel

Furthermore, as the effect of this proposal becomes apparent, landlords who would otherwise prefer to sell will have less money available to invest in existing property, thereby increasing the risk of cumulative disrepair and falling standards in the PRS.

Statement	**Agree strongly (%)**	**Agree slightly (%)**	**Disagree slightly (%)**	**Disagree strongly (%)**	**Does not apply to me (%)**
The Capital Gains Tax system fails to recognise the difference between long-term investment and short-term trading	46	29	4	2	19
I am worried about the Inheritance Tax implications of leaving my portfolio to my next of kin	35	28	10	7	20
I have delayed selling my property because of Capital Gains Tax	20	15	11	12	41
I would like to sell some poorly performing properties to reinvest, but am discouraged by the cost of Capital Gains Tax	19	17	10	7	47
I feel unable to retire because of the Capital Gains Tax I will have to pay on disposal of my portfolio	14	15	15	12	43

During the last 25 years of investment in the PRS, during which time the sector has grown from around 8 to 19 per cent of households, there has been significant house price growth and some landlords have experienced substantial gains.

Figures collated by the Nationwide Building Society[7] show that landlords who have held residential property for a number of years are likely to have a significant CGT liability.

The manner in which CGT is currently applied fails to recognise the difference between landlords' long-term holding of property as a business asset and short-term speculative trading.

Throughout the lifetime of a property investment, a landlord will contribute significantly to the Exchequer, and even more so following the restriction of this relief. This differentiates their activity from that of short-term trading.

We, therefore, believe that a taper should be introduced, proportionate to the time a property has been held. This would avert the potential issues related to landlords who are unable to sell.

[7] Nationwide House Price Index, Nationwide Building Society, Q1 2015

Previously we have proposed a taper that would apply only to property held for at least five years, and would increase in generosity to a minimum CGT liability of 50 per cent for property held for at least 10 years.

This means that a landlord selling a property bought three years previously would pay CGT on 100 per cent of any gains made (after deductions), whereas a landlord selling a similar property after nine years would pay 60 per cent of the relevant gain.

Additionally, when the increased revenue derived from the restriction of finance costs relief and the Stamp Duty Land Tax (SDLT) income from purchasers are taken into account; such a taper would not represent a significant shortfall for the Exchequer.

If there were concerns about cost, such a cut or taper could be made temporary in nature, and further restrictions and qualifications could be added. For example, a taper could be restricted to tenanted properties sold with a tenant in situ.

(iii) Business Asset Rollover

A landlord whose portfolio is leveraged is likely to maintain relatively high gearing in order to maximise income tax efficiency. However, the tax changes encapsulated in Section 24 greatly reduce this efficiency and may necessitate the restructuring of a portfolio to reduce its size, thereby reinvesting equity in remaining stock. This will reduce the landlord's gearing and subsequently his or her exposure to this change.

Unfortunately, the existing CGT mechanism discourages landlords from selling property in order to reinvest. Unlike many other businesses, landlords are unable to take advantage of business asset rollover relief.

As rental income is considered to be unearned, and consequently not resulting from trading activity (defined by the Income Tax Act 2007), landlords may not defer their CGT liabilities when disposing of assets to invest in new or existing rental property.

We believe that extending business asset rollover relief to the sale of residential property (used exclusively for the purposes of a lettings business) would:

- facilitate the sale of property and greater mobility between tenures;
- allow landlords to reduce the gearing of their portfolios, thereby protecting against market shocks and improving stability;
- mitigate the impact of the policies outlined in section 24, Finance (No. 2) Act 2015, thereby reducing the inflationary impact on rent levels.

(b) <u>SDLT surcharge</u>

Intended as a brake on buy-to-let investment, the SDLT levy of three per cent has simply increased landlords' tax burdens and as a consequence helped fuel rent inflation.

The NLA believes that this policy has failed to significantly reduce appetite for rental property, whilst increasing tax burdens considerably.

The NLA recommends the removal of the SDLT levy for additional property.