



Proposals to improve Land Remediation Relief to stimulate brownfield development

Addendum 1: 20th May 2016 (excluding Appendix 1)

With supporting data from: **Barbour ABI**



Proposals to improve Land Remediation Relief to stimulate brownfield development

Addendum to Report submitted to HMT on 7th February 2016

Proposals for a modified Land Remediation Relief (LRR) regime were issued to HM Treasury for consideration on 7th February 2016. A follow up meeting occurred on 7th April 2016 to discuss the proposals in more detail. That resulted in a number of follow up queries which are addressed in this addendum.

Section 1: Sensitivity Analysis on Cost to the Treasury

Further information was requested to show how the estimated costs were prepared and what their sensitivity was to different housing volumes.

The estimates of the cost of the relief were based on benchmark claim data for the top 10 housebuilders in the UK. The data collates the Qualifying Land Remediation Expenditure (QLRE) added in each year on sites that achieved their first legal completion in that year, being the date the claim is first made. If you divide this number by the total legal completions achieved in the year on all sites you get a benchmark QLRE / legal completion. There is clearly not perfect correlation between QLRE and number of legal completions but the data range is relatively close at £1,022 to £1,946 per legal completion (average was £1,290) and therefore provides a useful metric for extrapolation of the data to a market wide number.

DCLG data splits legal completions into private enterprise, Housing Associations and Local Authorities. Whilst some Housing Associations can and do claim tax relief on their private development activity we have assumed that most of their development activity does not qualify for tax relief. So, the potential market for LRR for housing is limited to private enterprise. In 2015 DCLG Data reports 119,200 units legally completed by private enterprise.

Applying the benchmark claim to total legal completions in future years the potential cost of the various proposals at various outputs is set out below. Each measure has been assessed adopting a 20% Corporation Tax rate with cost based on current volumes shaded in grey.

Cost to HMT of increasing LRR to 175%			
Legal Completions	150%	175%	Cost increase
100,000	£12.9m	£19.4m	£6.5m
120,000	£15.5m	£23.2m	£7.7m
140,000	£18.1m	£27.1m	£9.0m
160,000	£20.6m	£31.0m	£10.4m

The cost of the proposal to increase the scope of tax relief to include flood prevention measures, based on the benchmark of 16% of claims being made up of flood claims before withdrawal in 2009, would be as follows for each of the tax relief rates proposed:

Cost to HMT of including flood prevention costs at 150% / 175% relief		
Legal Completions	150%	175%
100,000	£2.46m	£3.7m
120,000	£2.95m	£4.42m
140,000	£3.45m	£5.16m
160,000	£3.92m	£5.90m

There is very little data on the amount of developable derelict land to provide any meaningful costs and the costs associated with small sites of <=25 units is discussed in the next section.

Section 2: Enhanced tax relief for small sites of <=25 units

The proposal to enhance the tax relief on small sites of 25 or less sites has a number of potential benefits including:

1. Encouraging smaller builders back into the market having seen a halving of capacity in the last 8 years.
2. Helping to subsidise remediation costs on these sites which can be more burdensome on some smaller sites than larger sites for the reasons set out in the previous paper
3. Accelerating the rate at which these sites are developed to get more housing delivered more quickly
4. Removal of blight caused by small pockets of undeveloped sites in urban areas.

Further research has now been carried out in conjunction with Barbour ABI to explore the size of the current market and to establish benchmark time periods from the point of planning permission to the point of start on site.

		Total Legal Completions	Completions on sites of <= 25 units	Percentage <=25 units
Q1	2013	22,350	2,701	12
Q2		26,420	2,849	11
Q3		28,370	3,952	14
Q4		21,680	2,309	11
Q1	2014	30,370	2,311	8
Q2		29,610	4,063	14
Q3		29,150	2,124	7
Q4		20,780	1,445	7
Q1	2015	32,760	1,553	5
Q2		29,930	1,687	6
Q3		30,600	1,894	6
Q4		25,910	1,545	6

The trend shows that the number of houses built on these small sites has approximately halved in two years which reinforces the point that the volume housebuilders are becoming less interested in these sites and there is little capacity in the smaller builders market to develop these sites out. As can be seen from the table below, if the tax relief was increased to 200% for these sites the cost to the HMT would be less than £1m at current levels of development and would only increase to over £5m if development increased to 40,000 units a year.

Cost to HMT of increasing LRR to 200% on sites of 25 units or less			
Sites < 25 units	150%	200%	Cost increase
6,700	£0.90m	£1.70m	£0.80m
20,000	£2.60m	£5.20m	£2.60m
30,000	£3.90m	£7.70m	£3.80m
40,000	£5.20m	£10.30m	£5.10m

Accelerating the rate at which small sites are developed.

One of the desired outcomes for the 200% enhanced tax relief is to avoid sites being delayed due to market conditions. It is therefore important to understand the current time it takes from the date of planning permission to start on site. The table below shows the average days and weeks for various development sizes.

Number of units	Average no. of days	Average no. of weeks	Range (weeks)	sample size
1-5	159	23	2-64	33
6-10	136	19	2-53	40
11-15	86	12	1-43	70
16-20	115	16	1-54	27
21-25	110	16	1-42	40
<=25	121	17	1-64	210
>25	91	13	1-54	327

This data reinforces some interesting points. As a general rule the smaller the site the longer it takes to mobilise and it takes 4 weeks longer on average to mobilise on sites <=25 than on sites > 25 units. This could be for a number of reasons but is likely to be that it is simply more difficult to engage a supply chain on these smaller sites in a timely manner and the resources available to the small builder are likely to be less than the larger housebuilders both in terms of the expertise available to them and also in their ability to raise development finance. They need more help.

The sample set is from sites which commenced on site from February 2015 onwards so represents a period of relative buoyancy. There are unlikely to be many scenarios where sites are delayed due to market conditions but this will not always be the case.

There is currently a provision in place that requires a “material commencement” of works within 3 years of planning permission being granted irrespective of the size of the site. A material commencement could be demolition or commencement of building works or structural alterations to an existing building.

Given that the intention is to accelerate the rate at which new housing is developed it is proposed that a housebuilder would qualify for the new 200% relief provided there was a material commencement of the works within 12 months of planning permission being granted.

Section 3: Land Remediation Expenditure Credit

As previously advised, the main reason for proposing the introduction of the Land Remediation Expenditure Credit (LREC) is to increase the opportunity for the benefit to feature in the investment decision and therefore for more sites to be developed. Having consulted further with industry on this matter there are a number of potential scenarios envisaged:

1. When land is acquired by a developer they will typically prepare a residual land calculation to determine what they are prepared to pay for the land. This involves the developer forecasting their income and costs to leave an amount they can afford for the land assuming an anticipated profit margin. The first potential scenario is that the LREC features in this calculation as additional income and in doing so increases the amount the developer can pay for the land. This has a number of consequences. Firstly, it increases the amount of the offer and so increases the likelihood that a transaction takes place meaning more brownfield land is brought forward for development. Secondly, the LREC brings more value to the deal and as such could increase the amount of affordable housing that can be accommodated in the deal.
2. An alternative scenario is that the LREC does not feature in the residual land calculation but is used by the developer in the investment appraisal he submits internally to get board approval and also to support the business case for funding either internally or to external funders. The consequence here is that he is more likely to achieve internally set rates of return (viability "hurdle rates") and his chances of securing funding are increased.
3. Not all transactions involve straight forward third party sale and purchase agreements for land but can involve a joint venture where land is put forward as equity by one party with an equivalent value put in by the other party in the form of development costs. In this scenario the LREC helps improve the overall viability of the scheme or where the scheme is already viable it could increase the capacity to fund more affordable housing.
4. There will also be sites with negative land values that will require grant funding or a contribution from the vendor for the remediation works to be undertaken either to remove environmental liability or to prepare the site for development. Depending on how the grant or subsidy is structured there may be scenarios where the amount of subsidy (which in many case will be public subsidy) will be reduced by the value of the LREC.

Section 4: Deadweight considerations

One of the primary concerns expressed about the new proposals was the issue of deadweight, namely that sites would be developed regardless of the presence of the tax relief benefits. Further data has therefore been compiled to understand the additional revenues generated from 1 new home so that an assessment can be made as to the number of new homes that need to be developed, as a direct result of the proposed modifications, for the additional cost of those modifications to be cost neutral to HMT.

For the purposes of this exercise, the following assumptions have been made.

1. According to the April release of the Office of National Statistics the average selling price in the UK in February 2016 was £284,000.
2. Data from October 2009 by L.E.K Consulting for the UK Contractors Group, called 'Construction in the UK; the benefits of investment' reported that 92% of this price will be subject to UK Tax with the remaining 8% being part of the supply chain that resides outside the UK.
3. On this basis £261,000 will be subject to UK tax either in the form of Corporation Tax payments or PAYE.

4. The blended tax rate has been taken as somewhere between 20% and 25% generating receipts for the Government of between £52,200 and £65,250 per home.
5. In addition, the purchase of the property will generate Stamp Duty of £4,200 making the total tax generated between £56,400 and £69,450, an average of £63,000.

By applying this average to the cost of each of the measures we can see the number of houses needed in each scenario to be cost neutral to HMT.

Cost to HMT of increasing LRR to 175%				
Legal Completions	150%	175%	Cost increase	New homes needed
100,000	£12.9m	£19.4m	£6.5m	103
120,000	£15.5m	£23.2m	£7.7m	122
140,000	£18.1m	£27.1m	£9.0m	143
160,000	£20.6m	£31.0m	£10.4m	165

Cost to HMT of increasing LRR to 200% on sites of 25 units or less				
Sites < 25 units	150%	200%	Cost increase	New homes needed
6,700	£0.90m	£1.70m	£0.80m	13
20,000	£2.60m	£5.20m	£2.60m	41
30,000	£3.90m	£7.70m	£3.80m	60
40,000	£5.20m	£10.30m	£5.10m	81

Cost to HMT of including flood prevention costs at 150% / 175% relief				
Legal Completions	150%	New homes needed	175%	New homes needed
100,000	£2.46m	39	£3.7m	59
120,000	£2.95m	47	£4.42m	70
140,000	£3.45m	55	£5.16m	82
160,000	£3.92m	62	£5.90m	94

It can be seen from these calculations that only a small handful of sites need to proceed as a direct result of the measures for the costs to be neutral.

Other deadweight considerations include:

1. There will inevitably be sites that would proceed regardless of the tax relief benefit. However, the developer who undertakes the development of these sites are generally taking on more risk than when developing greenfield sites. In these instances the tax relief acts as a reward and encourages companies to consider brownfield more favourably. It also improves the cash flow and balance sheet strength of these developers making them more financially stable resulting in improved confidence to undertake more development of this type.
2. The ability for the tax relief to positively change the decision to build will be a factor of three things; the ability to show the tax benefit in the investment appraisal, the value of the relief itself and the total amount of QLRE as a percentage of total cost. The sites that are most likely to be influenced are those where the land cost is largely made up of qualifying remediation costs.

Assuming the Land Remediation Expenditure Credit was introduced then the appraisal can benefit from an additional taxable receipt equivalent to (assuming a Corporation Tax rate of 20%):

- a. For sites >25 units @ a 150% headline relief: 12.5% of QLRE
 - b. For sites >25 units @ a 175% headline relief: 18.75% of QLRE
 - c. For sites ≤25 units @ a 200% headline relief: 25% of QLRE
3. Appendix 1 includes examples to show how sites would be impacted as a result of these measures being implemented.