EUROPEAN COMMISSION

Brussels, 19.V.2008
C(2008)2006

Subject: **State aid No N 35/2008 – United Kingdom**
Landlord's Energy Saving Allowance (LESA)

Sir,

1. PROCEDURE

By electronic notification dated 17.01.2008, registered as SANI 906 the same day, the UK authorities notified the Commission according to Article 88(3) of the EC Treaty of a planned tax allowance provided by the UK government to corporate landlords who operate a business of renting residential properties. By letter dated 30.01.2008 the Commission asked UK authorities for further clarifications, which were provided in their reply dated 02.04.2008.

2. DESCRIPTION OF THE MEASURE

2.1 Background

The Landlord's Energy Savings Allowance (LESA) was introduced for non-corporate landlords in 2004 and became available on qualifying expenditure incurred from 06.04.2004, but before 06.04.2009. It allowed individual landlords to deduct the cost of qualifying energy saving items against the profits from their residential property business for tax purposes. The scheme was originally not notified to the Commission, since the allowance was restricted to individual residential landlords and since the maximum amount available was limited to £ 1 500 per year per building. Hence, it was regarded as *de minimis* aid and not subject to the notification requirement pursuant to Article 88 (2) of the Treaty.[1]

[1] Commission Regulation No 69/2001 of 12 January 2001 on the application of Articles 87 and 88 of the Treaty to de minimis aid, Official Journal L 10, 13.01.2001, pages 30-32, and from 1 January onwards, Commission Regulation (EC) No 1998/2006 of 15 December 2006 on the application of Articles 87 and 88 of the Treaty to de minimis aid, Official Journal L 379, 28.12.2006, p. 5–10. According to UK authorities, since the allowance was introduced in 2004 no individual landlord has claimed more than € 100.000.

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Expenditure incurred by a landlord on items whose purpose is to improve energy efficiency of their rented properties could previously not be deducted when calculating the profits for corporation tax purposes. In extending the scheme to corporate landlords, however, the UK authorities have recognised a risk of exceeding the *de minimis* limit of € 200.000 over three years, particularly given that the £ 1.500 cap would now apply on a per dwelling basis.

2.2 Objective of the scheme

The LESA seeks to encourage energy efficiency in the residential rented sector by allowing landlords to deduct from their taxable profits the costs of acquiring and installing certain energy saving items in properties they let. The UK Government regards household energy efficiency as a key area for reducing carbon emissions and for environmental protection. Over a quarter of the UK's carbon emissions are currently produced by residential properties and there is a particular need for action targeted at the residential rented sector, since such properties typically produce around 500 kg more carbon emissions per year than other homes.

The UK authorities consider higher carbon emissions attributed to rented properties to reflect a market failure in the residential rented property sector. There is an incentive for a homeowner to improve the energy efficiency of its home, but this does not exist in the case of a landlord, since the benefits of such improvements (increased comfort and lower utility bills) are enjoyed by the tenant and not by the landlord.

Under normal tax rules, expenditure on making improvements to a property, including energy efficiency, is not deductible for tax purposes. In allowing such a deduction for specified energy saving items, the LESA aims at providing a financial incentive for landlords to make their properties energy efficient. It is estimated that the scheme has contributed to carbon savings up to 200.000 tonnes in 2004/05 and 2005/06 from individual landlords and, that it can deliver further savings of between 150.000 and 670.000 tonnes a year once the extension to corporate landlords is implemented.

2.3 Legal basis

The relevant legislation regarding individual landlords can be found in sections 312 to 314 of the Income Tax (Trading and Other Income) Act 2005 together with the Energy Saving Items Regulations 2007 (SI 2007/831). The main tax legislation governing corporate landlords is contained in the Income and Corporation Taxes Act 1988 (ICTA). The provisions which bring corporate landlords within the scope of the allowance follow from section 17 of the Finance Act 2007 and sections 31ZA to 31ZC of ICTA 1988. In addition, a draft secondary legislation which has been attached to the notification will be laid before Parliament if the aid receives approval by the Commission.

2.4 Eligible costs

At the introduction of the scheme, the types of qualifying energy saving items were restricted to loft and cavity wall insulation. It was also restricted in a number of other ways, i.a. it could only be claimed by landlords within the charge to income tax, only available on expenditure incurred before April 2009 and the maximum amount to be claimed each year was capped at £ 1.500 per building. Since then, the types of qualifying items have been extended. The following energy saving items are now eligible: cavity wall insulation, loft insulation, hot water systems insulation, draught proofing, solid wall insulation and floor insulation.[2]

Current building regulations[3] regarding the construction of new residential properties include high standards to ensure efficiency. The allowance cannot be claimed in respect of homes in the course of construction, since the LESA is targeted to correct the market failure which discourages landlords from investing in the energy efficiency of their properties where they would not otherwise do so. The UK Authorities have informed the Commission that there are no legal or similar requirements on landlords to achieve specific targets for environmental protection, so that the allowance does not provide any aid for adaptations to properties that are required otherwise by law.

2.5 Beneficiaries

The UK authorities have estimated that there are currently between 1.300 and 2.000 landlords of residential properties within the corporate sector, of whom around 30% own 100 properties or more. Therefore if every property was fully insulated, some landlords may exceed the *de minimis* limit of € 200.000 over three years. The UK authorities reckon that the number of such landlords is inferior to 1.000.

2.6 Support levels, cumulation and monitoring

A UK Company is liable to pay corporation tax calculated on the basis of the difference between taxable income in a particular accounting period and allowable expenditure for that period. Corporation tax is charged at a number of different rates, depending on the company's profits and the number of its associated companies. The highest rate is currently 30 % but many companies pay at lower rates depending on the amount of their taxable profits. Hence, the average level of aid which corporate landlords will receive from the LESA will be less than 30 %

The maximum amount of the relevant expenditure which may be taken into account in the calculation of the deduction is £ 1.500 per dwelling. Under the original scheme the cap was calculated per year for each building the landlord owned. However, in the cases where a single building is divided into a number of separate dwellings – such as blocks of flats – the 2007 Finance Bill now will allow for a deduction up to an annual maximum of £ 1.500 per dwelling. According to the UK authorities, this means that in the case of a block of 10 flats, a landlord who lets the whole block could claim a maximum allowance of £ 15.000.

With regard to possible cumulation with other state aid measures, the level of the allowance which landlords can claim will be reduced in cases where they have also received a contribution from any other source towards the qualifying expenditure.[4] The UK Authorities have stated in the notification that they will monitor the take up of LESA by identifying the small number of large corporate landlords and monitor

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2 See section 312 of the Income Tax (Trading and Other Income) Act 2005 section 312, supplemented with the list of qualifying items set out in SI 2007/831. When extending the scheme to corporate landlords, a similar list of qualifying energy saving items will be adopted in a statutory instrument pursuant to sections 31 ZA and 31 ZC of the Income and Corporation Taxes Act 1988.

3 Part L of schedule 1 of The Building Regulations 2000/2531.

4 See Article 3 (3) of the draft regulation attached to the notification.

their tax returns as they are submitted. This is considered to provide sufficient robust data for the purposes of the reporting requirements to the Commission.

2.7 Budget

The total aid amount is estimated at £ 8.000.000,00.

2.8 Duration

The aid scheme will apply from 01.04.2008 until 01.04.2015.

3. ASSESSMENT

3.1 Procedural requirements

With regard to the original part of the scheme, which was limited to individual landlords and with an annual maximum ceiling of £ 1.500 calculated per building, the Commission notes that aid measures that meet the criteria of the *de minimis* regulation[5] shall be deemed not to meet all the criteria of Article 87(1), provided that all the requirements according to the Regulation are fulfilled. The legislation that brings corporate landlords within the scope of the LESA (and certain other changes) has not yet entered into force.[6] By notifying those amendments before entering into force the UK authorities have complied with their obligation of Article 88 (3) of the EC Treaty.

3.2 Presence of State aid under Article 87(1) of the EC Treaty

In order to constitute State Aid under article 87(1) of the EC Treaty the measure must confer an economic advantage to the aid recipients, which is granted through or by state resources, the measure must be selective and the aid must distort or threaten to distort competition and affect trade between the Contracting Parties.

The measure has been notified by the UK authorities as a state aid measure. The scheme favours landlords in the residential rented sector, since the state provides a tax advantage for investments in energy saving measures. It is established case-law that a measure which relieves the recipients of a tax burden which otherwise they would have to incur constitutes an economic advantage.[7] Indirectly, the aid might also favour the users of the building which will have lower energy costs. However, as article 87(1) only applies to undertakings performing an economic activity any indirect advantages which might be passed on to private households renting the dwellings (reduced heating costs) do not fall under the state aid definition.

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5 Commission Regulation No 69/2001 of 12 January 2001 on the application of Articles 87 and 88 of the Treaty to de minimis aid, Official Journal L 10, 13.01.2001, pages 30-32, applicable at the time when LESA was introduced in 2004. From 1 January onwards, the relevant de minimis rules follow from Commission Regulation (EC) No 1998/2006 of 15 December 2006 on the application of Articles 87 and 88 of the Treaty to de minimis aid, Official Journal L 379, 28.12.2006, p. 5–10

6 Pursuant to Section 17 (2) of the Finance Act, the implementation of the LESA depends on a Treasury order, awaiting the outcome of the formal notification of the allowance as a notified State aid measure. Upon approval by the Commission, the UK Government will introduce regulations to provide details on how the allowance will operate in practice. A draft regulation has been attached to the notification.

7 See the Commission notice on the application of the State aid rules to measures relating to direct business taxation Official Journal C 384, 10.12.1998, pages 3-9.

A derogation from the tax rules which is not justified by the nature and logic of the tax system must be considered as a selective measure.[8] According to the UK authorities, under normal rules the expenditure on making improvements to a property, including energy efficiency, is not deductible for tax purposes. In allowing such a deduction for specified energy saving items, the LESA aims at providing a financial incentive for landlords to make their properties more energy efficient. Thus, the measure provides an economic advantage to certain undertakings, namely only those making the eligible investments and applying for the aid in connection with the submission of their taxable income.

Finally, the state intervention must distort or threaten to distort competition and affect trade between the Contracting Parties, in order to fall under article 87(1). Since some companies operate as residential landlords in more than one Member State, those operating in several Member States including the UK might use the advantage granted by the LESA in another Member State to the detriment of competitors operating in one or several Member States but not in the UK. Therefore, the aid in question may strengthen the position of beneficiaries and potentially distort competition between the beneficiaries and their competitors, thus also affecting trade between Member States.

Hence, the notified LESA scheme constitutes state aid in the meaning of article 87(1) of the EC Treaty.

3.3 Compatibility of the aid under Article 87(3)(c) of the EC Treaty

Although the LESA scheme was notified before the publication of the current Environmental Aid Guidelines,[9] the latter are applicable as on the basis of point 204 of these guidelines, the Commission is called upon to take a decision as of their publication.[10]

Following point 70 (2) of the Environmental Aid Guidelines the Commission considers energy saving measures as actions to protect the environment. Energy saving measures means any action which enables undertakings to reduce the amount of energy used notably in their production circle.[11]

The Environmental Aid Guidelines chapter 3.1.5 allows for investment and/or operating aid enabling undertakings to achieve energy savings, provided that certain conditions are fulfilled. According to section 3.1.5.1 investment aid shall, as the main rule, not exceed 60 to 80% of the eligible investment costs.[12] Those are defined in point 98 and must be limited to the extra investment costs necessary to achieve energy savings beyond the level required by community standards. A level of energy savings higher than Community standards must be identified, and operating benefits/costs must be taken into account.

8 See points 23 to 27 of the Commission notice on the application of State aid rules to measures relating to direct business taxation.

9 Community Guidelines on State Aid for Environmental Protection, OJ C 82, 1.4.2008.

10 See paragraph 204 of the Environmental Aid Guidelines.

11 With regard to the recognition of state aid to energy savings in buildings as environmental protection within the scope of the 2001 Environmental Aid Guidelines, see State Aid case N 401/2005 (Netherlands).

12 Maximum aid intensity is 60% (large enterprises), 70% (medium enterprises) and 80% (small enterprises).

Since the eligible costs are defined in an exhaustive list of energy saving items, the Commission takes the position that the eligible costs under the scheme are all directly related to energy savings. With regard to the counterfactual situation, i.e. the level of energy use in residential building without any aid, the UK authorities have presented figures showing that the original LESA scheme has delivered carbon savings from individual landlords and that further savings are predicted when extending the scheme to corporate landlords, see section 2.2 above.

According to the Energy Performance Directive 2002/91/EC of 16 December 2002 on the energy performance of buildings,[13] a mandatory minimum energy efficiency performance norm is introduced for newly constructed buildings and for major renovations of certain existing buildings. The UK Authorities have confirmed that there are no legal or similar requirements on landlords eligible under the notified scheme to achieve specific targets for environmental protection. Therefore, the tax allowance does not provide aid for adaptations to properties which are required otherwise by law.

According to point 98, third point, of the Guidelines eligible costs must be calculated net of any operating benefits and costs related to the extra investment for energy saving and arising during the first three years of the life of this investment in the case of SMEs, the first four years in the case of large undertakings that are not part of the EU CO2 Emission Trading System and the first five years in the case of large undertakings that are part of the EU CO2 Emission Trading System. The UK authorities have argued that all expenditure on the relevant items should be treated as eligible costs. According to the UK authorities, no benefits will arise to the landlords from making the investment, either in terms of lower running costs or increased rents or sale value. This is because energy efficiency is not a feature of the rental market or featured in advertising for lets and tenants are not expected to pay higher premiums for a property which is energy efficient.

To support this view, the UK authorities have pointed out the existing market failure in terms of energy efficiency for private rented properties. For instance, 10% of private rented properties rank among the lowest category of energy efficiency households as compared with less than 5% of all properties.[14] According to the UK authorities, this market failure indicates that landlords do not invest in energy saving appliances as they do not derive any benefit from it. For a typical installation, costs may represent £ 1.307 (cavity wall insulation) and £ 1.607 (internal wall insulation) per dwelling.[15] The UK authorities have argued that these investments would lead to annual energy savings of £ 295 and £ 505 per year, or £ 1.475 and £ 2.525 over five years respectively. Even if energy savings were fully converted in increased value (which the UK authorities contest), this would represent only around 1% of the average value of a flat in the UK (£ 175.712).[16]

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13 OJ L 1, 4.1.2003, p. 65.

14 Source: UK submission of information as of 2.4.2008, p.3. Data from Building Research Establishment (BRE), 2005.

15 Source: UK submission of information as of 2.4.2008, p.7. Data from Energy Saving Trust.

16 Source: UK submission of information as of 2.4.2008, p.4. Data from HM Land Registry, February 2008.

In the Commission's view, the fact that private rented properties are less energy-efficient than other homes does not imply that energy-efficient investments will not increase sale or rental value; it only indicates that the potential value increase is inferior to the installation costs. However, the UK authorities have provided evidence that the sale and rental value increases are not really quantifiable for the different individual cases concerned, but very limited in any event. In addition, the Commission notes that such a value increase might lead to an aid intensity higher than 30% but certainly below the maximum aid intensities for energy saving of 60 to 80%.[17] In light of these elements, the Commission can agree with the UK authorities that the LESA scheme will either not increase sale and rental value of property for beneficiaries at all or this impact will be negligible. Therefore it is acceptable that no benefits are to be deducted from the extra investment costs.

According to chapter 3.2 of the Environmental Aid Guidelines state aid for environmental protection must have an incentive effect. If the aided project has not started before the application, such an effect is presumed for all categories of aid granted to an SME, except in cases where the aid must be assessed in accordance with the detailed assessment of chapter 5. For all other measures, the notifying Member State: must demonstrate the incentive effect i.e. that without aid, the more environmentally friendly alternative would not have been retained. As described above, the UK authorities have indicated that the original LESA scheme has had an incentive effect: it delivered carbon savings of around 200.000 tonnes a year in 2004/05 and 2005/06.[18] The extended LESA scheme will have identical or superior incentive effects, as it applies to corporate landlords, to more energy saving investments and is granted on a per dwelling instead of a per building basis. Therefore the UK authorities expect further carbon savings between 150.000 and 670.000 tonnes a year due to LESA extension.[19] For each property, full insulation would lead to 2.480 to 4.030 kg of carbon emission savings a year,[20] while private rented properties currently produce roughly 500 kg more carbon per year than other homes. Thus, the Commission considers that the criteria in point 146 of the Guidelines are fulfilled.

Hence, the scheme can be approved under chapter 3.1.5 of the Environmental Aid Guidelines.

4. CONCLUSION

The Commission has accordingly decided that N 35/2008 "Landlord's Energy Saving Allowance (LESA)" (United Kingdom) constitutes State aid within the Article 87(1) of the EC Treaty and Article 61(1) of the EEA Agreement.

In addition, the Commission has concluded that such aid is compatible with the common market in accordance with Article 87(3)(c) of the EC Treaty and Article 61(3)(c) of the

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17 Environmental Aid Guidelines, section 3.1.5.1. Maximum aid intensity is 60% (large enterprises), 70% (medium enterprises) and 80% (small enterprises).

18 Source: UK submission of information as of 17.01.2008, Part III.10.

19 Source: UK submission of information as of 17.01.2008, Part III.10.

20 Cavity and internal wall insulation respectively. Source: UK submission of information as of 2.4.2008, p.7. Data from Energy Saving Trust.

EEA Agreement, since it complies with the relevant provisions of the Environmental Aid Guidelines.

The Commission reminds the UK Authorities that, in accordance with Article 88 (3) of the EC Treaty, plans to change this scheme have to be notified to the Commission pursuant to provisions of Commission Regulation (EC) No 794/2004 implementing Council Regulation (EC) No 659/1999 laying down detailed rules for the application of Article 93 *[now 88]* of the EC Treaty (OJ L 140, 30.4. 2004, p.1).

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http://ec.europa.eu/community_law/state_aids/index.htm

Your request should be sent by registered letter or fax to:

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Yours faithfully,

For the Commission

Neelie KROES
Member of the Commission