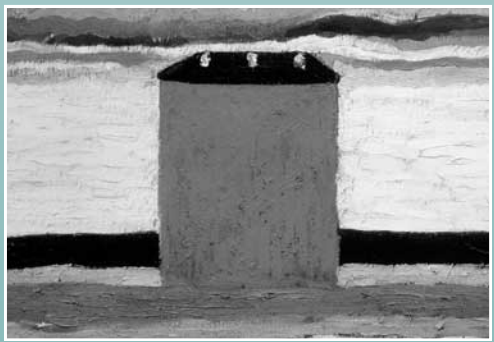
Section 2 Commentary



Chapter 6
Help with housing costs

This year's *Review* carries an article on the resurgent private rented sector, and the independent review of the sector commissioned by Communities and Local Government (see Contemporary issues Chapter 2). To complement that article this chapter sets out a detailed comparison of the tax treatment of home-owners and private landlords. It concludes with some brief observations on housing subsidies, to complement the article on the housing revenue account review currently being conducted by CLG (see Contemporary issues Chapter 3).

The taxation of home-owners and private landlords

The abolition of mortgage interest tax relief for home-owners in 2000 significantly reduced the long-standing fiscal bias in favour of owning rather than renting, that was one of the factors in the continuing decline of the private rented sector in the UK throughout the twentieth century.

However, there is a continuing, but less pronounced, fiscal bias in favour of home-ownership, notwithstanding the simplistic focus in some quarters which argues that landlords are favoured because they do get relief on their mortgage interest costs. The relative tax position of the two tenures needs to be seen in the round; not just in terms of one single component.

Mortgage interest tax relief

Private landlords do get tax relief on their mortgage interest costs, in the sense that those costs can be offset against the rental income they receive from letting. However, not since the abolition of 'Schedule A' tax in 1963 have home-owners been liable to any tax on the rental value of their homes (which they consume 'in kind' rather than receive as cash).

Indeed, it would have been logical to abolish home-owners' mortgage interest tax relief at the same time as the abolition of Schedule A Tax, rather than converting it into a relief against income tax. In that sense its eventual abolition in 2000 can be viewed as the closure of a 37 year long fiscal anomaly.

Nor are the sums involved insignificant. If home-owners were liable to Schedule A tax, but with mortgage interest available as a relief against that tax, even if the tax was levied at the same 20 per cent level as the basic rate for income tax this would potentially generate a net annual income of some £12 billion. However, if such a tax was ever levied it would reduce house prices; and this would in turn reduce the net income from the tax.

Capital gains tax

Moreover, while private landlords are subject to capital gains tax, home-owners are exempt (for their primary residence). While in aggregate the income the government receives from stamp duty is broadly equivalent to the value of the capital gains tax on home-owners' primary residences, that duty applies to both landlords and home-buyers.

The HM Treasury gross estimate of the value of home-owner capital gains tax relief was £16.3 billion in 2007/08. However, that estimate assumes that the tax is levied at the full rate, without any provisions for 'taper relief'. The estimated value of the relief will be lower in 2008/09, not just because of the collapsing market, but also because of the introduction of the standard 18 per cent rate, and the abolition of 'taper relief'. Also, as with Schedule A tax, if capital gains tax was applied to home-owners' primary residences this would be expected to have an impact on house prices that would consequently reduce the income from the tax.

Nor do the HM Treasury figures make any provision for 'roll over relief' which defers the application of the tax when the proceeds from the sale of a home are fully reinvested in another home, and which is typically a feature of the tax in those countries, such as Sweden, where the tax is applied to home-owners. However, neither is roll over relief available to private landlords in the UK.

An estimated value for CGT relief for home-owners is shown in Table 2.6.1, that takes into account the 'taper relief' provisions that applied in the years to 2007/08, and also makes provision for roll over relief. The estimates in Table 2.6.1 do not, however, make any adjustment for the potential impact of the levying of CGT on house prices.

Stamp duty

There is no clear economic rationale for stamp duty; rather it is simply a traditional and easily collected transaction tax, that has grown in significance with the introduction of higher tax rates for higher value dwellings, allied to the sharp growth in property values which have increased the proportion of sales subject to the higher rates of tax. While the overall yield from stamp duty (£6.7 billion in 2007/08), more or less equates to the realistic value of home-owners' capital gains tax relief, the benefits of that relief apply exclusively to home-owners; while the costs of stamp duty apply to private landlords and home-owners alike.

The overall tax provisions for private landlords and home-owners are summarised in Table 2.6.2. The key point is that while the abolition of mortgage interest tax relief for home-owners substantially reduced the extent of the fiscal bias in favour of ownership, it did not entirely remove that bias. Indeed the absence of a tax on the imputed rental value of home-owners' dwellings, together with their capital gains tax relief, represent a continuing significant fiscal bias in favour of home-ownership relative to private renting.

The taxation of private renting and other businesses

Landlords are also impacted by the way in which the tax arrangements apply to the treatment of private renting as a business, as compared to the tax provisions that apply to other businesses. While in the main private renting is taxed on pretty much the same basis as other forms of business, there are nonetheless some aspects where its treatment differs, and a number of issues that are of particular concern to private landlords.

There are also some important differences in the way in which the tax regime operates for small unincorporated individual landlords, and those landlords that operate as business corporations. There are also some differences in the way tax regimes impinge on larger or smaller landlords that are not specific to their corporate status.

Table 2.6.2 **Tax provisions for home-owners and private landlords**

Tax provisions	Home-owners	Private landlords
Tax on rents	No tax on imputed rents	Tax on rents
Stamp duty	Yes	Yes
Capital gains tax	No	Yes
Tax relief on:		
Mortgage interest	No	Yes
Management costs	No	Yes
Repair costs	No	Yes
Improvement costs	No	CGT only

Notes: CGT – capital gains tax.

Table 2.6.1 **Private owner taxes and tax reliefs**

£ million

	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Capital gains tax relief (gross)	- 2,000	- 1,000	- 850	- 850	- 500	- 600	- 800	- 1,400	- 3,000	- 3,300	- 6,000	- 10,000	- 10,500	- 13,000	- 12,500	- 15,800	- 16,300
Capital gains tax relief (net)	- 800	- 400	- 340	- 340	- 200	- 240	- 320	- 560	- 1,200	- 1,320	- 2,400	- 4,000	- 4,200	- 5,200	- 5,000	- 6,320	- 6,520
Inheritance tax	427	379	403	422	429	440	480	496	611	684	769	870	999	1,166	1,300	1,414	1,526
Stamp duty	630	280	465	520	465	675	830	1,065	1,825	2,145	2,690	3,525	3,710	4,620	4,605	6,505	6,680
Net tax position	257	259	528	602	694	875	990	1,001	1,236	1,509	1,059	395	509	586	905	1,599	1,686

Source: Inland Revenue Statistics (various years).

Notes: Estimates of capital gains tax relief are set at 40 per cent of Inland Revenue estimates to take account of roll over and taper relief provisions. Capital gains tax reforms begin in 2008/09. See text in 2007/08 *Review* for details. It should also be noted that the stamp duty and inheritance tax yields are for residential dwellings in all tenures; and do not exclusively relate to home-ownership.

Capital gains tax

Both corporate and unincorporated landlords are subject to capital gains tax, and are thus affected by the changes to the structure of capital gains tax introduced in 2008/09. In recent years the rate of capital gains tax applied in practice depended on the length of time a property was held. If a property was held for more than two years then only 25 per cent of the capital gains was liable for taxation. For a landlord paying the higher rate of income tax at the rate of 40 per cent this 'taper relief' resulted in an effective net capital tax gains rate of 10 per cent.

From 2008/09, the capital gains tax arrangements have been simplified, and the tax is now applied at a single rate of 18 per cent, regardless of the length of time over which the property has been held. This is effectively an increase in the rate of tax applied for dwellings rented for a period of more than two years, and thus increases the relative tax disadvantage as between private landlords and home-owners.

While there are provisions to reduce the impact of the new capital gains tax regime on small businesses these do not apply to the private rental sector (other than the letting of furnished holiday lettings). There is, however, a small standard annual capital gains tax disregard (£9,200 for individuals in 2007/08).

The absence of any provisions for 'roll over' relief in circumstances where the proceeds of property sales are wholly reinvested in other properties is also, together with the impact of stamp duty, a disincentive to landlords seeking to restructure their property portfolio in response to changing market conditions.

Stamp duty

Stamp duty applies to both home-owners and landlords; and in that sense is not a source of disadvantage between the tenures. It disadvantages the mobile home-owner who makes frequent moves, just as much as the landlord seeking to restructure their property portfolio.

There are, however, particular issues that arise in respect of landlords acquiring portfolios of properties, rather than purchasing single dwellings. While all the properties in a portfolio may have individual values of under £250,000 (which in themselves would attract a 1 per cent stamp duty), if they are part of a portfolio of dwellings with a collective value in excess of £500,000 their acquisition would involve stamp duty at the rate of 4 per cent.

Expenses eligible for tax relief

While for most businesses a tax allowance is made for the depreciation of capital assets this does not apply to residential property. Tax relief does apply, however, for expenditures on repairs, management costs and property insurance, as well as on mortgage interest.

The tax relief available on repairs does not, however, extend to investment in improvements, although the interpretation of the distinction between repairs and improvements has now been somewhat relaxed. When old worn out fittings (such as window frames) are replaced, the new replacements will typically include an element of improvement rather than like-for-like replacement, reflecting the changing standards in property construction over the decades.

Unincorporated landlords

For unincorporated landlords the income derived from their renting business is subject to income tax (but not corporation tax). While they can deduct any management expenditures, such as payments to letting agents, they cannot make any deductions for their own time directly committed to undertaking the management and/or the maintenance of their properties.

The marginal rate of income tax paid by the landlord will depend on the overall level of their taxable income and therefore will either apply at the rate of 20 per cent or 40 per cent (provided that their total income exceeds the minimum threshold level below which no tax is liable).

Corporate landlords

Corporate landlords are instead subject to corporation tax. The standard rate of Corporation tax is currently 30 per cent; but this only applies to annual profits in excess of £1.5 million a year. In practice, this rate consequently only applies to a very small number of large landlords. For the great majority of small to medium-size corporate landlords, with annual profits below that level, the lower rate of 20 per cent applies.

While incorporation does offer some potential tax advantages for large long-term landlords, they are quite limited and specific, and individuals taking short-term profits out of a corporation can also face additional corporation and income tax liabilities.

There have been a number of attempts to introduce tax vehicles to encourage long-term corporate investment in private renting, but the terms have been quite limited, and so far they have not had any impact. The provisions for Housing Investment Trusts (HITS) introduced in 1995 were not taken up in practice, and to date that is also the case for the provisions for UK-REITS (Residential Estate Investment Trusts) introduced to replace HITs in January 2007. However, it should be noted that some of the larger corporate landlords have mitigated their tax treatment by operating as offshore trusts.

Taking all the above into account some possible reforms to the tax arrangements for private landlords are discussed in the Contemporary issues Chapter 2.

Housing subsidies

Issues around the subsidies for council housing are discussed in Contemporary issues Chapter 3, in the context of the current CLG HRA review. However, while current cash 'bricks and mortar' subsidies to council housing are very limited (Compendium Table 109) and are forecast to end, with the sector moving into net overall surplus, this reflects the low level of investment in the council sector over the last three decades, with the overwhelming majority of new social sector housing (and the subsidy that goes with it) being routed through housing associations (Compendium Table 122).

The council sector as a whole thus has significant benefits arising from the low historic costs of past investment; with a large proportion of the associated debts having in turn been reduced by receipts from council house sales. This has enabled rents to remain substantially below economic value. For a discussion of the economic value to the sector, and its tenants, of those sub-market rents readers are referred to the article in the 2005/06 edition of the *Review*.[1]

Footnote

1. 'More apparent than real? The decline of bricks and mortar subsidies', S. Wilcox, *UK Housing Review 2005/06*, CML/CIH, 2006.

Key Reading

Departmental Report 2008, Department for Work and Pensions, Cm 7401, The Stationery Office 2008.

Department for Work and Pensions Statistics (website).

Housing Benefit and Council Tax Benefit, Summary Statistics, Quarterly Series, Department for Work and Pensions (website).

Inland Revenue Statistics (website).