Taxing tenants: how taxes on landlords end up hitting tenants

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The housing crisis has prompted the government to take a number of policy decisions aimed at making it easier for people to buy a home. Together with policies implemented by local authorities, much has changed in property markets for owner-occupying buyers, landlords and tenants. These changes are not sufficient to tackle the housing crisis, whose underlying cause is planning policy restrictiveness.

Summary

- The 3 per cent stamp duty additional homes surcharge will help prospective buyers but it will hurt tenants in rented accommodation
- The restriction of finance cost relief for individual landlords will also advantage prospective buyers at the expense of tenants
- Both policies will distort housing markets, with implications for incomes, employment and overall welfare
- These tax hikes make Britain's complex tax system even more complicated and distort ownership structures
- Other local policy choices such as increasing the cost of houses in multiple occupation (HMO) licences and introducing landlord licencing schemes will hit tenants
- Existing owner-occupiers taking advantage of lower house prices to expand their consumption will tighten supply conditions in the lettings market, raising rents

Recommendations

- Cancel the additional homes stamp duty surcharge and restrictions on finance relief
- Halve all stamp duty rates immediately with a view to abolishing it entirely
- Reform planning restrictions to declassify some green belt land and allow taller, denser construction in urban areas

1. Stamp Duty Land Tax on additional residential properties

Since April 2016, a new surcharge of 3 per cent has been added to the stamp duty payable on second homes worth more than £40,000, including those bought as holiday homes, development projects and buy-to-let investments. Any home bought by a company is liable, as are second homes of married couples and civil partners.

The policy's objective is to distort housing markets in favour of owner-occupancy by reducing demand for housing purchases from buyers who are not owner-occupiers. The 2015 Autumn Statement said that it:

> *"…supports families buying their own home through a 3 percentage point surcharge on rates of Stamp Duty Land Tax on purchases of additional properties like buy to lets and second homes".*

It is likely that this objective will be met, at least temporarily. Because the affordability problem is fundamentally caused by the mismatch of supply and demand, a measure which distorts the market towards a favoured group can only delay the impact of the failure of housing supply to respond to demand. And the costs of the advantages for owner-occupiers of this delay will not only fall on second home buyers and landlords. As the Institute for Fiscal Studies director Paul Johnson told the Treasury Committee[1]:

> *"…it can only push the rent one way, and that is up"*

The measure is too new to have been rigorously analysed and its design is also new, although similar taxes have been levied recently in some Asian countries. But while it may be difficult to model the tax, we can draw on the lessons from transaction taxes in general and look at the effects of measures which have some similarity, such as Switzerland's Second Homes Initiative, which prohibits the construction of homes that are not designed for primary residence.

The literature on stamp duty in general is unambiguous: it is a badly-designed tax which gums up property markets. Some research shows that it raises very little money once the impact of its behavioural effects are analysed. Both recent major UK tax policy studies, the Mirrlees Review (institute for Fiscal Studies) and the 2020 Tax Commission (TaxPayers' Alliance and Institute of Directors), recommended its abolition, as have an extraordinarily wide range of other reports and commentators.

Indeed, one of the reasons cited for its abolition is the way it disadvantages prospective owner-occupiers by increasing the effective deposit (ie, the stamp duty bill and the mortgage deposit) required to make a purchase. Because buyers cannot borrow to pay for stamp duty, those with less cash (such as first time buyers) are disadvantaged against those with more cash (such as existing owners with equity in their existing homes).

A study into the Swiss Second Homes Initiative by LSE economists Christian Hilber and Oliver Schöni found that the limit on second homes reduced the prices of primary homes but also damaged incomes and employment in the local economies in areas where they are common, which meant that renters were no better off. While there are differences between the Swiss policy and the additional homes surcharge, the

[1] Treasury Committee, Comprehensive Spending Review and Autumn Statement 2015, HC 638
9 December 2015, Q279,
http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/comprehensive-spending-review-and-autumn-statement-2015/oral/25757.html

similarities mean that the negative impact on the economy, particularly through tourism, should caution politicians against such a levy.

Questions must also arise as to how much revenue the charge raises, once dynamic effects are fully accounted for. Research undertaken by Walbrook Economics for the TaxPayers' Alliance[2] in 2013 found that stamp duty as a whole raised very little net revenue due to the highly responsive nature of the housing market to its rate. If the same effects occur then the overall additional revenue raised (after deducting reductions in revenue on other taxes) may be much lower than expected.

In summary, the additional homes surcharge complicates the tax system, is regressive, hinders labour mobility, is economically damaging and may not even raise much revenue.

[2] Available at http://old.taxpayersalliance.com/stampdutymodelling.pdf

2. Restrictions on financing costs of buy-to-let landlords

Another measure announced last year which is aimed at distorting property markets in favour of owner-occupiers is the restriction on the deductibility from tax of financing costs for landlords. This measure will be phased in from April 2017 and be fully implemented from April 2020. Rather than deducting finance costs from gross rental incomes to produce a taxable income, Income Tax will be levied on both the rental income used to pay finance costs as well as the profit. Instead, landlords will be able to apply for a deduction from tax equivalent to the basic rate on their finance costs. This essentially will mean that higher rate taxpayers will be taxed on their finance costs at the difference between the basic (20p) and higher rates (40p and 45p) of Income Tax.

False equivalence of landlord and owner-occupier finance costs

The measure was announced in the Summer Budget in 2015, which stated:

> *The current tax system supports landlords over and above ordinary homeowners.*
> *Landlords can deduct costs they incur when calculating the tax they pay on their rental income.*
> *A large portion of those costs are interest payments on the mortgage. Mortgage Interest Relief was withdrawn from homeowners 15 years ago. However, landlords still receive the relief. The ability to deduct these costs puts investing in a rental property at an advantage.*

This is a surprising statement about the UK tax system from HM Treasury. The reason mortgage interest relief was withdrawn for owner occupiers explains why a comparison with landlords' finance costs is false. Owner occupiers used to pay Income Tax on the imputed rental value of their property, under what was then called schedule A. Mortgage payments were clearly a legitimate expense against this, so they were deducted from the imputed income in much the same way as finance costs for landlords are still deducted from their rental incomes. When schedule A was abolished and Income Tax was no longer payable on householders' imputed rents, tax relief for mortgage interest was also ended accordingly. It only makes sense to treat tax relief on property finance equally if we also tax income (whether actual or imputed) from property equally.

It is also inaccurate to suggest that the status quo advantages landlords over owner-occupiers from a principled analysis, regardless of the historical roots. Landlords' rental incomes are subject to Income Tax payable either by the landlord directly or by the lender if the rent is paid towards a home that the landlord does not own outright. It makes no sense to tax the rental income twice simply because it passes through a landlord intermediary. If a rich person buys a property to let, why should the overall tax on the rental income be lower than it would be if the money was instead lent to a landlord who in turn used it to buy and let out the same property?

The table below shows three scenarios where a landlord acquires a property for £200,000 which earns an annual rental income of £10,000. We assume both parties have other income which makes them higher rate (40p) taxpayers:

1. Under the current tax rules, a lender lends £150,000 of his £200,000 to a landlord who combines it with his own £50,000 to buy a rental property worth £200,000, which earns a rental income of £10,000. In return, the landlord pays the lender £7,500 of annual interest.
2. The same arrangement with the restrictions of finance cost relief in place.
3. The lender buys the property directly

	Current tax rules		After restrictions, A		After restrictions, B	
	Lender	Landlord	Lender	Landlord	Lender	Landlord
Cash	£50,000	£0	£50,000	£0	£0	£50,000
Loan	£150,000	-£150,000	£150,000	-£150,000	£0	£0
Interest paid	£0	£7,500	£0	£7,500	£0	£0
Interest received	£7,500	£0	£7,500	£0	£0	£0
Rental income	£0	£10,000	£0	£10,000	£10,000	£0
Net rental income	£0	£2,500	£0	£2,500	£10,000	£0
Net income	£7,500	£2,500	£7,500	£2,500	£10,000	£0
Taxable income	£7,500	£2,500	£7,500	£10,000	£10,000	£0
Tax	£3,000	£1,000	£3,000	£4,000	£4,000	£0
Tax relief	£0	£0	£0	£1,500	£0	£0
Net tax	£3,000	£1,000	£3,000	£2,500	£4,000	£0
Real tax rate	**40%**	**40%**	**40%**	**100%**	**40%**	**n/a**

Under the current rules, the landlord pays 40 per cent tax on the net rental income, after the interest on his loan is deducted. The lender pays 40 per cent tax on the rental income received from the landlord. In total between the pair, £4,000 tax is paid on the £10,000 of rental income from the property. Which one of the pair owns the property has no effect on the overall level of tax paid on the property's rental income.

Under the new rules, the landlord's taxable income will no longer exclude interest payments to the lender. The taxable income will therefore be £10,000 and the tax payable on it will be £4,000 before deducting the new tax relief calculated at the basic rate (20 per cent) on the £7,500 of interest. The final tax bill will therefore be £2,500, an effective tax rate of 100 per cent on the landlord's net income.

The combined tax for the pair on their £10,000 of rental income will rise from £4,000 to £5,500, or 40 per cent to 55 per cent. But the pair can reduce their tax liability back down to the current levels if the lender buys the property directly instead of lending it to the landlord, as described by the numbers under the "after restrictions, B" column.

Alternatively, the parties may choose to incorporate, lend the money to the company and let the property through the company. There are tax disadvantages to incorporation which may outweigh this advantage, but a good tax system should not seek to distort ownership structures in this way.

3. HMO licensing, landlord registers and other costs

Other policies have recently been implemented or proposed, including extensions for the role of landlord licencing, especially regarding "houses in multiple occupation" (HMOs), which is defined as a property rented by three or more people who form more than one household. Certain large HMOs must now be licenced, with the licensing costs varying from council to council. The London borough of Wandsworth, for example, charges between £1,020 and £1,870, depending on the number of storeys and whether the landlord is 'accredited'.

In addition, many local authorities are implementing selective or comprehensive private landlord licensing schemes, with fees typically around £500 for a five-year licence. Many assume that the burden of such fees will fall on landlords, either because it is landlords who are legally required to pay the money, or because there is an assumption that because landlords already set their rents as high as the market will bear, they are unable to pass on any of the costs to tenants.

In fact, a number of factors suggest that the economic burden of the fees does not lie as clearly on landlords as it first seems.

The first is nominal "stickiness". Landlords with satisfactory tenants may neglect to raise rents as fast as they might do for fear of losing the tenant and having to find a new one, expending money, effort and potentially foregone rental income in the meantime. But while this may be tolerable to a landlord if the net rental income is unchanged, a reduction in net rental income caused by the introduction of a new fee may prompt the landlord to recover the loss.

Secondly, potential alternative uses for a property mean that landlords can switch their properties away from being let under a licenced use to being used as something else, perhaps from HMOs into single household occupation or perhaps sold entirely. This in turn alters the relative supply and demand in the relevant sectors of the market, leading to higher prices in the licenced sectors and lower prices in the unlicensed sectors.

It would be mistaken to assume that for every property a regulatory expense prompts a landlord to sell means that a marginal renter is converted to owner-occupancy because of the downward pressure on sale prices. That will happen in some cases, of course. But the substantial equity built up by existing owner-occupiers makes it likely that in other cases, existing owner occupiers will be in a better position to buy the switched supply, leading to a reduced relative scarcity of housing for them and, conversely, a greater relative scarcity for those renting. That's good news if your income is high enough to afford to buy or rent in the unlicensed sectors, but bad news for people too poor to buy or rent outside the HMO sector.

4. The real and unavoidable problem is planning restrictions

The fundamental problem with housing markets in Britain is the overly tight nature of planning restrictions. All regulations have costs which are passed on either to landowners or to tenants and buyers of property but the most harmful type of restriction are those which ration the availability of land in places where people want to live. This is because the cost of these restrictions cannot be borne by landowners. Instead, their effect is to ration housing in high demand areas which manifests in smaller homes that are more expensive.

Restrictions such as the green belt, which limits the physical land available for housing, are the most obvious type in this category. But height restrictions and other regulations which limit the density of housing in areas where it is allowed have the same effect. Economist Dr Kristian Niemietz reviewed the economic literature for the TaxPayers' Alliance in *The Spending Pl*an. Before listing the relevant findings, he summarised it briefly:

> *The empirical literature is remarkably conclusive: house prices can fluctuate for all kinds of reasons, but in the long term, the decisive factor is the severity of restrictions on development. Planning restrictions really do reduce housing development, rather than just redirecting it.*

The problem is political. The solution requires allowing more homes to be built on green belt land, taller buildings in cities, more infill and bulkier development. This will not be universally popular as it will change the character of areas and increase density and lead to different traffic patterns and other issues such as and changes in demand for public services.

Neighbourhood and national amenity groups exist to oppose and prevent all of this but their success has created the housing crisis we are now in. There are obvious benefits to the work carried out by political campaigning organisations such as the Campaign to Protect Rural England, the Victorian Society and the thousands of local groups watching over their neighbourhoods. But there are two sides to every story and the other, less obvious, side is the inevitable rise in the cost of housing that is a direct result of their success in preventing new supply.

The politically difficult fact is that housing cannot become more affordable unless it becomes cheaper and easier to build more of it in the places where historical, green belt and local neighbourhood amenity groups object.

5. Recommendations

Cancel the additional homes stamp duty surcharge and restrictions on finance relief

Both these measures are regressive, harmful and unnecessary. They complicate further our already labyrinthine tax system and create economically damaging distortions in the process. This is the exact opposite of the tax reform we need and these measures should be scrapped immediately.

Halve all stamp duty rates immediately with a view to abolishing it entirely

Stamp duty is a disastrous, unfair and unnecessary tax which impedes labour mobility, misallocates housing stock and leads to lower incomes and higher unemployment than necessary. It doesn't even raise much revenue, once dynamic effects are fully accounted for. It should be abolished entirely as one of the worst taxes in the system, but halving all the rates would be a good first step.

Reform planning restrictions to declassify some green belt land and allow taller, denser construction in urban areas

Pressure needs to be taken out of the housing market by freeing up land so that land with permission becomes less rare and therefore less expensive. The first impact of this policy will be to increase the profits of development, by lowering the cost of land. This in turn will stimulate more housing supply which will then bring down housing costs.

The way to do this is to declassify a small percentage of the vast green belt. The 'metropolitan green belt' surrounding London covers 5,140 km^2, over three times as much land as the city itself (1,572 km^2). Declassifying just 5 per cent of the green belt would transform London's land economy, allowing the city to expand by almost a sixth. This should be reinforced by reforms which allow people a presumed right to build taller than their neighbours within a reasonable limit, perhaps one or two storeys. Further reforms to deregulate other unnecessary elements of the planning system and speed it up to reduce the cost of delays and uncertainty should also be undertaken.