

The impact of recent tax changes on the private rented sector

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The tax changes that affect landlords announced by then Chancellor George Osborne in 2015 are, should they be implemented, likely to have significant and negative effects on the supply of rental properties. Stamp duty is now being levied at a higher rate on properties bought to be rented; most properties bought by private buy-to-let investors will pay an extra 3% in tax. And starting from April 2017 the rate at which interest on mortgages used to acquire buy-to-let properties can be offset against tax on rental income will be reduced from an investor's marginal income tax rate down to the basic rate.

If these changes were a move towards a more neutral (non-distortionary) system of taxation of rented property, relative to owner-occupied property, they would have a rationale. But rather than being a move towards neutrality – as was claimed – they in fact represent a further penalty against private provision of rented properties by potential suppliers who cannot (or chose not to) invest via a corporate entity. The reason for increasing the tax distortion against the rental sector is far from clear. Why would one want to deter provision of private rented accommodation from smaller landlords? Is it because there is a case for further subsidising home-ownership? Who is that supposed to benefit – existing home owners or aspiring home owners? It seems most unlikely that a policy whose main effect will be to reduce the supply of rental properties, and to increase the demand for owner-occupied property, will make life easier for those who do not yet own their home.

In the rest of this brief analysis I will explain how the tax changes are a move towards greater distortion against rental supply and roughly calibrate the extent of that further distortion – which is significant.

The starting point

Before these changes were announced in 2015 the tax system already favoured owner-occupation over renting. This reflects two things:

- Capital gains on owner-occupied homes are not taxed; landlords pay tax on capital gains
- Landlords pay tax on that part of rental income which exceeds allowable costs; home owners do not pay tax on any part of the implicit income they receive from living in their own home

The full tax deductibility of all expenses (including interest payments on mortgages) against landlord's rental income offset much, but certainly not all, of the advantage that immunity from tax of owner-occupier's implicit rental income brings.

This non-neutrality in the taxation of housing, and the ways in which it favours owner occupation over renting, has long been recognised. The authoritative Mirrlees Review of 2012 into the UK tax system, organised and managed by The Institute for Fiscal Studies, was clear on this:

“At present, the tax system treats rented and owner-occupied properties differently, creating a distortion in favour of owner-occupation. If, instead, we could treat all housing consistently both as a form of consumption and as a type of asset, such distortions could be removed.

Owner-occupied housing..... is bought out of taxed income, but no tax is payable on any returns or at the point of sale.... In contrast, housing that is bought to rent out is subject to something closer to a comprehensive income tax (TTE) treatment. Returns in the form of rental income and capital gains are subject to tax. This difference in treatment creates a major bias in favour of owner-occupation, albeit less so since the tax-deductibility of mortgage interest payments was gradually removed for owner-occupiers but retained for landlords The treatment of owner-occupied and rental property should be levelled out.

..investing in buy-to-let housing is currently discouraged by the tax system for no good reason.....Income tax and capital gains tax create a significant bias against the rental market in favour of owner-occupation.”

Mirrlees Review, chapter 16:

available at: <https://www.ifs.org.uk/uploads/mirrleesreview/design/ch16.pdf>)

The tax changes announced in 2015, if implemented, will *increase* this distortion against renting. They are a move in precisely the wrong direction and are likely to harm most those who they might be intended to help - that is people who are not (yet) home-owners. They do so by:

1. Not allowing appropriate tax deduction of legitimate expenses to many landlords (which in a non-distortionary system should be fully deductible at the marginal tax rate on income)
2. Levying an extra cost (via a higher rate of stamp duty) on those buying property to rent

The Institute for Fiscal Studies was very clear in its analysis of these tax changes at the time they were announced by George Osborne. In its post-budget presentation in 2015 the IFS summarised the measures in bullet point form thus:

Restricting mortgage interest relief for landlords

- **Budget announced restriction of tax relief to the basic rate**
 - To be phased in over 4 years from April 2017
 - Raises £0.7bn from high-income landlords
- **Budget speech:**
'landlords have a huge advantage in the market as they can offset their mortgage interest payments against their income, whereas homebuyers cannot.'
- **Nonsense**
 - Landlords taxed on rental income and capital gains
 - Owner-occupiers not taxed on (implicit) rental income and capital gains
 - Deduction of costs is appropriate counterpart to tax on returns
- **Exacerbates tax bias towards owner-occupation**

IFS budget analysis, 2015. Available at:

https://www.ifs.org.uk/uploads/publications/budgets/Budgets%202015/Summer/Adam_tax_.pdf

The scale of the impact of the tax changes - some illustrative calculations:

In order to illustrate the potential impact of the tax changes I analyse how the level of rent that a private landlord needs to charge to make an acceptable return will be affected. I calculate the after tax return (after all expenses) on a rented property to a landlord facing the personal income tax system before and after the proposed tax changes. I set this equal to a required return and from that estimate what the rent needs to be relative to the value of the property.

To explain the calculations, I use the following notation:

Let the annual gross rent on a property = $RENT$

Ongoing annual expenses (eg repairs, maintenance, administrative costs, insurance) = exp

Fixed cost of a purchase **and** sale (eg stamp duty, estate agent fees, legal fees) = FC

Size of Mortgage = M

Current value of property = P

Mortgage relative to price of property is leverage = lev (so $lev = M/P$)

Interest rate on mortgage = rm

Capital gain (change in value of property over a year) = CG

Percentage capital gain (CG/P) = $pinf$

Target post tax rate of return = R^*

Horizon over which the fixed cost of buying and selling a property are spread = T

I assume initially that there is a common tax rate used to offset all expenses against rent and that this tax rate levied on net rental income is equal to tax on capital gains. I denote this tax rate by tax

I then allow for interest expenses to be offset only at lower rate $taxb$ (basic rate tax) and for a higher rate of stamp duty.

For an equilibrium in the market we require that the after tax excess of rent over all expenses equals the amount of financing that the landlord has supplied themselves multiplied by the acceptable (or required) rate of return.

The after tax annual returns, assuming all expenses (including interest) are fully tax deductible, is:

$$(1-tax) \times [RENT + CG - exp - rm \times M - FC/T]$$

I have assumed here that the cost of buying and selling a property to rent (stamp duty, legal fees, valuations, estate agents costs) are spread evenly over the period when the property is owned by the landlord (T). So they represent an average annual cost of FC/T .

The required return on the funds of the landlords in the rental property is:

$$R^* \times (P-M)$$

Setting these two equal means we require that:

$$(1-tax) \times [RENT + CG - exp - rm \times M - FC/T] = R^* \times P \times (1-M/P)$$

Re-arranging this gives an expression for the required rental yield ($RENT/P$) which is:

$$RENT/P = R^* \times (1-lev)/(1-tax) + (exp + FC/T)/P + rm \times lev - pinf$$

Suppose we raise stamp duty so the new fixed cost of buying and selling a property rises to FC' and we only allow interest to be deducted at rate $taxb$, which could be lower than the rate charged on rental profits. Then we have that the new required rental yield ($RENT'/P$) becomes:

$$RENT'/P = R^* \times (1-lev)/(1-tax) + (exp + FC'/T)/P + rm \times lev \times (1-taxb)/(1-tax) - pinf$$

I use these two formulas, for the initial rental yield ($RENT/P$) and the rental yield after the tax changes ($RENT'/P$), to show the size of the change in rents it generates. For this calculation I am assuming house prices do not change (a point I return to below). I use some plausible assumptions about the size of costs, mortgage rates, required after tax returns and so on. The assumptions I use for the basic illustration are these (variants are considered in the table below).

All figures set at annual rates:

$$R^* = 5\%; \quad tax = 40\%; \quad taxb = 20\%; \quad rm = 4\%; \quad lev = 0.7; \quad pinf = 4\%$$

$$FC/P = 6\% \text{ (buy and sell costs) o/w stamp duty is } 2\%; \quad FC'/P = 9\% \text{ o/w stamp duty is } 5\%$$

$$exp/P = 3\%; \quad T = 10 \text{ years}$$

These assumptions generate a required initial rental yield ($RENT/P$) of 4.9%. This jumps to 5.83% if the only tax change is to reduce the rate at which interest is deducted against tax to the basic rate ($taxb$). To offset that, rent would need to be increased by about 20%. If we also factor in the effect of the rise in the stamp duty rate by three percentage points the rental yield the rental yield needs to be 6.1%. That would require a rise of 25% in rents.

The calculations are obviously sensitive to assumptions made about non-tax factors such as interest rates, leverage, non-interest expenses and so on. The two tables below show the impact of tax changes when we vary (one at a time) various of those assumptions relative to the base case shown above. Each column shows the situation when we vary one of the other assumptions keeping all other assumptions as described above. In each column we show first the rental yields required before any tax change. The cell beneath that shows by how much rent would need to rise to offset the reduced deductibility of interest payments (assuming the landlord is a 40% tax payer). The cell beneath this shows by how much rent would need to rise, at unchanged house prices, if stamp duty alone was changed. The final cell shows by how much rent would have to be increased to offset the effects of both reduced tax deductibility of interest and higher stamp duty.

Table 1

	T= 5	R*=0.06	Lev=0.5	Lev = 0.8
Initial required gross rental yield	5.5%	5.4%	5.8%	4.5%
Required growth in rent with reduced tax deductibility	17.0%	17.3%	11.6%	23.9%
Required growth in rent with higher stamp duty	11.0%	5.6%	5.2%	6.7%
Required growth in rent with both tax changes	28.0%	22.9%	16.8%	30.6%

Table 2

	Rm=0.06	Rm=0.05	Pinf=0.02	Lev = 0.8
Initial required gross rental yield	6.3%	5.6%	6.9%	4.5%
Required growth in rent with reduced tax deductibility	22.2%	20.8%	13.5%	23.9%
Required growth in rent with higher stamp duty	4.8%	5.4%	4.3%	6.7%
Required growth in rent with both tax changes	27.0%	26.2%	17.9%	30.6%

The effects of the tax changes are clearly large. Generally rents would need to rise between 20% and 30% to offset them - more often than not rents need to rise by closer to 30%. The impact of the reduced tax deductibility of interest payments, which affects cash flows every year, is substantially larger than the impact of higher stamp duty, which affects cash flows only at purchase and is spread over the length of the landlord's investment.

Of course not all rents would go up this much. Some buy to let properties are bought with cash or owned by basic rate tax payers, and for these landlords it is only the stamp duty change that would require higher rents. And part of the adjustment to the tax changes might come through lower house prices. But given the size of the private rented sector (around 20% of properties) one should expect most of the adjustment to come through higher rents rather than lower house prices.

Is there any rationale for the tax changes?

It is likely that the tax changes will have a material effect upon the supply of private rented property. The calculations described above suggest that unless rents rise significantly the supply of rented property from private landlords will fall. Is that an outcome we should welcome? Is there any rationale for tax changes that bring this about?

One possible argument is that the changes might help aspiring first-time buyers. But aspiring first-time buyers are hardly helped by squeezing the supply of rental property and driving rents up. Aspiring first-time buyers need to live somewhere; a large proportion rent. Nor is there anything intrinsically wrong with people being in the rented sector for an extended phase of their life. We should want to avoid a situation where people feel pressurised into taking big mortgages relative to their income early in life because the rental option is so poor. The whole thrust of the Mortgage Market Review (MMR) was to ensure that people could afford mortgages; the Bank of England's limit on the quantity of lending at loan to income ratios above 4.5 goes in the same direction, as do moves to increase the amount of capital lenders need to hold against mortgages. A property market in which people in their 20's borrow 5 or more times an inflated income at what are a currently very low interest rates, and then struggle a few years down the road, is something we should not want. The view that owner-occupation is a form of tenure that people should aspire to at the earliest possible point in their lives is deeply flawed. A tax change that reduces the incentive to supply rental property is entirely counter-productive here.

In a world where house prices might be consistently higher relative to incomes than in the past we might naturally expect the period in which people are in the rented sector is longer. And there are good economic reasons for believing that in a country with a rising population and where real incomes tend to increase over time house prices might well rise at least as fast as incomes. To then introduce measures that reduce the supply of rented property is perverse.

Can the tax changes be defended on the grounds that it is not appropriate for the private rented sector to be significantly supplied by small scale landlords? It is not at all clear that it can. There is no evidence that private landlords with a small number of properties are bad landlords. Nor is there any reason to think that investing in property to rent is an inappropriate thing for people to do with part of their saving. It is strange to believe that having households channel more of their savings into US government bonds or into equity issued by German companies is to be preferred to their investing in providing rented accommodation in the UK.

Conclusion:

It is hard to see any rationale for the tax changes announced in 2015. Evidence from Paragon suggests those changes are beginning to have a dampening effect on the supply of private rented property. They should be abandoned.

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