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@TheIFS

# Taxation and housing: How do we get the relationship right?



Economic  
and Social  
Research Council

# Housing in the tax system

- Key idea: housing is both a consumption good and an asset
  - Occupier enjoys a flow of services from living in the property
  - Owner gets a return on his/her purchase
- Tax system should treat it appropriately from both perspectives
- Starting point is neutrality: treat similar activities similarly

# Taxing housing consumption

- Housing should be taxed like other consumption
- Two ways this could be done:
  1. VAT on new build
  2. Annual tax on the stream of consumption
- From where the UK is starting, the latter makes more sense
- Tax the annual consumption value of housing: substitute for VAT
- Looks like a sensibly reformed council tax
  - Based on up-to-date values (rather than 1991 values)
  - Proportional to values (rather than regressive with wide bands)
  - No discounts for single occupancy (rather than 25% discount)
- ‘Dry’ tax → allow limited deferral of tax payments (with interest)

# Taxing housing as an asset

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**Private rental housing**

**Owner-occupied (main) home**

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# Taxing housing as an asset

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## Private rental housing

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Income tax on rental income

CGT on capital gains

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No tax on imputed rental income

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## Private rental housing

## Owner-occupied (main) home

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Income tax on rental income  
– and mortgage interest deduction  
restricted to basic rate

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# Taxing housing as an asset

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## Private rental housing

## Owner-occupied (main) home

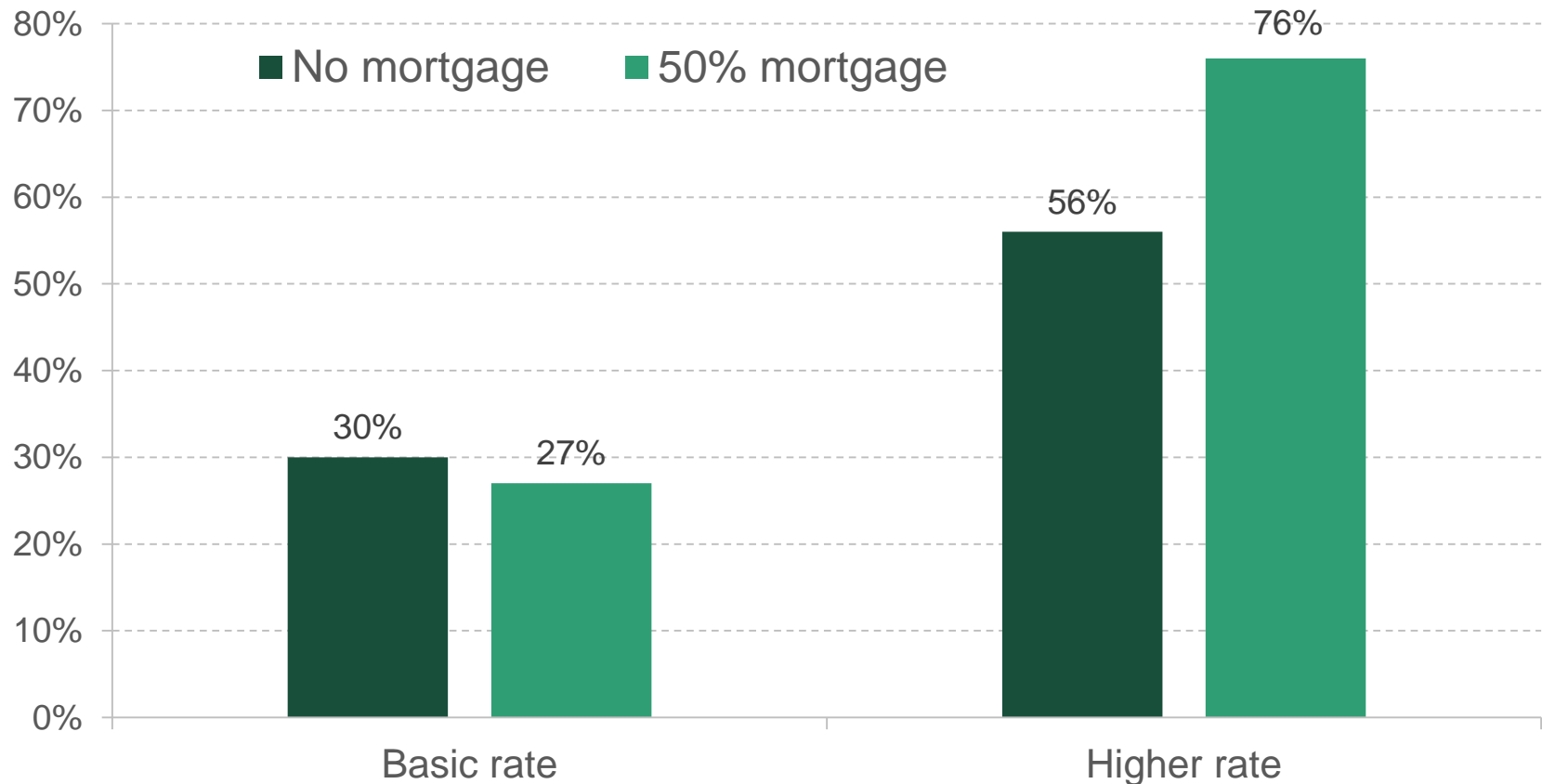
- 
- Income tax on rental income
- and mortgage interest deduction restricted to basic rate
- CGT on capital gains
- higher rates than for other assets

No tax on imputed rental income

No CGT

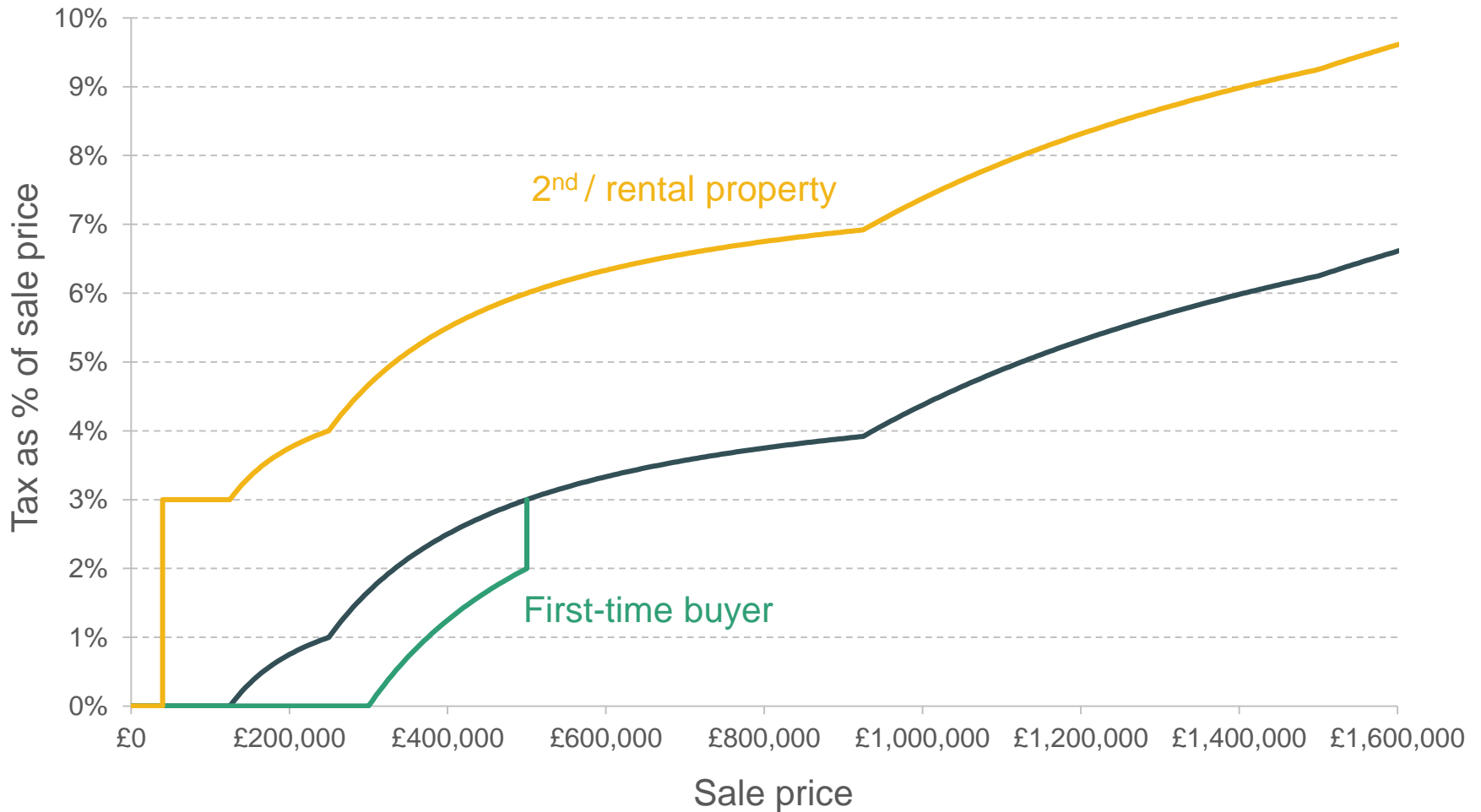


# Effective tax rates on 10-year buy-to-let investment



Source: Table 5.3 of Adam & Shaw (2016), *The effects of taxes and charges on saving incentives in the UK*. Full details and assumptions given there.

# Stamp duty land tax



Note: Applies in England and Northern Ireland, ignoring temporary Covid-related reliefs.

# Taxing housing as an asset

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## Owner-occupied (main) home

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# Taxing housing as an asset

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Stamp duty with 3ppt supplement	Stamp duty with 1 <sup>st</sup> -time buyer's discount

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	Lifetime ISA, Help to Buy,...

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# Rental vs owner-occupied housing



- Subsidising owner-occupation largely ineffective in making housing more affordable overall
  - Supply constrained, so just bids up prices
- But does affect the allocation of housing
- Debatable whether any justification for favouring owner-occupation
  - But certainly not on this scale
  - And certainly not in this odd cocktail of ways

# Reforming the taxation of property income

- Current regime for rental property distorts behaviour
  - Penalises buy-to-let investment and penalises renting
  - Inflation and capital gains cause particular problems
- Current regime for owner-occupiers seems too generous
  - Enormous returns have gone untaxed
- And distinction creates major bias in favour of owner-occupation
  - And between each housing investment and many other assets
- A ‘rate-of-return allowance’ could alleviate all these problems



# A rate-of-return allowance for rental property

- Based on current system
  - Taxing both rental income and capital gains
  - Ideally at full labour income tax rates
- But with an allowance for a (risk-free) rate of return on investment
  - EITHER deduct (say) 3% of purchase price from rental income each year; tax capital gains at full marginal income tax rates
  - OR tax rental income in full, but charge CGT only on gains relative to a purchase price stepped up by (say) 3% per year
    - Like old indexation for inflation, but for an interest rate instead
- Give tax relief for mortgage interest above the risk-free rate

# A rate-of-return allowance for owner-occupiers?

- In principle, same approach possible (& desirable) for owner-occupiers
  - Instead of actual rent, use imputed rent (which assessing anyway)
  - Using imputed rent instead of actual rent
  
- Two main obstacles:
  - Politics: introducing new tax where there is none now
  - Commitment: those with unrealised capital gains wait for repeal
  
- Retain current treatment of owner-occupied housing for now?
  - RRA for rental property alone would still be a major improvement

# Conclusion: recommendations

- Replace council tax and SDLT with flat % tax on up-to-date values
  - Allow some home-owners to defer payment (with interest)
  
- Introduce a 'rate-of-return allowance' regime for rental property
  - And perhaps owner-occupied housing in the (even) longer term
  
- Reverse recent ad hoc policies that exacerbate bias:
  - Subsidies for owner-occupation: IHT, LISAs
  - Penalties for buy-to-let: mortgage interest restriction, extra SDLT