Why BTL equals "Big Tax Let-off"

How the UK tax system hands buy-to-let landlords an unfair advantage

November 2013

Author:
David Kingman

intergenerational foundation
Fairness for Future Generations

The Intergenerational Foundation:

The Intergenerational Foundation (www.if.org.uk) is an independent, non-party-political charity that exists to protect the rights of younger and future generations in British policy-making. Whilst increasing longevity is to be welcomed, our changing national demographic and expectations of entitlement are placing increasingly heavy burdens on younger and future generations. From housing, health and education to employment, taxation, pensions, voting, spending, transport and environmental degradation, younger generations are under increasing pressure to maintain the intergenerational compact whilst losing out disproportionately to older, wealthier cohorts. IF questions this status quo, calling instead for sustainable long-term policies that ensure younger and future generations are better protected by policy-makers.

For further information on IF's work please contact Liz Emerson:

Intergenerational Foundation,
19 Half Moon Lane,
London,
SE24 9JS
www.if.org.uk
info@if.org.uk
07971 228823
@inter_gen

Contents

Foreword

Britain's housing policy is falling down. In common with every premier since Margaret Thatcher, David Cameron would like to build a "property-owning democracy" but the proportion of adults who own their own homes is actually falling. It is estimated that two in five adults now aged twenty will never buy one. Meanwhile, rents and prices are rising and commentators warn of the under-supply of new properties and a new housing bubble.

This ground-breaking paper sounds a klaxon blast, warning that the favourable treatment of buy-to-let landlords by the British tax system represents an underlying and underexplored threat to the "property-owning democracy". It reveals that Britain has spent more than a decade encouraging a form of housing investment that builds very few new homes, rinses the taxman, raises the cost of housing and prices-out first-time buyers.

As a tenant or a homeowner it is impossible to read this paper and not feel pangs of jealousy for the tax advantages available to buy-to-let landlords. No fair-minded housing analyst can help but throw their hands up in despair: sometimes the effect of policies reveals political naiveté, oftentimes policy creates incentives that stand in diametrical opposition to their stated purpose.

For an example of naiveté, you need only look at MIRAS – Mortgage Interest Relief At Source – abolished by Gordon Brown who called it a "middle-class perk" in 2000. What few realise is that MIRAS remains for buy-to-let landlords who deduct mortgage interest payments from their tax bills. The average landlord, incidentally, happens to own three times the average person's net wealth. So, one might say that the "middle-class perk" may be gone but Gordon Brown left an "upper-middle-class perk" untouched.

Landlords also benefit from a tax allowance to ensure they maintain the standards of their properties which is worth 10% of their annual net rental income. The allowance is designed to cover the depreciation of furniture and fixtures but there is convincing evidence that landlords are claiming the allowance but not doing the repairs. Studies find that one in four tenants who have asked landlords to fix their properties are ignored. Here, the tax policy that is designed to maintain housing standards simply cuts tax bills for wealthy landlords. Home-owners have no such tax advantages.

And what of Capital Gains? This paper reveals how prudent landlords, 70% of whom admit to speculating on land values, are surrounded by advice about the loopholes and dodges that can slash their CGT liabilities to zero. Is this fair? Well, it rather depends on your perspective. The vital distinction is whether landlords are running businesses or are the beneficiaries of "unearned income". For their part, the landlords argue that they are businesses who deserve their tax breaks. The Intergenerational Foundation, the Tax Tribunal and, for that matter, Adam Smith all disagree. Worryingly, Britain's Exchequer can't seem to make up its mind.

So, while buy-to-let landlords share many tax advantages with businesses – collectively deducting billions of pounds of what seem to be "business expenses" each year from their tax bills – last year, the upper tax tribunal found buy-to-let to be an "investment activity". And, in some literature, HMRC explicitly refers to rental income as "unearned income". That view is correct. HMRC should give landlords no special favours.

Indeed, economically, buy-to-let investors should not imagine they are small-business owners. They are much less useful to the economy, rarely employing anyone who would not be employed by owner-occupiers to service their homes and deriving their income from gambling on house price rises. Simply because these speculations have, in recent years, paid off does not make them the work of proper business. Indeed, these good returns may even been slowing economic growth by pushing investment money into bricks and mortar rather than the productive, profit-generating part of the economy that innovates and creates jobs.

Worse, the special treatment of landlords places first-time buyers at a disadvantage. This paper reveals good evidence that first-time buyers are losing out – paying more tax, enduring weaker mortgage terms and finding that buy-to-let investors are not encouraging more house building but pushing up the price of housing and skewing the types of homes that are built. Britain is getting good at building investment flats and worse at building family homes.

There is also a generational aspect to the impacts of buy-to-let. The average age of landlords is 53 and many of them invested in the housing market in response to the failures of the pension market. They have made good returns but future generations will have to pay more for their basic shelter as a result. Some may well be locked-out of home ownership completely.

The following paper argues that, rather than creating a '"property-owning democracy", our tax system is subsidising a '"rentier society." Is that really desirable? We hope to start the debate.

Ed Howker

Co-founder, The Intergenerational Foundation and author of *Jilted Generation*

November 2013

Executive Summary

The Intergenerational Foundation (www.if.org.uk) has analysed the taxation of the private rented sector in the UK in order to examine how it contrasts with the taxation of other types of housing tenure. The results of this study have been summarised below.

How is the private rented sector treated favourably by the tax system?

- **Landlords receive a public subsidy worth up to £5 billion in tax relief per year.** This is relief that they are able to claim for their business expenses, including the 10% "wear and tear" allowance and interest relief on mortgages.

- **Landlords are allowed to claim 10% of gross rent per property as a "wear and tear allowance", without having to prove what they spent the money on.** This creates a perverse incentive for landlords to claim the money without making any repairs to their property. Despite this allowance, over a third (35%) of dwellings in the private rented sector as classed as "non-decent", and a quarter of tenants have requested repairs from their landlords which have not been carried out.

- **A loophole enables landlords to avoid paying capital gains tax (CGT) on the final 3 years when they own a property.** As long as they have occupied it as their main residence at some point, any capital gains which accrue during the final 36 months of ownership will be exempt from CGT, even if they only live there briefly and then move to somewhere else.

- **Private residence relief and letting relief can be used smartly to eradicate landlords' capital gains tax liabilities.** In practice, many landlords avoid paying capital gains tax altogether, even though rental properties are supposed to be liable for it.

- **The tax treatment of rental property is inconsistent.** Landlords are able to claim tax relief against their costs as if they are running businesses, yet HMRC classifies rent as "unearned income."

Who benefits from this?

- **Rental property has produced massive returns for investors.** Returns on investing in rental property have been twice those from investing in equities since 2000, partly because investors are taxed more favourably.

- **Baby boomers (aged 46-65) account for 64% of landlords (nearly two-thirds)**. The average landlord is aged 53, so these tax advantages help them financially at the expense of younger tenants and would-be first-time buyers.

- **17% of sitting MPs are landlords, compared to 4% of UK adults.** This may help to explain why policy-makers have paid relatively little attention to how landlords are taxed.

Why should this be changed?

- **Tax breaks for landlords mainly help more affluent members of society.** Landlords are still able to deduct their mortgage interest against rental income for tax purposes, even though allowing owner-occupiers to do this under the MIRAS scheme was dismissed as a “middle-class perk” by Gordon Brown. However, the individual investors who own Britain’s rental property are a highly affluent group who are being given an enormous, highly regressive, tax subsidy from the public purse.

- **Giving landlords tax relief distorts the market against younger buyers.** Given the UK’s extremely inflexible housing supply, offering landlords tax relief helps them to outbid first-time buyers.

- **The growth of buy-to-let hasn’t significantly increased the overall supply of housing.** The “BTL boom” has mostly just led to increased competition between landlords and first-time buyers for our existing housing stock instead.

- **BTL pushes up prices.** There is clear evidence showing that the growth of BTL increases overall house prices for everyone, including first-time buyers.

- **High rents prevent young people from saving.** Rents are so expensive in many areas that most young people are unable to save money or build up their own assets while living in the private rented sector, a trend which could have important negative consequences in the future.

- **It is estimated that 40% of today’s 20 year-olds will never own their own homes.** This is despite clear evidence showing that the majority of young people still want to become owner-occupiers.

Introduction

The buy-to-let (BTL) sector, which consists of "private investors who purchase residential property using mortgages in order to rent out accommodation to tenants,"[1] has enjoyed enormous growth since the launch of the first BTL mortgages in 1996 (Fig.1). This paper argues that this growth has partly been fuelled by the extremely favourable tax advantages which the owners of rental property receive on their investments, meaning there is effectively a large public subsidy directed towards the BTL industry. Most of this subsidy goes to older landlords who benefit at the expense of younger tenants and first-time buyers.

The growth of BTL creates intergenerational conflict because it has made it harder for young people to get on the property ladder, excluding them from the benefits of property-ownership which previous generations have been able to enjoy. This paper provides a brief overview of the UK BTL sector and how it has developed, before outlining the tax advantages the sector currently receives followed by an examination of the negative consequences which these have had for younger people and society at large. It then recommends some ways in which these tax advantages could be modified to make it easier for younger people to share in the vision of creating a property-owning democracy for all.

The growth of buy-to-let

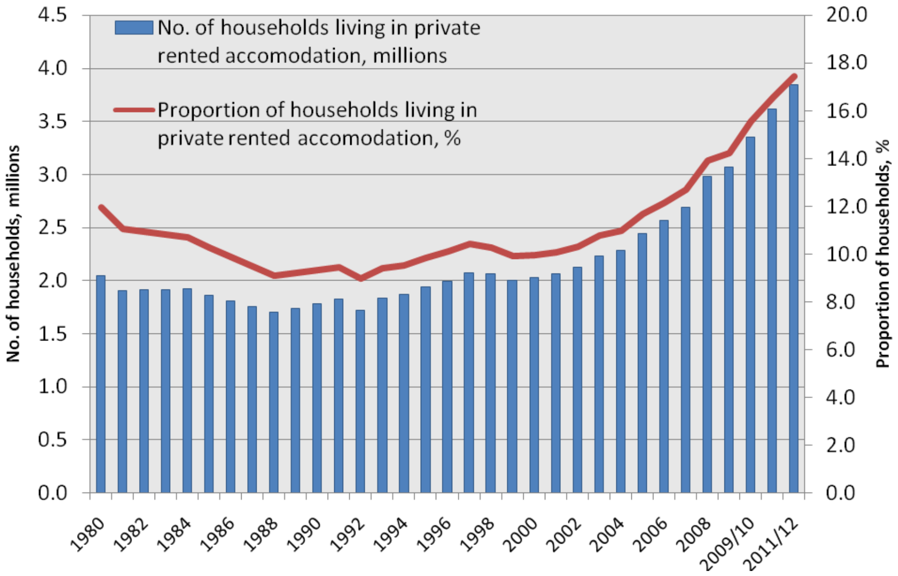

Fig.1 Growth of the private rented sector in England, 1980–2011/12[2]

Fig.1 uses data taken from the 2011/12 English Housing Survey to demonstrate how the private rented sector has expanded in England since 1980. This shows that the number of households who live in private rented accommodation has grown from a low point of 1.7 million in 1988

---

[1] Ball, M (2006) *Buy to Let: The Revolution - 10 Years On* London: ARLA
[2] Dept. for Communities and Local Government (2013) *English Housing Survey: Headline Report 2011-12* London: DCLG

(9.1% of all households) to reach 3.8 million (17.4%) in 2011/12, meaning that the number of private renters has virtually doubled in the space of a generation.

This represents an extraordinarily rapid change in a short space of time, as the story of the private rented sector between the time of the First World War (when 90% of the entire housing stock was rented privately) and the nadir reached in 1988 was one long narrative of decline.[3] For a long period, the development of large-scale social housing and the spread of increasing private home-ownership during the second half of the 20th century appeared to have consigned the era of mass private renting to history.

The perceived unattractiveness of private renting meant that it even gained a certain social stigma that found cultural expression through such vehicles as the comedy series *Rising Damp*, which introduced viewers to the seedy landlord Rupert Rigsby, and also in the reputation of certain real-life landlords such as Peter Rachman who grossly exploited their tenants. A major factor in the sector's decline during the period between the passing of the 1915 Increase of Rent and Mortgage Interest (War Restrictions) Act and the 1988 Housing Act was that landlords were subject to various controls over how much rent they could charge and how easily they could remove established tenants, which led to a reduction in the availability of private rental accommodation as investors fled the sector in search of greater financial returns which were available elsewhere.

However, these restrictions were gradually dismantled following the passage of the latter piece of legislation, which sought to liberalise the private rented sector so that it could compete more favourably with social landlords. This liberalisation eventually prompted the Association of Residential Letting Agents (ARLA) to decide to encourage private individuals to invest in rental property by creating the first BTL mortgage in 1996, which was revolutionary because it removed the additional 2% risk premium that had traditionally accompanied mortgage lending for properties which were being bought to be rented out.[4] Since then, private money has poured into the BTL sector in the UK: data from the Council for Mortgage Lenders (CML) shows that there are now around 1.46 million outstanding BTL mortgages (accounting for 13% of all mortgage lending), with a total combined value of £156 billion.[5] This figure almost certainly underestimates the total size of the private rented sector as many landlords will be letting out properties which they bought using owner-occupier mortgages, or which they have inherited.

Who has benefitted from the growth of buy-to-let?

One of the striking features of the private rental market in the UK is that the vast majority of this growth is accounted for by individual landlords who have often only invested in one or two properties, creating an ownership structure which is extremely fragmented.

---

[3] Allen, J. and McDowell, L. (1989) *Landlords and Property: social relations in the private rented sector* Cambridge: Cambridge University Press

[4] French, S. and Leyshon, A. (2009) "We all live in a Robbie Fowler house': The UK buy-to-let market in retrospect and prospect" *British Journal of Politics and International Relations*, 11(3), 438-460

[5] *Buy-to-Let Sector Continues to Grow, Reports CML* – CML Press Release, 9 May 2013

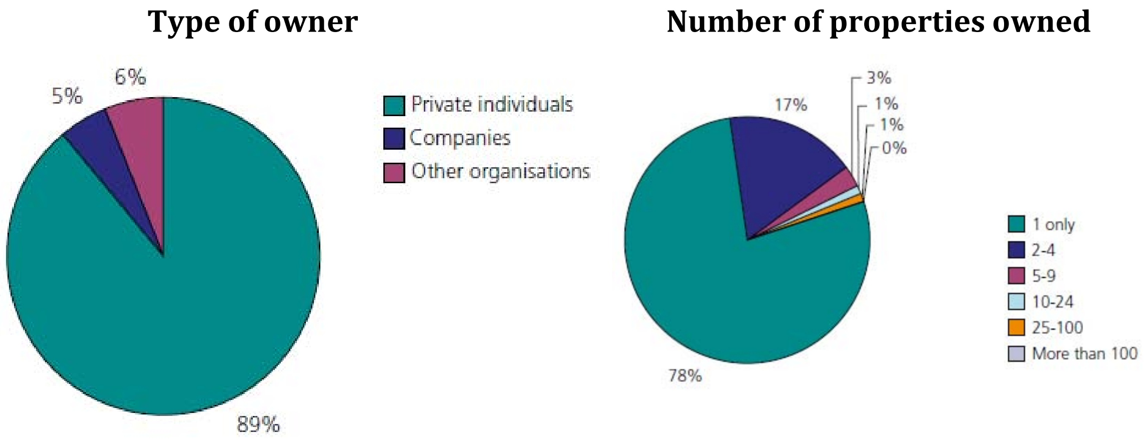

Fig.2 Private landlords in England by (left) type of landlord and (right) the number of properties they own, 2010[6]

There is also evidence that these owners tend to be significantly older than the rest of society (Fig.3).

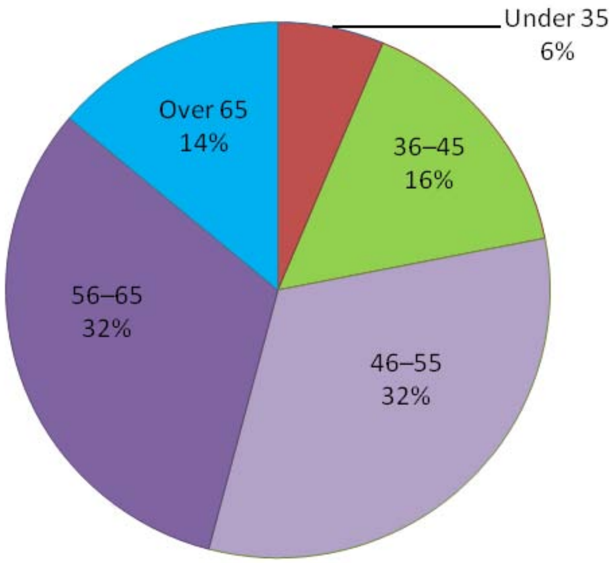

Fig.3 Proportion of UK residential landlords who fall into each age group, 2012[7]

Whilst it is to be expected that older people would own more property assets than younger ones simply because they are at different stages in the life cycle, the age structure of ownership within the BTL sector indicates that it has disproportionately been people who are aged 46 to 65 who have benefitted from its growth (as this age group accounts for 64% of landlords). According to the annual survey of residential investment landlords conducted by the Association of Residential Letting Agents (ARLA), the average age of a private landlord in the UK in 2012 was 53.

[6] Department for Communities and Local Government (2010) *Private Landlords Survey 2010* London: Department for Communities and Local Government
[7] Association of Residential Letting Agents (ARLA) (2012) *ARLA Survey of Residential Investment Landlords* Warwick: ARLA

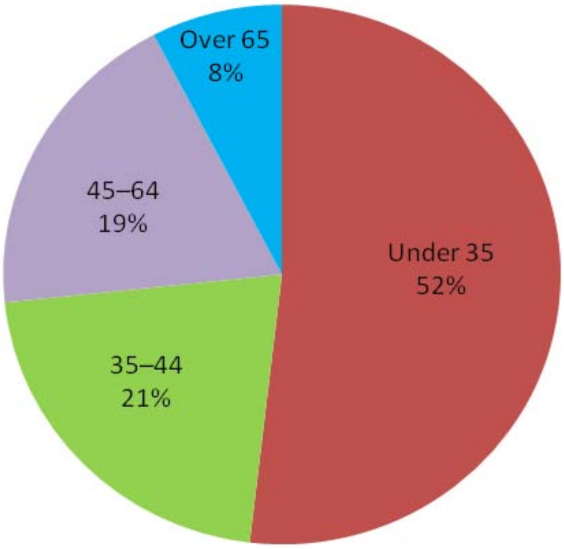

Fig. 4 The age distribution of households renting privately in England, 2010/11[8]

Fig. 4 displays the age distribution of households who are private rental tenants in England. Evidently they are predominately youthful, with over half being under 35. If we compare the pictures presented by both Fig.3 and Fig.4 then it seems obvious that the BTL market largely involves older landlords letting to younger tenants; the flow of resources which it facilitates is intergenerationally regressive, as money is being transferred from young to old on a large scale. This is probably an inevitable feature of any private rental market, as older people are more likely to have accumulated property assets; yet the extraordinarily rapid growth of the BTL sector in the UK over the last 20 years appears to have sharpened this age dynamic dramatically. It has also made it more difficult for today's young renters to start accumulating assets of their own, because the cost of renting is so high in many areas that it leaves them with little take-home pay which can be saved. It also means that any tax subsidies that are given to the BTL sector are far from age-neutral; in effect, they are tax breaks for older property investors to the disadvantage of young renters and younger first-time buyers.

One other interesting aspect of the question "who has benefitted from the growth of private renting?" is that current members of parliament are statistically more likely to be landlords than members of the general population (Fig. 5).

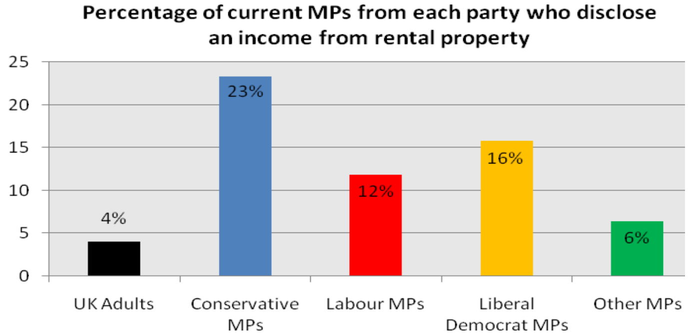

Fig.5 Percentage of current MPs who disclose an income from rental property[9]

[8] Shelter (2012) *A better deal: towards more stable private renting* London: Shelter

Fig. 5 shows the proportion of current MPs from each party who disclosed a rental income from residential property in the most recent register of members' financial interests, compared to the proportion of UK adults who are landlords. Overall, 17% of sitting MPs are landlords, and almost a quarter of Conservative MPs, compared to just 4% of UK adults. This may partly explain why landlords enjoy such favourable tax treatment, and why this issue appears to receive relatively little scrutiny within policy debates.

Why have more people been investing in property?

As illustrated by Fig.1, investing in residential property for the purpose of private letting was relatively unpopular until the Thatcher government liberalised the private rented sector in 1988. It appears that one of the major reasons why this sector has attracted so much private investment from older individuals since then has been because it provides some of the best returns which are available compared to other types of assets.

This is shown by evidence from the Investment Property Databank (IPD), who compile an annual Residential Investment Index which indicates how the returns from residential letting compare to the returns on other forms of investment. This index began in 2000 with the values in each category set at 100; Fig.6 displays the index values for 2012.

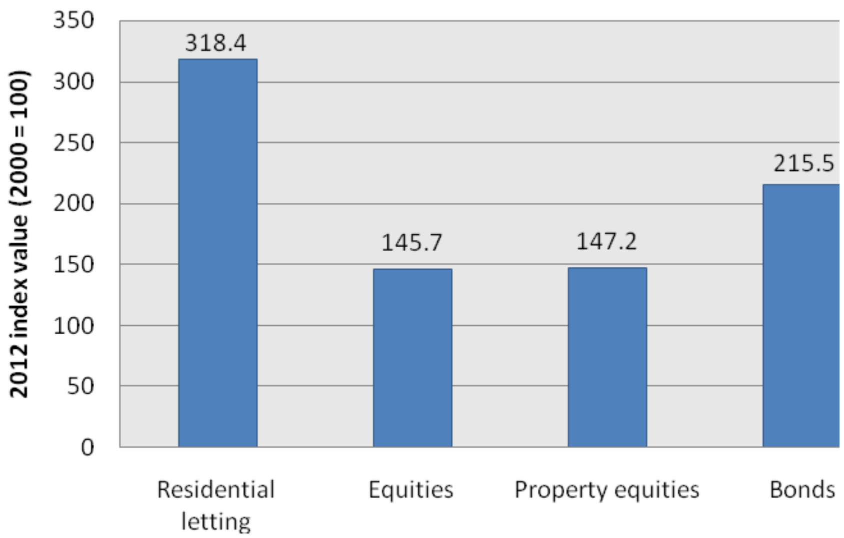

Fig. 6 IPD index of investment returns in 2012 (2000 = 100)[10]

Essentially, the chart in Fig. 6 represents an attempt at comparing how the total returns achieved by these different forms of investment varied between 2000 and 2012. It suggests that a sum of money which was invested in residential letting in 2000 would have been worth roughly three times as much in 2012, whereas the same sum of money invested in bonds would only have been worth about twice as much, and the same sum invested in equities would have

[9] House of Commons (2013) *Register of Members' Financial Interests - as at 20th May 2013* London: House of Commons

[10] IPD Annual UK Residential Investment Index (online): http://www1.ipd.com/Pages/DNNPage.aspx?DestUrl=http%3a%2f%2fwww.ipd.com%2fsharepoint.aspx%3fTabId%3d1006 [Accessed 30/08/13]

been worth about one and a half times as much. It also shows that investing in property through buying shares in a property company only delivered half the same return achieved by investing directly in residential property.

A report from the British Property Federation published in February 2013 also demonstrated the strength of the returns which have been generated by the residential property sector (this included the whole of the private letting sector, not simply individual landlords, but Fig.2 has shown that they are responsible for a large proportion of the investment in this sector). Figs.7 and 8 have been taken from this report (the returns for property letting have been circled):

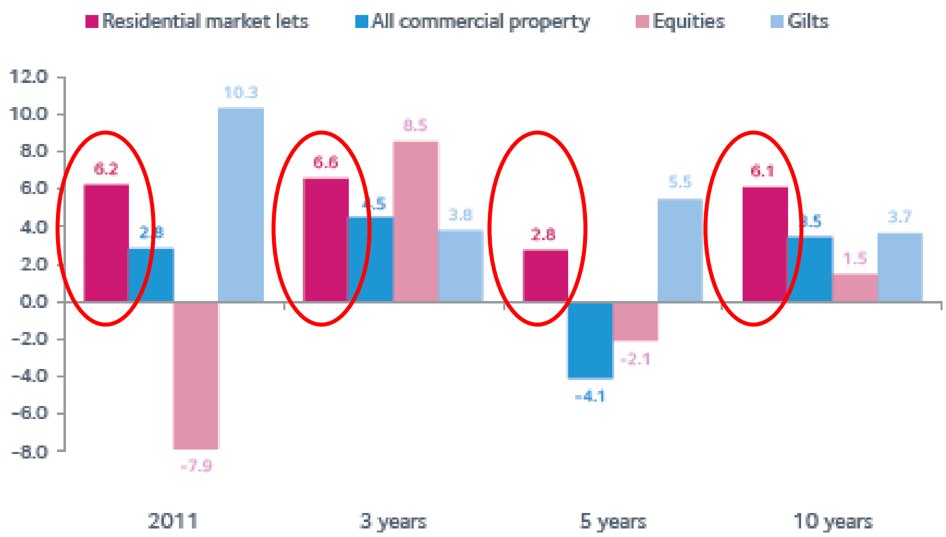

Fig.7 Real annualised total returns from residential market lets compared to other types of investment over different timescales[11]

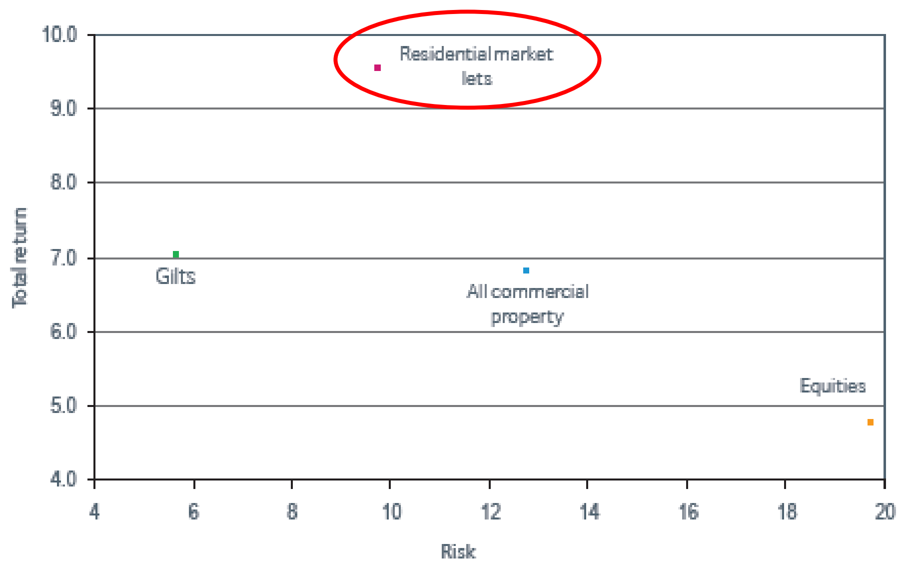

Fig.8 Risk-reward spectrum of investing in different UK asset classes, ten year total return vs standard deviation 2001–2011[12]

[11] British Property Federation (BPF) (2013) *Investing in Residential Property* London: BPF
[12] Ibid.

Figs.7 indicates how the returns from residential market lets have been superior to most other asset classes over a variety of different timescales, including the most long-term. Fig.8 displays the risk profile for different types of investment, and shows that during the first decade of the 21st century residential market lets provided some of the best total returns while also being comparatively low-risk.

Given the evidence presented here, it should not come as a surprise that investors have been flocking towards investing in rental property. In addition, there may also have been a range of slightly more subtle factors which explain the growth in private investments in this sector. In their history of the UK private rented sector, *Transforming Private Landlords: Housing, Markets and Public Policy*, Crook and Kemp (2011) proposed the following six reasons for its revival during the late 1990s and the early 21st century:[13]

- Historically low interest rates in the early 1990s, which made it possible for investors to heavily gear-up their properties, enabling them to expand their portfolios more quickly.
- The development of new financial products tailored towards investing in private rental property, following the housing slump in 1992 when more owner-occupiers started letting out their houses because they couldn't sell them.
- Financial deregulation and the growth of international capital markets meant that UK lenders had more money to lend to property investors in the late 1990s, which gradually led to them lending on higher loan-to-value ratios.
- Low interest rates made saving in banks and building societies less attractive, and reduced annuity rates for people who wanted to generate an income in retirement, making the returns offered by property investments more attractive.
- The shift away from final-salary pension arrangements in the private sector, which left many older workers looking for low-risk, high-return investments where they could put their pension savings.
- The rapid growth in house prices from 1997 onwards, which made the potential capital gains returns offered by investing in residential property more attractive.

However, there is another important factor whose significance has been consistently under-acknowledged: the favourable tax treatment which private landlords receive on their investments. This is the main focus of this paper, and will be explained further in the next chapter.

[13] Crook, T. and Kemp, P.A. (2011) *Transforming Private Landlords: Housing, Markets and Public Policy* Chichester: Wiley

The under-taxation of private landlords

There is significant evidence to show that landlords enjoy remarkably favourable tax treatment, compared both to people who put their money in other forms of investment and to owner-occupiers.

Rental income qualifies for a broad range of tax reliefs. As a general principle, HMRC divides business expenses into two types: "revenue expenses" and "capital expenses" – the important difference is that the former are granted tax relief and the latter aren't. Capital expenses are incurred during the purchase of an asset, or when it is being improved, whereas revenue expenses are incurred in maintaining the asset's value: for example, the initial purchase of a flat for letting is a capital expense, so this wouldn't qualify for tax relief, whereas replacing any furniture it contains is a revenue expense, so this does.

The following are all considered to be revenue expenses, meaning that landlords are able to claim tax relief against them:[14]

- Interest on property loans
- Maintenance and repairs (but not improvements)
- Letting agents' fees
- Legal fees for lets of a year or less, or for renewing a lease for less than 50 years
- Accountants' fees
- Buildings and contents insurance
- Utility bills paid by the landlord (such as gas, water and electricity)
- Rent, ground rent and service charges
- Council Tax
- Property maintenance services, such as cleaning or gardening
- Other direct costs of letting the property, such as phone calls, stationery, advertising or travelling to and from the property.
- Specific bad debts (rent arrears)

As the figures presented below will show, the most significant of these forms of tax relief is that on mortgage interest. Landlords also benefit enormously from the specific way in which they are able to claim tax relief on maintenance and repairs, which is through an instrument called the "wear and tear allowance". The wear and tear allowance enables landlords who let furnished property to deduct 10% of their net rental income per property each year in order to cover the depreciation of furniture and fixtures which are supplied with the property. The important point about this tax relief is that landlords are able to deduct the 10% without having to show what specifically they spent the exempted income on, meaning they are able to claim this relief regardless of whether they actually make any repairs or replacements to the furnishings or not.

Although there may be legitimate arguments in favour of assisting landlords with refurbishing their rental properties (not least that it should improve life for the tenants), the fact that they

[14] LandlordMoney.co.uk (online): http://www.landlordmoney.co.uk/taxation.htm [Accessed15/08/2013]

can simply take this relief as additional revenue without having to justify what they did to deserve it gives landlords a powerful incentive to claim wear and tear allowance without doing anything to make the property any nicer to live in. For this reason, it may even have the perverse impact of lowering the level of repair in furnished rental property, especially given that Britain's housing shortage means most landlords do not have great difficulty engaging tenants. As will be explained later on in this report, many tenants are suffering because of private rental accommodation which is in a poor state of repair, suggesting that this allowance is ineffective (see pg. 32).

As all landlords who let furnished property benefit from the same 10% wear and tear allowance regardless of where in the country their properties are located, this allowance is more valuable to landlords operating in areas with higher rents, despite the costs associated with refurbishing furnished accommodation being fairly similar in all areas of the UK. It is also regressive, being more valuable to landlords who have higher marginal tax rates, because the amount which they can save through not being taxed is greater.

In addition to these official tax reliefs, there is also evidence to suggest that a third type of relief which private landlords are not supposed to be able to claim – private residence relief against capital gains tax – may be being widely abused by landlords. It is also worth pointing out that property letting may be especially vulnerable to straightforward tax evasion by landlords, a theme which this section will also briefly explore.

How much does tax relief cost?

Figures released by HMRC in 2013 in response to a Freedom of Information request provided the following evidence of the cost of tax relief on rental income (all data is for the 2010–11 tax year, as this was the most recent period for which figures were available):

Total number of landlords who claimed some form of tax relief:	**1.2 million**
Total amount claimed in tax relief:	**£13 billion**
Mortgage interest relief:	*£6 billion*
Other tax-deductible expenses:	*£7 billion*

The following chart (Fig.9) contains a detailed breakdown of how much rent was deducted against tax in each of the eligible categories of expenditure. Clearly, it is mortgage interest which accounts for by far the largest share of the total (the wear and tear allowance is included under the £2.52 billion which was claimed for "property repairs, maintenance and renewals", although this section also includes the amounts deducted for individual items on a renewals basis):

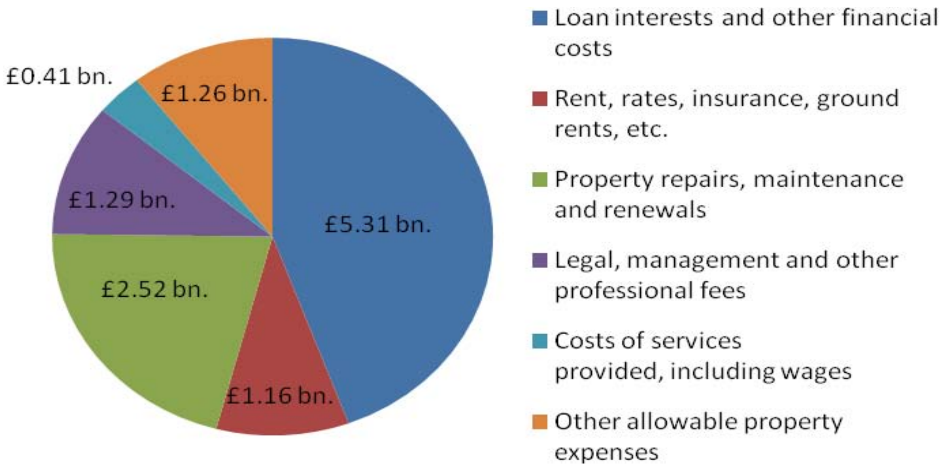

Fig.9 Breakdown of amounts of rent deducted against tax in eligible categories of expenditure, 2010/11 tax year

This data is based on the self-assessment tax returns which landlords submitted to HMRC at the end of the relevant tax year. However, the total amount deducted against tax relief, £13 billion, is not the same as the amount of tax revenue which was lost to the Treasury through allowing these various forms of relief to be claimed. A more accurate estimate of this figure requires an estimate of the tax rates of landlords.

During the 2010–11 tax year the income tax personal allowance was £8,105. Taxpayers had to pay tax at 20% on all earnings between this figure and £37,400; then 40% on all earnings above this up to £150,000; and the "additional rate" of 50% on all earnings which were above £150,000.[15] In order to estimate the amount of tax revenue lost to HMRC through these reliefs, we need to have some idea of how many landlords would have been in each tax bracket.

Unfortunately, there is no set of data covering landlord earnings which is detailed enough to allow us to produce an estimate with a high degree of accuracy. However, it is worth noting that a survey of private landlords which was based on data from the second wave of the Wealth and Assets Survey, collected during 2008–10, suggested that a high proportion of landlords are wealthier than average – almost a third had an income of over £24,000 per year, and their average net wealth was over three times the average for the general adult population.[16] This suggests that many of them are higher rate taxpayers.

If all landlords were 20% taxpayers then the amount of lost revenue would be somewhere around £2.6 billion. If they were all 40% taxpayers then it would be twice that, £5.2 billion. Therefore, the amount of tax subsidy they receive for their business expenses is somewhere within this range, probably towards the higher end of it, because the evidence suggests that landlords are on average a relatively wealthy class of individuals.

[15] HM Revenue and Customs (2011) *Rates and Allowances* London: HMRC
[16] Lord et al. (2013) *Understanding Landlords* London: The Strategic Society Centre

Capital gains tax

Capital gains tax is a tax on the profit which people make when they sell an asset which has increased in value. This is a very significant issue for landlords, because property values have risen enormously since the early 1990s, and most landlords intend eventually to realise the capital gains in their property portfolio through making sales. Whereas landlords enjoy significant tax advantages through property letting being treated as a business, in terms of being able to claim relief on their business costs, in theory one of the disadvantages of this is that it means they should be liable for capital gains tax, which is not levied on owner-occupiers when they sell their properties.

This is because owner-occupiers usually qualify for "private residence relief" from capital gains tax when they sell their main property, but this is not supposed to apply to properties which are owned for business purposes, including lettings. However, there is significant evidence to suggest that many, perhaps most, landlords successfully avoid paying capital gains tax when they sell their rental properties.

The HMRC regulations on capital gains tax provide a relatively straightforward means for them to do this. According to the regulations, someone selling a property only qualifies for private residence relief if all of the following conditions are met:[17]

- The *dwelling house* has been your *only* or *main residence* throughout your *period of ownership.*
- You have not been absent, other than for an allowed period of absence or because you have been living in *job-related accommodation*, during your *period of ownership.*
- The *garden or grounds,* including the buildings on them, are not greater than the *permitted area.*
- No part of your home has been used exclusively for business purposes during your period of ownership.

However, the regulations also contain the statement below:

"The final 36 months of your period of ownership always qualify for relief, regardless of how you use the property in that time, as long as the dwelling house has been your only or main residence at some point."[18]

These regulations create an opportunity for landlords to avoid being charged capital gains tax by living in their property for a period of time before they sell it, so that it qualifies for private residence relief. Landlords only need to live in their property for a relatively short period of time in order for it be exempt from capital gains tax for the next three years – possibly for as little as six months. Also, they can justify it as a main residence relatively easily, for example by providing utility bills which list it as their main address, or being registered on the electoral register there. Unmarried couples are each able to designate a separate property as their main residence, so if they rent out property together then they can also benefit from these rules.

---

[17] HMRC (2013) *Help Sheet 283: Private Residence Relief* London: HMRC
[18] Ibid.

In addition to claiming private residence relief, landlords are also able to claim a separate allowance called "letting relief", which is worth the lowest of the following three sums: the amount of private residence relief which has already been claimed, the value of the increase in capital gains which occurred during the period when the property was being let, or £40,000.

This tax allowance can be combined, so if a married couple sell a property which they own jointly then they can qualify for up to £80,000 worth of relief. It is also worth noting that all individual taxpayers have a personal allowance (known as their "annual exemption") for capital gains tax each year. During the 2012–13 tax year, all UK taxpayers are able to claim their first £10,600 worth of capital gains without paying any tax on them.[19]

When you add all of these allowances together, it is easy to see how they could enable a landlord to eliminate their total capital gains tax liability altogether. This can be demonstrated using the following example:

Arthur bought a flat in South London for £100,000 in the year 2000 and sold it in Jaunary 2010 for £223,000. This means he made a gain of £123,000. He lived in the property for the first three years and then rented it out for the remaining seven. For tax purposes, capital gains are assumed to have accrued equally throughout the period of ownership; therefore Arthur officially made gains of £12,300 per year. The capital gains which accrued during the first three years qualify for private residence relief, in addition to the gains which accrued during the final three years (because of the 36 month rule), so this shelters £73,800 from taxation.

This leaves £49,200 worth of gains which accrued during the first four years when the flat was rented out. Arthur can them claim letting relief, which would be worth £40,000 (because this is less than the amount of private residence relief which has already been claimed, £73,800, or the gains which occurred during the period under consideration, £49,200). This reduces the sum on which capital gains tax would be liable to just £9,200, but this liability can also be removed if Arthur has a wife or partner who can also claim her own £40,000 worth of letting relief; or if Arthur declares no other capital gains during this tax year, he can use his capital gains tax annual exemption, which was worth £10,100 during the 2009/10 tax year. Therefore, using entirely legal means he is able to avoid paying any capital gains tax, despite the size of the profit he made from selling his rental property.

Information about these ways of avoiding capital gains tax is widely available online. Simply entering "How can I avoid paying capital gains tax on rental property?" into a search engine produces multiple pages of results, many of which appear to refer to moving into a property to claim private residence relief. The following example was taken from www.Lawpack.co.uk, a website which provides free legal advice:

[19] HMRC (2013) *Capital Gains Tax rates and annual tax-free allowances* London: HMRC

"Live in the property for a few months before you sell it.

If you own a buy-to-let property, you could save a substantial amount of money by using it as your main home – known in the tax world as your "principal private residence (PPR)".

Buy-to-let investors usually claim partial residence relief. This can be claimed if you used the property as your main residence, but then you moved out of the property and still retained ownership (i.e. you rented the property out). In this scenario, you wouldn't be liable for capital gains tax for the duration that the property was your main residence and for the last three years of ownership. The latter is covered by what is called the '36-month rule'.

Numerous property investors are using this rule to save tax. When they purchase a new property, they rent out their existing private residence and then move into the new one; thereby taking advantage of the 36-month rule..."

Fig. 8 Extract from "How to avoid paying capital gains tax on buy-to-let sales"[20]

An FOI request was sent to HMRC which asked if they have ever attempted to calculate any estimates or researched the amount of revenue lost each year through landlords switching their main residence in order to avoid paying capital gains tax. In their response, they confirmed that no such research has ever been undertaken, although they did state that HMRC does investigate individual cases where they believe private residence relief has been claimed when it should not have been. However, given that these tactics are technically within the law as long as the landlord can convince the tax authorities that a dwelling genuinely was their main residence, the scope for penalizing people who have actually broken the rules is likely to be very limited.

Tax evasion

It appears that the tax which is due on rental income may be especially vulnerable to straightforward tax evasion by landlords. Landlords usually need to declare their rental income on a self-assessment tax return each year in order for HMRC to be aware of it, so there is a significant risk of landlords reporting their income dishonestly in order to pay less tax.

HMRC have estimated that tax evasion by landlords who did not complete a self-assessment tax return during the 2009–10 tax year may have been worth £550 million.[21] The clandestine nature of tax evasion means that this is likely to have been an underestimate of the true total. BTL landlords have been identified as a special target of several recent campaigns by HMRC against tax evasion, and between April 2012 and March 2013 617 landlords were prosecuted in court.[22]

[20] "How to avoid paying capital gains tax on buy-to-let sales" (online): http://www.lawpack.co.uk/landlord-and-tenancy/managing-your tenancy/articles/article885.asp [Accessed 16/08/13]
[21] HMRC (2012) *Measuring Tax Gaps 2012* London: HMRC
[22] Uren, A. (2013) "Middle class professionals and buy-to-let landlords targeted by HMRC as tax evasion prosecutions double" *This is Money* August 5 2013

Tax relief and the BTL business model

There are three significant reasons why the favourable tax treatment of letting property should be opposed. Firstly, there is the intergenerational argument that it has a range of negative impacts on the next generation of prospective first-time buyers, which will be explored in the following chapter. Secondly, there is the simple fact that providing any particular group with favourable tax treatment inevitably means that the rest of society has to pay more in tax to compensate for the lost revenue. This point was best articulated by William Gladstone during his Budget speech of 1863:

"...it must be borne in mind that in every case exemption means a relief to A at the charge of B.... I venture, Sir, to say that this state of things is unjust. It is not fair that the taxpayers of the country, to a very large proportion of whom taxation is, and must be, a serious burden—that the fathers of families, men labouring to support their wives and children, should be taxed at an augmented rate, in order to afford the luxury of exemption [for others]."[23]

Given the negative impacts which the growth of BTL has had on other sections of society, it is clearly debatable as to whether UK tax policy should be encouraging its growth at the expense of other taxpayers. Thirdly, favourable tax treatment appears to have played a significant role in shaping the dominant business model which is followed by most of the BTL sector, and so it has had a distortive impact upon economic behaviour.

According to French and Leyshon (2009),[24] the majority of BTL mortgages are interest-only. This means that borrowers are only required to pay off the interest which accrues each year, without making any reduction in the capital sum they have borrowed. The idea behind this is that when the borrowers eventually sell off their rental property, property values should have gone up sufficiently for them to be able to pay off the whole of the original mortgage amount while still being able to realise a profit. Rental properties are usually held for a lengthy period of time before they are sold, so landlords are well placed to benefit from the long-term upward trend in house prices. The same academic paper found that 70% of BTL landlords view capital gains appreciation as a major component of the financial return from renting out property.

Therefore, the current tax arrangements are extremely beneficial to landlords because they can offset the cost of mortgage interest – which is their only financing cost – against rental income, and then it is relatively easy to avoid paying capital gains tax when they realise their main financial return by selling the property. These tax advantages are integral to the functioning of this business model, as the removal of mortgage interest relief would significantly reduce the financial returns available to landlords. Without these tax advantages, less capital would probably be allocated towards the BTL sector as a result. This would reduce the unfair competition that currently exists between older landlords and younger first-time buyers within Britain's extremely tight housing market, although the overall shortage of housing, combined with the other factors that have influenced the growth of the BTL market (pg. 15) mean that the

[23] Hansard (Commons) 16 April 1863, column 224

[24] French, S. and Leyshon, A. (2009) "We all live in a Robbie Fowler house': The UK buy to let market in retrospect and prospect" *British Journal of Politics and International Relations*, 11(3), 438-460

private rented sector is unlikely to suffer a precipitous decline in investment if these tax arrangements were altered, as some proponents of BTL like to claim (see next section).

Should BTL be taxed like a business?

The main rationale for some of the tax advantages which the BTL sector currently enjoys – particularly allowing landlords to deduct mortgage interest and other business expenses – is that landlords are effectively acting as businesses, and so they ought to receive the same tax treatment which is given to other businesses.

Ray Boulger, the senior technical manager at mortgage advisor John Charcol, recently made the following comment about the tax treatment of BTL to the media:

"...BTL landlords are running mini-businesses, and a major part of their business expenses are mortgage interest... if landlords were not able to claim mortgage interest relief, this would make letting property significantly less attractive and you would see people exit the sector."[25]

However, whether landlords really are acting as businesses, and so should receive the same tax treatment, is very much open to debate. Firstly, there is the question of whether landlords deliver enough of social and economic benefit to the rest of society to justify their favourable tax treatment – after all, the main reason why businesses receive favourable tax treatment is because they provide such benefits, which it is in society's interest to encourage. It has been argued that property investment is an unproductive area of the economy, especially when compared to equities.[26] One particularly significant factor is that encouraging people to become landlords generates very few jobs: 89% of landlords work as private individuals, who tend to take a hands-on role in managing their properties themselves, meaning they employ few other people.[27] While the broader economy does benefit from multiplier effects when landlords invest in improving their properties, the same effect would probably be equally evident if these properties were controlled by owner-occupiers instead of being let to tenants, because all property owners, regardless of tenure, spend money on their property. Landlords regularly claim that they are providing a social good by increasing the supply of available housing, but it is arguable that they may simply be reducing the proportion of owner-occupiers (see next section). Given the costs associated with declining rates of property ownership and the rise of renting, there is a strong argument against giving the BTL sector favourable tax treatment if this is justified on the grounds that property letting is a business and therefore delivers benefits to wider society.

Secondly, there appears to be occasions when even the tax authorities themselves do not regard property letting as a business activity. On the one hand, BTL enjoys the same tax treatment that is given to businesses in the sense that landlords can deduct mortgage interest and other expenses against rental income, and (in theory) they are liable to pay capital gains tax when they sell their properties. On the other hand, a ruling made last year by the upper tax tribunal

[25] Lodge, S. (2013) "Landlords claim tax relief on £5 billion mortgage interest a year" *Exaro News* July 31 2013
[26] BBC News (2013) "House price inflation continues to rise, says ONS" *BBC News* August 13 2012
[27] DCLG (2010) *Private Landlords Survey 2010* London: DCLG

(*HMRC v Personal Representatives of Nicolette Pawson*) found that property letting does not qualify for inheritance tax business relief because they ruled it is an investment activity (similar to owning shares or putting money in a pension fund) rather than a business.[28] Property rentals also usually don't qualify for "roll-over relief" against capital gains tax (relief which is granted if the capital gains are reinvested in the productive activities of the business). HMRC explicitly states in its advice literature that rental income is classified as "unearned income" for tax purposes, because it arises from investment rather than employment.[29] These inconsistencies show that the argument that BTL operations deserve special tax treatment because they are effectively businesses is insufficient to justify the amount of tax relief that they receive.

[28] *HMRC v Personal Representatives of Nicolette Pawson* [2012] UKUT 050 (TCC)
[29] HMRC (date unknown) *RDRM10415 – Residence: Liability to UK Tax: Income arising in the UK* (online): http://www.hmrc.gov.uk/manuals/rdrmmanual/rdrm10415.htm [Accessed 21/08/13]

The negative impacts of private renting

The central argument presented in this paper has two parts. We have shown that landlords are receiving a large amount of public subsidy each year in the form of tax relief. Now we go on to demonstrate that the growth of private renting has a number of negative impacts for society. Each of these negative impacts is outlined below.

1. Renting is unpopular

One of the most important reasons why the government should not be stimulating the growth of private renting through the tax system is that, as numerous studies have shown, the majority of people would prefer homeownership.

According to a survey of current non-homeowners conducted by Halifax, there is a fundamental mismatch among people who rent privately between their aspirations of homeownership and the affordability crisis they face in today's housing market. This survey found that 79% of non-homeowners aged 20–45 would like to become owner-occupiers one day, but just 44% of people in this age group are actually owner-occupiers at the moment. Within this group, 39% of them said they would like to own a home but didn't think they would ever be able to afford it. The results of this survey also hinted at the broader negative impacts for society if many of these people never manage to become homeowners: 47% did not believe it was right to have children until they owned their own home, while 57% said they didn't think they would ever be able to retire if they were still renting. [30]

2. Increasing the conflict between landlords and first-time buyers

Given the shortage in overall housing supply, it follows that competition between landlords and would-be first-time buyers must be more intense than it would have been if overall housing supply had kept pace with demand and there was more housing to go around between everyone. As landlords tend to be older, and often are able to draw on larger reserves of capital, particularly if they are already owner-occupiers and can remortgage their main residential property to fund the purchase of new rental properties, they are likely to enjoy the upper-hand when competing with first-time buyer rivals to purchase the same type of property. It was recognised by HM Treasury as long ago as 2004 that the growth of the private rented sector was likely to make it harder for young people to become first-time buyers. In a briefing document on the housing market written by the Treasury at the request of the then Prime Minister, Tony Blair, they included the following statement:

"The increase in activity [among BTL landlords] may have the effect of crowding out FTBs [first-time buyers], as typically rental properties and those being sought by FTBs often have the same characteristics – such as one or two bedroom flats."[31]

[30] Halifax Bank (2013) *Generation Rent: A Society Divided* Halifax: Halifax Bank
[31] HM Treasury (2004) *UK Housing Market Trends* London: HM Treasury

Mortgage data supports the view that first-time buyers have been crowded out during the boom years of BTL (Fig.10).

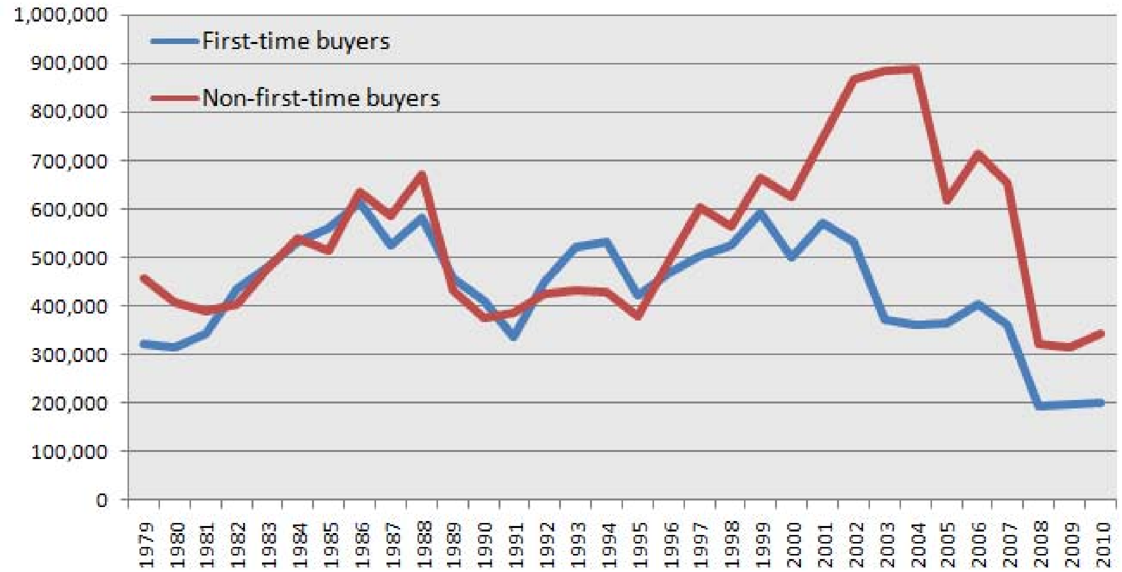

Fig. 10 No. of new mortgages lent to first-time buyers and non-first-time buyers in Great Britain by year, 1979–2010[32]

In Fig.10 the category of "non-first-time buyers" includes a number of different groups, including owner-occupiers who were remortgaging and BTL landlords. This chart must actually understate the extent to which first-time buyers were disadvantaged, as 20% of first-time-buyer mortgages may have been lent to people who had owned a home in the past but for various reasons were not current property owners when they took out a first-time-buyer mortgage, meaning that the ability of young people who genuinely haven't ever owned their home before to access mortgage finance is even more restricted than this chart implies.[33]

The data in Fig.10 suggests that financial institutions became significantly less willing to lend to first-time buyers during the period of rising house prices which began in the early 1990s, compared to the situation during the 1980s when it appears that the amount of lending to both of these groups was roughly similar. As explained in the introduction, one of the major changes which occurred within the UK housing market between the 1980s house price boom and the post-1992 house price boom was that the private rental market became deregulated and the risk premium which used to accompany borrowing to invest in rental property was removed. As a result, it appears that this crowding-out effect became much more pronounced. It thus seems likely that a significant proportion of the increase in the number of new loans to non-first-time buyers has been used to finance the purchase of rental properties.

[32] *CML Regulated Mortgage Survey (April 2005 onwards)* London: CML

[33] National Housing and Planning Advice Unit (2008) *Buy-to-let mortgage lending and the impact on UK house prices: a technical report* Fareham: NHPAU

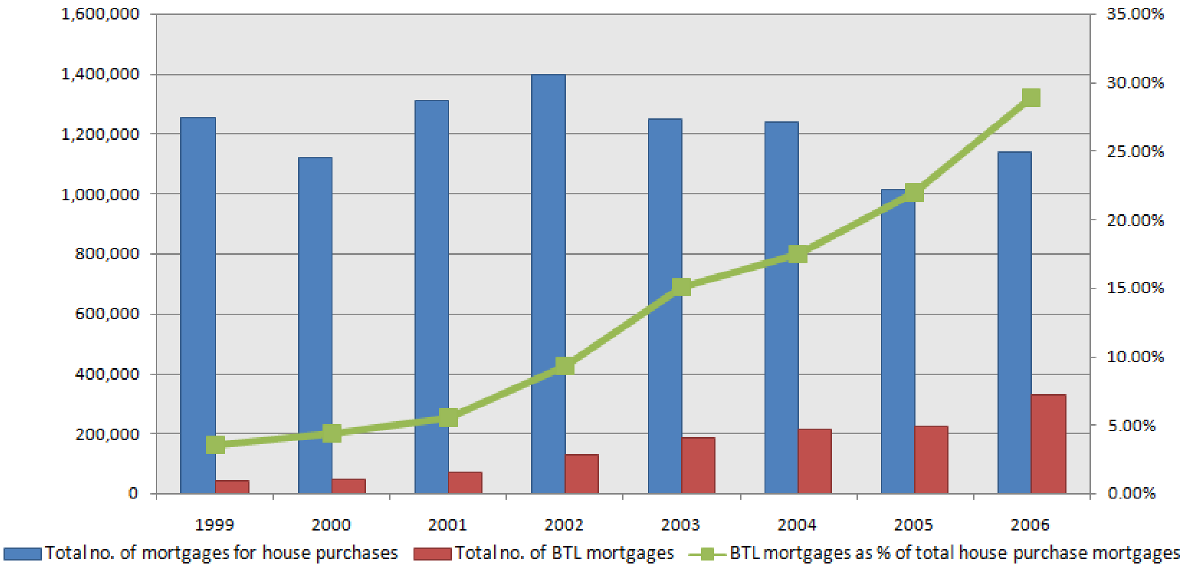

Fig. 11 BTL mortgages as a proportion of total house purchase mortgages, 1999–2006[34]

Fig.11 shows how the proportion of BTL mortgages as a percentage of total house purchase mortgages increased dramatically during the peak years of BTL growth, implying that mortgages for other types of borrowers – including first-time buyers – must have been crowded out.

Comparing BTL lending to the total number of mortgages which are issued for house purchases, rather than the total number of mortgages overall (which includes remortgages), reveals that during this period, BTL mortgages rose from 3.5% of house purchase lending to almost 30%. By 2006, BTL mortgages were involved in almost 20% of the total housing market transactions – this meant that 330,000 properties were acquired using BTL mortgages during a year when only about 188,000 new dwellings entered the market. These findings demonstrate that in the context of highly inflexible new supply, landlords are able to crowd out other types of purchaser, a phenomenon to which first-time buyers are especially vulnerable because they typically have lower salaries and fewer assets. A recent study by the Strategic Society Centre found that the average landlord in the private rented sector had mean assets of £75,103, compared with the average tenant (many tenants being prospective first-time buyers) who had mean assets of just £9,506.[35] In areas which have especially high property prices, or which are especially popular with property investors, such as London and the South East, these tensions are likely to have been sharpened even further. Given below is a real life case study of a would-be first time buyer who has been severely hindered by having to compete with BTL landlords (Fig.12).

[34] Sprigings, N. (2008) "Buy-to-let and the wider housing market" *People, Place and Policy Online*, 2, 2, 76–87

[35] Lord et al. (2013) *Understanding Landlords* London: The Strategic Society Centre

Case Study – How BTL squeezes out first time buyers

Tom Hewson, 28, is a professional musician who currently rents a property with his girlfriend in London. They want to put down roots and are planning to take their first step on the property ladder together. After house-hunting for six months, they have found themselves being pushed more and more towards the outskirts of the city because of rising prices and the lack of affordable housing which is available on the market.

They eventually decided to concentrate on buying a property in Forest Gate, Newham as this seemed like the area where they could achieve the best match between what they were looking for and what they could afford. However, Forest Gate is known for being a BTL hotspot, and Tom and his girlfriend have encountered significant problems trying to compete with landlords. One major problem they've encountered has been a basic shortage of properties: in almost four months of looking the couple haven't seen a single owner-occupied property come onto the market because such a high proportion of the local housing stock is owned by landlords. This has significantly pushed up prices for first time buyers, because they face much tougher competition on the rare occasions when properties do come on the market; Tom thinks the typical asking price for their target property has gone up by at least £100,000 during the past year. Another major problem is that they've found that when properties they are interested in have come on to the market, first-time-buyers like them regularly lose out to older BTL landlords because the landlords can afford to pay in cash rather than with a mortgage.

Having found a home they could afford in the area and had their offer accepted, Tom and his girlfriend recently suffered the disappointment of losing out at the last minute when the seller decided to renege on the deal in favour of taking a higher cash offer from a landlord instead. Ultimately, Tom and his girlfriend have had to significantly delay the purchase of their first property, a story which is repeated for thousands of other members of their generation in the parts of Britain where landlords now dominate the market.

Fig.12 Real-life case study showing how BTL squeezes out first-time-buyers

3. The growth of BTL raises house prices

As well as sharpening the competition between landlords and prospective first-time buyers, there is also evidence that the growth of BTL has directly pushed up house prices. A study published by the National Housing and Planning Advice Unit (NHPAU) in 2008 argued that, based on their model of UK house price inflation, the BTL sector was responsible for increasing average house prices by up to 7% between 1996 and 2007 through the additional competition which BTL landlords added to the market.[36] The authors note that average house prices would probably still have risen by 130% in real terms during this period for a range of different reasons, but the impact of BTL still added £14,000 to the cost of the typical property (this sum was probably higher in specific locations where competition between BTL landlords and first-time buyers was especially pronounced), meaning it made a significant contribution to the decline in housing affordability which first-time buyers suffered from during this period.

[36] National Housing and Planning Advice Unit (2008) *Buy-to-let mortgage lending and the impact on UK house prices: a technical report* Fareham: NHPAU

4. BTL distorts the supply of new housing being built

Proponents of BTL often claim that it provides a social good by increasing the overall supply of housing which is available. However, there is evidence to suggest that this view is misguided; instead, the growth of BTL has skewed the supply of new housing towards the particular type of properties which are more likely to appeal to property investors, without having a substantial impact upon the overall amount of new housing which is being built.

Nationwide, the BTL housing stock mainly consists of older properties, with only around 20% of BTL properties in new-build developments. Most new-build BTL developments consist of large complexes of one- and two-bedroom flats, often located on brownfield sites in formerly rundown parts of cities in the north and midlands of England, which have been built specifically for the purpose of letting by property investors.[37] The following pair of charts demonstrates the impact of BTL on the UK property supply:

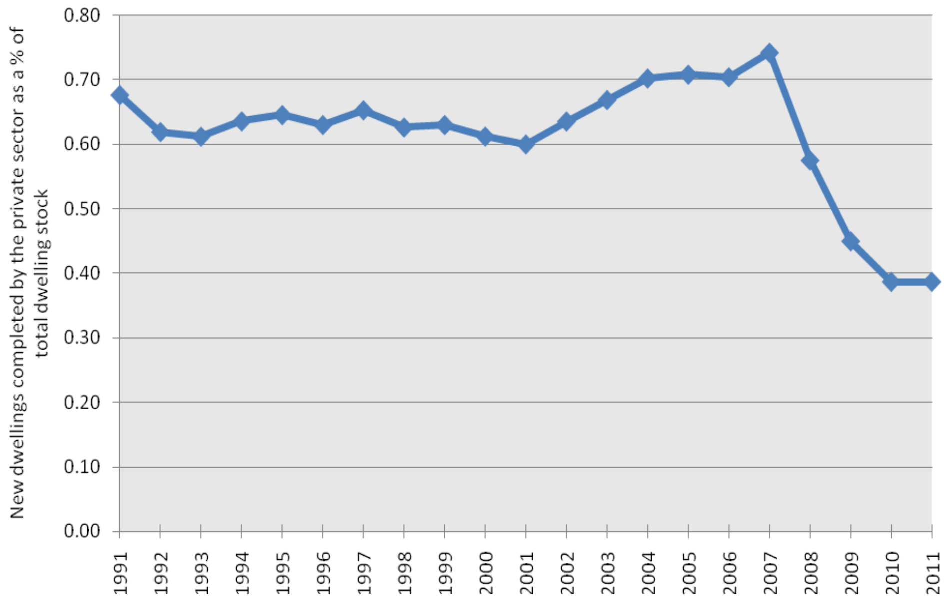

Fig. 13 New dwellings completed by the private sector as a percentage of total UK dwelling stock, 1991–2011[38]

Fig.13 presents the number of new dwellings completed each year as a proportion of the existing UK housing stock. The figures show that this is clearly very low – the housing supply only grows by between 0.6% and 0.7% a year, and even at the height of the UK property boom, before the recession in 2006–07, it barely crept above 0.8%, before falling precipitously after the crisis hit. What this chart suggests is that the growth in BTL during the 1990s and early- to mid-2000s did very little to increase the rate at which the UK housing supply expanded each year.

[37] French, S. And Leyshon, A. (2009) *'We all live in a Robbie Fowler house': The UK buy to let market in retrospect and prospect*, Report for the Financial Services Research Forum

[38] DCLG Live Data Tables 101 and 241

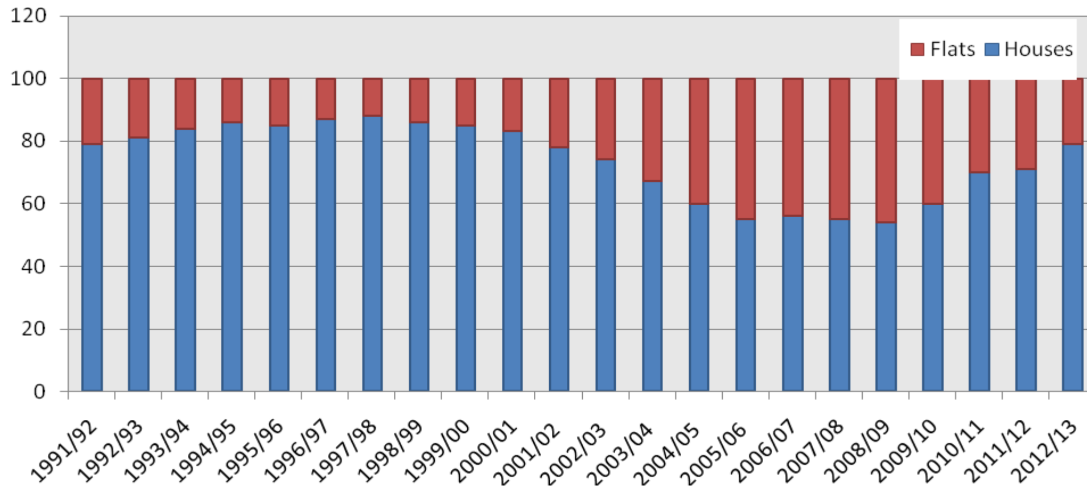

Fig. 14 New-build properties showing proportions of flats and houses, 1991/92–2012/13[39]

Fig.14 compares the numbers of houses and flats which were built in the UK each year over the two decades between 1991/92 and 2012/13. This suggests that the balance between the two dwelling types was relatively constant for almost the whole of the first decade of this period, but after that the proportion of new flats relative to new houses underwent a dramatic increase, which coincided with both the high point of the recent property boom and a key period of growth for BTL.

This suggests that the small increase in overall levels of housing construction which happened during the boom years is likely to have benefited property investors – who tend to prefer buying flats – at the expense of people who wanted to purchase houses, because the former took up a greater share of new development without increasing the overall level of development by a significant amount. This must also have contributed towards price inflation among the existing stock of houses, because the supply of new houses was increasing even more slowly than in previous years.

5. Poor dwelling standards

The standard of dwellings in the private rented sector tends to be lower than those found in other housing tenures, which potentially could have negative implications for the health of tenants.

According to the 2011–12 edition of the English Housing Survey, 1.4 million households in the private rented sector were classed as "non-decent", meaning they failed to meet the government's minimum standard of housing quality; this equates to over a third (35%) of all privately rented dwellings being non-decent, a higher proportion than in any other tenure type.[40]

[39] DCLG Live Data Table 254

[40] Dept. For Communities and Local Government (2013) *English Housing Survey: Headline Report 2011-12* London: DCLG

A further piece of research, published in August 2013, suggested that as many as 2.8 million tenants have problems with condensation in their properties, 2.5 million complain of damp, and 1.2 million have leaky roofs and windows. The same report suggested that a quarter of tenants have asked their landlords to do repairs which the landlords have ignored.[41] These problems could have serious health implications for the affected tenants, especially those who have to live in damp conditions.

Given that the "wear and tear" allowance is specifically targeted to assist landlords in refurbishing their properties, this suggests it has been ineffective. This issue also raises further questions about whether the government should be providing a tax subsidy to the form of housing tenure in which residents endure the worst conditions, and which may be actively harmful to their health.

6. Increased cost of housing benefit

High private rents have a substantial cost to the public purse in the form of the bill for housing benefit, the government's main form of support to help low-wage tenants pay their rent.

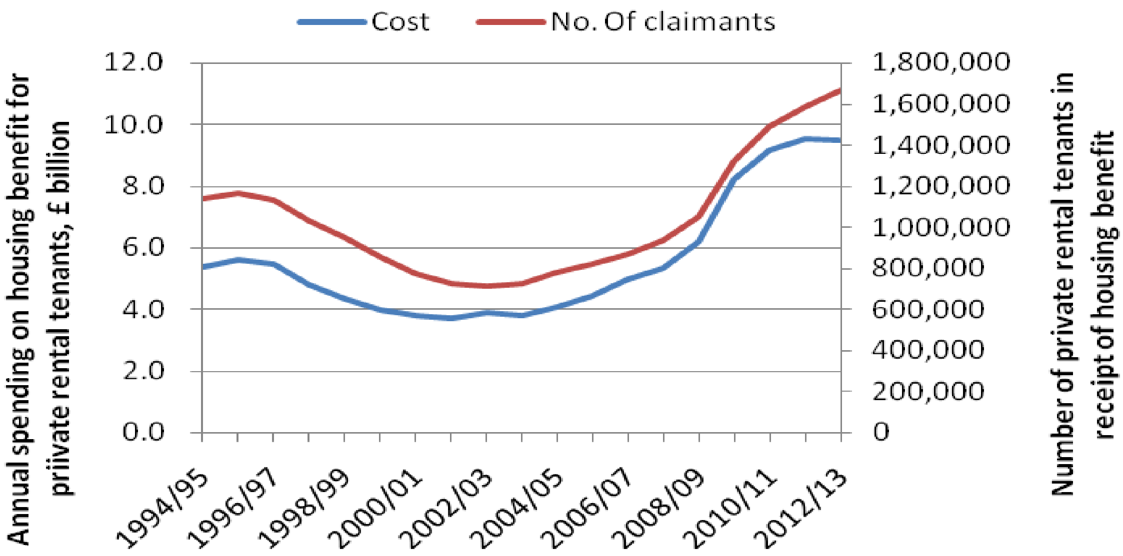

Fig.15 Annual cost and number of cliamants of housing benefit among private renters, real terms, 1994/95 – 2012/13[42]

Fig.15 demonstrates how the cost of providing housing benefit to private rented sector tenants has risen in real terms since 1994/95, along with the number of claimants. It is projected to cost almost £9.5 billion during the current financial year, meaning private landlords will receive nearly 40% of the total housing benefit bill of £24 billion. In 2011/12, 42% of households who rent privately were in receipt of housing benefit. The increase in the cost of housing benefit is more complicated than simply being the result of rising rents, because the formula which is used to calculate housing benefit eligibility also takes account of tenants' earnings (if earnings

[41] Radnedge, A. (2013) "Millions of families in danger due to damp, leaks and negligent landlords" *Metro* 20 August 2013

[42] Department for Work and Pensions (2013) *Benefits expenditure and caseload tables 2013* London: DWP

are falling then the housing benefit bill would still go up even if rents remain stable), while a increase in the number of claimants should also be expected simply because the overall number of private renters has risen enormously during the period covered by the chart. However, it is undeniable that rising rent levels have played a major role in increasing the cost of housing benefit to the state. This point was made by a report from the Institute of Economic Affairs:

"The HB formula pegs rates directly to local rent levels, so if rents increase, HB rates follow suit. Just as importantly, if local rent levels rise at a faster rate than local wages, more households become eligible for HB to begin with."[43]

The increase in rents, which has resulted from the favourable tax treatment given to private landlords, and the crowding-out effect this has had on first-time buyers, has clearly contributed to the increased demand for housing benefit, imposing higher costs on the rest of society.

This will become more of a problem as "Generation Rent" ages. It has been estimated that 40% of today's 20 year-olds will never be able to own their own homes, meaning they will still be renters when they are pensioners. Half of today's pensioner renters receive housing benefit, so if these trends continue then by 2060 – when today's 20 year-olds will have reached 70 – the number of pensioners receiving housing benefit will have more than doubled, adding over £8 billion to the annual bill for housing benefit in today's terms.[44]

7. Renting creates obstacles/disincentives for renters to save

A further point, related to Point 6, is that renting may act as both a barrier and a disincentive which prevents today's younger generation from saving.

The expense of renting for tenants is likely to be a considerable barrier against saving. A report published by Shelter in 2011 showed the affordability crisis facing young renters (Fig. 16).

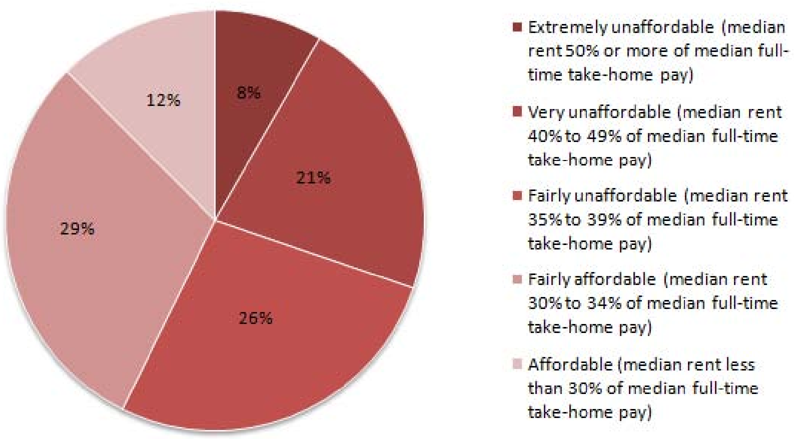

Fig. 16 The affordability of private rents in English local authority areas[45]

[43]Niemietz, K. (2012) *Abundance of land, shortage of housing* London: Institute of Economic Affairs
[44] Lloyd, J. (2012) *The Future Cost of Housing Benefit for Older People* London: Strategic Society Centre
[45] Shelter (2011) *Shelter Private Rent Watch, Report 1: Analysis of Local Rent Levels and Affordability* London: Shelter

Following conventions used by previous studies, “affordable rent” was defined as rent levels which cost less than 30% of full-time median take-home pay. The chart shows that 55% of English local authority areas have median private rents which are more than 35% of median full-time take-home pay, meaning they are classed as unaffordable. Strikingly, in almost a third of local authority areas (29%), the average private sector tenant would have to spend between 40% and half of their take-home pay on rent. In terms of the impact of this on saving, another study found that tenants in the private rented sector have accumulated median asset wealth of only £398. The equivalent figure for landlords was £20,500, while the same survey found that landlords were twice as likely to save money, and to save larger amounts of money when they did so.[46]

This is partly explained by life-cycle effects (as landlords tend to be older), and should also be expected simply because you would expect landlords to have more asset wealth in order to become landlords in the first place. However, these figures do suggest that the cost of renting may well be a major factor in making it more difficult for tenants to save money, with the result that the rental system serves to transfer wealth from one group who are already asset-poor to another group who are already asset-rich, making it much harder for today’s younger generation to begin building up their own asset wealth themselves.

Renting also creates a disincentive for young people to save. As mentioned in Point 6, 40% of today’s 20 year-olds are likely to be tenants for the whole of their independent lives, with the result that are likely to receive housing benefit once they become pensioners. However, another impact of this will be that it will no longer be in their interests to save for the future – especially to build up pension savings – because the more savings they have, the more money it will cost them in lost eligibility means-tested housing benefit. This could have a significant impact upon the government’s plans to encourage people to put more money aside for old age.[47]

8. Renting raises problems for “asset-based welfare” policies

The growth of private renting has the potential to create bigger problems for society if high housing costs mean that today’s younger generation has to either delay or radically reduce their accumulation of financial assets. This will particularly create problems for welfare delivery, because much of government welfare policy over recent decades has sought to transfer responsibility from the state to the individual.[48] Individuals have been encouraged to build up more assets partly so they will have a bigger financial buffer to fall back on in difficult times, meaning the welfare state will be required to do less (this was part of the reason for the encouragement of home ownership in the first place). The Coalition Government’s reforms to adult social care are just the latest example of this trend, as they are largely based on the assumption that many pensioners needing old age social care will be able to fund it through their housing wealth.

[46]Lord et al. (2013) *Understanding Landlords* London: The Strategic Society Centre
[47] Lloyd, J. (2013) “Buy-to-let: the fiscal dilemma” *Public Finance* 8 July 2013
[48] Heywood, A. (2011) *The end of the affair: implications of declining home ownership* London: The Smith Institute

However, fig.17 shows that rates of home-ownership have been declining among the younger generation over the last several decades, while they have been rising for older age groups:

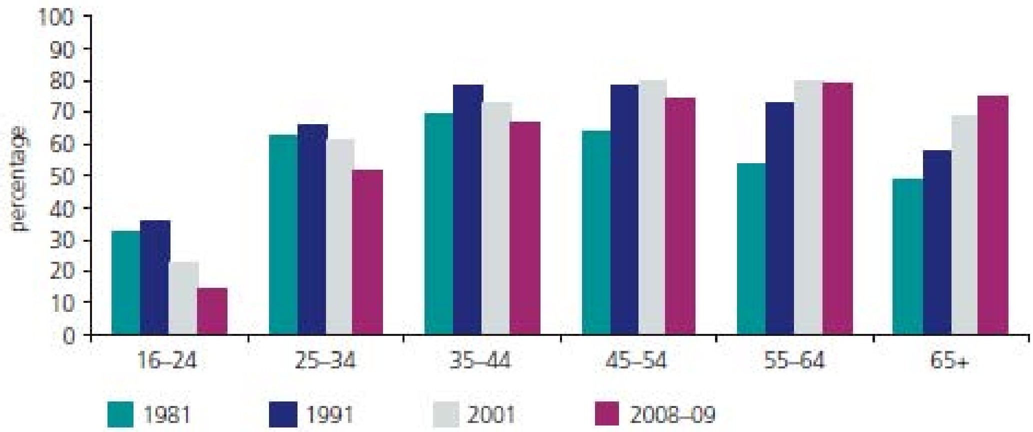

Fig.17 Percentage of owner-occupier household reference persons (HRPs) within different age groups, 1981, 1991, 2001, 2008–2009[49]

As explained in the previous point, survey evidence indicates that tenants in the private rented sector have very low levels of savings, on average, and find it difficult to add to their existing savings each year. This finding is supported by findings from the British Household Panel Survey, a longitudinal study which has been following the same representative group of British households since 1991. According to analysis by Professor John Hills and the Centre for the Analysis of Social Exclusion at the LSE which looked at how their wealth levels have changed over time, households within the sample who remained tenants between 1995 and 2005 witnessed very little overall growth in household wealth.[50] This trend appears to go against the classic life-cycle hypothesis that suggests younger people should acquire greater wealth over time, raising the question of whether the high cost of rent relative to incomes leaves too many young people without sufficient surplus income to begin accumulating assets. This is important, because property and pensions have historically been the two main stores of asset wealth which are available to ordinary savers – but if a large proportion of today's younger generation can never afford to become homeowners, coupled with the dramatic decline in pension-saving witnessed over recent years, then it raises substantial problems for asset-based models of welfare delivery.

[49] Department for Communities and Local Government (DCLG) (2010) *English Housing Survey: Household Report 2008–9*, London: DCLG

[50]Hills, J. et al. (2013) *Wealth in the UK: Distribution, Accumulation and Policy* Oxford: Oxford University Press

Recommendations

This report has explained the problems with the favourable tax status of BTL and outlined the negative consequences the present situation has for the rest of society. This section will put forward some policy recommendations which have been designed to try and improve the situation.

Summary

- Reduce the ability of landlords to deduct their mortgage interest against tax, because this allowance is regressive and distortive
- Abolish the wear and tear allowance and only allow landlords to claim for individual items on a renewals basis
- Greatly reduce the period of exemption covered by the 36-month rule on capital gains tax, ideally to as little as six months
- Curtail lettings relief
- Deduct capital gains tax at source during property transactions, as happens in other European countries (notably France)
- Build more housing to reduce housing costs for young people

Detailed Proposals

1. Curtail the tax reliefs available to landlords

Given the UK's limited supply of housing, it is distortive and unfair to permit landlords to claim the range of tax reliefs which they are currently entitled to; as this report has shown, these enable them to out-compete younger first-time buyers. It is especially unfair to allow them to claim mortgage interest relief against income when owner-occupiers have been unable to do this since the end of the MIRAS scheme under Gordon Brown. MIRAS, or "Mortgage Interest Relief at Source", was a housing subsidy implemented by the Thatcher government in 1983 (replacing similar subsidies which had been in place since the 1970s) that enabled owner-occupiers to deduct their mortgage interest payments against tax. The total subsidy given to homeowners was worth around £6 billion, in today's money, when it was first introduced and this had risen to over £14 billion by 1990. However, it was subsequently whittled away by both the Major and Blair governments before being finally abolished in 2000 by Gordon Brown, who claimed MIRAS was a regressive "middle-class perk".[51]

Recent research profiling the characteristics of Britain's private landlords has shown that landlords are significantly more likely than the general population to be university graduates, to be married, to live in London and the South East, to earn above £24,000 per year, to have had parents who owned their own home and to occupy a house with 4 or 5 bedrooms as their main residence; in other words, they appear to be a predominately middle-class group.[52] Therefore,

[51] Malik, S. and Howker, E. *Jilted Generation* London: Icon Books
[52] Lord et al. (2013) *Understanding Landlords* London: The Strategic Society Centre

the tax breaks which are given to landlords are just as much of a regressive "middle-class perk" as MIRAS ever was, except that it is middle-aged and older middle-class people who have already built up substantial levels of wealth that benefit, rather than young people trying to get on the property ladder. Allowing one group of property purchasers to claim tax relief on their mortgages but not the other is unfair, distorts the market in favour of older landlords and contributes to declining rates of homeownership among today's young people.

As this report has already shown, it also deprives the UK exchequer of somewhere between £2.6–£5 billion worth of revenue in lost tax income. This revenue would undoubtedly be extremely useful to the government during an age of austerity; in terms of its distributional impacts this would also be a progressive source of additional tax income, as it would mainly come from people who have large amounts of asset wealth.

The wear and tear allowance creates a perverse incentive for landlords to claim tax relief without actually doing anything to improve the condition of their properties, as they are not required to justify what they have done with the 10% of gross rent which they are allowed to claim tax-free. The evidence presented in the previous section which showed that over a third of Britain's private rented housing stock is rated non-decent suggests that the wear and tear allowance is failing to encourage enough landlords to make necessary repairs to their properties. At present, landlords are allowed to choose between claiming the wear and tear allowance or claiming for individual items on a renewals basis (i.e. claiming for each item which they've replaced individually, which involves providing proof that they have done so), but the former option should be discontinued in order to ensure that landlords can only claim tax relief for work which they have actually undertaken.

2. Enforce payment of capital gains tax on all rental properties

The present system makes it easy for landlords to avoid paying capital gains tax when they dispose of their rental properties, if they are able to claim private residence relief and/or letting relief.

This deprives the public purse of revenue, in addition to leaving property investors with additional funds which they can then channel into further properties, strengthening their purchasing position against that of first-time buyers in Britain's extremely rigid housing market. Therefore it would make sense to alter the existing rules so that landlords would find it more difficult to claim relief from capital gains tax in this way.

There are a couple of obvious reforms which would be beneficial. Firstly, the period in which any property which an owner has previously lived in qualifies for private residence relief could be cut from 3 years to a much shorter timeframe, such as 6 months. This would have the added incentive of encouraging people to sell properties they were no longer living in, rather than allowing them to stand vacant. This is likely to be feasible, given that HMRC has recently announced it is cross-referencing between data from tax returns and property records held by the Land Registry as part of a clampdown on tax evasion by landlords, so it must now have a fairly comprehensive knowledge of which properties around the country are being used to generate rental income.

Secondly, the wisdom of allowing landlords to claim letting relief should be revisited, as it makes no sense to excuse properties from capital gains tax simply because they have been let out at some point.

Either of these reforms would have the desirable effect of generating capital gains tax from a higher proportion of BTL property disposals than is currently believed to be the case.

The way in which capital gains tax is collected could also be modified to make it more difficult for landlords to avoid paying it. At present, even if capital gains tax is owed, landlords currently have to declare that they are liable for it by completing a self-assessment tax return. This clearly makes it easier for unscrupulous landlords to avoid paying it. Other countries employ different systems to make this more difficult. For example, in France capital gains tax is deducted by the notary (property lawyer) who conducts the sale before the money changes hands.[53] A similar system could be employed in Britain, to reduce the amount of tax lost during transactions involving landlords.

3. Build more housing

The single biggest problem with Britain's housing market, from all which all others originate, is the fundamental shortage of new housing supply. Data from the OECD supports the view that Britain has one of the most inelastic housing markets in the rich world (Fig.18).

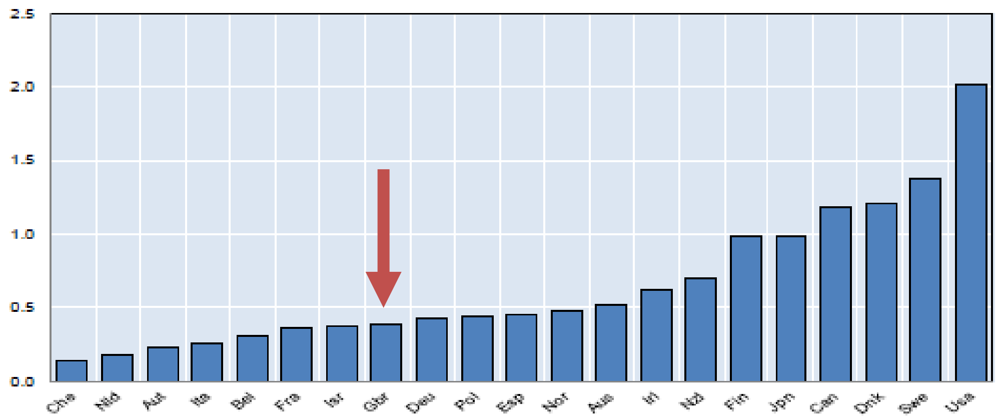

Fig.18 Estimate of the long-run price elasticity of new housing supply across a range of OECD countries, early 1980s to mid 2000s[54] (Great Britain is highlighted with the red arrow)

Fig.18 is based on a research report published by the OECD which examined the relationship between increases in house prices and housing supply across a range of member states. In a healthy market, rising prices should normally act as a sign of rising demand, which should lead

---

[53] This information is taken from a guide to French capital gains tax, which is available here: http://www.french-property.com/guides/france/finance-taxation/taxation/capital-gains-tax/ [Accessed 17/09/13]

[54] Caldera Sánchez, A. and Johansson, A. (2011) "The Price Responsiveness of Housing Supply in OECD Countries" *OECD Economics Department Working Papers,* No. 837

to an increase in the supply of new housing in order to satisfy it. However, the results showed that the relationship between these two variables is weaker in Great Britain than in many other OECD countries; it is less than a quarter of that observed in the USA, and roughly a third of that seen in Sweden. When supply is inelastic to demand, the extra demand is only expressed through higher housing costs, which is why we need to build more housing if we want today's young people to be able to experience the responsibility of homeownership to the same extent as previous generations.

Regulatory factors – especially the difficulty of obtaining planning permission for new developments – have previously been identified as one of the biggest barriers to increasing the housing supply. This can be observed from the striking effect that being granted planning permission has on the value of a piece of land: in 2009 a typical hectare of land on a greenfield site was worth £1.87 million if it had planning permission for residential development, compared to £600,000 if it was approved for industrial use and £16,000–£17,000 if it could only be used for pasture.[55] The Coalition Government has made a major issue out of reforming the planning laws to devolve more decisions to a local level, but it remains to be seen if this will have a substantial impact on increasing the supply of new housing.

[55]Morton, A. (2010) *Making Housing Affordable: A New Vision for Housing Policy* London: Policy Exchange

Conclusion

This report has demonstrated conclusively that the generous tax relief which is given to private landlords causes serious distortions within the UK housing market. Over the last 20 years, government tax policy has played a key role in encouraging individual investors, who have tended to be older, to enter the private rented sector at the expense of younger first-time buyers and owner-occupiers more generally.

Tax is far from the only explanation for why we have a housing crisis in Britain and why patterns of housing tenure are undergoing profound changes. The single greatest problem facing the UK housing market remains the fundamental mismatch between overall supply and demand, which needs to be reconciled if today's younger generation are going to be able to enjoy the responsibility of property ownership to the same extent as their parents and grandparents. However, within a context where the overall housing supply has remained limited and inflexible over a prolonged period of time, the fact that the tax system treats landlords much more favourably than owner-occupiers creates market distortions which are extremely harmful to the latter. The tax treatment of landlords has contributed to rising house prices and sharpened the economic inequalities between landlords and would-be first time buyers, while it has also contributed to the superior returns which BTL investment has generated compared to alternative types of investment, encouraging the inefficient allocation of capital within the economy.

Resolving the housing crisis is a problem which has flummoxed governments of both main parties, but one relatively straightforward intervention the politicians could make would be to significantly alter the taxation of property ownership so that BTL investment no longer receives special treatment. Given the benefits which accrue to society from higher levels of owner-occupation (not to mention that owner-occupation remains the desired tenure type for most non-owner-occupiers), it is even worth considering whether the government ought to investigate methods of explicitly favouring owner-occupation compared to other forms of housing tenure, although pursuing this aim without doing anything to increase the supply of housing could run the risk of causing additional distortions. Given Britain's present economic situation, and the evidence which suggests that today's landlords are predominately a wealthier group than the rest of society, it is also worth asking whether we should be forgoing large sums of public revenue in order to provide them with tax relief. If the government really is serious about helping more would-be first time buyers get onto the property ladder, reforming the ways that property ownership is taxed is a critical place to start.