Section 2 Commentary

Chapter 6
Help with housing costs

Housing taxation gets hot

The tax arrangements for private sector housing came under the microscope in 2007, and generated a level of controversy not seen since the long drawn out arguments over the abolition of mortgage interest tax relief for home-owners at the end of the last decade (Compendium Table 105).

First of all in the summer there was a flurry of controversy about the availability of mortgage tax relief to private landlords, which was alleged to give them an unfair advantage over first-time buyers, and then in the autumn the tax arrangements for inheritance tax and stamp duties became a political football, leading to some relatively minor tax changes announced in the 2007 Pre Budget report.[1]

While private landlords do benefit from mortgage interest tax relief, this is in the context of a tax regime where they do pay tax on their net rental profits, and where they are also subject to capital gains tax. In contrast, first-time buyers no longer get mortgage interest tax relief, but neither do they pay tax on the value they derive from the occupation of the home they are buying.

The 'Schedule A' tax for home-owners on that imputed rental value, which provided the initial economic rationale for permitting mortgage interest tax relief, was abolished over 40 years ago, and it took another 35 years before the abolition of mortgage interest tax relief (more or less) rebalanced the revenue dimension of the taxation arrangements for home-owners.

Moreover, home-owners continue to benefit from their exemption from capital gains tax on their primary home. The summer media circus focused solely on the mortgage interest tax relief arrangements, while neglecting to consider the considerable tax benefits still available to home-owners.

Indeed, the latest Inland Revenue estimates put the value of the capital gains tax (CGT) exemption for home-owners at a massive £15.8 billion in 2006/07. However, as the *Review* has regularly indicated this figure is misleading as the Inland Revenue figure makes no provision for 'roll over' relief (where the tax is deferred when households invest all of the proceeds from their former home into a new home), or the existing UK capital gains rules which only apply the tax to a proportion of any capital gain.

The experience in Sweden, where capital gains tax, with roll over relief, is applied to home-owners' capital gains suggests that the effective yield from its application would be more like 40 per cent of the gross figure. The Inland Revenue do not make any provision for these factors on the grounds that it is not government policy to apply capital gains tax to home-owners' primary dwellings, so it is not appropriate for them to engage in speculation about how such a tax change might be applied in practice.

At the same time it does also provide an estimate of the value of the 'taper relief' on those capital gains that are subject to CGT, and for 2006/07 this was put at £6.3 billion; against actual receipts of £3.8 billion in the year. However, CGT applies primarily to business, rather than 'non-business' assets, and the levels of 'taper relief' for business assets are significantly greater than for non-business assets.

The taper relief currently varies depending on the length of time the capital asset is held. For business assets if a capital asset is held for one full year only 50 per cent of the capital gain is then liable for CGT; if it is held for more than two full years then only 25 per cent of the capital gain is liable for CGT.

For non-business assets, which would in principle include home-owners' primary residences were they not exempt, the taper relief is less generous. Taper relief only begins to apply when assets are held for more than three years, and then only reduces at the rate of 5 per cent for each additional year the asset is held until a rate of 60 per cent is applied to assets held for ten or more years.

The estimate of a potential 40 per cent net yield from CGT on home-owner primary residences (Table 2.6.1) is for the combined provision of both taper and 'roll over' relief, based on the Swedish experience which provides both roll over relief, and the equivalent of taper relief. In the Swedish case CGT is only eventually applied to two-thirds of the home-owners' capital gain.[2]

In the UK the chancellor has now proposed to change the arrangements for CGT taxation and taper relief from April 2008. Currently, subject to the tapers, CGT is applied at the rates for savings income

(10 per cent, 20 per cent or 40 per cent depending on which tax band is applicable). From April 2008 the chancellor proposes to abolish taper relief, for both business and non-business assets, and to apply a single rate of 18 per cent to all capital gains.

This reform will result in both gainers and losers for those currently subject to CGT, depending on the rate at which they are liable to CGT, and the extent to which their assets are eligible for capital gains tax. For example a private landlord with assets held for more than two years, and liable to the highest rate of CGT will currently pay an effective rate of 10 per cent (40 per cent applied to 25 per cent capital gains); from April 2008 they will be liable to the proposed single rate of 18 per cent.

Conversely, the proposed new regime will reduce the CGT rate for higher rate tax payers with non-business capital assets, even in cases where they have held those assets for more than 10 years. At the time of writing there is some vocal opposition to the proposed CGT reforms but it seems likely that they will nonetheless go forward.

Inheritance tax and stamp duty

There was even more controversy about inheritance tax (IHT) and stamp duty in the Autumn, with the Conservative Party proposing to lift the inheritance tax threshold to £1 million, from its current level of £300,000, and to remove stamp duty for first-time buyers on purchases of dwellings valued under £250,000. The cost of the proposed hike in the inheritance tax threshold was estimated at some £3,500 million per annum; roughly equivalent to the cost of a one pence in the pound reduction in the rate of income tax.

Subsequently the government announced in the November Pre Budget report[1] that is was to double the threshold for the surviving partner of married couples (or civil partners), where they do not make use of the £300,000 tax fee allowance on the death of the first partner. In practice many couples had already been advised by lawyers to enter into legal arrangements that would have the same effect under the old IHT rules, so this change is not as far reaching as it might sound.

It will, however, cut down on households' legal fees, and the effective net cost may be rather lower than the estimated £1,000 million in the first full year (2008/09), to the extent that the estimate does not take full account of the capacity for households to enter into broadly equivalent legal arrangements under the old scheme. Nonetheless, this provision was by far and away the most expensive of the tax and benefit changes announced in the Pre Budget Report.

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

£ million

	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07
Capital gains tax relief (gross)	- 2,000	- 1,000	- 850	- 850	- 500	- 600	- 800	- 1,400	- 3,000	- 3,300	- 6,000	- 10,000	- 10,500	- 13,000	- 12,500	- 15,800
Capital gains tax relief (net)	- 800	- 400	- 340	- 340	- 200	- 240	- 320	- 560	- 1,200	- 1,320	- 2,400	- 4,000	- 4,200	- 5,200	- 5,000	- 6,320
Inheritance tax	427	379	403	422	429	440	480	496	611	684	769	870	999	1,166	1,300	1,414
Stamp duty	630	280	465	520	465	675	830	1,065	1,825	2,145	2,690	3,525	3,710	4,620	4,600	6,445
Net tax position	257	259	528	602	694	875	990	1,001	1,236	1,509	1,059	395	509	586	900	1,539

Source: Inland Revenue Statistics (various years).

Notes: Estimates of capital gains tax relief are set at 40% of Inland Revenue estimates to take account of roll over and taper relief provisions. See text for details.

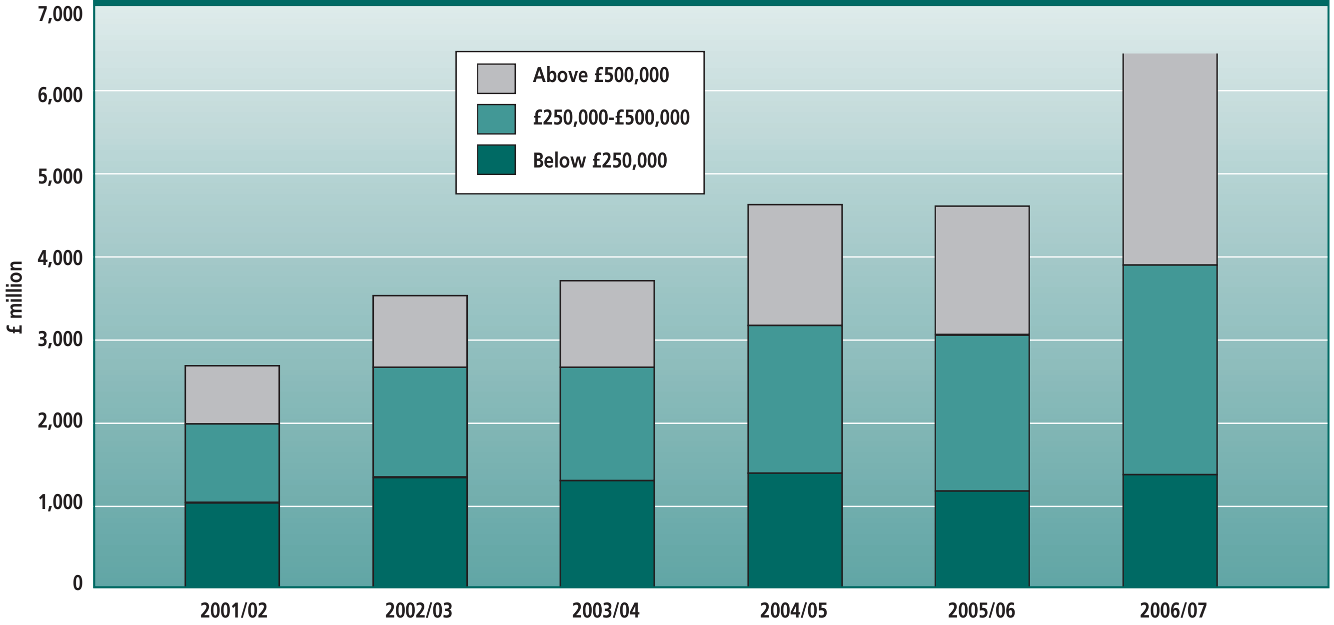
It should also be noted that the stamp duty and inheritance tax yields are for residential dwellings in all tenures; and do not exclusively relate to home-ownership.

Estimates vary but the Conservative Party proposals would clearly have been far more expensive. At one level these issues are the very stuff of politics, and the balance and shape of tax and expenditure measures are an expression of political choices and priorities.

Politics aside, however, there is little to commend the proposal to abolish stamp duty for first-time buyers on properties valued at under £250,000. First of all a large part of that change would benefit existing owners, as the removed tax liability would be factored into house prices. Secondly the measure would exacerbate the existing bunching of prices just below the £250,000 threshold; as any price even a £1 over £250,000 would mean an extra £7,500 liability for stamp duty for a first-time buyer (compared to the £5,000 leap in stamp duty at this point that occurs under the current rules).

If any government did wish to reduce the tax take from stamp duty there would be a far better case for measures to remove, or ease, the market distortions arising from the current hikes in tax liability that occur at the £125,000, £250,000 and £500,000 thresholds. Those distortions would not arise if the higher rates of duty only applied to the value of the dwelling over the threshold, rather than to the whole value for properties above each threshold.

Figure 2.6.1 **Yield from stamp duty on residential property**



Source: Inland Revenue Statistics.

There is in any event a case for a cost neutral move to such a progressive structure, although this would necessitate the marginal rates of duty to rise quite substantially from their current 1 per cent, 3 per cent and 4 per cent levels if they are only to apply to the element of value above those thresholds.

Table 2.6.1 shows the current tax yields from residential property, and the gross and net value of the home-owners' exemption from capital gains tax. In particular it shows the sharp rise in the yield from stamp duty in 2006/07 (also see Compendium Table 108) as more properties became liable to the higher rates of duty. In 2005/06, 34 per cent of the stamp duty income from residential properties came from dwellings valued over £500,000; in 2006/07, 40 per cent of the yield came from such dwellings (see Figure 2.6.1).

The yield from inheritance tax estimated to arise from residential property within taxable estates rose to £1,414 million in 2006/07, giving a total tax yield from residential property of some £7.86 billion. Against this the estimated net value of home-owners' exemption from capital gains tax (taking account of roll over and taper relief provisions) was £6,320 million for the year.

However, while this shows a net tax gain of some £1.5 billion from residential property, it should be recognised that an element of the stamp duty and inheritance tax income relates to the private rented sector, while the CGT tax exemption applies solely to home-owners and their principal residence.

Housing benefit

Issues arising from the new evidence of a very poor take-up rate of housing benefit by working households are discussed in the Contemporary issues Chapter 4, *Housing benefit isn't working*.

References

1. *Meeting the aspirations of the British people: 2007 Pre-Budget Report and Comprehensive Spending Review*, Cm 7227, HM Treasury, The Stationery Office, 2007.
2. 'Taxing Questions', S. Wilcox, *UK Housing Review 2004/05*, Chartered Institute of Housing and Council of Mortgage Lenders, 2004.

Key Reading

Departmental Report 2007, Department of Work and Pensions, Cm 7105, The Stationery Office, 2007.

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Housing Benefit and Council Tax Benefit, Summary Statistics, Quarterly Series,

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