

Cambridge Centre
for Housing &
Planning Research

The impact of taxation reform on the private rented sector

Michael Jones
Kathryn Muir
Chihiro Udagawa
Dr Gemma Burgess

May 2018



UNIVERSITY OF
CAMBRIDGE

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1. Executive Summary

- Over the past two years there have been significant policy changes affecting the private rented sector, including the removal of mortgage interest relief for unincorporated landlords and the three percent increase in Stamp Duty Land Tax for buy-to-let and second homes.
- The aim of this research was to investigate the impact of taxation reform on the private rented sector, in the light of emerging evidence on how landlords have responded thus far.
- The research involved a survey of landlords on the RLA database. There are approximately 70,000 people on the RLA mailing list. The RLA also published the survey on their website and advertised it through social media, and it was mentioned in the trade press, which helped to widen the reach of the survey.
- The survey covered questions on landlords' personal finances, portfolio and property management. The survey ran from 12 March to the 9th April 2018. 5,425 landlords viewed the survey, although not all landlords answered every question, but 5,002 provided at least one piece of information about their letting business.
- Survey responses were then used to model the impact of reform of different tax policies.
- In November 2015, the government announced its intention to impose an additional rate of Stamp Duty Land Tax (SDLT) at 3% for the purchase of additional residential properties from 1 April 2016. The analysis suggests that landlords brought forward their buying activities in anticipation of the increase in SDLT, with a significant increase in the number of landlords buying properties, and in the number of properties bought in 2015/16.
- However, the analysis also showed that the number of properties purchased and the number of landlords buying properties fell in 2016/17 and 2017/18 after the introduction of the additional 3% rate of SDLT. In 2017/18, the number of properties purchased had fallen to 62% of the average number bought in the two years of 2013/14 and 2014/15, and the number of landlords buying properties had fallen to 65% of the number active in 2013/14 and 2014/15.

- From 1 April 2016, the Wear and Tear Allowance (WATA) for furnished lettings has been replaced by the Replacement of Domestic Items Relief (RDIR). Just over half of all landlords with furnished lettings in the survey had recorded no expenditure qualifying for RDIR in 2016/17, and would therefore have lost around £1,000 of expenditure which would have qualified for tax relief had the WATA still been in existence. The increase in tax due to the loss of relief would therefore have been some £200 for a 20% taxpayer and £400 for a 40% taxpayer, in a year in which no expenditure on repairs or replacements was incurred.
- With only one year's evidence so far, it is not possible to say with what frequency landlords are likely to incur significant expenditure qualifying for the RDIR, but on average, landlords letting a furnished property would need to spend around £1,000 per annum in order to receive a similar amount of tax relief to that previously available under the WATA.
- Over the four years from 1 April 2017 to 1 April 2020, the amount of Income Tax relief available on finance costs for let residential property will be progressively reduced to the basic rate of tax. The analysis shows firstly that 55% of survey respondents will not be affected in the first year of tax relief withdrawal, and that nearly half (47%) will remain unaffected by 2020/21.
- Just under 38% of responding landlords will lose over £1000 in tax relief by 2020/21. However, the largest impact will be felt among landlords losing over £3,000 in tax relief: while only 5% of landlords will lose over £3,000 in tax relief in the first year, this will rise to 23% of all landlords by 2020/21.
- The survey suggests that landlords with one property are unlikely to sell in the next year, but landlords who will lose over £1000 in tax relief by 2020/21 are more likely to sell a property in the next year.
- The change to mortgage interest tax relief was the single most dominant reason for landlords deciding to sell property.

2. Literature review and methodology

This research, funded by the Residential Landlords Association (RLA), investigates the economic impact of government taxation reform on the private rented sector. Over the past two years there have been significant policy changes affecting the private rented sector, including the removal of mortgage interest relief for unincorporated landlords and the three percent increase in stamp duty for buy-to-let and second homes.

The private rented sector in England has grown rapidly over the last 20 years, faster than the increase in the total housing stock. Between 2002 and 2014, the amount of private rented stock more than doubled, from 2.51 million units to 5.34 million units (DCLG, 2017). This increase is largely due to the influx of individual landlords to the sector, who now constitute 89 percent of landlords in the UK (Ronald and Kadi, 2017). The private rented sector is frequently described as a 'cottage industry', as more than three quarters (78 percent) of all landlords only own a single dwelling for rent, and only 2 percent of landlords have a portfolio of more than 10 properties (DCLG, 2011).

The private rental sector is complex, and made up of different niche markets, including young professionals, students, the housing benefit market, tied housing and high-income renters (Rugg and Rhodes, 2008). There is a lot of regional variation in the private rented sector as the configuration of these constituent markets varies from area to area. Rugg and Rhodes (2008) highlight that Greater London is the area with the largest private rented sector in England (comprising 16.4% of households, compared to a national average of 11%). They also highlight that the private rental sector is significant in rural as well as urban areas, although research has tended to focus on urban renting.

The growth of the private rented sector is linked to the political and economic conditions of the 1990s and 2000s. The Housing Act 1988 introduced shorthold tenancies and lifted rent controls on new tenancies. There was also an increased demand for rental properties due to the decreasing affordability of owner-occupied properties, increased economic uncertainty, higher levels of debt, worsening access to social renting, an increase in the number of students and migrants, and an increase in professionals relocating for work (Scanlon, Whitehead and Williams, 2015). Lastly, from 1996, buy-to-let mortgages became available, which offered cheaper financial deals for the purchase of property to let.

The growth of the buy-to-let market has been perceived to have a number of positive impacts. It has reversed the long-term decline of the private rented sector, and therefore increased the tenure choice available to individuals and households (Leys and French, 2009). A survey of almost 15,000 tenants conducted by HomeLet (2015) found that tenants are largely happy with their experience of renting a property: 90% of those who rented their

property through a landlord were happy with the service they received and 86% of tenants were happy with the standard of their rented home. A strong private rental sector is important to provide a housing option for households who are unable to get a mortgage and those who desire the flexibility of renting, as well as for aspiring first-time buyers saving for a deposit to secure their first home. Having a choice of tenures prevents “a situation where people feel pressurised into taking big mortgages early in life” (Miles, 2016).

However, the growth of the buy-to-let market has also been perceived to have a number of negative impacts. There is a stated concern amongst policy makers that the expansion of the private rented sector has come at the expense of would-be first time buyers, who find themselves unable to compete with buy-to-let landlords and are therefore trapped in rented housing when they would prefer to own their own home. Scanlon et al. (2015) suggest that, in reality, the extent of competition between demand from buy-to-let landlords and first-time buyers varies around the country. In some areas, such as London, the two groups are in direct competition but in many markets there is no meaningful competition for properties between these two groups (ibid).

There has also been stated concern from the government that the buy-to-let sector is a potential cause of economic instability because landlords tend to invest in the upturn and sell in the downturn, thus putting undesirable pressure on prices. The government has emphasised that it would favour the development of an institutionally funded and professionalised private rental sector (Scanlon et al. 2015). However, Scanlon et al (2015) suggest that the concerns that landlords might sell properties during a crisis does not reflect the experience to date of landlords' behaviour, as during the last financial crisis there was no large scale sale of property. Rugg and Rhodes' (2008) review concludes that small-scale landlordism does not necessarily mean financial instability because the majority of 'cottage industry' landlords have low loan-to value-ratios and many have unmortgaged properties. Rugg and Rhodes (2008) also suggest that 'cottage industry' landlords tend not to factor their management time into their rents, and that therefore larger institutional landlords may have higher management costs.

The government has recently made a range of reforms to the taxation of private landlords, ostensibly to help redress the balance between landlords and owner-occupiers. These reforms are detailed in the next section.

2.1. Overview of taxation and regulatory changes

2.1.1. Increasing Stamp Duty by 3 percent for purchase of Buy to Let and second homes

As of 1 April 2016, anyone purchasing a second home or buy-to-let investment has been required to pay an additional three percent in Stamp Duty Land Tax. The additional tax applies to low value properties (worth over £40,000 but under £125,000) which were previously exempt from Stamp Duty and which now incur a three percent charge, whilst at the top end, landlords purchasing properties worth over £1.5m now pay a total of 15% Stamp Duty (12% paid by all purchasers of high value homes, plus 3% buy-to-let rate).

2.1.2. Allowing mortgage interest to be offset only against basic rate tax

In the Summer 2015 Budget, George Osborne announced that tax relief for buy-to-let landlords would be restricted in order to “create a more level playing field between those buying a home to let and those buying a home to live in” (Osborne, 2015). From 6 April 2017 to 6 April 2020, new rules are being phased in which will cap the amount of tax relief landlords can claim on mortgage interest payments to 20 percent, rather than 40 percent or 45 percent, as would normally be claimed by landlords with higher gross incomes. This increases the tax bill for landlords whose gross income is in excess of the higher rate tax allowance (£45,000 in 2017/18).

2.1.3. Removing the fixed 10 percent wear and tear allowance on furnished lettings

Landlords letting furnished properties were previously able to offset 10 percent of the net rent for ‘wear and tear’. From April 2016, this 10 percent allowance was abolished and, instead, landlords can only offset actual expenditure against tax.

2.1.4. Capital gains tax

When a landlord sells a property, they must pay capital gains tax of 18% (basic rate) or 28% (higher rate) on the difference between the sale value and the original purchase value. This rate of taxation has been retained for disposals of residential property that are not a primary residence, while the rate for gains on all other asset types were reduced to 10% and 20% respectively from April 2016.

2.2. Impact of changes

Existing research into the impact of these changes has not been conclusive.

Scanlon and Whitehead (2016) suggest that the majority of landlords will be unaffected by the reforms, either because their gross income (including rent) is still below the higher rate tax threshold, because they do not have any mortgage debt, or because they own properties through a company structure. They suggest that:

“Those who will be most affected by the various changes are not small-time accidental landlords or investors with only a single unit, but rather the more ‘professional’ landlords...with sizeable portfolios who are more likely to transact (and therefore be exposed to higher Stamp Duty Land Tax (SDLT) and Capital Gains Tax), as well as more likely to have buy-to-let mortgages and incomes high enough to be impacted by the change in the treatment of mortgage interest.” (Scanlon and Whitehead, 2016, p.7)

On introducing the change to mortgage interest (only allowing it to be offset against basic rate tax), HM Revenue and Customs anticipated that one in five individual landlords will receive less relief as a result of this measure, and that it will impact on those with above average incomes most. They state that the measure:

“is not expected to have a significant impact on either house prices or rent levels due to the small overall proportion of the housing market affected” (HM Revenue and Customs, 2017)

However, the Institute for Fiscal Studies (IFS) highlights that those landlords who are affected will be affected quite severely (Adam and Shaw, 2016). For landlords with a high level of borrowing and small profit margins, it is possible that the tax due will be higher than their rental profits in financial terms, and they suggest that this reform will “significantly reduce the attractiveness of buy-to-let housing as an investment among higher-rate taxpayers who require mortgage finance” (Adam and Shaw, 2016, p.5). They calculate that for a ten year buy-to-let investment 50% financed by a mortgage, the effective tax rate will increase from 47% to 76%.

Scanlon and Whitehead (2016) found that around 9% of buy-to-let landlords report making a loss on their lettings business, and a further 23% report that they break even rather than making a profit. They suggest that landlords whose gross incomes are over the higher rate tax threshold will be at particular risk of arrears or of selling up in response to the tax increases, although anticipated capital growth will also affect decisions to sell or remain in the market.

Recent research by the RLA (Simcock, 2018) found that 70% of landlords reported that the changes to mortgage relief would reduce their profitability as a business, with 62% of landlords reporting this would reduce their profitability by at least 20%. Pattison (2017) found that around one in five landlords think that the changes will make them less likely to let to under-35s. Miles (2016) suggests that unless rents rise significantly the supply of rented property from private landlords will fall.

2.3. Landlord responses to changes

One potential landlord response to the changes would be to pass on the cost to their tenants by increasing rents. Simcock (2018) found that 67% of landlords reported they would increase rents to mitigate the negative impact of the changes to mortgage interest relief, and that 43% of landlords reported they had increased rents in the past 12 months, with 31% of these reporting this was due to changes in mortgage interest relief. Simcock also found that 69% of landlords reported they were discouraged from purchasing further rental properties by the changes to Stamp Duty Land Tax. He found that the proportion of landlords adding property to their portfolio is in decline, and now stands at 18%, down 9 percentage points from the previous year. He also found that the proportion of landlords that have sold properties from their portfolio is increasing, up 4 percentage points on the previous year, to 13% (Simcock, 2018).

Miles (2016) suggests that the effect of the changes will be to reduce the supply of rental properties. Research by Clarke and Heywood (2017) suggests that the Stamp Duty reform is slowing the rate at which landlords expect to grow their portfolios, but concluded that the recent tax changes are likely to reduce the speed at which the sector grows, but not cause a sudden exodus of landlords. Other research has found that landlords are still more likely to say they intend to grow their portfolios rather than shrink them, albeit more slowly (Sateriale and Offord, 2017; Scanlon and Whitehead, 2016).

Company landlords are unaffected by the tax changes, and recent evidence suggests that landlords are increasingly looking to purchase new properties via a company structure, thus avoiding the tax increase (Clarke and Heywood, 2017).

The changes to mortgage tax relief make it more complex for landlords to work out what tax is due, and recent research suggests that, prior to the introduction of the reforms, they were not well understood (Clarke and Heywood, 2017). The government has, however, published guidance and case studies to help landlords understand how the changes will affect them and there has been considerable coverage in the press and from landlord bodies, such as the RLA, suggesting that landlords may now be more aware of changes than they were a year ago.

2.4. Methodology

The research comprised:

1. Review of existing evidence
2. Short survey of landlords on RLA database, focusing on finance
3. Modelling of the impact of changes to taxation on landlord finances

The research involved a survey of landlords on the RLA database. There are approximately 70,000 people on the RLA mailing list. The RLA also published the survey on their website and advertised it through social media, and it was mentioned in the trade press, which helped to widen the reach of the survey. It covered questions on their personal finances, portfolio and property management. Survey responses were then used to model the impact of reform of different tax policies on landlord finances.

The sampled landlords were resident in England and their letting properties are located across England. The survey ran from 12 March to the 9th April 2018. 5,425 landlords viewed the survey, although not all landlords answered every question, but 5,002 provided at least one piece of information about their letting business. Where reasonably possible, some missing values were imputed and some outliers (e.g. those caused by decimal point errors) were appropriately converted. However, the total number of landlords providing information varied across the survey questions.

Of the valid respondents:

- 945 landlords (19%) let one property
- 2,185 landlords (44%) let two to five properties
- 927 landlords (19%) let six to ten properties
- 811 landlords (16%) let eleven to forty-nine properties
- 102 landlords (2%) let fifty or more properties

In terms of the legal structure of the respondents, 4,022 landlords (86%) were letting as individuals, 159 landlords (3.5%) formed a company and 486 (10.5%) had a mixed portfolio structure.

1,606 (62%) of landlords' latest letting properties were unfurnished.

3. Findings

The aim of this research was to investigate the impact of taxation reform on the private rented sector, in the light of emerging evidence on how landlords have responded thus far. The data from the survey were used to model the impact of the recent tax changes on landlords. The key reforms analysed were:

- Increases in Stamp Duty by 3% for purchase of buy-to-let and second homes, announced in November 2015 and introduced from April 2016.
- Removal of the fixed 10% wear and tear allowance on furnished lettings, announced in July 2015 and introduced from April 2016.
- Allowing mortgage interest to be offset only against basic rate tax, announced in July 2015 and introduced over four years from April 2017.

The following sections present the data from the survey on the impact of these reforms.

3.1. The impact of the 3% increase in Stamp Duty

In November 2015, the government announced its intention to impose an additional rate of Stamp Duty Land Tax (SDLT) at 3% for the purchase of additional residential properties. The additional rate of SDLT applies to individuals and companies, and to the purchase of any property in addition to an individual's main residence, whether as a second home, a buy-to-let, or for any other purpose. The additional 3% rate of SDLT became effective from 1 April 2016.

The survey asked landlords with multiple letting properties (whether owned by an individual or by a company) how many properties they had purchased in each of the five years from 2013/14 to 2017/18. 2,031 landlords responded with details of their purchases over the five-year period.

In 2015/16, one respondent recorded a total purchase of 1,275 properties, or 39% of all properties purchased by responding landlords in that year. In no other year did any respondent record a total of purchases larger than 155. The data are therefore presented both with this single purchase, and without, in order to highlight the underlying trends. Table 1 shows the data excluding the single large purchase, and Table 2 shows the data including the single large purchase.

The numbers of properties purchased in each of the five years is shown in the tables below, with the two years of the 3% additional rate shaded.

Table 1 Properties purchased by responding landlords 2013/14 to 2017/18 (excluding one purchase of 1,275 properties in 2012/13)

Properties purchased by landlords 2013/14 to 2017/18 (2,030 respondents)					
	2013/14	2014/15	2015/16	2016/17	2017/18
Number of landlords who did not purchase in that year	1153	1140	1049	1271	1460
Number of landlords who purchased property in that year	878	891	982	760	571
Number of properties purchased by each purchasing landlord	Total number of properties purchased in each year by purchasing landlords				
1 property	534	537	595	495	373
2 properties	416	430	466	306	216
3 properties	180	195	243	150	135
4 properties	124	104	80	124	84
5 properties	105	100	105	65	30
6 to 10 properties	111	141	145	94	91
11+ properties	259	171	348	90	134
Total number purchased	1729	1678	1982	1324	1063
Average number per purchasing landlord	1.97	1.88	2.02	1.74	1.86
% of all landlords purchasing properties	43%	44%	48%	37%	28%

Table 1 shows that:

- The numbers of properties bought, and the number of landlords buying, was similar in the years 2013/14 and 2014/15.

- The number of landlords buying properties, and the number of properties bought, increased by 16% in 2015/16, over the average of the previous two years, suggesting that landlords brought forward their buying activities in anticipation of the increase in SDLT in 2016/17.
- The number of properties purchased in 2016/17 fell by 22% compared to the average number bought in the two years of 2013/14 and 2014/15, and the number of landlords buying properties fell by 14% compared to those years.
- The number of properties purchased fell further in 2017/18, to 62% of the average number bought in the two years of 2013/14 and 2014/15, and the number of landlords buying properties fell to 65% of the number active in 2013/14 and 2014/15.

Table 2 Properties purchased by responding landlords 2013/14 to 2017/18 (including one purchase of 1,275 properties in 2015/16)

Properties purchased by landlords 2013/14 to 2017/18 (2,031 respondents)					
	2013/14	2014/15	2015/16	2016/17	2017/18
Number of landlords who did not purchase in that year	1153	1140	1049	1271	1460
Number of landlords who purchased property in that year	878	891	982	760	571
Number of properties purchased by each purchasing landlord	Total number of properties purchased in each year by purchasing landlords				
1 property	534	537	595	495	373
2 properties	416	430	466	306	216
3 properties	180	195	243	150	135
4 properties	124	104	80	124	84
5 properties	105	100	105	65	30
6 to 10 properties	111	141	145	94	91
11+ properties	259	171	1623	90	134
Total number purchased	1729	1678	3257	1324	1063
Average number per purchasing landlord	1.97	1.88	3.32	1.74	1.86
% of all landlords purchasing properties	43%	44%	48%	37%	28%

Table 2 shows that including the single large purchase of 1,275 properties in 2015/16 would increase purchases in 2015/16 to 91% more than the average of the preceding two years.

The falls in purchases in 2016/17 and 2017/18, when compared to the two years 2013/14 and 2014/15, are unaffected.

The fall in the number of landlords purchasing property after 1 April 2016, and in the number of properties that they purchased, might of course have been influenced by other housing

market factors, such as changes in the mortgage market or in the supply of properties, rather than the imposition of the additional rate of SDLT.

Landlord buying decisions are influenced by a number of factors rather than by the increase in Stamp Duty alone. An econometric test was carried out to disentangle the impact of changes in the real rate of interest on buy-to-let mortgages, the effect of increased supply from new build completions, and the effect of the increase in Stamp Duty. This showed that increased supply had a small positive effect, increasing the number of properties purchased, and that a decline in the real rate of interest on buy-to-let mortgages had a significant effect on increasing landlord purchases, however, it also showed that both positive effects were outweighed by the increase in Stamp Duty, which had an overall negative effect on landlord purchases.

The findings would suggest that if the government announced a prospective cut in Stamp Duty, landlords would postpone purchases while waiting for the cut, and would then buy more than average immediately afterwards.

3.2. Removal of the fixed 10% wear and tear allowance

From 1 April 2016, the Wear and Tear Allowance (WATA) for furnished lettings has been replaced by the Replacement of Domestic Items Relief (RDIR). The WATA allowed landlords who let furnished properties to claim a wear and tear allowance, set at 10% of net rents, to cover the costs of replacing furnishing and fittings in the property.

The RDIR allows landlords of both furnished and unfurnished properties to claim relief on capital expenditure incurred on the replacement of domestic items, including furnishings, appliances and kitchenware. The relief is available for the cost of replacement on a 'like for like' basis: the cost of improvements does not qualify for relief.

The RDIR applies from 1 April 2016 to individuals, and from 1 April 2019 to companies. Furnished holiday lettings, which are entitled to capital allowances, are unaffected.

In the survey, landlords with furnished lettings were asked to split their expenditure on repairs and maintenance between (a) replacing or repairing furnishings and fittings in furnished lettings and (b) other maintenance expenditure. 185 landlords (out of 945 respondents with one property) were letting a furnished property, and supplied details of their expenditure qualifying for RDIR in 2016/17.

Just over half of these had not incurred any expenditure on repairing or replacing furnishings during 2016/17, while the remainder had spent an average of £466 in that year.

If the 185 landlords with furnished lettings had been able to claim WATA instead, the average (mean) amount would have been £1,030.03.

Average expenditure in the year which qualified for RDIR was therefore some £564 less than the amount which might have been claimed had the Wear and Tear Allowance still existed. For a 20% taxpayer, the average increase in tax would have been some £112, while for a 40% taxpayer, the average increase in tax would have been some £225 in that year.

Just over half of all landlords with furnished lettings had recorded no expenditure qualifying for RDIR in 2016/17, and would therefore have lost around £1,000 of expenditure which would have qualified for tax relief had the WATA still been in existence. The increase in tax due to the loss of relief would therefore have been some £200 for a 20% taxpayer and £400 for a 40% taxpayer, in a year in which no expenditure on repairs or replacements was incurred.

It is not possible to assess the long term impact of the change from the WATA to the RDIR on the basis of one years' experience. Significant expenditure on repairing or (more likely) on replacing furniture, appliances and kitchenware is likely to be 'lumpy' and only to take place at relatively long intervals, typically in between tenancies.

With only one year's evidence so far, it is not possible to say with what frequency landlords are likely to incur significant expenditure qualifying for the RDIR, but on average landlords letting a furnished property would need to spend around £1,000 per annum in order to receive a similar amount of tax relief to that previously available under the WATA. Expenditure is of course more likely to be intermittent, but expenditure of £5,000 every five years, or £10,000 every ten years would be required in order to receive a similar aggregate amount of tax relief as that previously available under the WATA.

The change from the WATA to the RDIR does, however, alter the tax incentive for landlords. Under the WATA, landlords were presented with an incentive to hold down actual expenditure on repairs and replacements while receiving tax relief on a theoretical expenditure. Under the RDIR however, the tax relief may act as an incentive to replace items on a proactive rather than a reactive basis.

The RDIR is also likely to provide an incentive for landlords with unfurnished properties equipped with white goods, carpets and curtains to replace these on a regular or programmed basis, before breakdown expenditure on repairs becomes significant.

3.3. Tax rule change on treatment of mortgage interest

Over the four years from 1 April 2017 to 1 April 2020, the amount of Income Tax relief available on finance costs for let residential property will be progressively reduced to the basic rate of tax.

This restriction applies to private individuals, partnerships and trusts, but not to companies, or to landlords of furnished holiday lettings.

The transitional percentages are shown in Table 3 below:

Table 3: Transitional percentages per tax year

Tax year	% of finance costs deductible from rental income	% of basic rate tax deduction
2017/18	75%	25%
2018/19	50%	50%
2019/20	25%	75%
2020/21	0%	100%

1,860 landlords gave sufficient information on their finances to estimate the effects of the phased withdrawal of tax relief on finance costs. The data collected included gross rental income, mortgage expenses, non-finance allowable costs, and other personal income such as earnings or pensions.

Obvious typing mistakes and decimal point errors were corrected, but there were a number of extreme values where it was not possible to judge whether these were genuine values or errors. The sample used for this analysis therefore trimmed the highest 1% of values.

The analysis compared the cost of income tax that would have been paid had tax relief above the basic rate continued to exist, with the tax that would be paid in each of the four years as the relief is phased out.

In terms of the methodological approach, to examine the impact of the tax relief, we took a with-or-without comparison approach. More specifically, we assessed the impact on each individual landlord as the difference in income tax to be paid between the old and new tax rule as in the below equation:

$$D_{it} = TN_{it} - TO_{it}$$

Where:

D: Difference in income tax (£ per annum),

TN: Income tax to be paid under the new tax relief rule,

TO: Income tax to have been paid under the tax relief rule in effect up to 2016/17,

Subscript *i*: each of individual landlords in the survey and

Subscript *t*: each tax year over the examination period up to 2020/21.

The data used was drawn from landlords' 2016/17 tax returns. Future inflation was held at zero, and no adjustments were made for any behavioural change such as re-mortgaging, pre-payment, changing from fixed to floating rates or vice versa, or changes in employment income among higher rate taxpayers. Income Tax and Personal Allowance thresholds followed announced government policy for 2017/18 and 2018/19, and used 2018/19 rates for the final two years of the relief reductions.

Table 4: Distribution of landlords by impact band (%)

£s	2017/18	2018/19	2019/20	2020/21
0	54.9	52.4	49.2	46.5
0 to 100	4.6	2.7	2.1	1.6
101 to 250	7.3	4	3.3	2.3
251 to 500	8.4	6.6	4.1	4.5
501 to 1,000	8.4	8.3	7.9	7.5
1,001 to 2,000	8.1	8.6	9.8	9.1
2,001 to 3,000	3.4	4.7	5.4	5.8
over 3,000	4.9	12.7	18.1	22.7

[Note: N=1,860 landlords]

Table 4 shows firstly that 55% of these landlords will not be affected in the first year of tax relief withdrawal, and that nearly half (47%) will remain unaffected by 2020/21.

Just under 38% of these landlords will lose over £1000 in tax relief by 2020/21. However, the largest impact will be felt among landlords losing over £3,000 in tax relief: only 5% of landlords will lose over £3,000 in tax relief in the first year, rising to 23% of all landlords by 2020/21.

One possible response by landlords would be to reduce their income from employment, if that would balance their tax position. However, of the 423 landlords who would be losing

over £3,000 by 2020/21, 180 (43%) had no income from employment. Of the landlords who would lose over £3,000 in tax relief by 2020/21, 243 landlords had income from employment with an average income of £60,240 per annum. 88 landlords had pension income whose annual average was £18,081. 115 landlords had any other type of income whose annual average was £21,587. Of the 699 landlords who would be losing over £1,000 by 2020/21, 234 (34%) landlords had no income from employment, and the remaining 66% of landlords had an average income from employment of £57,695.

3.3.1. Changes to MITR and the decision to sell

The survey asked landlords if they were likely to sell property in the next year, and 2,267 landlords returned a valid response.

Amongst all landlords who responded to this question, 55% said they would probably not or definitely not sell property in the next year, and 31% said they would probably or definitely sell property in the next year.

Amongst landlords who responded to this question and had only one property, 73% said they would probably not or definitely not sell property in the next year, and 12% said they would probably or definitely sell property in the next year.

Amongst landlords who responded to this question and would lose over £1000 in tax relief by 2020/21, 42% said they would probably not or definitely not sell property in the next year, and 44% said they would probably or definitely sell property in the next year.

The survey suggests that landlords with one property are less likely to sell but those more affected by the changes to tax relief are more likely to sell a property in the next year.

The landlords who indicated that they would probably or definitely sell property in the next year, and confirmed that the number of likely sales is one or more property, were asked to identify the reasons why. Landlords could tick as many reasons as they wished. The most frequent reasons were:

- It is not profitable – because of changes to taxation of mortgage interest: 76%
- It is not profitable – because of government regulations and licensing requirements: 38%
- It is not profitable - because of changes to the wear and tear allowance: 29%
- In order to invest my money in some other asset: 17%

Landlords were then asked to tick the single most important reason for deciding sell at least one property within the next twelve months. The most important reasons were:

- It is not profitable – because of changes to taxation of mortgage interest: 61%
- It is not profitable – because of government regulations and licensing requirements: 8%
- I want to invest in a different buy-to-let property or properties: 5%
- Other: 4%

The changes to mortgage interest tax relief was clearly the single most dominant reason for deciding to sell property.

We conducted specific analysis of the responses of the landlords who will lose over £1000 in tax relief by 2020/21, who indicated that they would probably or definitely sell property in the next year, and who confirmed that the number of likely sales is one or more property. They were asked to identify the reasons why. Landlords could tick as many reasons as they wished. The most frequent reasons were:

- It is not profitable – because of changes to taxation of mortgage interest: 91%
- It is not profitable – because of government regulations and licensing requirements: 35%
- It is not profitable – because of changes to the wear and tear allowance: 29%
- In order to invest my money in some other asset: 15%

These landlords were then asked to tick the single most important reason for deciding sell at least one property within the next twelve months. The most important reasons were:

- It is not profitable – because of changes to taxation of mortgage interest: 78%
- No specific main reason: 5%
- It is not profitable – because of government regulations and licensing requirements: 4%
- I think the housing market will fall soon, so it is a good time to sell: 3%

The reduction in mortgage interest tax relief was clearly the single most dominant reason for deciding to sell at least one property in the next year amongst landlords who will lose over £1000 in tax relief by 2020/21.

3.4. Other possible tax changes

3.4.1. Capital Gains Tax

From April 2016, the basic rate of Capital Gains Tax has been reduced for individuals from 18% to 10%, while the higher rate has been reduced from 28% to 20%. However, the reductions are not applicable to capital gains on residential property that are not a primary residence. In the survey, 332 landlords letting out one property provided valid information relating to any capital gain which would be incurred if the property was sold. Of those, 51 (15%) were eligible for the basic rate of tax, while 281 (85%) were eligible for the higher tax rate. The average chargeable gain that would be potentially subject to taxation would be £38,541 for the valid survey respondents. However, this would likely then be reduced by Private Residence Relief and Letting Relief.

The survey asked landlords if they were likely to sell their property in the next year. 73% of landlords letting one property said that they would probably not or definitely not sell their property in the next year. However, RLA research suggested that 77% of private landlords would consider selling their property to tenants if the tax liability was reduced (RLA, 2017). Although there are no specific government proposals regarding the appropriate degree of Capital Gains Tax reductions to stimulate sales of letting properties, the reduced Capital Gains Tax rates now applicable to individuals could be benchmark levels. If we apply the reduced rates of Capital Gains Tax to the landlords who provided the relevant information in the survey, the average chargeable gain that would be potentially subject to taxation is £27,472, a reduction of just over £11,000 on average. Further research would be required to determine if a chargeable gain reduction of around £11,000 would incentivise landlords to sell their properties to sitting tenants, bearing in mind that the chargeable gain would likely be reduced by Private Residence Relief and Letting Relief.

For example, consider a situation where a landlord owns a property for 12 years, lives in it for 6 years, and then lets the property out for 6 years, and assuming that they make a gain of £120,000 when they sell the property. The owner gets Private Residence Relief (PRR) for the time they lived in the property, plus relief for the last 18 months they owned the property, even though they were not living in it. Private Residential Relief is therefore £75,000. If the owner then claims Letting Relief, they would receive a further reduction of £40,000. This means that they will pay Capital Gains Tax on a chargeable gain of £5,000. At the basic rate of Capital Gains Tax of 18%, this would be a Capital Gains Tax to be paid of £900. At the higher rate of Capital Gains Tax of 28%, this would be a Capital Gains Tax to be paid of £1,400. This is based on the example provided by the gov.uk website:

<https://www.gov.uk/tax-sell-home/let-out-part-of-home>

$$PRR = £120k \times \frac{(6+1.5) \text{ years}}{12 \text{ years}} = £75k$$

Letting Relief (LR) is deductible from the CG. The LR amount is the minimum of the following three options:

- £40k
- the amount of PRR (i.e., £75k)
- the amount of Capital Gain minus PRR (i.e., £45k = £120k - £75k)

Thus, LR is £40k.

The capital gain on which CGT will be charged is: £120k – (£75k + £40k) = £5k.

If we hypothesise that tax changes are introduced such that, when selling a property to a sitting tenant with a long tenancy, the whole period of letting to the tenant is included in the calculation of Private Residence Relief, and if we assume that in the scenario above, the landlord lets the property to the same tenant for 5 years, Private Residence Relief is therefore applied to the whole period of letting to the tenant, resulting in a Private Residence Relief of £110,000.

Letting Relief is then applied, which in this case would be £10,000 (the amount of capital gain minus PRR). This means the landlord would not pay any Capital Gains Tax.

$$PRR = £120k \times \frac{(6+5) \text{ years}}{12 \text{ years}} = £110k$$

Letting Relief (LR) is the minimum amount of the following three options:

- £40k
- the amount of PRR (i.e., £110k)
- the amount of Capital Gain minus PRR (i.e., £10k = £120k - £110k)

Thus, LR is £10k.

The capital gain on which CGT will be charged is zero: i.e., £120k – (£110k + £10k) = 0.

Given that the average chargeable gain that would be potentially subject to Capital Gains Tax would be £38,541 for the valid survey respondents, and that this would likely then be reduced by Private Residence Relief and Letting Relief, it is not clear whether a chargeable gain reduction, or a reduction in the rates at which Capital Gains Tax is applied, would incentivise landlords to sell their properties to sitting tenants.

3.4.2. Tax relief for longer-term tenancies

According to the English Housing Survey 2015/16, 42.1% of private tenant households had been living in the current property for one year or less, while around a quarter had been tenants in a property for five years or longer. Prior to the Budget in November 2017, the RLA called for tax incentives for landlords offering longer tenancies. It is possible that the 38% of landlords who will lose over £1,000 in tax relief by 2020/21, and the 23% of all landlords who will lose over £3,000 in tax relief by 2020/21, might be incentivised to offer long term tenancies in return for retaining such tax relief. However, no information was collected in the survey in relation to this and further research would be needed to try and determine how landlords might respond, particularly as the existence of shorter tenancies is likely to be a result of both supply and demand side factors.

Although no information on the length of the current tenancies was available from the survey, we can make some assumptions about the likely impact of tax relief for longer tenancies, measured as a reduction in gross rental income which is then subject to income tax.

In the analysis below, we hypothesise that tax relief is available on the properties with a long term tenancy at a 20%, or 50%, reduction in the gross rental income subject to income tax.

Currently, the average gross rental income per property for the 1,741 landlords with multiple properties who provided this information in the survey was £9,611 per annum.

For landlords with multiple properties, if one property in four were let on a longer tenancy, then the average gross rental income subject to income tax would reduce, at a 20% rate, from £9,611 to £9,131 per annum, and at a 50% rate to £8,410 per annum.

If three properties in four were let on a longer tenancy, then the average gross rental income subject to income tax would reduce, at a 20% rate, from £9,611 to £8,170 per annum, and at a 50% rate to £6,007 per annum.

3.4.3. Energy efficiency improvements and the Replacement of Domestic Items Relief (RDIR)

The Minimum Energy Efficiency Standards (MEES), introduced from April 2018, requires all rental properties to meet at least an Energy Performance Certificate of Level E or above, with the maximum fine for the infringement being £4,000. The regulations currently apply to new tenancies or contract renewals, but by 2020 will apply to all types of tenancies. Landlords have called on government to provide extra tax relief to help them finance energy efficiency upgrades to their properties. For example, the expansion of the RDIR application from “repairs and maintenance (RM)” to “RM plus improvements” might incentivise more landlords to upgrade their rental properties’ energy efficiency standards.

In the survey, 185 landlords were letting furnished properties, and supplied details of their expenditure qualifying for RDIR in 2016/17. Drawing on the same sample used in the analysis of the removal of the Wear and Tear Allowance above, we estimated the impact of an extended RDIR (i.e., making allowance not only for the cost of replacement on a ‘like for like’ basis but also for the cost of improvements relating to energy efficiency).

The survey did not ask landlords to disaggregate the annual improvement cost into that of energy efficiency (more specifically, the cost of improving energy efficiency up to Level E Performance) and the other costs. Therefore, we examined the following three scenarios – where 25%, 50% and 100% of the annual improvement cost relates to energy efficiency improvements. As per the previous RDIR analysis earlier in the report, the measurement unit is at 2016/17 prices.

Of the 185 landlords, 119 (64%) had incurred any improvement cost (IC). The average of RDIR was £466 in 2016/17. If we hypothesise that the cost of improvements relating to energy efficiency were also taken into account, the RDIR + 25% of IC would be an average of £682, RDIR + 50% of IC would be an average of £899, and RDIR + 100% of IC would be an average of £1331.

For a 20% taxpayer, the average tax reduction from the RDIR base to the level including these energy efficiency costs would be £43.27 (where 25% of IC was for energy efficiency), £86.55 (where 50% of IC was for energy efficiency) and £173.10 (where 100% of IC was for energy efficiency). For a 40% taxpayer, the equivalents would be average tax savings of £86.55, £173.10 and £346.20 respectively.

4. Discussion

The introduction of the additional rate of Stamp Duty Land Tax (SDLT) at 3% for the purchase of additional residential properties meant that landlords brought forward their buying activities in anticipation of the increase in SDLT, with a significant increase in the number of landlords buying properties, and in the number of properties bought in 2015/16. However, the analysis showed that the number of properties purchased and the number of landlords buying properties fell in 2016/17 and 2017/18 after the introduction of the additional 3% rate of SDLT. The direct impact appears to be that landlords became less likely to buy a rental property. This may have an indirect impact on tenants as prospective tenants might see a reduction in the supply of properties to rent.

However, the long term impact is unclear. Stamp Duty revenues have been higher than expected by government and HM Treasury has raised forecasts of how much the tax increase will generate: even with rising house prices, this suggests that the higher tax rates have not deterred purchases overall. Further analysis would be needed to assess the longer term impact on landlords' property purchases.

Average expenditure domestic items in the year which qualified for RDIR was £564 less than the amount which might have been claimed had the Wear and Tear Allowance still existed. Just over half of all landlords with furnished lettings had recorded no expenditure qualifying for RDIR in 2016/17, and would therefore have lost around £1,000 of expenditure which would have qualified for tax relief had the WATA still been in existence.

For landlords with furnished properties, tax relief has declined. For landlords with unfurnished properties, this is a new tax relief, but expenditure on replacement domestic items is unlikely to be significant so that the amount of relief is likely to be limited. The RDIR may act as an incentive to landlords to replace items on a proactive rather than a reactive basis, which may be of benefit to tenants. If energy efficiency improvement costs were taken into account in the calculation of RDIR, it may incentivise landlords to replace domestic items and systems with more energy efficient options, which could potentially reduce tenants' energy bills.

On introducing the change to mortgage interest tax relief, HM Revenue and Customs anticipated that one in five individual landlords will receive less relief as a result, and that it will impact on those with above average incomes most. The survey results suggest that just under 38% of responding landlords will lose over £1,000 in tax relief by 2020/21. However, the largest impact will be felt among landlords losing over £3,000 in tax relief: only 5% of landlords will lose over £3,000 in tax relief in the first year, rising to 23% of all landlords by 2020/21.

The survey suggests that landlords with one property are unlikely to sell but those more affected by the changes to tax relief are more likely to sell a property in the next year. The landlords in the survey who indicated that they would sell at least one property in the next year indicated that the change in mortgage interest tax relief was the most important reason. Longer term analysis would be needed to measure the actual impact of the tax change on the sale of letting properties.

If Capital Gains Tax for landlords was reduced to the same level as for individuals, this would mean that the chargeable gain that would be potentially subject to taxation would be reduced by just over £11,000 on average for the landlords responding to the survey. If Capital Gains Tax when selling a property to long term tenant was reduced, for example, by including the whole period of letting to a tenant in the calculation of Private Residence Relief, this might incentivise landlords to sell their properties to sitting tenants. However, given that the average chargeable gain that would be potentially subject to Capital Gains Tax would be £38,541 for the valid survey respondents, and this would likely then be reduced by Private Residence Relief and Letting Relief, it is not clear whether a chargeable gain reduction, or a reduction in the rates at which Capital Gains Tax is applied, would necessarily incentivise landlords to sell their properties to sitting tenants.

Overall, the change in Stamp Duty Land Tax has had an impact on landlords' property purchases, with purchases increasing before the change in tax, and declining after its introduction. The shift from WATA to RDIR has reduced tax relief. The change to mortgage interest tax relief suggests that landlords losing over £1,000 in tax relief by 2020/21 may be more likely to sell a property in the next year.

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