PO-CH/NL/0387

PART A

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PART A

SECRET

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1987 CAPITAL ALLOWANCE:
MORTGAGE INTEREST RELIEF
TAX TREATMENT OF PRIVATE
RENTING AND FRINGE
BENEFITS

DD'S 25 years NA 7-12-95.

PO -CH /NL/0387
PART A

24-12-87

TASK FORCE SECRET

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FROM: F CASSELL
19 November 1987

CHANCELLOR

I shd be grateful if the FST wd look @ this as a matter of urgency, & let me have his recommendations.

cc Chief Secretary
Financial Secretary
Economic Secretary
Sir Peter Middleton
Mr Byatt
Mr Scholar
Mr Culpin
Miss Sinclair
Miss Hay
Mr Cropper
Mr Tyrie
Mr Call
Mr Painter, IR
PS/IR

TAX TREATMENT OF PRIVATE RENTED ACCOMMODATION

Earlier this year you agreed with the Secretary of State for the Environment that a group of officials from Treasury, DOE and the Inland Revenue should examine the case for providing an added stimulus to the deregulated private rented sector in the form of a modest new tax relief for private renting. I am formally submitting their report to you today, and DOE officials will be submitting it to Mr Ridley. But of course our discussion was against the background of the current tax regime, and in this note I should like to comment briefly not only on the report itself but also on how its conclusions would be affected by the major tax reforms you have in mind.

2. The group based its analysis on DOE's estimates of the likely levels of supply and demand for rented accommodation over the next 10-15 years. DOE's aggregate figures indicated a potential shortfall in the supply of rented accommodation (on conventional defintions of housing needs) of the order of 300-400,000 in the early 1990s. DOE were unable to provide much detail of the particular types of families or individuals falling within the "supply gap" or the alternatives to renting which might be open to them. Nor could they provide any detailed analysis of who the potential suppliers of additional rented

CASSELL TO CH/EX 19 NOV

accommodation might be. As a result, it was difficult for the group to get a firm grasp of the size and precise nature of the problem against which to consider the need for, and potential efficacy of, particular options.

3. Nonetheless though Treasury and Revenue officials would be unwilling to sign up to the precise numbers put forward by DOE we did reach broad agreement that (given the currently accepted minimum standards for accommodation) there was likely to be a significant shortage of privately rented accommodation, particularly in the South East, even after deregulation of rents. Our analysis pointed to a substantial yield gap between the level of rent required to make private renting sufficiently profitable to landlords and the rent they were actually likely to be able to secure. We estimated that (on certain stylised assumptions on real interest rates, inflation and gearing) the yield gap between the required post-tax rate of return and that obtainable in the deregulated market might be of the order of 5 percentage points.

4. We then examined whether it would be feasible and desirable to close this yield gap by means of tax relief. Of the original list of measures proposed by Mr Ridley for further consideration by the group, several were quickly ruled out on tax policy grounds - as running seriously counter to the objectives of reducing tax rates and simplifying the system by cutting back special reliefs and allowances. This left a short list of four possible options, which were considered in detail by the group:-

i. BES type relief for investment in housing for rent,

ii. extension of 4 per cent writing down allowances to residential property for rent,

iii. sideways relief for interest,

iv. exemption (up to a fixed ceiling) of rental income from letting a room in one's own home.

5. Under the existing regime of personal tax rates and allowances, BES relief for investment in private housing would push up the post-tax rate of return from such an investment to someone with a marginal tax rate of 50 per cent by some 11 percentage points. This is clearly overkill. If the highest income tax rate were reduced to 35 per cent, the effect of BES relief would be diminished, but it would still push up rates of return by 7 per cent. This is more than required to close the "yield gap" and would, therefore, remain over-generous (quite apart from the other disadvantages mentioned in the Report).

6. DOE officials, I think, would go for option ii., possibly combined with iii. The arguments against giving a writing down allowance to landlords of rented housing are well brought out in the Report. A concession in this direction would undoubtedly lead to great pressure for an extension to commercial property generally, which would be very costly. The value of this tax relief to private landlords would, of course, be reduced by the sort of reductions to income tax rates you are considering for the Budget, though it would remain significant (perhaps equivalent to 2½ percentage points).

7. More generally, the Budget package would affect the economics of investment in private renting in two ways. First it would reduce the value of any tax break for private renting, while at the same time increasing net income available for such investment. Second, on the assumption that it would reduce the value of mortgage interest relief it would reduce the bias in favour of owner occupation. There should therefore be less of a case for a tax relief for landlords in the post-Budget regime than under the existing regime. Moreover, a new tax break would not sit easily in a "tax reforming" Budget aimed at broadening the tax base and reducing rates.

8. The Treasury's, and I think the Revenue's, view is that a good case has not been made for any of the possible tax options considered by the group. But we do recognise that a problem exists; and if you wished to make a gesture, the exemption

of rental income from letting a room in one's own home (option iv) would be a marginally helpful one for housing, though not for the presentation of your philosophy of tax reform. I would stress, however, that none of us in the Treasury and Revenue believes that tax reliefs are the right way to tackle the problem of insufficient rented accommodation. And that conclusion is likely to be reinforced by the sort of tax reforms you have in mind for the Budget.

F CASSELL

42/2.BTW.4366/28

FROM: J J HEYWOOD
DATE: 1 December 1987

MR LEWIS IR

cc PS/Chancellor
Mr Scholar
Mr Culpin
Mr Michie
Mr Cropper
Mr Tyrie
Mr Isaac IR
Mr Prescott IR
PS/IR

BENEFITS IN KIND

The Financial Secretary has received the attached paper from Deloitte, Haskins and Sells, which originated out of a discussion he had with them at lunch last June.

2. He would value your comments on the points made.

JEREMY HEYWOOD
Private Secretary

ENC

MEMORANDUM CONCERNING THE SIMPLIFICATION AND THE REMOVAL OF ANOMALIES RELATING TO BENEFITS IN KIND

INTRODUCTION

1. Few would argue with the principle that benefits in kind provided by an employer and conferring a personal advantage on the employee should be taxable as though that benefit were additional remuneration. However, in our view problems arise in the following key areas:-

1.1 Anomalies and inconsistencies

1.2 Quantification of the benefit

1.3 Reporting requirements

2. This memorandum considers the difficulties caused by the legislation and the way in which the legislation is interpreted by the Inland Revenue. The rules relating to benefits in kind, like many other areas of Revenue law, can be compared to a patchwork quilt. The basic material is there, but it has become overlaid with so many patches that the original pattern has become obscured. Occasionally it is necessary to strip back the quilt to its original substance and recover it with a material which provides a more coherent and orderly pattern. We hope that the Government will be able to achieve this with benefits in kind, which affect many millions of tax payers, and we hope that this paper may assist the Government to this end.

3. This memorandum will not attempt to analyse the existing legislation and procedures, nor make detailed recommendations for new legislation, but will highlight what we consider to be problem areas and suggest ways in which these difficulties could be overcome.

ANOMALIES AND INCONSISTENCIES

4. The introduction in recent years by the Inland Revenue of reviews of PAYE and benefits-in-kind procedures has undoubtedly brought to light major reporting omissions by employers resulting in a loss of tax in past years which, quite correctly, is now being rectified. However, these reviews have also clearly identified anomalies and inconsistencies in the current legislation, interpretation of concessions and Revenue practice.

5. Whilst there are always people who object to paying tax at all, in general there is little objection to being taxed on an actual benefit received, but great exception is taken where a taxable benefit is determined and yet, as far as the individual is concerned, no benefit has been received. Similarly, great exception is taken where a taxable benefit is determined considerably in excess of the actual benefit received by the taxpayer.

6. One of the major reasons for this problem is that the original legislation was enacted in a different era. It does not reflect current business practice and the changes in staff relationships. In particular, it does not take into account the increased movement of staff both internationally and within the UK. Much of the existing benefits legislation was introduced in 1975 and 1976 but the position has never been reviewed. In a number of cases the Inland Revenue have placed their own interpretation on the legislation, have amended their concessions and have changed their own practice. This may well have resulted in the collection of more tax, but has caused resentment and uncertainty in the mind of the tax payer. The following are specific examples in this respect:

6.1 REMOVAL EXPENSES FOR ASSIGNEES TO THE UK

Whilst this is denied by the Inland Revenue, it has always been the practice that the removal expenses of an individual assigned to the UK by an overseas employer were, provided they were justifiable and reasonable, allowable for UK tax purposes under Extra-Statutory Concession A5.

In recent months the Revenue interpretation of this concession has been that it can only apply to assignees to the UK if they divest themselves of their overseas home. If they retain their overseas home removal expenses paid by the employer are regarded as a taxable benefit of the employee.

We, in common with the other major accountancy firms and bodies representing the employers, do not agree with this interpretation. It is obvious that the majority of assignees to the UK wish to retain their home in their own country so that they may return to it when their tour of duty ends. The same applies to the UK national who undertakes an overseas assignment. The expense is incurred so that the individual is in a position to take up his duties in the country to which he is assigned. It is expenditure which is only incurred because of his overseas assignment and should not be treated as a "benefit" of his employment.

6.2 "TEMPORARY" ACCOMMODATION EXPENSES

An employee within the UK can have his temporary accommodation expenses reimbursed without incurring a tax liability provided that he is working away from his normal place of work and it is not intended that the assignment will exceed one year.

If the employee's assignment is for more than one year then the reimbursement of such expenses is regarded as an assessable benefit in kind, although the reimbursement of his relocation expenses (if he moved home) would not be taxable.

If an employee is to be assigned to another part of the UK for (say) 15 or 18 months, the employee will not want to move home bearing in mind the schooling requirements of his children, the substantial differences in property prices throughout the UK and the resultant financial losses that can arise from a fluctuating and volatile property market.

From the point of view of the employer, there is a substantial financial disadvantage in reimbursing relocation expenses many times greater than the total reimbursements he would otherwise make to the employee for temporary accommodation costs. In our experience, this is a major problem for employers attempting to achieve economical and reasonable movement of labour that the current environment requires, and the Government wishes to encourage.

In addition, where the employee is considered to have no permanent work location the reimbursement of his travel and accommodation expenses is taxable unless it is covered by a Working Rule Agreement. As a result, we have a situation where employees of one organisation can be working in close proximity to the employees of another, with the expenses of the first being allowable for tax purposes, but the expenses of the second not being allowable.

Clearly there must be restrictions in determining what expenses should be allowable, but the current basis is too restrictive and should be drafted to encourage rather than restrict the movement of employees from one part of the country to another.

6.3 EMPLOYEE SHAREHOLDINGS (UNAPPROVED SCHEMES)

We have already corresponded with you on the question of employees who exercise share options after taking up residence in the UK, and the implications of Section 67 FA 1976. We do not intend to go into this particular matter in depth in this memorandum but it is a matter of concern that this legislation continues to exist without the matter being covered by Extra-Statutory Concession or, at the very least, a statement of practice from the Inland Revenue. In our view, Section 67 should be amended to restrict its application to those situations it was intended to cover. At present it stretches its net too widely.

6.4 ENTERTAINMENT WHERE THERE IS NO UK EMPLOYER

The normal situation with regard to entertainment is that the disallowance for tax purposes should apply to the employer (apart from overseas customers etc.). The amounts incurred by the employee are then reported on form P11D, but the employee is able to make a formal claim under Section 189 ICTA 1970 provided the expenses have been incurred wholly, exclusively and necessarily in the performance of his duties.

However, inevitably there are employees resident in the UK who work for non-UK employers that are not subject to corporation tax in the UK. As a result, since the entertainment expenses are not disallowed for corporation tax purposes, the employee is regarded as being in receipt of a taxable benefit-in-kind in carrying out entertainment required by his employer.

Whilst this may be correct in strict legislative terms, it seems to us to be inequitable that an individual should be assessed to tax on the reimbursement of an expense required by his employer, and from which he has received no personal benefit.

6.5 LATE NIGHT JOURNEYS BY EMPLOYEES FROM WORK TO HOME

The Inland Revenue Press Release dated 25th September 1987 on this subject is obviously welcome, but, in our opinion is far too restrictive.

It does not fully resolve the problems that have arisen due to reductions in available public transport, increased violence on the streets and later closing hours for certain types of business, particularly the entertainment, hotel and catering industries.

Any reasonable employer is prepared to meet the cost of travel from work to home of staff where public transport facilities are not available, particularly female staff, and the Extra-Statutory Concession should be extended to cover them. The restriction on the basis of frequency and regularity means that they will not be entitled to the relief in question.

A further concern relates to businesses situated in areas where there is no public transport at all. In such cases a bus facility is often provided by the employer either free of charge, or at a fare comparable to that charged by a normal bus operator. However, where the cost of hiring the bus exceeds the equivalent of the normal fare that would apply, a charge to tax is made on the total cost, not on the excess over the normal fare.

6.6 CLOTHING

It is appreciated that the tax free provision of clothing can be open to abuse if the limitations are not strictly defined. However, the Inland Revenue's interpretation of "wholly, exclusively and necessarily" in this area is excessively restrictive and should be reviewed.

There are two particular areas that cause us concern, the first being where clothing is provided for employees who travel abroad in areas of extreme climatic conditions. For a person to be assessed to tax for the purchase of clothes that are necessary to either keep him alive in cold temperatures never experienced in this country, or to be able to work effectively in tropical regions seems totally unfair, when the basis of the Revenue contention is that such clothing can be worn for personal use as well. Clearly such clothing can be used in this way, but it is extremely unlikely. The only reason these clothes are purchased is to enable the employee to perform the duties of his employment. Any private use will be incidental and should be ignored.

The other matter of concern is the provision of certain forms of protective clothing which do not fall into the category of overalls and do not bear logos. One example is the case of TV news camera men who do not wish to publicise their employer (by wearing a logo) in inflamatory situations such as strikes and riots.

6.7. CRECHE FACILITIES

We are aware of at least one local council that is insisting on new employers moving into the area under it's jurisdiction providing free creche facilities.

On the one hand we have the employer who must provide the facility in order to be able to do business in the community and on the other hand the employee is being taxed on the provision of a benefit. The Government's attitude does not appear to be in accord with good employment practice.

6.8 CONSISTENCY WITH NIC

At present there are different rules for income tax and National Insurance. These should be brought into line and the DHSS should follow Inland Revenue legislation and practice.

7. These anomalies and inconsistencies could be eliminated if Policy Divison could publish a comprehensive code of practice which should be reviewed and updated on a regular basis. Policy Division should be prepared to accept submissions from interested professional bodies such as the Institutes of Chartered Accountants and the Law Society and should be instructed by the Government to have as its objective the smooth operation and not the strict interpretation of the benefits in kind legislation.

8. Amendments to the code of practice should be published periodically and employers should be able to obtain advance rulings from a central unit to determine how a particular benefit in kind should be taxed. The same code of practice should apply to the application of the benefits in kind legislation to National Insurance Contributions.

QUANTIFICATION OF THE BENEFIT

9. Wherever possible the individual should be taxed on the market value of the benefit he receives. In many cases this will present no difficulty since it will be represented by the cost to the employer. However, there are instances where, for convenience, an artificial method of arriving at the taxable benefit has been incorporated in the legislation. The benefits which are most affected are the provision of a company car and living accommodation.

10. It is generally recognised that the scale benefits give the executive whose car is provided as a "perk" a considerable advantage over the salesman or other company representative who uses his car almost exclusively for business purposes. It is likely that the executive's taxable benefit is too low, even if his benefit is increased by 50%, whereas the salesman's taxable benefit may well be too high.

11. It would be fairer if the employee's costs were to be accumulated on an individual basis and his business mileage recorded. However there would be a considerable amount of additional administration expense.

12. There may be scope for introducing a more sophisticated method of determining the benefit by distinguishing those employees who use their cars more than 50% for business purposes. Those employees should qualify for the minimum scale benefit. Those who do less than 50% but more than 2,500 miles p.a. on business should qualify for the intermediate scale benefit and those who use their cars less than 50% and drive less than 2,500 miles p.a. on business would qualify for the maximum scale. The benefit could be related to the original retail price of the car. The minimum scale rate would be 5%, the intermediate scale rate would be 10% and the maximum scale rate 20%. This would mean that the company director with a Porsche costing £30,000 would pay £6,000 p.a. compared with a salesman with a Ford Escort costing £7,000 who would pay £350 p.a.

13. Where the individual is taxed on the benefit of occupying company accommodation, he should be taxed on the true market rental. Where the property costs less than £75,000 the taxable benefit is generally too low. Where the property costs in excess of £75,000 the taxable benefit is invariably too high. It is also to be noted that the limit of £75,000 was fixed in 1983 and has not been revised upwards in spite of the increase in property prices.

14. A market rental should be agreed with the District Valuer at the outset for all company owned property occupied by an employee, not only property in excess of £75,000. That market rent should be reviewed every five years.

15. It is accepted that the charge for the use of company owned furniture should be 20% p.a., but when the whole of the cost has been assessed on an employee no further taxable benefit should be charged.

16. Other problems relating to valuation occur where a taxable benefit arises, but it is difficult to measure. For example, the cost to each individual employee if the office party costs more than £35 per head. Some employees may have consumed more food and drink than others, who may have gone home early. We think that company entertainment of this nature should always be tax free. Another example would be the case of four employees who share a taxi to take them to their homes so that the taxi goes to four different locations. Probably the only sensible way of dividing up the benefit is to attribute the cost equally to the employees concerned. There is also the problem of the cost of parking private cars on company premises. These problems could be addressed in the code of practice referred to in Paragraph 7.

REPORTING REQUIREMENTS

17 The current system places on each employer the onus of completing a multiplicity of return forms at the end of the tax year. Most of the information should be readily accessible from the wages records. The exception is form P11D. The completion of a form P11D for each director and "higher paid" employee is a time consuming task, and few employers have the resources to make these returns by 6th May, the statutory date by which they are required.

18 In practice the employer may need to undertake considerable analysis of expenses records for a large number of employees to obtain the information required in the prescribed format of form P11D. This task is particularly burdensome where most or all of the expenses payments will qualify for a deduction under Section 189, Income and Corporation Taxes Act 1970. At present the only way to avoid this task is to negotiate a dispensation with the relevant tax office. The local Tax Inspector will require full particulars of the various expenses involved, and may make detailed and extensive enquiries into the expenses records. Thus the negotiation of a dispensation will normally prove to be a time consuming exercise for the employer.

19 The Inland Revenue will naturally require sufficient information to establish the existence of taxable benefits and expenses payments. The employer is in the best position to provide this information. However, it may be possible to ease the burden in the following ways:-

19.1 By extending the period allowed for making the return to 3 months instead of 30 days.

19.2 By accepting information in any reasonable format provided the employer declares that all benefits and expenses payments have been included. For example it may be convenient for an employer to list items according to the type of expense, e.g. listing those with cars, listing those in a company BUPA scheme, etc.

19.3 By standardising and publishing dispensations so that the employer does not need to negotiate individually. This would formalise what tends to happen in fact, i.e. that employers will try to match civil service standards for expenses, as this is usually the best way to achieve a dispensation from the local Tax Inspector. It should be possible to produce standard schemes for removal allowances, mileage allowances, etc. which the employer could adopt, knowing that they had been approved by the Inland Revenue, or indeed by Parliament itself if the system was given statutory force.

20. Finally, it should be noted that most employees will rely on the employers records, and the form P11D when completing their own personal Tax Return. However, this is a matter of good management between the employee and employer, and there is no entitlement for the employee to have a copy of the form P11D. This is inefficient in that the employee may need to keep records and prepare figures when the employer has already done this for the P11D. It is also inequitable in that the employee may have no opportunity to question an incorrect entry on the form P11D completed in respect of his employment. This anomaly could be readily corrected by a statutory provision that the employer is required to provide a return of expenses, payments and benefits to or for directors and "higher paid" employees, and to provide a copy of the return to the corresponding employee.

21. In the event of a dispute the Inspector of Taxes will raise an assessment on an individual taxpayer, so that the taxpayer can lodge an appeal for hearing before the Special Commissioners or more commonly the General Commissioners. The employer has no standing in the matter, indeed were the employer to meet the costs of the appeal this would be a taxable benefit in the hands of the individual.

22. In practice the amount of tax involved for an individual employee may be quite small, and would not warrant the time and trouble of going through the appeals procedure. Furthermore, the appeal is heard in closed session and the Commissioners decision is not published and cannot be relied upon as a president for other cases.

23. There is no procedure whereby the employer can challenge an Inspector's decision on a dispensation, or the Inspector's interpretation of the Inland Revenue practices established as extra-statutory concessions or published in Inland Revenue guidance booklets.

24. An alternative system could be devised to give a consistent and equitable result. Where an employer believes that a benefit or expenses payment should qualify for dispensation, he should be entitled to ask for clearance in advance of making such payments. These clearances could be processed, either by the local Tax Inspector or by a centralised unit, whichever proved operationally easier, but there should be a right of appeal.

25. If such appeals were made to the Special Commissioners this would ensure consistency of treatment, while retaining the opportunity for a local hearing when the Special Commissioners are on circuit. Furthermore, if the Commissioners findings were published, a matter which is under consideration, this would provide a bank of case law, against which employers and the Inland Revenue could judge the merits of future cases.

CONCLUSION

26. In view of the difficulties involved in preventing anomalies and inconsistencies and in determining the quantum of the benefit in certain circumstances, it will be difficult to produce legislation which deals fairly with the taxation of benefits in kind.

27. The existing legislation published concessions and Revenue practice should be reviewed in depth in order to make the legislation and Revenue practice more coherent and consistent. At the same time an urgent review should be made of reporting requirements in order to simplify matters for employers and permit the Inland Revenue to be

more flexible in this area. It would be most helpful if Policy Division could publish a code of conduct relating to employee benefits and if Policy Division could be given the authority to publish amendments to the code of practice and give advance rulings to employers introducing new benefits.

28. We would be happy to discuss any of the issues raised in this memorandum or to carry out a preliminary review of the legislation referred to in paragraph 27 if it would be of assistance.

DELOITTE HASKINS & SELLS NOVEMBER 1987

JW219

CONFIDENTIAL

15/12

Now fixed for 5.30 on 15/12

Ch. / Fixed for post-Cabinet on 17/12.

FST should be providing advice on the substance tomorrow. Should he attend the meeting?

Yes.

2 MARSHAM STREET
LONDON SW1P 3EB
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CH/EXCHEQUER
REC. 04 DEC 1987
FST – for info

My ref:

Your ref:

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
SW1P 3AG

2 December 1987

Dear Nigel

TAX TREATMENT OF PRIVATE RENTED ACCOMMODATION

I have seen the report of the inter-departmental working party of officials which was set up in the summer to advise us whether there was a case for improving the tax treatment of private rented housing.

I think that officials have produced a very useful analysis. I would find it helpful to talk to you about this and about the various options set out in the report. Perhaps your office could arrange with mine an early date when I might come to see you.

Yours ever

Nick

NICHOLAS RIDLEY

RIDLEY TO CH/EX 2 DEC

100% RECYCLED PAPER

CONFIDENTIAL

CHANCELLOR OF THE EXCHEQUER

SECRETARY OF STATE FOR THE ENVIRONMENT

TAX TREATMENT OF PRIVATE RENTED ACCOMMODATION

In an exchange of correspondence with the Secretary of State for the Environment last summer, the Chancellor agreed to consider whether there were any possible modest tax measures that could give a boost to the private rented sector following deregulation and that would be good value for money. A group of officials from the Treasury, Department of the Environment and Revenue were asked to examine this.

The attached report sets out their analysis and conclusions.

F CASSELL - TREASURY

P OWEN - DEPARTMENT OF ENVIRONMENT

T PAINTER - INLAND REVENUE

REPORT

4428/002/AC

THE TAX TREATMENT OF PRIVATE RENTED ACCOMMODATION

Introduction

The Secretary of State for the Environment wrote to the Chancellor in June expressing his concern that deregulation of rents would not by itself be enough to stimulate the revival of the private rented sector, and suggesting that a further stimulus in the form of tax relief might be required. The Chancellor replied that he saw no case for a major new tax relief, but that he was prepared to consider any possible modest tax measures that would be good value for money.

2. A group of officials from the Treasury, Inland Revenue and Department of Environment was asked to examine whether in the context of the Government's housing and tax policy objectives there was a case for a new tax relief for private renting; and to assess the possible tax options. This report sets out the group's analysis and conclusions.

Role of private rented sector in the housing market.

3. There are three broad sectors within the housing market: the owner occupied sector, the public rented sector and the independent rented sector. The last of these is subdivided into housing associations, many of which receive public subsidy, and other private landlords who generally do not. The Government's housing policy objectives, set out in the recent White Paper, are:-

(a) to continue to spread home ownership as widely as possible;

(b) to put new life into the independent rented sector by deregulating new lettings and restructuring subsidy to housing associations to enable them to employ private finance;

(c) to encourage local authorities to change their role from providers of housing to enablers; and

(d) to focus the use of public money more effectively so that tenants are given a better deal.

4. The tax system already provides a major incentive to owner occupation. In practice, this tends to be seen as the relief for mortgage interest. Alternatively, and perhaps more accurately, the incentive can be seen as the exemption from capital gains tax of the gain on the disposal of a taxpayer's main residence, coupled with the fact that the imputed rent of owner occupied property is untaxed. Partly as a result of this incentive, over the past 35 years owner occupation has grown from 27% of households to over 63%. While this growth is likely to continue in future, there will remain a substantial minority of households - perhaps 25% - who do not want to buy their own house or cannot afford to do so.

5. Neither the public nor the private rented sector is at present providing adequately for households unable to buy a house. In many parts of the country, particularly in London and the South East, there is a severe shortage of housing to rent. This restricts labour mobility and at the extreme leads to a growing number of homeless families. The Department of the Environment estimates that in 1986 there was a shortfall in the supply of rented housing on conventional definitions of "housing need" (see Annex A) of about 200,000 dwellings compared with 100,000 in 1981. This shortfall will increase, possibly to around 400,000 at the beginning of the 1990's as the "baby boom" generation reaches household forming age. Even with additions to the supply of rented housing expected from the new policies of deregulation of the private rented sector, private finance for Housing Associations and schemes where local authorities make revenue contributions to private landlords, the shortfall is expected to improve only slightly, to about 350,000 by 1996. A more rapid improvement would be expected in the late 1990's when the effect of the 'baby boom' on household formation will be diminishing, but even at the turn of the century the shortfall is likely to be over 100,000.

6. On present prospects, given public expenditure constraints, it does not seem feasible to look to the public rented sector to close this gap. These constraints also apply to additional subsidy to housing associations. Moreover, reliance on the public rented sector would not be consistent with the housing policy objectives set out in paragraph 3 above. An increase in private provision of rented housing which could substitute,

at the margin, for provision by local authorities and subsidised housing associations would have considerable advantages both in terms of housing policy objectives and public expenditure constraints.

Rate of return

7. In the medium term the amount of investment forthcoming in the private rented sector is likely to be mainly influenced by the rate of return obtainable and the perceived degree of risk in the investment.

8. The rate of return from investment in private rented accommodation is made up of two components:

(i) an average running yield (equal to the gross rent earned from the property less maintenance and management costs, expressed as a percentage of the current market price of the property with vacant possession);

(ii) an average annual rate of capital appreciation net of renewal and refurbishment costs.

DOE analysis suggests that the long run average real rate of capital appreciation on housing is around 1% (excluding price increases reflecting quality improvements), but there are regional differences around this national average. In recent years the rate of capital appreciation has been significantly higher, but if an increase in the supply of rented housing is to be sustained, it is necessary to attract into the market landlords taking a longer term view; for them the long-run 1% figure is appropriate. DOE estimate that the annualised renewal/refurbishment cost is also 1 per cent. Maintenance and management costs are put at some 1 to 2% of capital value. Essentially, therefore, the rate of return from investment in private renting will be determined by the level of rents private landlords are able to achieve in the deregulated market, less the 1-2 per cent maintenance and management costs.

9. The rate of capital appreciation in London and the South East has been higher than the national average. Since the supply/demand gap is likely to pose the greatest problems in the South, in analysing the effect of possible tax measures we have used variables appropriate to the South

East including capital appreciation at 1½ per cent.

10. Typical rental yields on modern properties let at registered rents have been of the order of 3 to 4% gross, ie only 1 to 2% net of maintenance and management costs. The British Property Federation have suggested that after making some provision for risk under the present system of regulated rents, a net rental yield of 6 to 8% is the minimum necessary to maintain the current supply of private rented housing. The DOE's analysis suggests similar figures and is supported by the fact that a net rental yield of 6% obtainable from renting under the assured tenancy scheme attracted only 600 new lettings between 1980 and 1986.

11. Net rental yields of 6% to 8% would require average rents of some £55-£70 for new houses of the type bought by first time purchasers, and £50 to £60 for second-hand houses (excluding houses bought by sitting tenants at discounted prices). The figures in London would be roughly half as high again; while those in the North would be between two-thirds and three-quarters of the national figures. In all but the very short term, such rents would be substantially higher than the cost of buying the same houses with tax relief. At these rent levels a household would opt to rent only if it valued certain features of renting sufficiently highly to pay the additional costs (for instance through having a job that made necessary frequent moves of house) or was unable to get a mortgage (usually through low, or unstable, earnings) or had insufficient savings for a deposit.

12. DOE estimate that the rents most tenants would be able and willing to pay would give a yield of 4-5 per cent, leaving a gap of 2½ per cent. This conclusion assumes the continuation of present policy on multiple occupation and overcrowding (See Annex A). In theory the market could solve the problem if landlords were allowed to make unfettered use of space but this would involve a major reversal of current social policy.

Risk

13. The rate of return required by an investor in private rented housing will reflect his perceived risk of that particular investment relative to other forms of investment. The ordinary risk arising from fluctuations in rental income and capital value around expected trends is probably (given

recent experience) rather less than the risk in investing in equities. But in assessing his required rate of return in a deregulated market, the investor will also assess the political risk that regulation will be reimposed thus reducing rent for sitting tenants below free market levels. It is very difficult to quantify the premium required by an investor to cover political risk since it will depend on the investor's assessment of the probability of a future government reimposing rent control. A required rate of return incorporating even a fairly modest risk premium could involve rents well above the levels in paragraph 11.

Implications for Housing Policy

14. The yield gap between the rents at levels which would be economic and the rents which most potential tenants could afford clearly has implications for the supply of rented housing. Either the market will result in very high rents or, alternatively, the increase in supply of private rented housing will be insufficient to meet the shortfall discussed in paragraph 5. A combination of these two features may result.

15. If deregulation of new lettings produces high rents without a significant increase in the supply of accommodation, the benefits which Ministers hope that it will achieve - increasing labour mobility and shifting the public/private sector boundary so as to reduce the public expenditure cost of housing - will not materialise. Moreover high rents would lead to housing benefit problems: the pubic expenditure cost would rise substantially and disincentives to work would increase.

16. Even with the protection offered by the housing benefit system, for many households market rents would absorb a very high proportion of their income. Although benefit will continue to pay 100% of the poorest peoples' rents, above lowest levels of income it is to be withdrawn steeply, at 65% of net income in 1988/89 and 70% in the following year. At the latter rate of withdrawal, a single person (aged 25 years or over and in paid employment) would get no assistance even with a £50 a week rent if net income exceeded £109 (equivalent to £151 a week gross) and would be paying over 45% of net income in rent. Households with insufficient income to buy a house could, therefore, find that rents sufficient to provide a net yield of 6 to 8% could cost them 40% of net income or even more.

Closing the Yield Gap

17. The group concluded that following deregulation there was likely to be a substantial yield gap between the level of rent required to make private renting sufficiently profitable to landlords, and the rent that could be afforded by most of those seeking rented accommodation given the Housing Benefit system that will be in force, and the economics of owner occupation.

18. Earlier discussion of the economics of private renting focused on the rental yield. However, to compare the attractiveness of investing in rented accommodation with other forms of investment, it is necessary to calculate the rate of return implied by a given rental yield. The post-tax rate of return is the appropriate comparator since it takes account of any relevant tax allowances etc available to an investor in a particular form of investment. For example, unlimited tax relief is available on borrowing, both by individuals and companies, to finance investment in rented housing.

19. Tables 1 to 4 of Annex B set out the pre and post-tax rates of return (on various inflation and interest rate assumptions) obtainable by a higher rate taxpayer (with a marginal rate of 50%) and a company paying Corporation Tax at 35 per cent. These show that (on the base case assumptions) a net rental yield of 4½% would produce a post-tax rate of return of around 4% (5% pre-tax). A net rental yield of 7½% (taking that as indicating the "required" rental return) would produce a post-tax rate of return of around 9% (12% pre-tax). In other words, the rental yield gap equates to a difference of around 5 percentage points in the post-tax rates of return. This calculation, as the Annex explains, depends upon a number of assumptions - eg about inflation, the real cost of borrowed money and the level of gearing - but we have taken it as a broad indication of the size of fiscal action that would be needed to raise the supply of rented housing sufficiently to meet the projected demand without any reduction in the current standards of accommodation.

20. The group considered the desirability and feasibility of closing this gap through increasing the post-tax rate of return by subsidy. This could be achieved in two ways: first, by a subsidy to tenants to enable them to pay higher rent, and second, by a subsidy to landlords that increased

the post-tax return from a given level of rent. In either case the subsidy could in principle be by way of grant or tax relief.

21. There are several disadvantages with giving a generally available subsidy to tenants not eligible for housing benefit. First, a widely available subsidy could increase rent levels generally and hence the cost of housing benefit. At the extreme, if housing benefit were to underwrite rents yielding 6 to 8 per cent this would have a cost of £700 million per year by 1998/99. Second, any generally available relief would have a dead weight cost since it would be available to tenants already willing and able to pay market rents. This leads on to the question of whether a grant or relief should be confined to a specific group of tenants by reference to income. But such subsidies run contrary to the objective of breaking down the dependency culture since any income related subsidy always carries with it problems of work incentives for those subject to the withdrawal taper.

22. The group ruled out the option of introducing tax relief for tenants' rental payments analogous to mortgage interest relief. Quite apart from its other disadvantages, not least of all the administrative impracticality for the Inland Revenue within present manpower constraints, such a relief would alter the balance between owner occupation and renting, undermining the Government's policy of encouraging owner occupation.

23. Arguably, therefore, if some subsidy were thought desirable, it should be aimed at the landlord by enhancing the return he receives from a given level of rents. We therefore concentrated on tax reliefs directed to this end. There is a wide range of potential new landlords, from the individual wanting to let out a single room in his own house, through the individual wanting to invest in one or two properties for rent, to institutions such as building societies and insurance companies willing to invest in substantial numbers of such properties. The interests of these various potential suppliers are varied, but in examining possible assistance to landlords, DOE were concerned to extend any help to as wide a group as possible.

24. It has been argued that a short term "kick-start" tax measure could speed up the adjustment to deregulation. This could take two forms. A measure giving a small fillip to post-tax rates of return from renting after deregulation could attract interest and help to change attitudes,

offseting to some extent the barrier imposed by the current perceptions of political risk. A more significant kick start could aim to offer landlords a sufficiently large short-term return as to induce them into the market even at the risk of being unable to exit should the political environment change. This would be expensive if used on a large scale, and could be difficult to present and justify.

Possible tax options

25. A prime objective of current tax policy is to bring down tax rates, widen the tax base and simplify the tax system by removing special reliefs and allowances. Any potential new relief for private renting has to be assessed in the light of this objective.

26. Of the original list of possible tax options considered by the group, some could be quickly ruled out on the grounds that they would seriously undermine current tax policy:-

i. 100 per cent first year capital allowances for new buildings for rent

ii. Tax free bonds/tax credits for investment in new housing to rent.

iii. Exemption of part of commercial landlords' rental income.

27. The group therefore confined its detailed consideration to the following tax measures aimed at landlords:

a. Business expansion scheme type relief for investment in companies investing in new or renovated accommodation for rent.

b. The extension of writing down allowances currently available for assured tenancies.

c. Sidways relief for landlords' interest costs

d. A minor measure - the exemption (up to a fixed ceiling) of rental income received by those renting out rooms in their own house.

In order fully to assess the efficacy of any particular relief, it is necessary to consider who the potential new investors are likely to be, since the effect of any particular measure on their post-tax returns will depend on their tax status. (For instance, tax measures will have very little direct effect on pension fund investment since pension funds are exempt from tax)

28. The Revenue undertook an analysis of tax options (a)-(c) above in terms of their impact on the post-tax rates of return for:

(i) a company paying tax at 35%;

(ii) a higher rate taxpayer with a marginal rate of 50%.

Full details of the analysis are at Annex B.

If you were attracted to any of these options, a considerable amount of further work would be necessary to ensure that the relief was targeted correctly and to prepare the legislative framework.

(a). Relief for equity investment in companies undertaking private renting (BES type relief)

29. BES is designed to encourage equity investment in unquoted companies. It is available only to outside investors eg not to directors of the company concerned, and is particularly attractive to higher rate taxpayers. An investor can obtain relief for genuinely additional investment in a company provided that he holds the shares for at least five years. In addition, shares issued after 18 March 1986 are exempt from Capital Gains Tax when first disposed of. There is a ceiling of £40,000 on the BES relief available to any investor in any one year. The Revenue estimate that at present 20,000 individuals make a BES investment each year (this compares with 1.2 million higher rate taxpayers). BES relief is aimed at high risk companies and is not available for certain financial businesses, in particular leasing, hiring, or dealing in shares and land. In addition the net value of the company's land holdings may not exceed half the net value of its total assets.

30. It would be possible to extend the scope of BES to companies investing in private rented accommodation, by treating letting as a qualifying trade, and disregarding the value of let properties in applying the land holding restriction described above. Annex B shows the effect of this on post-tax rates of return for a higher rate taxpayer with net rental yields of 4½ per cent and 7½ per cent. Extending BES to companies investing in new rented housing achieves a dramatic increase in the prospective post-tax rate of return on such investment. In the case of a five year holding period, the post-tax rate of return is 15 per cent with 4½ per cent net rental yield, and 25 per cent with 7½ per cent net rental yield; in the case of a 30 year holding period, the figures are 7 per cent and 14 per cent respectively. Provided they could sell their equity stake, it seems likely that many investors would come out after the minimum holding period of 5 years, having received a most attractive rate of return in the interim.

31. The cost of giving BES relief to a 50 per cent taxpayer investing in a new dwelling costing £35,000, would be £17,500. It would, therefore, cost £17.5m to provide 1000 new dwellings in this way.

32. Extending BES in this way would clearly be too generous, producing post-tax rates of return well beyond those needed to bring forward new supplies of housing for rent. It would also represent a major volte face following the restrictions introduced in 1986 specifically because asset-backed investments were not seen as the kind of risky investment on which BES relief should be targeted. The attractiveness of this relatively safe type of investment - in BES terms - could reduce BES investment in the riskier types of projects for which the scheme was orginally set up. Such an extension of BES would also run counter to the Government's objectives of reducing the tax shelters available to higher rate taxpayers. A new housing tax shelter could attract public criticism, especially if the investment were seen as being mainly channelled into 'safe' and expensive types of renting eg prestige blocks in central London. Restrictions aimed at preventing this, say by limiting the relief to investment in less expensive housing would add further complications to what is already a complicated scheme of tax relief.

33. It would be possible to have a more limited form of BES relief for investment in housing, say by restricting it to half the value of the investment. This would be in competition with BES. It would also be an additional complication of a very complicated relief. The number of

existing BES investors is relatively small, suggesting that this form of tax relief would have a limited impact on the housing market, despite very attractive rates of return on short-term investment. On the other hand, the greater attractiveness of investment in real property referred to above could generate greater interest. There is no way of knowing what would be the right level of relief to attract the desired amount of investment or the effect on the high risk investment on which BES itself is targeted.

34. If either a full or partial BES scheme were adopted for housing, there would be advantages in time-limiting the scheme. That would both limit the extent of the precedent created and might help to provide a "kick-start" for investment in private rented housing.

(b) **An extension of writing down allowances**

35. Writing down allowances, currently set at 4% per annum, are available (on an experimental basis) for capital expenditure incurred by bodies approved under the Assured Tenancies Scheme on construction or renovation of dwellings let on assured tenancies. The present relief was introduced in 1982 for a five year trial period for new buildings let under the scheme. By April 1986 only 609 assured tenancies had been granted, and of these, only a proportion would have qualified for the tax relief (some of the assured tenancies will relate to housing associations many of which are exempt from tax). In June 1987 the scheme was extended to cover substantially improved properties and was made available until 1992. Following deregulation the system of approval will be abolished and any landlord will be able to let on an assured tenancy basis (ie at a freely negotiated rent with full security of tenure for the duration of the tenancy). These new assured tenancies will not qualify for tax relief (the landlords not being approved bodies) and the old style tenancies will start to wither away. The group considered whether the scope of the relief should be extended to encompass some or all of the new style assured and shorthold tenancies.

36. The Revenue calculated the effect of 4% writing down allowances on the post-tax rates of return to a company and a higher rate taxpayer. The analysis shows that (on the base case assumptions) the effect of the 4% writing down allowance would be to enhance the rate of return from an investment in new building for let by 2 percentage points to a company paying CT at 35% and by 3 percentage points to an individual paying IT

at 50%, to 6.8 and 6.5% respectively. This compares with an implied required rate of return of the order of 9%. The WDA does not, therefore, close the gap completely but it does reduce it significantly. The Revenue calculate that on the basis of DOE's assumptions on the number of tenancies over the next 15 years (before taking account of any impact of extending WDAs) the cost of giving this allowance to all tenancies would be of the order of £25 million in 1995/96, £45 million in 2000 and £150 million in the long-term.

37. Capital allowances are not generally available for commercial buildings. They are given in recognition of the depreciation of assets and it would be hard to justify extending their availability to commercial property which, particularly in the case of residential property, tends to appreciate. The current exception for assured tenancies applies only to a limited group of approved bodies. An extended form of AT allowances applying to a much wider range of taxpayers would be a major step and would need to be considered in relation to the Government's objective of minimising tax allowances in order to reduce rates of tax reliefs. Any extension on these lines would necessarily involve a significant administrative cost particularly in the case of claims for individuals and would require complex legislation inter alia including rules for the claw back of allowances in the event that a building ceased to be rented but was not sold, and keeping long leasehold property out of the scope of the allowance.

38. Some countries such as Germany, USA and Canada do give depreciation allowances for private rented property as part of a scheme of such allowances for commercial property generally. DOE's discussions with those involved in housing policy in those countries indicate that these tax allowances are considered to be important for the economics of private investment in rented housing there. In extending the current writing down allowances available for residential property in the UK, the aim would be to limit the WDA to housing for rent, but this line could be difficult to hold against pressure to extend the relief to commercial buildings generally, since if anything, they are more likely to depreciate than are residential buildings. To give WDAs for all commercial buildings would involve a revenue cost rising to £1.5 billion over the next 25 years.

(c) Sideways relief for interest

39. In general, interest on borrowing for investment in property is already favourably treated in comparison with borrowing for investment in other assets. For example, an individual would receive no relief for interest on borrowing to finance investment in equities whereas, as will be seen interest on loans to purchase or improve property would be allowed for tax against the rental income.

40. Generally speaking, companies already get sideways relief for interest paid in respect of let property. A change in the rules, therefore, would be a measure designed to help individual landlords. In their case, (unless they are considered to be trading rather than investing) interest paid on loans for the purchase or improvement of property to be let at a commercial rent, is allowable only against the income from the property itself or any other rental income. Any excess tax relief can be carried forward and set against rental income in future years. Allowing relief for interest (or other losses from renting) to be set sideways against an individual landlord's other income would only be of benefit in the case where rental income was less than expenses and interest in the early years.

41. The Revenue's analysis indicates that allowing sideways relief for interest for loans for the purchase of new or renovated dwellings for let would enhance the post-tax rate of return from such an investment from 4.0 to 4.7 per cent for a 50% taxpayer. The cost of such a relief could be of the order of £5m in the first full year rising to £20m after 5 years - this includes a deadweight element. An increase of less than one percentage point is the post-tax rate of return from renting is unlikely to have much of an impact by itself on the supply of private rented accommodation

Writing down allowance combined with sideways relief for interest

42. Sideways relief for interest together with a 4% a year writing down allowance also taken sideways (see paragraph 36 above) would together raise

from 4.0% ro 8.2% the post-tax rate of return that the individual taxpayer on a 50% rate would receive from a 4½ percentage net rental yield. That would offset most of the yield gap identified in paragrah 19.

(d) Tax exemption for rental income (up to a fixed ceiling) received from letting rooms in an owner occupied house

43. In addition to the three fairly major measures considered above, the group also considered a more minor measure designed to encourage householders to let spare rooms in their homes. (A similar proposal was put forward in the Alliance manifesto.) A number of the people at whom this proposal is aimed would probably have not much, if any, tax to pay on a small amount of rental income in any event particularly if services such as meals and laundry are provided since the cost of those services can be offset against the rental income before tax. Whether or not the people concerned are aware of the tax rules, is another matter, and it is possible that some people are discouraged from letting rooms in their houses by a misunderstanding of the current tax position and an unwillingness to get involved with the tax authorities for what is essentially a fairly small sum of money.

44. It is arguable that a straightforward exemption of rental income, from letting a room in one's own house might lead to a greater willingness to let such rooms. Any relief would have to be limited so as to avoid someone living on the top floor of a very large house letting out the other two or three floors and paying no tax. But accurate targeting would be essential and would need further study.

45. The group considered whether this measure might be accompanied by a relaxation of the current Capital Gains Tax treatment for people selling houses who have previously let rooms in them. In fact, these reliefs are already very generous, eg if the exempt gain on the part of the house which was not let exceeds £20,000 relief will normally also be available on up to £20,000 of gains on the part which was let. The group, therefore, concluded that no further Capital Gains tax relief was necessary. But this may be another area where lack of knowledge of the tax system may be discouraging people from renting rooms in their houses. If the income tax measure is adopted, there is a case for publicising the current Capital Gains Tax treatment as part of a campaign to promote letting.

46. This proposal is open to the objection that it would be a new special tax relief at a time when tax policy is aiming to abolish such reliefs as far as possible. But it is a fairly minor measure given the reliefs available already. Further detailed consideration of the scope of the relief and how it might be differentiated from other "deserving" cases which would no doubt be put to Ministers in its wake would be required before any firm proposals could be formulated.

CONCLUSIONS

47. Though owner occupation will continue to grow, there is likely to remain a substantial number of households, perhaps 25% of the total, who do not want to buy their own house or cannot afford to do so. There would be considerable advantage if the needs of these households were met by an adequate supply of private rented housing.

48. Even after deregulation, however, it seems unlikely that the rents obtainable will provide a sufficiently attractive return to landlords to call forth a supply that would meet the expected housing needs of those seeking to rent. The ready market for sale into owner occupation created by rising real earnings and the greater availability of mortgages (and improvements in their terms) has put a floor to the net rate of return that landlords can accept from private renting before outright sale becomes a preferable option. The ease of owner occupation also places a ceiling on the amount that individuals are willing to pay in rent before opting to buy.

49. The group of potential tenants who could not afford owner occupation, but who would not be eligible for housing benefit if they had to pay the level of rents that would make renting rather than sale the sensible choice for landlords, would have to spend perhaps as much as 45-50% of their net income on accommodation costs. In principle, further support through housing benefit could make substantially higher rents affordable for this group, but the public expenditure cost would be unacceptable, and dependency on state support would be increased with adverse consequences for work incentives. There is, therefore, a case for considering methods of providing investors with a rate of return which would encourage the building of housing for rent, without driving rents up beyond a reasonable affordable

level for these potential tenants.

50. Any measures which raised rates of return to a level which brought forward significant additional supply would also enhance job mobility by increasing housing choice for those not wishing to buy.

51. Tax reliefs are not usually regarded as an appropriate tool for helping specific groups of the population. It is difficult to focus tax relief on the target group; but generally available reliefs tend to carry with them a significant deadweight cost. Attempts to restrict the relief so as to reduce this deadweight element usually add to the associated bureaucracy - so making the relief less attractive and at the extreme dampening take-up. As a result, reliefs of this nature tend not to give good value for money. Many of the tax reliefs that have been suggested in this area can be ruled at on these grounds.

52. Of those that we have considered in more detail, it is clear that the extension of BES relief to cover investing in housing for rent would substantially increase the rate of return to a higher rate taxpayer. This could have a significant impact on the market, but at a high cost in terms both of money and the coherence of the Government's policy on taxation. It looks like overkill. A more restricted version of BES relief for investment in housing for rent would be an additional complication and there is no way of knowing what would be the right level of relief to attract the right amount of investment

53. An extension of the 4% writing down allowance would increase post-tax rates of return by 2 percentage points for companies and 3 percentage points for higher rate taxpayers. (Sideways relief for interest and the writing down allowance together would increase the rate of return for higher rate taxpayers by 4 percentage points.) This could bring returns much closer to the required 9% but would raise a number of difficulties for tax policy. It would also be expensive of the order of £25 million in 1995-96 rising to £150 million in the longer term. If the Government were subsequently forced to extend such allowances to all commercial buildings, the cost would rise to £1.5 billion over the next 25 years.

54. A minor, but useful measure would be the exemption from tax of rental income from letting a room in one's house up to a limit of say £50 a week. Such a measure would have a limited impact on the number of dwellings

available, but it could help at the margin by providing additional accommodation for single people, for whom job mobility is often restricted by relatively high housing costs in London and the South East. It would cost very little but would require some rules to prevent abuse and careful presentation so as to dampen pressure for similar reliefs for other "deserving causes". As with the other options, therefore, considerable further work would be necessary to target the measure correctly and to prepare the necessary legislative framework.

1. "Need" for housing is conventionally defined as the difference between the housing actually available, and what would be required to enable each household or family that does not wish to share to have its own dwelling which is not overcrowded and has the basic amenities.

Households/families and sharing

2. A "household" is defined in Britain as one person living alone, or two or more persons living in the same dwelling and sharing a common house-keeping. To count as a separate household a person living alone must have his (or her) own house-keeping, including the provision of meals; and must not share the use of a living room or sitting room with other persons living in the same dwelling. Three young adults living in the same dwelling, each with his (or her) own bed-sitting room, getting their own meals, and sharing expenses like water-rates and electricity bills, thus count as a single household (and not three separate one-person households) if they share the use of a sitting room or living room.

3. This definition of a household does not count as a separate household, a married couple living with in-laws, or a lone mother and child living with her parents. They are termed "concealed families", and are respectively examples of married couple concealed families and lone parent concealed families.

4. "Sharing" occurs when two or more households live in the same dwelling. By definition, only separate households can share: persons not living as separate households - for instance people in flat-shares who use the same living room or sitting room, or adult sons and daughters living with their parents - are not counted as sharing.

5. A 'dwelling', in the sense just used, must be self-contained accommodation. The vast majority of dwellings are individual houses or flats designed for occupation by one family, though there are border-line instances in large multi-occupied houses where it is arguable whether the accommodation is sufficiently self-contained to count as separate dwellings or not.

Overcrowding

6. The standard most commonly used to measure overcrowding is the 'bedroom standard'. The standard number of bedrooms for a household is:

(a) one for each married couple (or couple living as married);

(b) one each for other men and women aged 21 or over;

(c) one for each two persons of the same sex aged 10-20;

(d) one for any person aged 10-20 and a child under 10 of the same sex;

(e) one each for any persons aged 10-20 not paired as at (c) or (d);

(f) one for each two of any remaining children;

(g) one for any child remaining.

This standard does not have statutory force. Its origins lie in protection of morals.

<u>Basic amenities</u>

7. The 'basic amenities', recognised by statute since 1959 through entitlement to improvement grants to provide them, are:

(i) a fixed bath in a bathroom;

(ii) an inside WC;

(iii) a wash hand basin;

(iv) a sink;

(v) a hot water supply to the bath, hand-basin, and sink.

8. Technically therefore, elimination of "housing need" requires that there should be available sufficient dwellings provided with the basic amenities for all separate households or concealed families that wish not to share to be separately accommodated in accordance with the bedroom standard. This is generally a matter of established expectations rather than statutory right, though the homelessness legislation (now Part III of the Housing Act 1985) imposes on local authorities a duty to provide accommodation for persons in priority need who are homeless or likely to become homeless. 'Priority need' covers persons with dependent children; expectant mothers; and persons who are vulnerable owing to age, or physical or mental handicap.

Annex B

ANNEX B

1. The tables below show real pre and post tax rates of return from private renting. These are derived from the rental yield. The rental yield is simply that proportion of the capital value of the property which can be obtained as rent. This can be expressed either before management and upkeep expenses have been deducted (gross rental yield) or after (net rental yield). The rental yield will usually differ from the pre tax rate of return. This is the annual internal rate of return, after inflation, which can be obtained on the capital, invested over the lifetime of the project, and taking into account the disposal price of the asset.

2. The main factors which interact with each other and cause the rate of return to differ from the rental yield are (i) the real rate of appreciation on the property, (ii) the real interest rate paid on borrowed money, (iii) the level of gearing, (iv) the rate of inflation.

3. The first two tables are for an individual higher rate taxpayer, assumed to have a marginal tax rate of 50 per cent. The first table is for a net rent of 4.5 per cent of the capital value of the property in the first year. The second table assumes a net rental yield of 7.5 per cent. Tables 3 and 4 provide similar information for a company paying corporation tax at 35 per cent. The four per cent writing down allowances which are now temporarily available to approved companies are not part of the tax regime in the first four tables; they are examined as an option in Tables 5 and 6.

4. It is assumed in all the examples, unless stated to the contrary, that investments are held for a period of 30 years.

5. The "baseline" assumptions for the first line of the tables are 3 per cent inflation and 1.5 per cent real growth in gross rent, assuming that 1.5 per cent is the growth in the capital value of the property, and gross rental yields remain constant. Each table presents in turn a rent growth and inflation assumption either side of the central case, together with a "best" and "worst" case where the two variable factors are combined to give the best and worst return. Each set of rates of return is presented pre and post tax, in real terms, and at three different real rates of interest: four, six and eight per cent. The loan is assumed to be an interest only loan, with the principal repaid after 30 years at the same time as the property is sold.

6. There are clearly many more combinations which could be tested, but it is hoped that those presented here will serve as a useful sensitivity analysis. We decided to analyse only the "Greater London" option put to us by DOE, and not look at the "Midlands and North" option. The main difference here is the assumption about rent growth. Apart from that, the numbers are very similar. The assumption of 1.5 per cent rent growth (equals real capital appreciation) rather than the national average of one per cent can be justified by the belief that the

major area where the shortage of rented accommodation is likely to be felt is in London and the South East. The sensitivity analysis has rent growth as one of its dimensions, so some indication of the differnce this makes can be obtained from the tables.

7. The level of gearing is taken to be endogenous; it is assumed that the landlord will borrow the amount of money which maximises his return, taking into account the rate of inflation, the real rate of interest, the rental return, the likely growth path of rents, and the tax regime. The two decisions available to the investor were taken to be that the percentage of the investment financed by a loan could be either 67 per cent or 80 per cent. The columns in the tables marked with an asterisk have a debt finance proportion of 67 per cent. All other examples assume 80 per cent. If the range had been wider, then most of the rates of return would have been higher.

8. DOE suggested that it was necessary to make some allowance for renewals which are not funded from annual upkeep. These would be major repairs and replacements such as a new roof. For tax purposes, however, a provision for renewals is not allowed as a deduction; it is only permitted when the money is spent. This gives the problem of deciding how much should be spent and when. For these examples, it has been assumed that two thirds of the annual amount provided (0.8 per cent of capital cost) is adequate for a provision for 30 years and, for simplicity, this has been deducted from the rent receivable. This is therefore equivalent to the position of a landlord with several properties (perhaps ten?), who will have some major repairs to make each year, and can claim a deduction for them.

9. The DOE suggested allowance for voids has been taken into account by reducing both the net rental return and the upkeep and management figures by four per cent.

Inflation

10. The effect of inflation on rates of return depends on the other assumptions. On the one hand, inflation can raise the return, because the interest payments are fixed in money terms, but the rents rise more quickly. On the other hand, the interest payments are higher, depressing the return in the early years. This will be especially true where real interest rates are low, and/or no sideways relief is given during the early years when losses are being made. From Table 1 it can be seen that higher inflation raises pre and post tax returns at eight per cent real interest rates, but lowers them at four per cent. Table 3 shows the same thing happening for companies.

Rent Growth

11. All the tables show, for each option, that higher rent growth raises returns, as one would expect. The effects seem fairly consistent, with an extra percentage point on the rent growth raising rates of return by around two percentage points.

Best and Worst

12. These numbers show the possible range of values that we could be considering. For an individual, depending on the rental return available, the post tax real rates of return could vary between -0.3 per cent and 13.4 per cent. For companies, who enjoy more favourable tax treatment, the range is between -0.1 per cent and 15.6 per cent.

Net Rental Yields

13. The tables show very clearly how sensitive the rates of return are to the net rental yield that a landlord can obtain. On the examples used, a three percentage point rise in the assumed net rental yield raised the real post tax return by between 4.0 and 7.1 percentage points for companies, and between 3.3 and 5.2 percentage points for individuals.

Tax Options

14. These have been considered on the central case of six per cent real interest rate, and the baseline assumptions for inflation (three per cent) and real growth (1.5 per cent). Tables five and six give the details for net rental returns of 4.5 per cent and 7.5 per cent respectively.

15. Companies already enjoy sideways relief for interest so only the 4 per cent writing down allowance is considered for them.

16. Sideways relief benefits an individual only where he is making losses in the early years, before rents start to exceed the interest he is paying on the loan. Table 6 shows that with a rental yield of 7.5 per cent, sideways relief makes no difference, but with 4.5 per cent, the post tax return is raised by 0.7 percentage points.

17. The BES scheme examined here is one where the individual 50 per cent taxpayer receives tax relief on his initial investment at his marginal rate. Any income generated is kept in the company and taxed at the corporation tax rate, with the benefit of sideways relief on interest. At the end of the period (which must be at least 5 years) the equity can be realised free of capital gains tax.

18. The return after 30 years is shown mainly for comparison with the other rates of return. It can be seen that for an individual his post tax return is raised from 4.0 per cent to 7.0 per cent or or from 8.7 per cent to 14.1 per cent depending on the rental yield assumption.

19. In practice, there would be no incentive to hold on for more than 5 years. On sale, the investor receives his original equity stake plus any appreciation on the property. The tables show that the post tax rates of return would be 15.5 per cent or 25.3 per cent. For both rental yield variants, it can be seen that the tax wedge (the difference between pre and post tax returns) actually becomes negative.

20. A negative tax wedge is also created when writing down allowances are given. These are especially generous when the asset is appreciating in value. Moreover, if the asset is held for more than 25 years, they are not recoverable. Sideways relief is available on writing down allowances (for individuals as well as firms) and the numbers take account of this.

TABLE 1

INDIVIDUALS

Four and a half per cent net rental yield

	Real pre tax and **post tax** rates of return (%)					
real interest rates	4%		6%		8%*	
	pre tax	post tax	pre tax	post tax	pre tax	post tax
baseline (3% inflation 1.5% rent growth)	7.4	**5.8**	5.2	**4.0**	4.0	**2.9**
1% inflation	8.3	**6.3**	5.0	**4.0**	3.3	**2.6**
5% inflation	6.9	**5.3**	5.3	**4.0**	4.3	**3.5**
0.5% rent growth	4.9	**3.8**	2.6	**1.8**	1.6	**0.9**
2.5% rent growth	9.5	**7.6**	7.4	**5.9**	6.0	**4.6**
best	10.7	**8.2**	7.7	**6.3**	6.1	**4.6**
worst	4.8	**3.5**	1.4	**0.8**	0.2	**-0.3**

* debt finance proportion of 67%

TABLE 2

INDIVIDUALS

Seven and a half per cent net rental yield

	Real pre tax and **post tax** rates of return (%)					
real interest rates	4%		6%		8%	
	pre tax	post tax	pre tax	post tax	pre tax	post tax
baseline (3% inflation 1.5% rent growth)	15.6	**10.5**	11.9	**8.7**	9.1	**7.0**
1% inflation	18.8	**11.5**	13.5	**9.1**	9.3	**7.0**
5% inflation	13.7	**9.9**	11.0	**8.3**	8.9	**6.8**
0.5% rent growth	13.1	**8.6**	9.3	**6.7**	6.3	**4.7**
2.5% rent growth	17.8	**12.3**	14.3	**10.6**	11.5	**8.9**
best	21.1	**13.4**	16.1	**11.2**	12.2	**9.2**
worst	11.5	8.1	8.7	**6.5**	5.8	**4.3**

TABLE 3

COMPANIES

Four and a half per cent net rental yield

	Real pre tax and **post tax** rates of return (%)					
real interest rates	4%		6%		8%*	
	pre tax	**post tax**	pre tax	**post tax**	pre tax	**post tax**
baseline (3% inflation 1.5% rent growth)	7.4	**6.0**	5.2	**4.3**	4.0	**3.0**
1% inflation	8.3	**6.5**	5.0	**4.0**	3.3	**2.5**
5% inflation	6.9	**5.7**	5.3	**4.4**	4.3	**3.3**
0.5% rent growth	4.9	**3.8**	2.6	**1.9**	1.6	**1.0**
2.5% rent growth	9.5	**7.9**	7.4	**6.3**	6.0	**4.8**
best	10.7	**8.7**	7.7	**6.4**	6.1	**5.0**
worst	4.8	**3.8**	1.4	**1.0**	0.2	**-0.1**

TABLE 4

COMPANIES

Seven and a half per cent net rental yield

	Real pre tax and **post tax** rates of return (%)					
real interest rates	4%		6%		8%	
	pre tax	**post tax**	pre tax	**post tax**	pre tax	**post tax**
baseline (3% inflation 1.5% rent growth)	15.6	**11.9**	11.9	**9.5**	9.1	**7.5**
1% inflation	18.8	**13.6**	13.5	**10.2**	9.3	**7.4**
5% inflation	13.7	**10.9**	11.0	**9.1**	8.9	**7.5**
0.5% rent growth	13.1	**9.8**	9.3	**7.2**	6.3	**5.0**
2.5% rent growth	17.8	**13.9**	14.3	**11.5**	11.5	**9.6**
best	21.1	**15.6**	16.1	**12.5**	12.2	**9.9**
worst	11.5	**8.9**	8.7	**7.0**	5.8	**4.3**

EFFECT ON RATES OF RETURN OF DIFFERENT TAX POLICIES

Assumptions: 3% inflation) Baseline
1.5% real rent growth)
6% real interest rate

TABLE 5

Four and a half per cent net rental yield

	Real pre tax **and post tax** rates of return (%)			
	individuals		companies	
	pre tax	post tax	pre tax	post tax
baseline (3% inflation 1.5% rent growth)	5.2	**4.0**	5.2	**4.3**
Sideways Relief	n/a	**4.7**	n/a	
BES scheme (30 year holding period)	n/a	**7.0**	n/a	
BES scheme (5 year holding period)	n/a	**15.3**	n/a	
4% writing down allowance	n/a	**6.8**	n/a	**6.5**

TABLE 6

Seven and a half per cent net rental yield

	Real pre tax **and post tax** rates of return (%)			
	individuals		companies	
	pre tax	post tax	pre tax	post tax
baseline (3% inflation 1.5% rent growth)	11.9	**8.7**	11.9	**9.5**
Sideways Relief	n/a	**8.7**	n/a	
BES scheme (30 year holding period)	n/a	**14.1**	n/a	
BES scheme (5 year holding period)	n/a	**25.3**	n/a	
4% writing down allowance	n/a	**13.5**	n/a	**12.7**

n/a = not applicable

FROM: FINANCIAL SECRETARY
DATE: 9 December 1987

CHANCELLOR

cc Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Cassell
Mr Scholar
Mr Culpin
Miss Hay
Mr Cropper
Mr Tyrie
Mr Painter IR
Mr McGivern IR
Mr Elliott IR

FST TO CH/EX 9 DEC

TAX TREATMENT OF PRIVATE RENTED ACCOMMODATION

You asked for my views on this.

2. I have to say that I am not convinced that a compelling case has been made for providing tax reliefs for private renting. Obviously we do not wish to see the deregulation initiative falling flat on its face, but neither do we wish to bring in ad hoc general tax reliefs which will be difficult to defend particularly in the context of our general Budget strategy.

3. In my view, the real need is to rectify the market failure which leaves many low income families unable to afford the rents at which scarce properties are offered. I see the importance too of increasing the supply of rented accommodation more generally (in particular, to improve job mobility) but to my mind that should be a secondary objective. Judged against the rather narrow objective I see for the initiative, the tax reliefs analysed in the paper seem ill-targetted, in most cases costly and potentially much less effective than a set of up-front state grants.

4. Nevertheless, I have considered whether any of these proposed measures could be contemplated since I am sure that Nicholas Ridley will be pressing for some help through the tax system.

BES Relief

5. The attraction of BES is that since it gives front-end relief it would provide the most effective incentive for investors who might be worried about a subsequent return to regulation under a different regime. It would also allow the tax relief to be reasonably ring-fenced.

6. However, I think that the proposal is much too generous and more importantly, cuts right across what we have been trying to do with BES since 1986. I believe that if we extended BES to companies investing in rented accommodation this would have a disastrous impact on the riskier type of BES investments, for which the scheme was, of course, originally intended. I am not attracted to a "partial" BES relief either.

Writing Down Allowances (WDA)

7. If one wanted a faily modest general tax relief which was not too expensive in the short to medium term and would have some beneficial impact on rates of return then this looks to be the front-runner to me. I understand that DoE officials will probably be recommending this to Nicholas Ridley.

8. However, it really would look very odd to introduce a WDA for let residential property which will tend to appreciate rather than depreciate over the first 25 years or so. The introduction of a 4% WDA for property which did not depreciate would rest very uneasily alongside the 1984 tax reforms. There is, of course, no WDA for commercial buildings (apart from those in enterprise zones and certain hotels) which are, if anything, more likely to depreciate than residential property. I think this would be extremely difficult to defend in terms of tax policy and against the inevitable pressure for an extension to all commercial buildings. There would, too, be a substantial deadweight cost, unless relief could be restricted to new build or substantial renovations.

9. One further point; the present experimental 4% WDA for assured tenancies has not been very successful: only 609 assured

tenancies had been granted under the Scheme by April 1986. The relief ends in 1992 and will not apply to deregulated tenancies. Some changes will be required to the existing legislation mainly to prevent the clawback of relief.

Sideways relief

10. Again, this proposal would be difficult to defend conceptually. It could really only be justified if one viewed the landlord as a trader rather than as an investor. The Conservative Accountants recently suggested to me that private landlords should indeed be treated as traders and taxed under Schedule D rather than under Schedule A. But I think it is difficult to argue that the purchase of a building and the receipt of a steady flow of rental income is in any sense a trade. The full sideways relief for "traders" is necessary to prevent damage to a business because genuine traders can experience great fluctuations in income from one year to the next. It cannot be argued that most private landlords are in this position.

11. The narrower question of whether sideways relief for interest should be given needs to be seen in this context. But even in isolation, it is not clear that it would have much effect on rates of return. It would also have deadweight costs.

Tax Exemption for Rental Income

12. This proposal - originally an Alliance idea - would be a minor and fairly cosmetic gesture, but one not without its complications. If the target here is to encourage the letting of single rooms, it is not clear that this would contribute greatly to the under-supply of rented accommodation. (It may just convert a black economy activity into a legal activity!). If the intention were to encourage more widespread letting of rooms the rental income exemption would have to be set much higher than £50-£60 per week. This would doubtless be a welcome windfall gain to the professional landlord in Bournemouth letting out 15 rooms in his coastal (owner-occupied) boarding house. Again deadweight would be a major problem and there would be complicated rules required to

limit the costs.

13. I am not in favour of this token measure, and nor do I favour an easement of the already generous CGT relief. But I do think it would be sensible for the Revenue to produce a simple leaflet explaining to people what reliefs are available to them if they wish to let rooms in their own homes.

Grants not Reliefs

14. My general view, having trawled through the options, is that there is a much better chance of reducing deadweight cost and improving targetting by using grants rather than by changing the tax system. That was outside the remit of Mr Cassell's Working Group, but my strong view is that if Nicholas Ridley wants more public money to give his deregulation initiative a "kick-start" the grants route is the more appropriate. I note that there are already signs of increasing pressure for further grants from such as the building societies. This would presumably take the form of extending the availability of the existing Housing Association grants to private landlords.

Wider Issue

15. I confess that after reading the Working Group Report and having talked to officials I remain slightly puzzled by the seeming intractability of this problem. Why is it that post-deregulation we are likely to be faced with a situation where people still cannot afford to pay the rents which landlords will have to charge to make their investments viable? Why, even in low cost housing areas, for instance, in the inner cities of the north, is it not possible to provide low rents at a profit?

16. It is tempting to argue that this is a "mortgage interest relief problem". But I am not sure that it is. There will be many families and single people who cannot afford to buy a house, even with interest relief, and are not poor enough to qualify for housing benefit. These people presumably wish to rent, but will not be able to. Why not?

17. There seem to be two possible answers:

(i) We are not seeing full deregulation: there will, of course, continue to be "minimum standards" which accommodation has to meet;

(ii) Perhaps we are exaggerating the size of the "supply gap" and perhaps the problem I am trying to address does not exist. I have to say that I find some of DoE's figuring in the Working Group report very surprising. For instance, is it really the case that the long-term investor only expects real capital appreciation of 1% p.a.?

CONCLUSION

18. Whether the analysis in the Report is accurate or not, I remain convinced that there is little to be said for a new tax relief for private landlords. I see more case for a targetted grant if we can agree on whom to target.

NORMAN LAMONT

CONFIDENTIAL

Inland Revenue

Policy Division
Somerset House

FROM: P LEWIS

DATE: 9 DECEMBER 1987

Chancellor

BENEFITS IN KIND: DELOITTES MEMORANDUM

1. You asked for quick comments on the main points in advance of your meeting tomorrow.

General

2. The note draws attention to a large number of mainly minor points most of which are familiar to us - and in many instances - to Ministers also. It is written very much from the practising accountant's point of view. That is both its strength and its weakness. On the one hand, it gives a feel for the irritations accountants may experience with the present system - particularly if, like Deloittes, they are heavily involved in responding to our Schedule E compliance work. On the other hand, it understandably often shows little recognition of the policy considerations or the administrative realities for the Revenue - for example, in our present manpower situation it really is cloud cuckoo land to suggest that employers/accountants problems with difficult cases might be solved by an appealable advanced clearance system run by the Revenue.

---

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Scholar
Mr Culpin
Miss Sinclair
Mr Riley
Mr Michie
Mr Cropper
Mr Tyrie

Mr Battishill
Mr Isaac
Mr Painter
Mr Beighton
Mr Lewis
Mr Prescott
Miss Rhodes
Mr Northend
Mr Hodgson
Mr Allen
Mr I Stewart
PS/IR

3. The points raised are generally very much at the margin of the tax system - small points on perceived inequities, practice and procedure. Many are already under review in one way or another, or would be affected by the changes you are already considering. It seems doubtful whether there is much here of relevance to the "broad canvas" issues we shall be looking at on Thursday.

Removal expenses for overseas employees working in the UK

4. As we have already mentioned to the Financial Secretary, we will need to review this ESC at the same time as we are carrying out the review Ministers have requested of the additional housing costs allowance ESC (this was originally timed for after the Budget, but we shall need to take a view before then on how these expenses are to be handled for FBT). Briefly, the point here is that the "removals" concession has always been regarded as applying only where someone sells one home and moves to another - whether a UK or overseas employee - though Tax Districts may on occasion have adopted a more generous interpretation. The suggestion is that overseas employees will often wish to retain a home abroad but should nonetheless be exempt on all employer funded costs of setting up a second home here.

"Temporary" accommodation expenses

5. If an employer pays the costs of an employees permanent home, that clearly ought to be taxable; but if the employee is away from his home for a few days for business purposes, the cost of his "temporary" accommodation ought to be exempt. The problem is the dividing line between these two situations. Our long standing practice - based on the approach we think the Courts might adopt - has been to regard a period of a year as the dividing line between (taxable) permanent accommodation and (non-taxable) temporary accommodation. The suggestion is that this period might be extended. Any dividing line of this kind would be largely arbitrary; and, so far as I am aware, we have not had any other representations on this point.

Employee shareholdings (unapproved schemes)

6. The Financial Secretary had a meeting, which included a Deloittes representative, on this on 16 November. At the Financial Secretary's suggestion, discussions with officials on the points raised are now in hand.

Entertainment where no UK employer

7. The note is concerned with the comparatively rare case in which the employee liable to UK tax has no employer within the UK tax net. In such cases, since the disallowance of entertaining costs cannot be made on the employer, it is, in effect, made on the employee by prohibiting an expenses deduction. While, as the note suggests, this may seem a bit unfair looking only at the position of the employee if the entertainment is a genuine business occasion, there would be opportunities for circumventing this anti-avoidance provision without a rule on these lines. Moreover, this sort of case would generally involve imports which, at the time this legislation was enacted (1965) it was hoped to discourage. As we noted in the FBT papers on exemptions, the treatment of entertainment under an FBT would need to be reviewed generally.

Late night journeys

8. The suggestion is that the new ESC is too restrictive. But it was, of course, intended to cover only cases where it was the exception and not the rule for employees to be sent home late. Where late night transport home is regularly provided, it seems right to tax it as a benefit; and one would normally expect it to be reflected in the remuneration for the job.

Clothing

9. Our practice follows the decisions of the Courts which have shown that clothing which can be worn as ordinary "civilian" wear does not fall within the general Schedule E expenses rule.

Workplace nurseries

10. There is not necessarily an inconsistency between Local Authorities requiring employers to provide workplace nurseries and taxing the recipients on the benefit they receive. But this is, of course, one of the benefits we have suggested you might consider exempting under FBT.

Consistency with NIC

11. The broad objective of DHSS has generally been to get NICs on all forms of earned income. But because NIC is collected - for employees - on a non-cumulative cash basis, it is difficult to collect contributions on income which it may not be possible to quantify until the employee has put in an expenses claim after the end of the year, and it has been agreed. Special machinery would be required - hence, in part at least, FBT.

Quantification of benefit

12. A graduated scale based on the cost of the car is suggested. We would not accept Deloitte's underlying assumption that the value of the private use of a car varies with the extent of its business use. The present scale charge is cruder but simpler - so long as the employee stays within the same engine range the calculation of benefit does not change; whereas if it were based on cost there would be a change with every car.

13. When we looked at cars earlier in the Autumn, the Financial Secretary was not attracted to a system based on the actual costs - including running costs - of individual cars. But both the Australians and the New Zealanders use a system based on the capital cost of the car alone and we could, if Ministers wished, explore this simpler proposition further in the FBT context.

14. As Mr Prescott's note mentions, we will need to invent a new system for charging accommodation in any case because of the disappearance of domestic rates.

Reporting requirements

15. If Inspectors are to give a dispensation, they must be reasonably satisfied that the expenses covered by it would otherwise be allowable - in effect, the Inspector is dealing with expenses claims for all the employees, probably for a five year period, in one go. If the circumstances are complex, this may be time consuming; but the employer benefits in subsequent years through the reduced reporting requirements. Our new leaflet on dispensations encourages employers to give all the necessary information at the outset when they apply for a dispensation so that in a straightforward case the Inspector should be able to decide on the dispensation straightaway. In cases where there is some element of doubt negotiations inevitably take longer.

16. In practice, the 30-day time limit for P11Ds is not enforced.

17. Generally we are happy to accept P11D information in list form provided the information is given in such a way that it does not increase work in Tax Offices. The provision of computer generated lists is already common.

18. Once the results of the current dispensation exercise are available - we should be getting the results of the first six months fairly soon - we shall consider whether there is further help we could give on dispensations.

19. Cases where the employee disputes the amounts the employer has returned on the P11D are rare. Requiring the employer to copy P11D information to every employee, therefore, would put a largely unnecessary burden on the employer.

20. It seems doubtful whether an appeal system for dispensations would be appropriate - the whole system depends on the Inspector forming a broad view about the employers' arrangements for expenses and continuing trust between the Inspector and the employer that the employer will keep to the rules in the future. An appeal system needs a precise legal point - not to second

guess the Inspector's broad judgement that, on the whole, most expenses would probably qualify for relief so the employer can be relieved from returning them. Inspectors are not reluctant to give dispensations whenever they can reasonably do so because there will be an ongoing saving of work in the Tax Office.

Lisa Miles

for P LEWIS

CONFIDENTIAL.

Chancellor.

Employee Benefits

Reading Deloittes memorandum, and Mr Lewis' commentary on it, it occurs to me that – if we end up by staying with the P11D – the whole business of taxation of employee benefits might usefully be remitted to a Keith-like Committee.

We need to find a way of restoring legitimacy to this section of the tax system and a serious public examination of it would be one way of doing that.

PJC

10 Dec

Ch.

Revised scorecard for your meeting this afternoon.

[initials] 15/11

Copy 1 of 4

TASK FORCE SECRET

TABLE 1

COST OF TASK FORCE PACKAGE AS AT 15 DECEMBER

All figures highly provisional. Figures net of cost or yield of indexation or revalorisation

Proposal Number	Proposal	Cost(-) or Yield(+) in £ billion 1988-89	1989-90	1990-91
1	Excise Duties	Nil	Nil	Nil
2	VAT	Nil	Nil	Nil
3	Reduce basic rate of IT to 25p	-2.5	-3.2	-3.4
4	Increase higher rate IT threshold to £25,000	-0.8	-1.5	-1.7
5	Abolish higher rates of IT above 35p, phased in over 3 years	-0.8	-1.7	-2.1
6	In October 1988 abolish employees' UEL, and set rate above it at 9%, phased in over 3 years	+0.5	+1.4	+1.9
7	Abolish Class 4 NICs upper profit limit in April 1989, set rate above it at 6.3% and abolish 50% deductibility against tax. Raise LPL to £6,400	Nil	+0.1	+0.4
8	Changes to Class 1 NICs at lower end	-0.4	-0.8	-0.9
9	Independent taxation from 1990-91	Nil	Nil	-0.6
10	Exempt first £6,600 gains from CGT, add remaining gains to income and tax at IT rates (25%/35%)	Nil	+Neg	+Neg
11	Rebase CGT to 1982 (cost includes rebasing CT on companies' gains)	Nil	-0.1	-0.3
12	Restrict MIR to residence basis from 1.8.88 and raise ceiling to £35,000 (cost ignores behavioural effects)	-0.2	-0.2	-0.3
13	Abolish tax relief on home improvement loans	+0.1	+0.2	+0.3
14	Abolish tax relief on new covenants between individuals; change rules for maintenance payments	Neg	+0.1	+0.2
15	Abolish tax on employees' benefits in kind and introduce fringe benefits tax on employers	Nil	Nil	*
16	Reduce corporation tax rate to 33p in 1990-91	Nil	Nil	Nil
17	Reduce small companies' CT rate to 25p	Neg	-0.1	-0.1
18	Raise IHT threshold to £105,000 and set single rate of 40%	-0.1	-0.2	-0.3
19	Minor starters	+Neg	+Neg	+Neg
	TOTAL	-4.2	-6.0	-6.9

*Cost/yield not yet available

* year earlier?

TASK FORCE SECRET

●tes on the Scorecard

All figures highly provisional and show cost (-) or yield (+) in £ billion unless otherwise indicated.

Excise Duties

1. The base forecast assumes excise duties revalorised by 3.6% (the inflation rate assumed for the twelve months to December 1987). This would imply the following price increases and would add 0.27 percentage points to RPI inflation.

Product	Unit	Price Increase (pence)
Beer	Pint	0.8
Cider	Pint	0.4
Table wine	70cl	2.8
Spirits	75cl	19.6
Cigarettes	20KS	3.3
Cigars	5 whiffs	1.8
Pipe tobacco	25 grams	0.3
Petrol (leaded)	Gallon	3.6
Derv	Gallon	3.1
VED (cars)	-	£ 3.60

Excise Duties paper to be submitted shortly.

VAT

2. The base forecast assumes no change in the standard rate and assumes revalorisation by 3.6% of the VAT registration threshold to £22,100 (from £21,300).

Income Tax Basic Rate and Personal Allowances

3. The base forecast assumes statutory indexation by 3.6% of main personal allowances.

The extra cost of reducing the basic rate to 24p (assuming a higher rate threshold of £25,000) would be £1.3 billion in 1988-89, £1.6 billion in 1989-90 and £1.8 million in 1990-91.

Income Tax Higher Rates

5. Phasing assumes abolition of higher rates above 37p in 1988-89, reduced to 36p in 1989-90 and to 35p in 1990-91. If the reduction to 35p were instead introduced in one step in 1988-89 the cost would be

1988-89	1989-90	1990-91
-0.9	-1.9	-2.1

The cost of abolishing higher rates of IT above 40p in one step in 1988-89 would be

1988-89	1989-90	1990-91
-0.7	-1.3	-1.5

The cost of a phased abolition of higher rates above 30p (ie to 32p in 1988-89, 31p in 1989-90 and 30p in 1990-91) would be

1988-89	1989-90	1990-91
-1.1	-2.3	-2.7

If, with a phased-in higher rate of 30p, the threshold were increased to only £20,000 the cost would be reduced by £0.2 billion in 1988-89, by £0.3 billion in 1989-90 and by £0.4 billion in 1990-91.

National Insurance Contributions

6. Phasing assumes NIC rate above UEL of 7% from October 1988 until April 1989, 8% to April 1990, then 9%. If the 9% rate were instead introduced in one step in October 1988, the yield would be

1988-89	1989-90	1990-91
+0.6	+1.6	+2.0

If the UEL were abolished in October 1988 and the top rate of employees' NICs reduced at the same time to 8 per cent (no phasing) the cost would be

1988-89	1989-90	1990-91
-0.2	-0.3	-0.2(sic)

7. An alternative variant would be as shown but instead of raising LPL reduce Class 2 NICs to £2.50pw thus leaving cost unchanged.

8. Assumes Option F (Macpherson 19 October) selected at the meeting on 19 November: extend 5 per cent reduced rate band for employees to £130, with 7 per cent band between £130 and £155 and no change in employers' rates. Costings assume LEL uprated in April 1989 but no uprating of reduced rate bands. Benefit savings would be

£ million

1988-89	1989-90	1990-91
+15	+50	less than +50

Independent Taxation

9. Assumes implementation from 1990-91 and:

- Disaggregation of all husband and wife's income
- Introduce Married Couples' Allowance equal to difference between MMA and single allowance with MCA transferable to wife if husband cannot use
- MCA withdrawn gradually if husband's income exceeds £40,000
- Disaggregate husband and wife's capital gains with separate exemption of £6,600 each
- Only one CGT residence exemption per couple
- Abolish APA and replace by benefit in 1989-90
  Or review APA entitlement rules to remove tax penalty on marriage
- Transitional protection for breadwinner wives
- Abolition of minor personal allowances in 1988-89; yield included in minor starters
- Give age allowance only on basis of taxpayer's own age

Capital Gains Tax

10. & 11. These are the key components of the option preferred at the meeting on 12 November at which alternative options were dropped.

Mortgage Interest Relief

12. If MIR were instead given on an individual basis with £20,000 ceiling for singles and £40,000 for couples, the cost, ignoring behavioural effects, would be

1988-89	1989-90	1990-91
-0.2	-0.2	-0.3

On the same basis a ceiling of £30,000 for singles and £60,000 for couples would cost

1988-89	1989-90	1990-91
-0.4	-0.6	-0.7

These options considered in Mr O'Connor's submission of 27 November.

Covenants and maintenance

14. Assumes abolition of relief on all new covenants between individuals. Relief on maintenance payments to divorced/separated spouses only, limited to £2425. No tax on payee. Consideration being given to ways of avoiding losers among deserted unmarried mothers.

Fringe Benefits Tax

15. Assumes FBT on employers with comprehensive coverage and rate of 50 per cent. FBT to be non-deductible for CT. Costings are net of cost of abolishing tax on employees of £ billion in 1990-91.

Corporation Tax

16. It was provisionally decided at Chancellor's meeting on 10 December to cut the CT rate by 2p to 33p at the same time as the FBT on employers is introduced in 1990-91. There are no revenue costs until 1991-92 when the first year cost would be £0.8 billion and the full year cost £1.1 billion.

Inheritance Tax

18. Chancellor (20 October) also asked for a costing of the following variants

- Raise IHT threshold to £100,000 and single rate of 40 per cent

1988-89	1989-90	1990-91
-0.1	-0.2	-0.3

- Single rate of 35 per cent and threshold set to give no losers (the threshold turns out to be £100,000)

1988-89	1989-90	1990-91
-0.2	-0.3	-0.4

Minor Starters

19. Minor starters (ie those with revenue yield/loss of £5 million or more) are as follows:

	Cost(-) or Yield(+) in £ million		
	1988-89	1989-90	1990-91
Abolition of minor personal allowances	+10	+10	+10
Tax on supply to be liability of person completing VAT invoice	+5	+5	+5
Personal pensions, delay in commencement	+10	+10	+Neg
Total	+25	+25	+15

Not included are starters which protect existing revenue and are thus already assumed in the base forecast. The proposal to exempt forestry from tax will yield less than £5 million even in the third year although its full year yield is £10 million.

cc Mr Cropper
+ return → mpw

CENTRE FOR POLICY STUDIES

8 Wilfred Street, London SW1E 6 PL. Tel: 01-828 1176

10th December, 1987.

The Rt. Hon Nigel Lawson, MP,
Chancellor of the Exchequer
11 Downing Street,
London, S.W.1.

Dear Nigel —

It was good of you to see Philip Chappell and myself and to exchange views.

We do hope you and Cabinet colleagues will stress that "one man's tax privilege is another man's tax rise" because the more this is understood the easier we believe your task will be in removing privileges and thus cutting tax overall.

We have found the copy of the Australian Government advertisement that makes this point using slightly different expressions - I hope the concept will be helpful.

We are particularly anxious that the huge tax privileges given to institutions should be shifted to benefit individuals so that Great Britain Ltd., can be owned at first hand.

Ever —

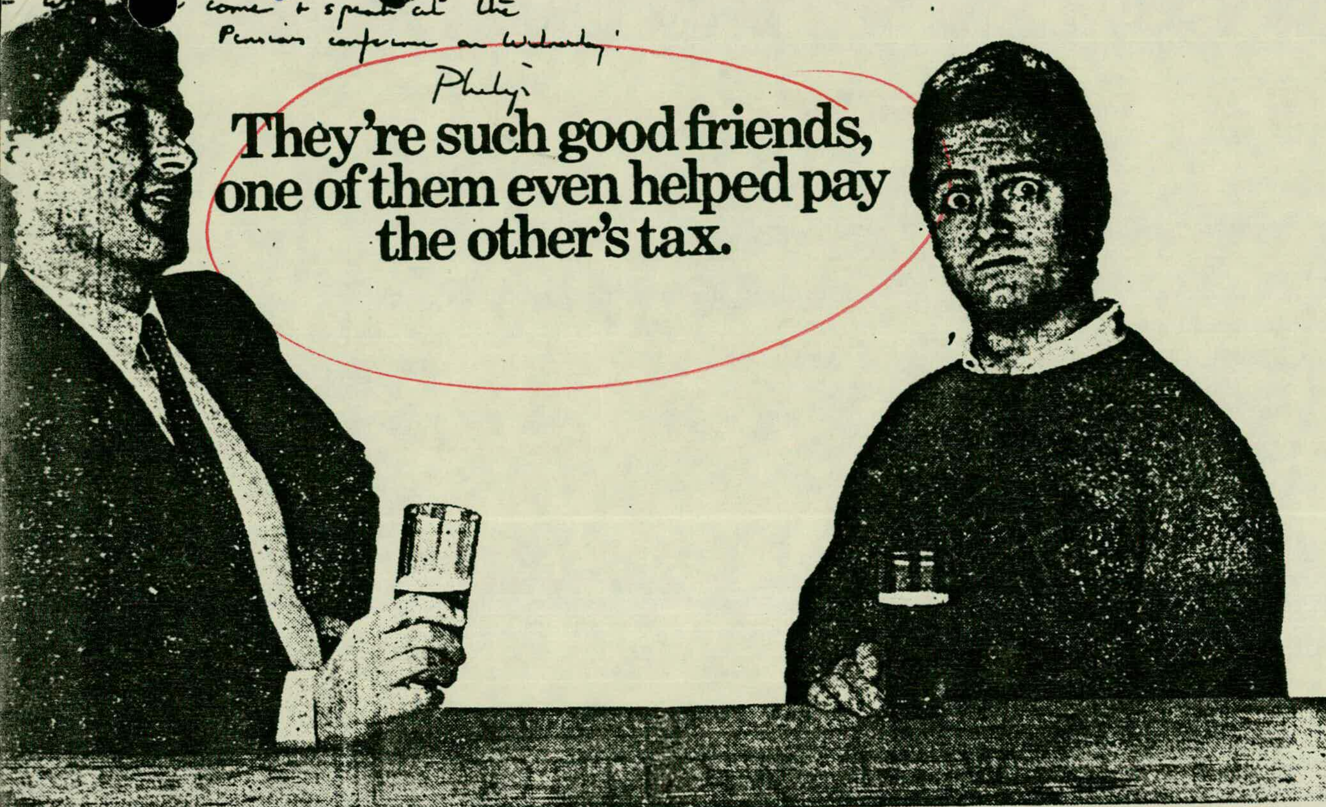
LORD VINSON

c.c. P. Chappell, Esq.

BR

HM TREASURY – MCU
RECD: 11 DEC 1987
ACTION: Mrs Burnhams PP
cc APS/CHX
CHX

BOARD OF DIRECTORS Lord Thomas (Chairman) Sir Ronald Halstead (Hon Treasurer) Lord Beloff Peter Bowring Professor Alan Dashwood Dr Richard Haas Professor R V Jones Sir Hector Laing Shirley Letwin Professor Kenneth Minogue Ferdinand Mount Nathalie Brooke (Secretary) FOUNDERS Rt Hon Margaret Thatcher Rt Hon Sir Keith Joseph England and Wales, No. 1174651, registered office at above address.



Under the old tax system, people who paying tax on their full income were tively subsidising those who got part eir income in untaxed fringe benefits.

Luxury cars, entertainment, school overseas holidays, that sort of thing.

It simply wasn't fair that some people paying less tax than they should.

But it's also unfair to assume that all people were at fault.

Most of the blame lies with the old ystem that encouraged the situation.

That's why our tax system is changing.

Not surprisingly, the introduction of r reforms caused considerable debate in the community.

So, as you're probably aware, some nonsense changes have recently been e to one part of the tax reform package, ely F.B.T. = Fringe Benefit Tax

Log books have now been virtually inated, and a wide range of minor fits are now exempt.

But these changes have done nothing to alter the underlying principles of the tax reform package.

To restore fairness, increase incentive and help create the foundations for a more dynamic future.

The benefit to the community will become more obvious on December 1st and July 1st, when the proceeds from F.B.T., plus a lot more, will all be redistributed in the form of tax cuts.

Furthermore, the double tax levied on dividend payments is being abolished, which will help small business profits.

In the meantime, if you need any help or advice on F.B.T. matters, the tax office has set up a hotline to assist you.

(You'll find your relevant telephone number at the bottom of the page.)

Achieving a fair tax system was never going to be easy.

But, we believe, it'll be easier than you thought.

A fair country deserves a fair tax system.

e open between 8.30am and 5.00pm. For the cost of a local call, country residents can dial the 008 numbers. New South Wales & ACT: Sydney (02) 267 1066, Parramatta (02) 891 1100, Newcastle (049) 26 5588,) 51 6077. Country residents (008) 112 466, (008) 422 144, (008) 451 162, (008) 405 909. Victoria: Melbourne (03) 329 1677. Country residents (008) 03 3895. South Australia: Adelaide (08) 231 1488. Country 888 477. Northern Territory: (All residents) (008) 888 477. Western Australia: Perth (09) 221 2050. Country residents (008) 112 466. Queensland: Brisbane (07) 229 6655, Townsville (077) 21 1433. Country residents, Brisbane (008) 112 466, Townsville (008) 019 308. Tasmania: (002) 20 4033. Country residents (008) 001 111.

TRS (367) 106

COPY NO 1 OF 24

FROM: C J RILEY
DATE: 17 DECEMBER 1987

1. SIR T BURNS 17/12/87
2. CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Byatt
Mr Scholar
Mr Culpin
Miss Sinclair
Ms Munro

Inland Revenue
Mr Battishill
Mr Isaac
Mr Painter
Mr Beighton
Mr Johns
Mr O'Connor
Mr Weeden
Mr I Stewart
PS/IR

MORTGAGE INTEREST RELIEF AND HOUSE PRICES

At your meeting on 19 November you asked for advice on the housing market impact of the various proposals under consideration for changing mortgage interest relief. The attached paper has been prepared by Alison Munro, and reflects discussion with the Revenue and interested parties in the Treasury.

2. The paper concludes that the effects on real house prices of all the options under consideration are likely to be small - well under 5% even in the medium term. The price effects vary more or less in line with the estimated revenue costs of the different options. The effect of raising the ceiling to £40,000 on a residence basis would be somewhat less than the effect of a £30,000 individual ceiling, though the difference is negligible to all intents and purposes.

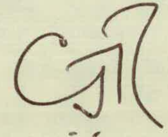
3. Although the price effects are likely to be small, they must be seen in the context of a range of measures affecting house prices:

- the increase in MIR;
- the reduction in personal tax rates;
- the replacement of domestic rates by the community charge.

The abolition of domestic rates will tend to raise real house prices; one estimate has put the effect at around 15%, though we think this is much too high and would expect an effect closer to (or even below) the DOE estimate of 5%. Higher personal disposable incomes also tend to raise house prices; but the cut in tax rates

in the Budget will reduce the value of mortgage interest relief, especially for higher rate taxpayers, putting downward pressure on prices. Nevertheless on balance we would expect these other factors to be raising house prices in the medium term, augmenting any (small) effect of a rise in MIR.

4. An important aim of your proposals for tax reform is to limit the value of tax breaks and reduce the distortions which they cause. This argues for limiting the overall scale of MIR as far as possible. But in any event our estimates suggest that, given the size of the effects, the choice between the various options should rest primarily on considerations other than house prices.



C J RILEY

THE EFFECT OF CHANGES IN MORTGAGE INTEREST RELIEF ON HOUSE PRICES

This note examines the effect on house prices of various options for changing the level of and eligibility for mortgage interest relief (MIR) in the 1988 Budget:

(a) £35,000 on a residence basis
(b) £40,000 on a residence basis
(c) £20,000 individual ceiling
(d) £30,000 individual ceiling

2. Section I outlines the economics of the house price effects of changes in MIR. Section II describes the methodology for quantifying these effects, and presents the results for the four 1988 Budget options. Section III puts these results into the context of other influences on house prices over the next few years, including other proposed budget changes, and other policy objectives.

I. The economics of an increase in MIR ceiling

3. With no change in the basis for eligibility for MIR, we would expect the main effects of an increase in the current £30,000 ceiling to be:

i) An increase in the price of houses financed with mortgages over £30,000. Since on average the size of new mortgages increases with the value of the house being purchased, the maximum percentage increase in price would probably be for houses purchased with mortgages at the new ceiling. Above this level, the percentage increase would be lower, the more expensive the house. Cheaper houses would become relatively more attractive, putting upward pressure on their prices also.

ii) The magnitude of the price increase would depend on the degree of capitalisation of reduced mortgage payments into house prices. This would depend upon the price elasticities of demand and supply for housing. Estimates of the elasticity of demand for housing are generally around -0.5 to -0.8. Estimates of the elasticity of supply are less certain; in the short run, supply

would be expected to be fairly inelastic, while in the medium term (say up to 5 years) it might be reasonable to assume an average supply elasticity of around 1.0 (though lower in areas such as the South East). Putting these considerations together, we would expect capitalisation to be less than 100%, even in the short run (perhaps around 80%); and in the longer run capitalisation would probably be less than a half.

iii) The effect on average house prices would depend on the proportion of new mortgages which would benefit from the increased ceiling. In 1986-87 29% of mortgages were for £30,000 or more; but over time we would expect this proportion to rise, because of income growth and general inflation.

iv) The demand for mortgages would rise, putting upward pressure on mortgage interest rates. This secondary effect would tend to limit the rise in house prices, though in current circumstances, with the supply of mortgages fairly elastic, it would probably be small.

v) Regional house price differentials would change. In 1986 the average mortgage advance was £37,800 in Greater London, £31,800 in the rest of the South East, and £18,560 in the Northern region. But the average ratio of advance to house price was slightly higher in the north (76%) than in London and the South East (67%). Thus increasing the MIR ceiling would affect more mortgages in the South East and would widen regional differentials in the lower to middle range of the market, at least in the short to medium term. More restricted supply of housing land in the south east would strengthen this effect.

vi) The main gainers from the MIR change, especially in the short run, would be existing home owners experiencing capital gains. Those with mortgages above £30,000, and especially higher rate tax payers, would have more disposable income. First time buyers taking out mortgages below £30,000 would generally be worse off. First time buyers taking out mortgages above £30,000 would be better off, assuming less than 100% capitalisation.

vii) The ultimate long run effect on house prices of any change in MIR would depend on whether it was a permanent real change (ie the ceiling was indexed), or a one-off nominal change. A purely nominal change would account for a progressively smaller proportion of house prices as time went on, and would ultimately leave real house prices broadly unaffected.

4. Changing the basis of MIR eligibility might also affect house prices. A change to the residence basis (with no change in ceiling) would leave the majority of purchasers unaffected. The losers - unmarried sharers - comprise only about 5% of house-buyers, so any effect on house prices would be very small. A change to an individual ceiling which left married sharers unaffected would reduce the price that single purchasers and unmarried sharers would be willing to pay. Single people are a significant proportion of housebuyers (about a quarter). On average, they buy rather cheaper houses, so house price differentials would widen as prices fell more at the lower end of the market.

II Quantifying house price effects

Methodology

5. The full effects of changes in MIR on house prices are complex, and difficult to quantify. We have looked at two simplified methods for estimating the possible scale of effects;

a) A discounting method, in which the annual saving in mortgage payments is discounted to a present value, and assumptions are made about the degree to which this is capitalised into house prices in the short and medium term.

b) A modelling method, using the new house price equation in the Treasury model. The effect of a change in the MIR ceiling on the weighted average net of tax mortgage interest rate is calculated, and multiplied by the interest rate elasticity in the equation.

6. The results of these calculations for the four MIR options, are presented in Table 1. For calculations on the residence basis,

unmarried sharers are assumed to have an insignificant effect on overall house prices. For the individual ceiling basis, the house price effects weight together the likely effect for single people and others assuming full transferability of ceilings between married couples. (Less than full transferability would mean slightly smaller effects.) All calculations assume the 1988 Budget tax rates.

7. In the discounting method, it has been assumed that house purchasers regard an increase in ceiling as a one-off nominal change, so a nominal discount rate has been used. To the extent that people expect further increases in the ceiling this method will underestimate house price increases; this is perhaps less likely with the individual ceiling, which is more likely to be seen as a one-off change associated with independent taxation than an increase in ceiling on the residence basis.

8. The <u>maximum</u> possible price increase produced by the discounting method is for 100% capitalisation and a 100% mortgage at the level of the new ceiling. This calculation is shown in column (1) of Table 1. These figures considerably overstate average house price effects because:

- capitalisation will be less than 100%;

- the average ratio of new advance to house price is about 70%; and

- only a proportion of mortgages are in the range where they derive maximum benefit from the increase in the ceiling. (Table 2 shows actual and projected distributions of mortgages by value; in 1988-89 about 40% of mortgages are likely to exceed £30,000.)

9. A more realistic estimate of average house price effects taking these points into account is shown in columns (2) and (3) of Table 1. The short term figures use the 1988-89 distribution of mortgages, after allowing for behavioural response to the change in ceiling, and assuming 80% capitalisation. The medium term figures assume 50% capitalisation and a hypothetical distribution of mortgages where all mortgages derive maximum benefit from the new

ceiling (which therefore rather overstates the possible medium term effect).

10. Another possible approach is to discount the reduction in mortgage interest payments for all mortgages, not just new ones and use this to calculate the change in value of the whole owner-occupied stock. In our view this method is likely to understate house price effects, because the existing stock of mortgages includes smaller mortgages taken out in earlier years; whereas house prices, even for those houses that are not actually traded, are determined by current (actual and potential) transactions. The results of this calculation are shown in column (4) of Table 1. The reductions in mortgage interest payments used in this calculation, calculated by the Inland Revenue, are shown in columns (7) and (8).

11. Estimates of house price effects using the Treasury model elasticity are presented in columns (5) and (6). The medium term figures allow for all new mortgages to benefit fully from the increase in ceiling.

12. Average house price increases conceal considerable variation between houses and mortgages of different values. Table 3 illustrates the possible range of direct effects for the £35,000 residence based ceiling and £30,000 individual ceiling, using the discounting methodology.

Results

13. The discounting and modelling methods give broadly similar answers. They suggest that average house price effects are likely to be quite small for all the options under consideration:

	% increase in average real house prices	
	short term	medium term
£35,000 Residence basis	½-¾	1
£40,000 Residence basis	1-1½	1½-2
£20,000 Individual ceiling	½-¾	1
£30,000 Individual ceiling	1½-2	2½-3

14. The pattern of house price effects for the different options reflects the pattern of revenue effects quite closely. The effects of the £20,000 individual ceiling are smaller than the £40,000 residence basis because of the impact on single buyers. The £30,000 individual ceiling gives the largest effects, 2½-3 times the effects of the £35,000 residence basis but still small in absolute terms.

15. Estimates of the medium term effects are rather more tentative than the short term effects, because of difficulties in forecasting supply effects and future levels of house prices and the distribution of mortgages. Increases in the supply of housing would tend to reduce house price effects over time. But the rise in average mortgage levels would lead to larger effects in the medium term; the higher the new ceiling, the greater is the scope for the proportion of mortgages benefitting from the change to increase over time. This explains the relatively high medium term figure for the £30,000 individual ceiling; in 1988 we would expect only about 5% of mortgages to exceed £60,000 (the effective ceiling for married couples under this option), but this would probably increse substantially in the medium term.

16. In an attempt to get a feel for the plausibility of our estimates, we have applied both of the methodologies described above to the increase in ceiling from £25,000 to £30,000 in 1983. For that change, we would have predicted prices to increase by around ½-1% in real terms, the effect building up over a number of years after 1983. In view of other, much larger, influences on house prices since 1983 (such as income growth and mortgage availability), this provides no reason to doubt the accuracy of our estimates.

III Other Considerations

Changes in tax rates

17. Our calculations are based on the tax rates in place after the 1988 Budget. However, the reductions in tax rates in the Budget will themselves affect house prices. The value of MIR will be reduced, especially for higher rate tax payers; this will raise the net of tax mortgage interest rate and so depress prices, mitigating

the impact of rising real disposable incomes on real house prices. The proposed tax rate changes might reduce house prices on average by ½-1% by comparison with an equal change in personal tax allowances. These changes in house prices, and those directly associated with a change in MIR ceiling, need to be viewed against a background of a long term increase in house prices broadly in line with real income growth.

Community Charge

18. The replacement of rates with the community charge in 1990-91 is also likely to raise house prices, because a tax on the value of houses is being replaced by a tax on individuals. Estimates of this effect are very uncertain, because we do not know the extent to which people do actually perceive rates as a tax on housing, especially in view of the imperfect link between rate payments and house prices. Some estimates put the figure as high as 15% on average, with significant regional variation. But while we accept that the abolition of rates is likely to have a positive effect on house prices, we think these figures are a considerable overstatement.

Other policy considerations

19. Increases in MIR would tend to widen regional differentials and hinder labour mobility, at least in the short to medium term. We have not examined regional effects in detail, but the figures given here suggest that house prices in the lower to middle range might increase by at least 1% more in the south than the north for the £35,000 residence based ceiling, and by possibly 2-3% more for the £30,000 individual ceiling.

ETS
17 December 1987

Table 1: Effects of Changes in MIR on Real House Prices

	House price effects with Discounting Methods (%)[1]	Average New Mortgages			House price effects with Treasury Model (%)		Changes in Tax Revenue[2] £million	
	Maximum possible Effect	**Short Term**	**Medium Term**	**All mortgages, whole stock**	**Short Term**	**Medium Term**	**1988-89**	**1989-90**
£35,000 Residence basis	2½-3	¾	1	½	½	1	-170	-220
£40,000 Residence basis	4¼-5½	1½	1½-2	¾	1	1¾	-300	-400
£20,000 Individual ceiling	Married couple 4¼-5½	¾	1	½	½	1	-210	-240
	Single -5 to -8							
£30,000 Individual ceiling	Married couple 8½-10½	2	2½-3	1	1½	2½	-430	-620
	Single 0							
Columns	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)

1 The ranges reflect our assumptions about interest rates, assumed to be in the range 6-10%.
2 Inland Revenue estimates, with no behavioural response to change in ceiling.

Table 2: Distribution of mortgages, by value (%)

	less than £30,000	£30-40,000	over £40,000
1983-84	92	5	3
1986-87	71	14	15
1987-88*	63	15	21
1988-89*	60	15	25
1990-91*	54	15	30

* Forecast. Assumes no behavioural change to proposed MIR ceiling increases.
Source: Inland Revenue.

Table 3: Increases in real house prices by value of mortgage and house price (%)

	House price £						
	25000	35000	50000	60000	100000	150000	200000
a) £35000 Residence basis							
mortgage of < £30,000	0	0	0	0	0	0	0
£35,000+	-	2½	1¾	1½	¾	½	½
b) £30000 Individual ceiling							
Single, all mortgages	0	0	0	0	0	0	0
Married couple; mortgage of < £30,000	0	0	0	0	0	0	0
£35,000	-	2½	1¾	1½	¾	½	<½
£40,000	-	-	3½	2¾	1¾	1	¾
£60,000+	-	-	-	8½	5	3½	2½

Assumes 80% capitalisation, 10% discount rate.
Direct effects only.

Inland Revenue

Policy Division
Somerset House

FROM: P LEWIS

DATE: 23 DECEMBER 1987

CHANCELLOR OF THE EXCHEQUER

FBT - BEHAVIOURAL EFFECTS: YIELD: CT RATE

1. My note of 4 December looked at the implications for neutrality of a 45 or 50% non deductible FBT rate and what the yield would be on the assumption that there were no behavioural changes.

2. Taking account of your (provisional) decision to go for a 50% rate, this note (which FP have seen in draft) takes a first look at

- likely behavioural changes (important not only for the impact on yield but in assessing the extent to which

---

cc		
	Financial Secretary	Mr Battishill
	Chief Secretary	Mr Isaac
	Paymaster General	Mr Painter
	Economic Secretary	Mr Beighton
	Sir P Middleton	Mr Lewis
	Mr Scholar	Mr Prescott
	Mr Culpin	Miss Rhodes
	Miss Sinclair	Mr Northend
	Mr Riley	Mr Hodgson
	Mr Michie	Mr Allen
	Mr Cropper	Mr I Stewart
	Mr Tyrie	Mr Geraghty
	Mr Jenkins (OPC)	PS/IR

FBT would encourage employers to move away from benefits towards cash pay)

- the implications for the net yield of FBT

- the implications for the increased net burden on employers, and what that might imply for offsetting corporation tax rate changes.

3. We will be sending you before Chevening a note on the CT rate generally, and will take account of the FBT implications brought out in this submission.

Behavioural changes

4. In looking at likely behavioural changes the starting point is to try to establish what would be the optimum financial position for both employer and employee.

5. This is fairly complex because there are so many possible variables to take into account

   - the employee's tax position (3 main variants)

   - the employer's tax position (4 variants)

   - the extent to which benefits are fully valued for tax purposes (2 main variants)

   - the different kinds of possible behavioural responses (we have identified 6 variants)

6. Of the 6 possible behavioural responses we have identified the first 2 are easy to analyse. They are either no change in the provision of benefits or - its exact opposite - the total withdrawal of benefits without any cash compensation. In the first case there would be no change to the FBT yield figures previously given and the employer's additional burden would be the whole of the FBT. In the second case there would be no FBT yield, there would be a loss of the

income tax previously paid, and the employer would gain the net cost of the benefit previously provided. Responses at either extreme are, we think, likely to be insignificant.

7. The remaining 4 variants fall into 2 groups. They involve the employer

- shifting the whole cost of FBT back to the employee (which would leave the employee worse off), or

- shifting the cost of FBT back to the employee to the extent that the employee's net income has increased because he is no longer paying tax on his benefits (which would leave the employer worse off).

In both cases this position can be reached either by withdrawing the benefits and giving an increase in cash remuneration ("cashing out") or by continuing to give benefits at the same level, but reducing the level of cash remuneration below what it would otherwise have been.

8. Of these two responses we think that, on balance, the "employee neutral" is likely to be much more comon than the "employer neutral". Employers may well feel that they should be able to pass back the whole of FBT to the employee since it is extra taxation in respect of benefits the employee receives (though it represents in part employers' NIC). The employee, on the other hand, may regard his own tax savings from the change as irrelevant to his remuneration package, and certainly not be prepared to see a reduction in his net income on account of the employer's increased tax liability. The "employee neutral" position is intermediate between these two "negotiating positions"; and it recognises the reality both of the switch in the basis of taxation and that the weight of tax on benefits has been increased. The following paragraphs look at

- the arithmetic of employee neutrality

- whether "cashing out" or retaining benefits would be advantageous in various circumstances

- the effect on yield and employer's burdens if eventually full "employee neutrality" were achieved.

Employee Neutrality - the Arithmetic

9. The table below illustrates how the employee's and the employer's position, and the tax/NIC yield, might change following the introduction of FBT. It assumes the benefit is worth £1,000, the employer is liable at 35% and the employee at 25%. It shows:

(a) what the position would be under the main package with no FBT;

(b) the ex ante position following the introduction of FBT;

(c) how the picture changes if the employer withdraws the benefit, but pays the employee extra cash of £1,136 to leave him with the same net income as in (a) (cashing out);

(d) what happens if the benefit is kept, but net pay reduced, again to leave the employee with the same net income as in (a).

	Value to Employee	Cost to Employer	Tax/NIC Yield From Introducing FBT
(a) 25/35 no FBT			
Benefits	+ 1,000	+ 1,000	
Income tax	- 250	-	
Corporation tax relief	-	- 350	-
Net value	+ 750	+ 650	
(b) 25/35 with FBT			
Benefits	+ 1,000	+ 1,000	
Income tax	-	-	
FBT	-	+ 500	
CT relief	-	- 350	
Net value	+ 1,000	+ 1,150	+ 250
(c) 25/35 with FBT and cashing out			
Benefits	-	-	
Earnings	+ 1,136	+ 1,136	
Income tax	- 284	-	
NIC	- 102	+ 119	
CT relief	-	- 439	
Net value	+ 750	+ 816	+ 166
(d) 25/35 with FBT & reduced earnings			
Benefits	+ 1,000	+ 1,000	
Earnings	- 379	- 379	
Income tax	+ 95	-	
NIC	+ 34	- 40	
FBT	-	+ 500	
CT relief	-	- 203	
Net value	+ 750	+ 878	+ 228

10. Under "cashing out" ((c) in the table) the tax/NIC yield from introducing FBT falls from £250 to £166, paid £136 by the employee and £30 by the employer. But the whole of the extra cost falls on the employer because he has to increase his employee's pay to cover his extra liability and maintain his net income.

11. If the benefit is continued but cash salary reduced to maintain the employee's net income ((d) in the table), the increased yield from FBT is £228. This is made up of £607 extra tax/NIC paid by the employer, and £379 tax/NIC saved by the employee. Again, the employer's extra costs are the same as the extra yield because he saves £379 in gross salary to offset against his additional tax/NIC of £607.

12. In this particular case (basic rate taxpayer, employer paying CT at 35%, fully taxed benefit) "cashing out" is cheaper than retaining the benefit with a reduced cash salary. The effect is to reduce the ex ante yield of FBT of £250 to £166.

Whether "cashing out" or retaining benefits with reduced cash remuneration is cheaper

13. The outcome of calculations on the lines above will depend on the tax position of employee and employer. The following table summarises which option under "employee neutrality" saves the employer most (C = cashing out; B/C = retains benefit but reduces cash pay).

	Ordinary Benefits		Cars	
Employer's Tax Rate	Basic Rate	Higher Rate	Basic Rate	Higher Rate
Nil	B/C	B/C	B/C	B/C
25%	B/C	B/C	B/C	B/C
35%	C	B/C	B/C	B/C
37.5%	C	B/C	B/C	B/C

The fact that benefits still have the edge over cash in most cases in this table is unsurprising because of

a. the undervaluation of cars for tax purposes

b. the fact that the FBT rate is less than neutral for higher rate taxpayers.

14. The extent of the saving on the gross FBT cost varies from the marginal to more than 100% - this applies in the case of higher rate employees of employers whose tax rate is nil or 25%. In these cases the employer can provide the same net benefit at less than the cost under the present system because when salary is reduced to take account of the employee's tax savings there is either no loss or a smaller loss of CT relief to offset against the employer's savings from the reduction in gross salary and employer's NIC liability.

15. We would expect about 5% of benefits (by <u>taxable</u> valuable) to be in this position. For about 25% to 30% of benefits "cashing out" would be the best "employee neutrality" option; for the rest retaining the benefit but with reduced cash pay would be cheaper for the employer.

<u>Effect on yield</u>

16. We have fairly good information about the marginal tax rates of employees who receive benefits. But our information about the marginal tax rates of their employers is much less reliable. The best estimate we can make is as follows:-

Non-taxpayers - 15% of benefits
25% taxpayers - 5%
35% taxpayers - 75%
37.5% taxpayers - 5%

17. On this footing, and using a 50% non-deductible FBT rate, the yield would change as follows if, in all cases, pay arrangements were rearranged to an "employee neutral" position, either by cashing out or by retaining benefits and with reduced cash pay, whichever was cheaper:-

Ex ante	£m	Ex post (employee neutrality)
FBT + 1450		FBT + 1060
IT - 750		IT - 780
Net + 700		CT + 190
		Net + 470 say + £450m

18. We are reasonably confident that the bulk of benefits are provided by employers paying tax at 35%. If the proportion were as high as 90%, the yield would be £530m. If it were as low as 65% the yield would be £420m.

Employers' net additional costs

19. At your meeting on 10 December we discussed the additional burden on employers (which might be compensated for by a CT reduction) in terms of the gross FBT yield ie £1,450m on the figures in paragraph 17. But, as explained in paragraphs 9 to 11, in the ex post situation the employer's additional burden is limited to the net yield. This follows, of course, from the assumption on which these figures are constructed that the employee is left with the same net income after the introduction of FBT as he was before.

How much should the CT offset be?

20. This analysis suggests that the additional net burden on employers might be about £450m. To the extent that some employers managed to pass on the full cost of FBT to employees, this figure would fall. But there are also a number of reasons why this might be too low a figure on which to base a CT offset. It assumes that everyone has moved to the optimum position adopting "employee neutrality" as the yard- stick. But in practice

- some employers may not identify the optimum position (the calculations are complex) or have good commercial reasons for not attempting to move (fully) to it.

- in some cases it will be impracticable to withdraw benefits even if the arithmetic pointed to "cashing out" eg in the case of a benefit which is also required for business purposes.

- in some cases, particularly perhaps small family companies, it may be decided simply to continue the benefits and for the company to pay the full tax.

- even where employers seek to move to the optimum position, there may be substantial employee resistance to reductions (or smaller increases) in cash pay, or the cashing out of benefits, to offset the employee's income tax savings. Income tax savings do not normally play a prominent part in pay negotiations. Pension entitlements may complicate the issue.

- although, given the long lead time, many employers may be ready to change their arrangements "overnight" when FBT becomes effective, the process of adjustment is unlikely to be fully accomplished for some time.

21. It is thus a matter of judgement where, between the £1,450m ex ante figure and the theoretical ex post figure of about £450m the actual net additional burden on employers would initially turn out to be. A reasonable working assumption might be that at the start of FBT it would fall in the range £500 to £1,000m.

22. On the footing that you might consider a two point reduction in the CT rate, we have checked all the above calculations with a 33% CT rate (marginal CT rate 35%) . That would make no significant difference to the behavioural pattern, but would shade about £10m off the aggregate ex post net yield from introducing FBT.

Timing of FBT

23. You have not yet decided the timing of FBT payments. If

they were made quarterly, up to three quarters of the 1990/91 liability should be received in 1990/91, thus off setting, or rather more, the loss of income tax on benefits currently received with monthly PAYE payments. If, on the other hand, payments were made annually, there would be no receipts until 1991/92, thus resulting in a loss of revenue of some £700m in 1990/91 from the introduction of FBT. We will cover the payment options in our next note on the operational side of FBT.

24. What you decide will have implications for the year for which any off setting CT deduction would need to be made. If FBT is payable during 1990/1991, it will be necessary to reduce the CT rate for the preceding financial year ending 31 March 1990. But if FBT were only payable annually, the CT reduction could be left until the following year.

25. A CT reduction would, of course, only help corporate employers. But the amount of the additional cost attributable to unincorporated businesses is relatively small - and they will receive "compensation" from the main "Task Force" package.

<u>What if employers succeeded after all in achieving the "employer neutral" position</u>?

26. While we think this outcome unlikely in most cases, it is worth considering briefly what difference it would make to the figures, if it were adopted as the working assumption. The answer is that it would not make a great deal of difference to the net yield - it might fall by £50m or so. Broadly speaking, the loss of IT/NIC on the employee's reduced income would be largely balanced by the reduction in CT relief.

27. By definition, the additional costs on employers would fall - to nil - if all employers achieved this result. No question of compensation through the CT rate would then arise.

Summary

28. This note discusses the behavioural response to FBT. Many variations are possible, but the most likely outcome, in the longer term, seems to be that employers will generally seek to recover the employee's tax savings to cover part of their extra costs. To the extent that happens

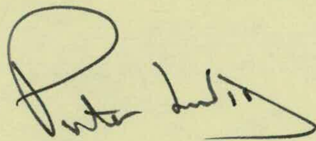
- "cashing out" benefits would be the cheapest option for about 25%-30% of benefits (but for about 5% the new system could actually be cheaper than the old)

- the aggregate net yield might eventually settle not at £700m but about £500m

- employers' additional costs would, in the longer term and with complete adjustment on the basis of "employee neutrality", equal the net yield; but in the shorter term might more realistically be expected to be some £500 - £1,000m

- to offset these additional costs, which would fall very largely on employers paying CT at 35% or 37.5%, a reduction in the CT rate of 1 or perhaps 2 points would be required

- it would need to be effective either for the financial year 1990, or 1991, depending on the payment pattern for FBT on which you decide.



P LEWIS

CONFIDENTIAL

Inland Revenue

Policy Division
Somerset House

From: E McGivern
Date: 23 December 1987

1. MR PAINTER note at end.

2. CHANCELLOR

TAX TREATMENT OF PRIVATE RENTED ACCOMMODATION

1. At your meeting on 14 December you asked for some further work to be done on two possible schemes of tax relief to encourage private renting, ie -

   i. BES relief for investment in rented dwellings; and

   ii. the exemption of rental income (subject to a fixed amount) from letting a room or rooms in owner-occupied houses. ("Rent-a-room").

2. The attached papers by Mr Reed and Mr Elliott set out the various options. We have not yet consulted Parliamentary Counsel, but subject to that our view is that a scheme of either kind could be got ready for the 1988 Bill if we can discuss the question of targeting with DoE early in the New Year. If you judge that some tax relief should be provided to encourage private renting, we would recommend the BES route. The case for rent-a-room seems much weaker - particularly if

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cc		
cc	Chief Secretary	Chairman
	Financial Secretary	Mr Isaac
	Economic Secretary	Mr Painter
	Sir P Middleton	Mr McGivern
	Mr Cassell	Mr Beighton
	Mr Byatt	Mr Johns
	Mr Scholar	Mr Calder
	Mr Culpin	Mr Cleave
	Miss Sinclair	Mr German
	Mr Instone	Mr Elliott
	Mr Betenson	Mr Keith
	Miss Hay	Mr Reed
	Mr Cropper	Mr Dawson
	Mr Tyrie	PS/IR
	Mr Call	
	Mr Jenkins (OPC)	

McGIVERN TO CX 23 DEC.

you decide to do BES - and it has, we believe, potentially major implications elsewhere - see paragraph 9 below.

Rent-a-room

3. We have, as you requested, tried to keep this as simple as possible. But clearly the shape of the final scheme must depend on decisions on targeting.

4. Each option envisages exemption of rental income up to a monetary ceiling. The exemption could apply -

- (Option A) - to income received by owner-occupiers (and probably tenants) from letting up to (say) 3 furnished rooms in their homes for periods of more than (say) 30 days;

- (Option B) - to income received by individuals from letting any number of furnished rooms (or flats) in their homes (for whatever length of tenancy);

- (Option C) - to income received by individuals from letting furnished rooms or flats whether in their homes or elsewhere and for whatever length of tenancy.

5. It would be possible to devise various half-way houses between these options but, to a greater or lesser extent, they raise much the same issues. These are discussed in Mr Elliott's paper.

6. The simplest scheme would be Option C where, it will be argued, the logic of the exemption inevitably takes one; although in extending the relief beyond owner-occupied (or tenanted) properties, it would, I think, go much further than you at present intend. Ministers could perhaps defend

restricting the relief on the grounds that it was intended to bring onto the market spare accommodation in such houses and was not designed for the rented sector generally, where the basic proposition (ie that the profit element would probably be covered by allowances anyway) would not apply. But you would undoubtedly come under strong pressure from landlords like the Leeds Residential Property Association (paragraph 26) to extend the scheme to them on the grounds that they are performing a social service in providing short-term accommodation to groups like students and young single people.

7. The narrower Option B would confine the relief to the owner-occupied/tenanted sector but would let in those carrying on a boarding house business in the property in which they live, as well as the residential landlord of furnished holiday lettings. If you felt this went too wide, you would then be driven back towards the more restrictive (and slightly more complex) Option A which would inevitably come up against the criticisms which Mr Elliott mentions in paragraph 23 of his note.

8. In short, we feel that the boundaries of this exemption for rental income will inevitably come under pressure if they stop short of extending the benefit to all private sector landlords of residential property.

9. But perhaps more important, a unique exemption of this kind for rental income seems to fit rather uneasily with your tax reform policies and, in particular, with the Budget strategy. Moreover, it would be seen as a significant development by those who have been pressing for a similar exemption for their particular interests, eg an exemption for the first year or 2 of the profits of a newly formed unincorporated business (particularly in the inner cities); and the exemption of a first tranche of the profits of a small company. You will want to consider therefore whether the rent-a-room exemption could be defended in principle from "me too" claims.

BES relief

10. Here we are suggesting that the simplest course would be to fit the new relief so far as possible into the existing BES scheme rather than draft long and complex new legislation, though some new rules are inevitable.

11. On targeting, my own view - based on earlier discussions with Environment - is that they would probably be more than content if any new relief were directed at new style assured tenancies which is to be the principal form of tenancy post-deregulation (see annex I of Mr Reed's paper). But you may wish to discuss this with Mr Ridley before deciding how far you want any new relief to go. It would certainly be most helpful if you could let us have a steer before we get round the table with DoE officials.

12. Two major arguments for targeting the relief on new style assured tenancies would be that this would underpin the kind of tenancy which the Government is committed to under its housing policy in the deregulated private sector; and adopting these tenancies as a basis for relief would automatically exclude certain kinds of lettings which Ministers might not in any event want to cover, eg holiday homes, lodging and hotels, and, lettings to students. Mr Reed's paper deals with these and other lettings which could be within the new relief and discusses whether the scheme should be limited to new build and substantially refurbished properties and whether any exclusion of more expensive property is necessary.

13. There are three important features of a BES scheme which you will want to consider;

i. Once the BES company has completed the qualifying period for relief (at present 3 years, although you may wish to consider a longer period, say 5 years for the new relief) there would be nothing to prevent it

selling the property into owner-occupation, either to the tenants or to other purchasers if the property was then vacant. There would then be no lasting additionality in the size of the rented sector.

ii. Again at the end of the qualifying period, there would be nothing under existing BES rules to stop a company selling the property on to another company whose shareholders would be eligible for a further tranche of BES relief, subject to the usual conditions. We could consider inserting a rule to counter this but companies would then look for other vacant property instead and the earlier property could be sold into owner occupation. In other words, there would be no guarantee of lasting additionality. However, you have in mind again to place a time limit on any new scheme of relief and the problem envisaged here would not arise, or at least on any significant scale, if you decided that the legislation should provide that the scheme would come to an end after, say, 5 years.

iii. The scheme could be costly depending on the amount of relief and take up. As Mr Reed points out, (para 39) giving less than full relief carries some risk making the scheme unattractive. On the other hand, even with half relief (and a higher fraction would, of course, be possible if Ministers so wished), investment in rented property might prove very attractive in comparison with other higher risk BES projects.

Recommendation

14. If you judge that something has to be done in the overall context of the Government's housing policy - perhaps by way of a kick-start relief - our recommendation would be to go for a

time-limited BES scheme (say for 5 years) targeted on the new-style assured tenancies or on a slightly wider basis if you conclude that this is necessary following your discussions with Mr Ridley. Treasury LG see some attraction in the rent-a-room scheme but we do not recommend it (particularly if you go for BES): whatever option was chosen, apart perhaps from the wide-ranging Option C, there would be difficulty in drawing and holding the boundaries, and there would inevitably be knock on effects outside the rented sector. X

I shd be grateful for FST's views ASAP. Provisionally, I am inclined to the 5 year BES scheme suggested immediately above, with 1/2 BES relief (in recognition, as it were, of the exemption from the property restriction) — & I wd still have a ceiling on other BES ventures, even if there wd be a higher ceiling for them. But I wd not rule out also going for a rent-a-room scheme, where the best variant wd seem to be Option B, but with a restriction on the minimum length of tenancy. (Incidentally, cd not the Lords RPA, about whom IR are so concerned, use the BES route?) NL.

[signature]

E McGIVERN

I'm afraid this is a thick bundle of paper for what is inevitably a hurried first shot at possible schemes of relief, but a fair amount of detail is necessary to show how they might work. X has of course been acknowledged throughout as a real factor. The crucial justification for the present BES — subsidising high risk — could not be present to the same extent in a property-based variant. There would be a very strong case for putting the maximum emphasis on the other BES characteristics - additionality and close-targeting - in particular restricting relief to new building or substantially refurbished property. (And it would be important to emphasise the 'kick-start' purpose of the incentive.)

Similar scope does not really exist for ring-fencing the 'rent-a-room' scheme which is much like a higher personal allowance for one particular type of socially or economically desirable activity.

[initials] 23.12.

FROM: J H REED
DATE: 23 DECEMBER 1987

1. MR McGIVERN
2. MR PAINTER
3. CHANCELLOR

See covering note. 23/12.

TAX TREATMENT OF PRIVATE RENTED ACCOMMODATION

At your meeting on 14 December you asked for an early paper on options for a BES-type relief to encourage investment in private rented accommodation. This note has been agreed with the Treasury. In the time available, and without consulting DOE, it has not been possible to produce as thorough a note as we would have liked. Nevertheless we hope you will find it helpful in narrowing down the options.

Summary

2. We have not yet, of course, been able to consult Parliamentary Counsel, but we think that it would be possible to introduce in next year's Finance Bill a BES relief for the letting of residential accommodation. However, we are not yet entirely clear about the precise housing policy objectives and hence how best to target the relief (in the way Ministers would wish). The length of this paper reflects this uncertainty but once this has been removed we would expect the legislation not to prove too difficult. We think it would be necessary to consult DOE about targetting, preferably fairly early in the New Year.

General

3. We recommend that any BES type relief should be based on the BES itself, with any necessary modifications. The reason for this is that BES is inescapably complicated (the legislation runs to 38 pages) and the same would be true of the new relief. So using BES as a basis would avoid a lot of unnecessary duplication. Furthermore, there is now a fairly good understanding of BES by individuals who are likely to put up capital and by professional advisers. It would be easier for

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them - and make the scheme more effective - if they had to think only of the modifications and could take the rest of the conditions for granted.

4. We also recommend that the relief should be restricted to companies specialising in residential lets. This would simplify matters, in particular when it came to the modifications. In essence, we see the relief working along the following lines. Individual investment in a company would be eligible for the new BES relief if:

i. the shares were issued by the company for the purposes of raising money for a business of providing qualifying lettings of residential accommodation in the UK;

ii. throughout the 3 years following the share issue the company exists wholly or almost wholly for the purpose of carrying on this business (or is the holding company of one or more subsidiaries carrying on such a business); and

iii. throughout this 3 year period the business does not consist to a substantial extent (ie, over 20 per cent) of activities which are not eligible for the new BES relief.

As is usual with BES, after the 3 year period the company would be free of restrictions - eg it could sell the properties if it wished - although the shareholders would not be able to sell their shares for a further 2 years without loss of relief. If you felt that the 3 year period was too short it could easily be lengthened for the purposes of this special relief only. The Treasury think that there may be arguments for a longer period in order to discourage potential harassment of tenants but we would need to discuss that with DOE.

5. In practice, a relief like this would be incompatible with the land and buildings restriction and so this would need to be disapplied. Apart from this, the normal BES rules would apply (subject to what is said below).

Qualifying let residential accommodation

6. The first question is what sort of residential lettings should qualify. In principle the new BES relief could be more closely targetted than the alternative forms of tax relief considered in the working party's report. Discussion with DOE will clearly be necessary before the details can be settled.

7. Meanwhile we assume that Ministers would want the new relief to cover not only new buildings but also properties which have been substantially refurbished (ie all "new accommodation"). This would be consistent with the declared aim of making effective use of the existing housing stock. Furthermore, we assume that in general because of the likely deadweight cost they will not want relief to be available if the property is already let when acquired by the company. But what about empty property ("existing accommodation"), which might previously have been owner-occupied or let and in private or public ownership? If the main aim is to increase or improve the housing stock it would not be cost-effective to allow in existing accommodation. On the other hand, if the overriding aim is to increase the proportion of property which is rented and make renting more competitive in comparison with owner-occupation (eg to facilitate labour mobility) it may be preferable to allow in both new and existing accommodation.

8. You indicated that you would want to consider whether the scheme should apply to local authority dwellings taken over by private landlords. Derelict buildings which were to be refurbished for letting would qualify, but if existing let property were to be excluded from the scheme, we would need some special provision to allow in those cases where local authority dwellings which were already occupied were acquired by private landlords. However, there are strong grounds for not applying a scheme to occupied local authority dwellings. The

Housing Bill provides for transfers to landlords at tenanted market value. The valuation will take account of the need for repair and substantial renovation, the existence of sitting tenants, and the need for landlords to make a reasonable return. In effect, the valuation process itself will provide a mechanism for encouraging profitable investment. A tax relief would therefore simply produce a deadweight cost.

New and Existing accommodation

9. If existing accommodation (ie vacant property not in need of substantial refurbishment) were to be included we propose that - subject to any special exemption for local authority dwellings referred to earlier - the rule should be that in order for a letting to qualify, it must be in respect of a dwelling-house which was either built by the company or was not let in whole or in part at the time the company acquired it. To avoid deadweight cost it would be necessary to exclude cases where although the property was empty, arrangements had been made for it to be let (maybe to the previous tenant). A case can be made for a condition that the property should not have been let for a period - eg that the property had not been let for the 12 months before the company acquired it. This would reduce the chance of avoidance arrangements and any possibility of harassment of existing tenants to get rid of them so that the property would be eligible for the new relief. But it might lead to properties being sold for owner-occupation (because a potential landlord might not be willing to wait for 12 months before letting the property); instead and requiring properties to remain empty would be difficult to justify. So on balance we think it best not to have such a condition.

10. There is an argument that in some circumstances a property should be eligible for relief even if it is let when the company acquires it. It may be that the letting will anyway come to an end shortly afterwards (and this would be reflected in the price paid by the company). It could be argued that the criticism of deadweight cost/lack of additionality was met in part by a recognition of the risk

that when the property became vacant it might have otherwise been sold into owner-occupation. However, covering this case while still excluding other let properties seems to be an unnecessary complication.

11. There is a slightly different case in which the company acquires a property with multiple dwellings (either in the public or private sector) and one or more of the dwellings is still let. The company might then be hoping to obtain vacant possession of those dwellings (perhaps so as to carry out refurbishment of the whole building) or it might be content for the tenancies to continue. While there is an argument for allowing in such cases, it would not be easy to devise rules to allow relief in appropriate cases but not in others. We think it would be sufficient to rely upon the let-out for ineligible activities (see subparagraph 4.iii. above). If the company did nothing else but provide residential lets, the effect of the let-out would be that up to 20 per cent of the building could be let at the time of acquisition and BES relief would still be available. If Ministers felt that, notwithstanding what is said in paragraph 8 above, the transfer of local authority property was to be within the scheme, this 20 per cent rule would obviously not cover those cases where a higher proportion of the dwellings were let. But we can do further work on this and on the equivalent position in the private sector.

12. There is one general point we should make about this option. As with BES relief generally, there would be nothing to stop a dwelling being sold to another company, under different ownership, after the 3 year period. This company too would be eligible for the new BES relief (subject to the conditions being satisfied - eg that the dwelling was vacant at the time). So there could be a continuing cost unless there was a time limit on the life of the relief (see paragraph 35 below). Of course, if there were seen to be a

continuing need to subsidise private rented accommodation there would be no objection in principle to a property qualifying for the new BES relief more than once* (over a period of time).

* This would be difficult to justify generally and inconsistent with the "high start" and additionality themes of a BES-type relief. [initials]

New accommodation only

13. We assume that Ministers would want the construction or, as the case may be, refurbishment of the dwelling to be carried out after acquisition by the company. There is less risk of deadweight cost with this option, but nevertheless it seems preferable to exclude properties which are let when the company acquires them (ie before refurbishment). So we would propose the same rule as for the option where both new and existing accommodation are eligible.

Types of letting

14. The existing capital allowances provision is restricted to assured tenancies. The BES relief could be restricted to these (in their new form - see Annex 1) or it could go wider. If restricted to the new style assured tenancies it would not apply in Northern Ireland because the assured tenancy scheme is not being introduced there. But it might be possible to extend the relief to tenancies there which would be assured tenancies if they were in England.

15. As Annex 1 explains, assured shorthold tenancies ("short assured tenancies" in Scotland) will be very similar to assured tenancies. The disadvantage of including them in the BES relief is that because the landlord can arrange to regain possession when it will suit him it would be easier for the BES company to cease its business of residential letting after the end of the 3 year period (or a longer period if you chose to have one - see paragraph 4 above). We also need to consider whether there would be a more general problem of assured tenancies with a relatively low rent and high premium. You may wish to discuss these areas with the Secretary of State for the Environment or you may prefer us to raise them with his officials in due course and report back.

16. Some of the conditions and exclusions of the assured tenancy scheme could be relaxed for the purposes of the new BES relief. At this stage, it would be helpful to know whether you wish to consider going wider than assured tenancies and in which directions. But discussion with DOE will be necessary before the details can be settled. This note now looks at some of the choices if you wish to go wider (or narrower) than assured tenancies.

Expensive properties

17. Subject to the need to raise sufficient finance (considered below), a company would, if there were no restrictions, be able to invest in any types of property - eg houses or flats in Mayfair. If you wish to exclude expensive properties, we need to consider ways of targetting the relief more precisely.

18. One possibility might be to use the rateable value of the dwelling, as is done in the Housing Bill (England and Wales) for the new assured tenancy scheme (£1,500 in Greater London and £750 elsewhere) - there will be no limits in Scotland. This would be somewhat arbitrary in its effect given the changes in relativities that there have been since the last revaluation (1973). And in the longer term rateable values will disappear (although presumably the DOE will need to devise suitable replacement limits for the assured tenancy scheme, which might also be used for the new BES relief). What the limits should be would depend upon the housing policy objectives. Ministers might feel that the assured tenancy limits are too high and that lower limits would be appropriate (even if otherwise the new BES relief is to be coterminous with the assured tenancy scheme). But you might wish to consult the Secretary of State for the Environment. You would also need to consider whether it would be acceptable to have no limit in Scotland.

19. There are alternatives to using rateable value limits. The existing scheme for giving capital allowances to assured tenancies (ATS) has a limit on the amount of capital

expenditure on a dwelling which qualifies for capital allowances. This is £60,000 in Greater London and £40,000 elsewhere. This relates only to the construction cost of a building, not the cost of the land. It would be possible to have a similar limitation for the new BES relief by reference to the purchase price of the property, including construction and refurbishment costs where appropriate. This would be more complicated in the case of buildings in multiple occupation, particularly where conversion work was carried out (eg splitting one dwelling into several flats). But we think that a limit along these lines would be workable. The actual monetary limits could be decided later.

20. Another possibility would be for the limit to apply by reference to the market value of the dwelling (with vacant possession) at any time in the 3 year period. If this went over the limit the letting would be ineligible. Legislatively, this would be simpler. But it would mean that relief could be lost because of a fortuitous increase in property values (this is why the land and buildings restriction takes the lower of the current value of the property and its original value plus the costs incurred on it).

21. Finally, the limit could be on the amount of rent payable (some account would also have to be taken of any premium paid for the tenancy). There is a slight complication in that part of the amount payable might be in respect of services or furniture provided. But the legislation could deal with this.

22. At this stage there does not seem to be an overwhelmingly strong case for going down one route rather than another, although the balance of advantage might shift as we worked up the relief. Clearly whatever DOE have in mind to replace the rateable test for assured tenancies would be a relevant consideration if the relief is targetted at those tenancies.

Sub-standard properties and rent paid by housing benefit

23. We assume that Ministers will not be looking for any lower limit on qualifying lets. There would however be some

risk that the scheme would be used to let sub-standard dwellings. If you wish to avoid this we could in due course consult DOE about how real this risk is and whether they could think of some condition which would prevent it.

24. A different point is that the tenants might have their rent effectively paid for by housing benefit, ie a possible double subsidy. The Housing Bill provides for Rent Officer assessment of rents and the restriction of housing benefit subsidy to rents at or below market value, so housing benefit consequences will be limited to an extent. But Treasury suggest that you might like us to discuss this further with DHSS.

Connections between investors/directors/ tenants

25. Under the new BES relief there would be three separate parties:

i. the BES investors;

ii. the directors and employees of the BES company; and

iii. the tenant or tenants.

There are various possible combinations of these parties, some of which would be prohibited by the normal BES rules if these were not amended. Our initial view is that we might need a special rule excluding any letting to the BES investor or an associate of his - we can develop this in more detail later.

Tied accommodation

26. One possible use of the new BES relief would be to ease the problem of job mobility by providing job-related accommodation. But the existing BES rules would largely prevent this. The BES company cannot be a subsidiary, or under the control, of any other company and of course a corporate investor is ineligible for BES relief. All that an

employer would be able to do would be to sponsor, possibly with an element of subsidy, a BES company and possibly (subject to the investor protection legislation) encourage its employees to invest in the BES company. This might happen where the directors of a smaller company were willing to put up their own money to provide accommodation for an employee. This might be of some value in terms of housing policy and you might want to cover such cases. But, because of the risk of abuse, we do not recommend any relaxation of the BES rules to allow a closer relationship between the two companies than is currently possible.

27. There is a potential deadweight cost by an employer using the new BES relief to attract outside investment in a company set up to provide tied accommodation to replace existing tied accommodation (possibly using the same property). But because of the limitations explained in the previous paragraph the scope for this should be limited.

28. A related possibility is that a BES company would let property to a separate company which would make it available to its own employees (who might be non-residents working in the UK for a time). This would be excluded if the new BES relief were restricted to assured tenancies since under these the tenant must be an individual. You will want to consider whether this kind of letting should be covered but it seems an unnecessary complication.

Holiday homes

29. The assured tenancy scheme would exclude holiday lets. We assume that you would want to do this even if the new BES relief were to go wider than the assured tenancy scheme.

Lodgings and hotels

30. Similarly, the assured tenancy scheme excludes these and we assume you will want the BES relief to do so too.

Letting to students

31. These are excluded by the assured tenancy scheme, presumably to prevent students getting security of tenure (in order to encourage landlords to provide accommodation). There would be a case for extending the new BES relief to lettings that would be assured tenancies were it not for the specific exclusion of lettings to students. This is something else you might wish to discuss with the Secretary of State for the Environment.

Assured agricultural occupancies

32. There are special provisions in the Housing Bill for dwelling-houses provided for agricultural workers by their employer (there is nothing equivalent in the Scottish Bill). Subject to certain conditions, these are treated like assured tenancies but with enhanced security of tenure for the occupier and his family. Some of these would anyway be assured tenancies and there seems no reason to exclude these from the new BES relief. But you might wish to consult the Secretary of State for the Environment about the extent to which the new BES relief should extend to these occupancies.

Housing associations

33. In principle, we think that a BES company should not also be eligible for the tax reliefs and subsidies given to housing associations. We think they would not at present qualify for these (because we understand that housing associations cannot be companies), but we would need to look at this further to make sure.

Capital allowances

34. The existing measure to provide capital allowances for assured tenancies (ATS) is due to expire in 1992 - ie from that date new expenditure under the existing assured tenancy scheme (ATS) would not qualify for capital allowances. We need to consider in any case what we should do about the

changeover to the new assured tenancy scheme. If nothing were done not only would new expenditure not qualify for capital allowances but allowances already given would be clawed-back by balancing charges on deregulation. We assume you will wish to prevent this claw-back and we shall be returning to this separately. Although there is an argument in principle for keeping the ATS in existence for new capital expenditure until 1992 (some people will have made their plans on this basis) this would be difficult to reconcile with the new assured tenancy scheme. But we shall say more about this when we come back to you about the future of the ATS.

A time limited scheme

35. If you wanted a time limit so that shares issued after a certain date would be ineligible for the new BES relief, this could be easily provided. As indicated above (paragraph 12) a time limit would reduce the risk of one property giving rise to more than one amount of BES relief.

Amount of relief

36. There are two, potentially conflicting, aims when considering whether the full BES relief should be available or only a restricted version (eg that only half the amount invested would qualify for relief). On the one hand, the relief must be sufficiently attractive to encourage people to use it. On the other hand, it should not crowd out other BES investment in, say, high risk companies.

37. It is not easy to decide how generous the relief would need to be to be attractive. But using the methodology of the recent report by Mr Cassell's group on the tax treatment of private rented accommodation it is possible to produce some helpful figures. Annex 2 sets out the real post tax returns from a 4.5 per cent rental yield on various assumptions about increases in capital value and the marginal tax rate of the investor. It assumes that the debt is limited to the amount which can be serviced out of the rental income. (The calculations in the report assumed much higher debt finance

(80 per cent) and that all the interest could be relieved immediately for tax purposes - this is an unrealistic assumption if the new relief is restricted, as we have suggested, to independent companies which do little else other than provide rented accommodation.) It then makes two different assumptions about the relief. Table 1 assumes that only half the amount invested is eligible for relief while Table 2 assumes that the whole amount is eligible for relief.

38. The Cassell report concluded (paragraph 19) that a net rental yield of about 7.5 per cent was the "required" rental return to attract potential landlords. There is no automatic way of turning this into a post-tax rate of return because this depends upon the landlord's particular circumstances. But on the face of it even assuming a 1.5 per cent annual increase in capital value, the option where only half the amount invested qualified for the new BES relief (Table 1) would produce an attractive return.

Given X and the real danger of Y there is a strong case for limiting relief to some proportion of the amount invested.

39. This may be too optimistic. We are looking at the incentive to an outside investor who will have only a minority interest in the company and will be locked in for five years. Furthermore, he will be comparing this kind of investment with other possible BES investments. There is no need to make any decisions now, but you may feel that giving anything less than full BES relief would risk making the relief unattractive. This would admittedly create a danger of crowding out other deserving BES investments, particularly if it is seen as a secure asset-backed investment of the kind that Ministers have legislated to exclude from BES. But there is no way of knowing in advance what would be the right balance.

Ceiling on BES finance raised by a company

40. You are separately considering the possibility of a ceiling on the amount of equity capital issued by a company within a period of 12 months which would be eligible for BES relief. The effect of this, depending upon the amount chosen, might be to discourage public issues. But it would still be possible for BES funds to raise money because the amounts they

normally invest in a company are likely to be below the amount of the ceiling. Indeed, removing the present competition from public issues might make it easier for BES funds to raise money. There would be a similar consequence for companies which wished to raise BES finance locally, eg from friends or business acquaintances, possibly with the assistance of a local enterprise agency or similar body.

41. The effect of a ceiling on the new BES relief would vary. It seems to us that assuming a ceiling of, say, £0.5 million to £1 million there would be no adverse effect on the smaller local investment in up to say 10 or 20 dwellings (depending on the part of the country and the type of property). This is the sort of scheme which an estate agent might want to set-up and manage. Larger schemes might find it more difficult. For example, if a company wished to buy and refurbish a block of flats (which might currently be owned by a local authority) the cost could run into £millions. The company might therefore have to become highly geared in order to do this and the financing costs could be difficult to meet (particularly since there would be no rental income during the refurbishment). So this kind of operation might be discouraged by a ceiling.

42. It would be possible to disapply the ceiling in particular cases, for example, this proposed BES relief or ship chartering. You might want to consider whether such a dividing-line could be defended.

Costs

43. The cost of the scheme would depend on take-up. As a ready-reckoner, we could assume that the whole of the cost of a property is financed by the new BES relief (although in practice there might be debt). So taking an average cost of a dwelling of say £35,000 (more in London and the South-East) the tax cost would be the marginal tax rate of the average investor. At present this is about 50 per cent and so the tax cost would be £17,500. So the provision of 1,000 dwellings would cost £17.5 million.

44. The DOE estimate of the gap in the supply of lettings is of the order of 300-400,000 at the beginning of the 1990s falling off to 100,000 by the turn of the century. It is very difficult to predict the extent to which the new BES relief might help fill this gap.

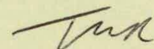
45. The staff cost depends not only upon take-up but also on the number of companies and investors (for a given amount of qualifying investment the staff cost is lower if there are a few big companies and a few big investors). But a reasonable assumption might be that every £25 million of BES finance might take one or two man years to process.

Conclusion

46. Our initial view is that it would be feasible to introduce a special BES relief for the letting of residential accommodation. There is however quite a lot of work which would need to be done, particularly in targetting the relief on the kinds of tenancies Ministers wish to encourage post deregulation. To do this we would need to consult DOE.

47. The length of the legislation would depend upon the outcome of these consultations and your decisions about the exact scope of the relief. But at the moment we would hope that, at most, no more than a few pages of legislation would be required. If we can talk to DOE fairly early in the New Year it should be possible to include this in the Finance Bill.

48. At your meeting on 14 December you said you would discuss the possibilities with Mr Ridley early in the New Year. We can, if you wish, attempt to do some more work before we talk to DOE officials, but it would be helpful if you were able to narrow down the options (although we recognise that this note is of necessity rather sketchy in parts).



J H REED

ANNEX 1

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ANNEX 1

Assured tenancies and assured shorthold tenancies

1. The new scheme for assured tenancies will come into effect two months after enactment of the Housing Bill. It will apply only in England and Wales but a separate Scottish Housing Bill will provide something equivalent in Scotland. Nothing similar is being done in Northern Ireland.

2. Subject to certain exceptions, it will cover all tenancies of separate dwellings by individuals for whom it is their only or principal home (they are allowed to sub-let part of the dwelling, subject to the landlord's consent). Unlike the present scheme, there is no need for DOE approval of a landlord.

3. The main exceptions are:

i. existing tenancies (other than under the current assured tenancy scheme);

ii. where the rateable value of the dwelling-house exceeds £1,500 in Greater London or £750 elsewhere (but there will be no limit in Scotland);

iii. where no rent is payable or the rent is less than two-thirds of the rateable value of the dwelling-house (in Scotland this lower limit will be set by order of the Secretary of State and may vary for different kinds of houses and different areas);

iv. business tenancies;

v. where the tenancy includes over two acres of agricultural land;

vi. tied dwellings on agricultural holdings (although there are separate provisions in the Bill for "assured agricultural occupancies");

vii. lettings to students; and

viii. holiday lettings.

There are also exclusions for resident landlords, Crown tenancies and local authority tenancies which would not be relevant to a BES company.

4. In general, the landlord will not be able to regain possession of the dwelling-house unless he offers suitable alternative accommodation; he intends to carry out substantial works on the dwelling-house; the tenant has not carried out his obligations (eg payment of rent); or it was tied accommodation and the tenant has ceased to be in that employment.

5. With one exception, there will be no control of rents. The exception is that where the landlord proposes a new rent for a tenancy the tenant will be able to refer it to a rent assessment committee who will determine the rent at what might reasonably be expected to be the open market rent for such a tenancy (ignoring any improvements voluntarily carried out by the tenant).

Assured shorthold tenancies

6. An assured shorthold tenancy ("short assured tenancy" in Scotland) will be a variant of an assured tenancy. It will have to be for a term of at least 6 months. The landlord will be able to gain possession at the end of the term, or subsequently, if he gives the tenant at least two months notice.

7. The tenant will be able to apply to the rent assessment committee for the rent to be reduced. They will not reduce it unless there is a sufficient number of similar tenancies in the locality and the rent is significantly higher than the rent which might reasonably be expected having regard to the rents payable under the similar tenancies. (The Secretary of State will be able to designate areas (or circumstances) in which the tenant will not have the right to ask for a rent reduction.)

ANNEX 2

ANNEX 2

BES INVESTMENT IN PRIVATE RENTED HOUSING

This note examines the real post tax rates of return arising from allowing BES investment in private rented property.

The assumptions used are the same as those used in the annex to the report which the joint Treasury, Revenue, DOE working group submitted to the Chancellor and the Secretary of State for the Environment in November 1987.

To recap:

Inflation	3.0 per cent
Gross rental yield	4.5 per cent
Real interest rate	6.0 per cent
Provision for Repairs	0.8 per cent

The exceptions in this note are that

(i) The BES investor is assumed in every case to sell his stake after five years, because this will provide him with the greatest return.

(ii) In Table 1, BES relief is allowed at half the investor's marginal rate. These rate of return calculations cannot distinguish between an investment of £80,000 receiving relief on £40,000 and an investment of £40,000 receiving relief on £20,000. In Table 2, full BES relief is given.

(iii) A different gearing assumption is used. A restriction on the amount of borrowing is imposed. The company making the investment is assumed to be new, small, and not a subsidiary of another company. The interest it pays on any borrowing it has is therefore taken to be not more than its rental income in the first year. Under this restriction, the proportion of the investment financed by debt is around 45 per cent.

(iv) The effects of greater real increases in the capital value of the property are examined. What is important is the expectation of a rise in value by the company and its investors. Since a BES company would be free to switch out of property after three years, and a BES investor can sell after five years, the long run capital appreciation figure of 1.5 per cent which was used in the previous exercise may not be relevant. The tables show the rates of return flowing from 1.5, 3, 5 and 10 per cent a year real increases in capital value

The rates of return rise roughly lineally with the investor's tax rate, so approximate values can be obtained for other tax rates by interpolation.

The results are fairly intuitive. The higher the investor's marginal tax rate, the higher the subsidy, and the greater the rate of return. And faster capital appreciation means that rates of return rise.

TABLE 1

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Table 1

REAL POST TAX RETURNS ARISING FROM A 4.5 PER CENT RENTAL YIELD

HALF BES RELIEF

Annual Increase in Capital Value (%)	1.5	3	5	10
Proportion of investment financed by debt (%)	43	44	44	46
Marginal Tax Rate of BES investor	Rate of Return (%)			
25	5.8	8.0	10.8	17.6
40	7.4	9.7	12.5	19.4
50	8.6	10.9	13.7	20.7
60	9.9	12.1	15.0	22.2

Table 2

REAL POST TAX RETURNS ARISING FROM A 4.5 PER CENT RENTAL YIELD

FULL BES RELIEF

Annual Increase in Capital Value (%)	1.5	3	5	10
Proportion of investment financed by debt (%)	43	44	44	46
Marginal Tax Rate of BES investor	Rates of Return (%)			
25	8.6	10.9	13.7	20.7
40	12.8	15.1	18.1	25.4
50	16.3	18.7	21.8	29.4
60	20.7	23.2	26.5	34.5

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RENT A ROOM

The proposal

1. The proposal as put to Mr Cassell's group by the DoE was that there should be an exemption from income tax for the first £X of income received from letting rooms in an owner-occupied house.

Purpose of the proposal

2. No single identifiable objective of this proposal emerged from the discussions in the Cassell group; it was variously seen as a small stimulus to one part of the private rented sector, as legitimising a part of the black economy, and as a harmless gesture to satisfy the DoE. But for the purpose of this note we take it that the intention is (a) to increase the supply of rooms available to let to single people for example young people travelling round the country looking for work; and (b) to achieve that objective in a deliberately limited way by encouraging people who are not professional landlords but simply happen to have a room, or rooms, empty in their houses to make them available for letting.

Overriding considerations

3. First, the Chancellor made it clear that he wanted any relief to be as simple as possible, so as to encourage maximum take-up. Second, because this will be the first exemption ever provided for any sort of rental income, there is going to be a lot of pressure to widen its scope and coverage - exemption is the most obvious form of tax expenditure. So there will be an even greater need than usual when introducing a new relief to have a scheme the boundaries and limitations of which can be clearly and effectively defended in principle. Our

feeling, on looking at this again after the Chancellor's meeting, is that the first consideration may be easier to reflect than the second.

4. The main justification for the relief would be that there was a gap in the market which could be filled, or partly filled, by the rooms potentially available in private houses; that the rental income in many of these cases would not in practice attract a tax charge (because of existing tax allowances); and that the exemption was a practical recognition of this fact, and by short-cutting the normal system of submitting accounts of rents and outgoings, gave a real encouragement to individuals (at low cost to the Exchequer) to make rooms available without having to worry about possible tax implications. These considerations do, to some extent, distinguish the "rent-a-room" scheme from other possible candidates for similar treatment. But a unique exemption of this kind will undoubtedly be seized upon as a precedent and Ministers will want to decide whether the line could be held against, for example the exemption of the profits of new small businesses up to, say, £5000 p.a. for the first couple of years for which they are trading which has been suggested in Budget representations.

Present tax treatment of income from letting rooms

5. Present tax treatment falls into two broad categories. If substantial services are provided for the tenant, for example meals and laundry, the income may be taxed as trading income. That means that it is treated as earned income, and - where the services are provided by a married woman - wife's earned income allowance will be available to set against it. In addition, the other advantages of trading treatment - e.g. tax payable in two instalments, rollover and retirement relief for CGT - are available. In all other cases (i.e. where no services are provided or where they are not provided on a scale which amounts to trading) rental income is treated as

investment income, and none of the reliefs associated with trading are available. There are slightly different rules about allowable expenses for furnished letting on the one hand and unfurnished letting on the other, but the differences are not significant (and in any event, as discussed later in this paper, there is a case for excluding unfurnished letting from the scope of the new relief altogether).

6. Finally, as Ministers will recall, there are special rules for furnished holiday lettings (defined by reference to availability for short letting periods at particular times of the year). These rules apply to small seaside owner-occupied boarding houses just as to larger-scale operations and self-catering accommodation. The rules are that income from letting which satisfies the qualifying conditions gets all the reliefs available to trading income, regardless of the level of services provided.

Possible schemes of relief

7. Given the objectives of the relief and the two overriding considerations, it seems to us that a closely targetted scheme of relief might be on the following lines -

(Basic) Option A

- Income received by owner-occupiers from letting up to (3) furnished rooms in their owner-occupied property, for periods of more than (30) days, would be exempt from tax up to a ceiling of £X per year.

Comments on Option A

Looking at the various elements of that option in more detail :-

8. Owner-occupiers Clearly the aim would be to include anyone owning and living in a house or flat. But it is arguable that the relief should go wider than that, and extend to people living in rented accommodation who are allowed by the terms of their lease to sublet. There seems to be no reason of principle to cut such people out: on the contrary, an additional room brought into the market in these circumstances is as useful as any other. Bringing them in should not complicate the relief presentationally, but there might be definitional problems which would need further consideration.

9. Limit on number of rooms. The purpose of a limit on the number of rooms would be largely presentational - given the over-riding limit on the amount of income. It would serve to underline that the relief was aimed not at the provision of more rented accommodation generally but narrowly at encouraging people to cash in on the odd spare room or so in their own houses.

10. It was presumably for this reason that the Alliance suggested a limit of 2 rooms in their Manifesto proposal. We suggest 3 not just to outdo the Alliance, but because we are aware that a number of people who act as local authority "carers" - i.e. who take in mentally or physically disabled people newly discharged from hospital and care for them during a period of rehabilitation, in return for payment from the Council - may have as many as 3 disabled "guests" at any one time. Equally, anything over 3 rooms starts to look less like releasing the odd spare room for renting and very much more like a planned business or investment activity.

11. It would need to be recognised, however, that it would in practice be virtually impossible to police such a limit, the only effective limit on the amount of relief would be the monetary one. In addition the limit would look pretty arbitrary. Why should someone who happens to have 5 spare rooms and lets them all out, and whose total

rental income is within the monetary ceiling, get relief only on the income from 3 out of the 5 rooms? It would inevitably be said that it was more sensible and realistic to let the monetary limit stand alone.

Furnished rooms only?

12. The sort of landlords at whom the scheme would be aimed seem highly unlikely to want to let rooms unfurnished. So it would seem reasonable to confine the relief to furnished lettings only. (There could be definitional problems here too however).

13. On the other hand, it could be said to be presentationally simpler if both furnished and unfurnished lettings qualified, especially if not only single rooms but also small flats in owner-occupied houses were to be within the scheme.

Rooms not flats?

14. Flats - however defined - could be excluded on the footing that while the letting of up to 3 rooms could be seen as a casual, spare time activity of the kind the Government wanted to encourage, the letting of a flat implies more of a business undertaking. (Stopping short of giving the relief where the action is akin to a business activity might help to ring fence the relief). And in any event the sort of rent which might be charged for a flat would be likely to exceed the resources of the sort of people at whom the relief would be aimed.

15. But distinguishing between flats and rooms again moves away from the Chancellor's objective of a simple scheme. And it would not be easy to justify refusing the relief to someone who lets 2 rooms to a single tenant, one a bed sitting room and the other a small kitchen (converted from a bedroom). So simplicity and common sense suggest no distinction should be made even if we

could find suitable definitions (DoE might be able to help). This would be a wider and more generous approach, but it would have implications for the level of the monetary limit, which would need to be set at a level which did not give an unjustifiable benefit to someone who bought a large Victorian house, converted it into, say, four or five self-contained flats, lived in one and let the rest at fairly substantial rents.

Letting for period of more than 30 days

16. The purpose of a restriction on these lines would be to cut out holiday (typically bed and breakfast but often half or full board) letting by owner-occupiers. It could however be a pretty difficult restriction to defend. Single people arriving in a new area and looking for work may be lucky and find it quite quickly, in which case they may want to move equally quickly nearer to their new work place. Or they may rapidly decide that they must try elsewhere. In short, people of the kind this measure would be designed to help seem to need maximum flexibility of tenure. So this sort of restriction could be seen as running counter to the overall objective of the relief.

Monetary ceiling

17. This would need careful consideration, and we should want if possible to consult the DoE before putting forward a firm proposal. The Alliance suggested £60 per week (£3120 a year), but we do not know on what basis they arrived at it. In effect an exemption level of this size would be roughly midway between the higher personal allowance and the limit on wife's earned income relief.

18. To ensure the scheme's success, it has been suggested that something more than £60 per week would be necessary. But the higher the limit the greater the

benefit to those at the margins of the scheme e.g. the (owner-occupier) landlord of self contained flats if these were included, and the greater the discrepancy in tax treatment compared with other "deserving" cases - e.g. a pensioner with an exiguous investment income from some other source - e.g. shares. So the limit which should be set depends to some extent on how widely the scheme is drawn.

19. There are also considerable regional differences in rental levels and these would make it awkward to arrive at an appropriate national figure. (To have different figures for different regions would as we see it introduce an unacceptable measure of presentational and operational complexity). Since the main shortages of rented accommodation are presumably in London and the South East, there would be an argument for setting a fairly high figure.

20. There is a final point on this. The preceding paragraphs are written on the basis that, for simplicity, the limit would apply to the gross amount of rents - i.e. taking no account of expenses. That would make for maximum simplicity, because people would then know right away what benefit they would get from the exemption. But it would then be necessary to decide whether relief for expenses should be restricted, on a proportionate basis, where some rent was chargeable because it exceeded the limit. Alternatively, the limit could apply to net rents (and could then be set a good deal lower); but that would be less presentationally attractive.

Hotels

21. Finally, we should need to ensure [again in consultation with the DoE] that we had a satisfactory way of cutting out hotels run by resident proprietors.

Would Option A be workable or realistic?

22. It seems to us that a scheme on the lines of Option A, as summarised in paragraph 7, need not be unduly complicated to describe and publicise in the sort of "kiddy speak" leaflet which it has been suggested might be produced to take in the capital gains tax rules. Whether the legislation itself could be kept reasonably short is more difficult to say at this stage. The point here is that a tightly drawn scheme needs a lot of tightly drawn definitions and without some advice from the DoE we cannot say how concisely we could define either the target group of landlords, or the target type of accommodation. And from an operational point of view the more limiting conditions built into the relief the greater the potential work burden.

23. But as we see it, the more important question is whether a closely - targetted relief like Option A could realistically be expected to survive the considerable pressures that would be brought to bear to extend it in other directions. We have touched on these pressure points in the preceding paragraphs (e.g. rooms not flats, furnished not unfurnished, letting periods, need for limit by reference to numbers of rooms). Ministers will want to assess the weight they think should be attached these various points; and there is a wide range of possible alternatives. But if, for example, the conclusion was that the relief ought to be available to people who sublet as well as to owner-occupiers, that there was no need for a restriction on the number of rooms or by reference to the duration of the letting, but that the restriction to furnished lettings should remain, then one would have a scheme which looked this this :-

Option B

Income received by individuals from letting any number of furnished rooms or flats in their homes would be exempt from tax up to a ceiling of £X per year.

Comment on Option B

24. This option has the advantage of being simpler than A. But at the same time it could be more difficult to defend in principle. First, the removal of any "length of occupation" test would mean that furnished holiday lettings provided in the landlord's home would qualify for relief, since a length of occupation test is the only way we can see of cutting them out. That would, we assume, run counter to the spirit of any relief of this kind, though it could perhaps be said that some seaside boarding house owners who house young people out of the holiday season are performing the sort of activity which the Government want to encourage.

25. Second, the removal of the limit by reference to the number of rooms, and the extension to flats, seems to make it much more difficult to present this relief as a measure aimed only at increasing the supply of single rooms by releasing for occupation the odd spare room or two in a house occupied by somebody who, if it were not for this relief, would probably have never contemplated becoming a landlord. The choice here, as in other places, is between simplicity on the one hand and the introduction of a considerable dead weight element on the other.

26. Next, if a relief is to go that far, and especially if flats are included, Ministers would be asked why it should stop at landlords who live on the premises? Thus, Ministers get annual representations from a body known as the Leeds Residential Property Association. This group of landlords provides mostly fairly short-term accommodation

(often to students and young single people) in self-contained bedsitters etc in and around Leeds, and many of these bedsitters are as we understand it in houses quite separate from the landlord's own homes. The LRPA feel themselves somewhat hard done by since the furnished holiday letting legislation was introduced, because although many of them provide considerable personal services these do not in law amount to trading, and they are therefore at a disadvantage compared with furnished holiday landlords; but they say - with some justification in our view - that they are providing a more important social service. They - and others like them - would have an even greater sense of grievance if they found they missed out on the new relief simply because none of the letting was carried out in their own homes.

27. To concede the force in that sort of argument would lead to a yet simpler version of Option A, i.e. -

Option C

Income received by any individuals from letting furnished residential rooms or flats would be exempt from tax up to a ceiling of £X per year.

Comment on Option C

28. This is obviously a very long way down the road from the limited objectives of "rent a room". But we feel it is worth mentioning, if only to illustrate the point that there is a whole spectrum of possibilities here, ranging from something as limited and restrictive as Option A to a much broader based exemption taking in a big slice of the furnished residential property market.

Exchequer cost of the options

29. Existing landlords would clearly benefit from any new relief; and we estimate that the cost of Option A could be in the region of £m10 a year with a limit of £60 a week, and barely more with a limit of £120 a week. The extra costs of the various relaxations which would apply for Options B and C would be difficult to establish. But it may be some help, as indicating something of the sort of range we have in mind, to say that the cost of a relief for all income from furnished residential letting (i.e. including the letting of whole houses, and therefore going wider even than Option C) would be £m60 with a £60 a week limit and £m80 with a £120 a week limit.

Staff costs of the options

30. We think it unlikely that there would be any net staff cost with any of these schemes, though clearly the more restrictions which applied to a scheme the greater the possibility that there might be some cost.

Conclusions

31. If Ministers are attracted to any of the possible schemes discussed in this paper, we will set in hand more detailed work immediately - consulting DoE officials, if that is acceptable, as soon as we are authorised to do so.

32. Our advice is that this would be a potentially dangerous road to go down at all unless Ministers can feel really certain that the limits of whatever scheme they favour can be sensibly defended. We for our part have serious doubts; and we share the view expressed in Mr Cassell's note on his group's report that special reliefs of this kind do not fit at all easily with the broad thrust of the Chancellor's tax reform policies.

d

But we hope we could produce a workable and reasonably straight forward scheme on the lines of whichever option set out above - or variant of one of these options - Ministers favour, if they feel that something of this kind is an essential ingredient in the Government's new housing policy.

MJE.

M J G ELLIOTT

Conqueror

3975/11

CONFIDENTIAL

FROM: P J CROPPER
DATE: 11 December 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Mr Culpin
Mr Instone
Miss Sinclair
Miss Hay
Mr Tyrie
Mr Call
Mr Painter IR
Mr McGivern IR
Mr Elliott IR

TAX TREATMENT OF PRIVATE RENTED ACCOMMODATION

I participated in the Financial Secretary's meetings on this earlier in the week, and was given full opportunity to speak. My perception was somewhat different from others in the group, so it may be worth setting down a few comments.

2. I found the study group report on which we based our discussions rather unsatisfactory. Maybe its terms of reference were not right. Its assumptions of the likely levels of supply and demand for rented accommodation over the next 10-15 years seemed to me to be quite spurious - ending up with a ludicrously low figure of 300-400,000 in the early 1990s. I believe there is a vastly bigger potential market for private rented accommodation.

3. The point is - obviously - what assumptions one makes. The Department of Environment report seems to be starting from the lower end of the scale, looking at people who cannot afford to buy property and are not adequately catered for by the State under present arrangements. I believe one should be looking much more widely, for example at:-

(i) people who can perfectly easily afford to buy property, but for whom it would make more sense, both personally and economically, to rent.

(ii) people who are at present housed in the public rented sector but who would be better off in the private rented sector. But not necessarily going all the way to owner-occupation.

4. There may be several million households in these categories. One is reminded that Switzerland, normally thought of as an economically sophisticated country, has an owner-occupation rate of only 35%. What is it the Swiss know that we don't? [low inflation!]

5. I do, of course, realise that it has been one of our prime political objectives to get the owner-occupation rate up to 70 per cent - and quite right too, if one sees it as the best and only way of getting people out of local authority ghettos. But time moves on: it is now possible, without being laughed out of court, to think <u>politically</u> and <u>legally</u> about the revival of private renting.

6. There are two reasons why it is still proving so difficult to make a reality of the private rented sector:

1. The fact that the dice is heavily loaded in favour of ownership by mortgage tax relief. This is the problem addressed by the Department of Environment paper.

2. The fact that security of tenure and landlords' rights are still delicate issues. An investor could not by any means build into his calculations, even now, an assumption that he would be left free to manage a newly built block of flats, on a continuously commercial basis, for the next fifty years.

7. Because the political element in (2) is still an obstacle, I take the view that we need to look at the upper and middle ends of the market, not the lower end, as our starting point. Much as I feel for the unhappy people caught in the King's Cross boarding house trap, I do not think there is much hope of bringing a decent private rented sector to their rescue. They are the victims of the anti-landlord vendetta of the last eighty years, and they will remain its victims for some time yet. Where we should be straining every sinew to get the thing going is in that sector of the market in which those with 1930s hang-ups are not interested. For example, the housing of single young graduates coming to London for the first time, and of ambitious young professionals working for ICI or Marks & Spencers or Barclays Bank, who expect to be moved five times in their first fifteen years. They are the people who ought not to be constantly buying and selling: they are the people who would comply with a contract they had signed, agreeing to vacate on 31 December, without threatening to get the rent officer round.

8. If I am right in this, then the question of how to recreate a market takes on a slightly different complexion. Curtailment of mortgage interest relief is still the obvious first step. But failing that, I do not think that government cash grants are the next best step: nobody could justify pouring public money into the construction of rented property for yuppies to live in. So perhaps it does come back to tax relief: perhaps there is no alternative. Perhaps we have simply got to devise a new tax relief, with the specific purpose of encouraging the building of property to rent.

Capital Allowances

9. The Inland Revenue resists the application of 4 per cent writing down allowances to residential property on the grounds that:-

(i) such property normally accrues value (in real terms) rather than losing it, over time.

(ii) it would be impossible to prevent a costly knock-on effect on the rest of commercial property.

10. Although I understand these objections, I do not find them conclusive. We are faced with a major problem; it is a widely understood problem; surely it would be possible to explain that we were introducing writing down allowances for residential property in order to deal with that problem. Full stop. I would go further, and consider writing down allowances at five, six, seven per cent, if I thought they would do the trick. Anything that would enhance the return sufficiently to mobilise the investors. And I would, incidentally, restrict them to new property and substantially new conversions. How about writing down allowances applicable only to the first 20 or 25 years of the existence of a given property - running off at the end of that period?

11. Are there any other possibilities along these lines? The Department of Environment paper rejects the reintroduction of 100 per cent first year capital allowances for rentable residential property. Can we afford to reject them? Call them something else maybe - the Rented Property Allowance. This would have the advantage of bringing much of the tax relief up front, without going the whole hog and doing a BES.

12. The recent working party was invited to consider whether "there were any possible modest tax measures that could give a boost to the private rented sector following deregulation and that would be good value for money". The answer was more or less "No". Let us therefore move on and ask ourselves whether there are any immodest ones. The prize is great. The supply side frictions arising from the imperfections of our present property market are incalculable.

P J CROPPER

TASK FORCE SECRET

Copy No 1 Of 4

FROM: A G TYRIE
DATE: 11 DECEMBER 1987

CHANCELLOR

cc Financial Secretary

A FRINGE BENEFITS TAX

I sat on the fence at the last meeting because you put significant reductions in the CT rate into play. I have now pondered further.

There is clearly a price (in lower corporation tax rates) at which we can buy out most of the opposition, both in Standing committee and from industry, to an FBT. The prize we would be obtaining, as you put it at the meeting on 10 December, was that the reform would give us a better tax system and simplification for employees and the Revenue.

Like almost everyone else at the meeting, I would prefer to see benefits cashed out. But I doubt that we can achieve it. At 50% (you don't want to go higher than this) an incentive at the top end would remain, car scales might be impossible to jack up for a year or two, tax wheezes might be found to evade the new tax.

But let us assume that we really did succeed in expunging benefits. I still think it's touch and go whether the FBT would be worth doing:

i. We have blown benefits in kind up to be a major problem. In fact the Revenue estimate that the problem probably consists of around £830 million (net of CT relief on employers' NICs) of uncollected tax, of which just under £500 million is accounted for by inadequate car scales. Do we really need to rewrite the tax system to deal with this?

ii. I think it's a red herring to suggest that we have to act because of an impending problem created by the

removal of the UEL. The incentive will increase. But benefits were already growing before 1985 when there was no incentive (neutrality above the UEL). The main growth of uncollected tax has been in cars (there are over 40% more company cars since 1983-4) and that's hardly surprising. That's where the big incentive is, not 10% or 20% but 70% plus of the value goes untaxed.

iii. I think Peter Cropper is right when he suggests that conceptually we should tax individuals on their total remuneration package, not the businesses that pay them. But I don't think that's a deciding factor.

iv. Whatever the real compliance burden (and I can't believe it would be small) the introduction of this new tax would be perceived as a burden and the opposition to it would make the task of getting a good presentation to this budget package that much more difficult.

All this leads me back to where I started, use nutcrackers to crack a nut, and jack up car scales.

I think the car scale/kink loser overlap is overrated as an obstacle to doing something on cars this year. Assuming we do 24 pence on the basic rate (!) I think we could certainly push through an increase in the car scales for those who use their car little (say, less than 5,000 miles) or not at all for business purposes. There should be no extra compliance burden because employers are already expected to keep this information for claims on fuel scales. It would, I suspect, substantially reduce the uncollected tax on benefits in kind at a stroke.

I think this would be justifiable. We would simply say that those people who are supplied a company car exclusively (or almost exclusively) for personal use will be treated by the tax system as if they were receiving income. We would get complaints but I think we could wear them. The howls of protest would be far more difficult to face down if they came from people who really do use and need their car for business

purposes and for whom the use of the car for personal purposes is in the true sense of the term a benefit 'at the fringe'.

So I would drop the EBT for this year. Action on car scales would not prevent its introduction at the beginning of the next Parliament if non-car benefits burgeoned in the years ahead.

pp A G TYRIE

NOTE OF MTG
14 DEC

MR 2/30

SECRET

NOTE OF A MEETING HELD IN THE
CHANCELLOR'S ROOM HM TREASURY
AT 11.30 AM ON MONDAY 14 DECEMBER

Present:

Chancellor
Chief Secretary
Financial Secretary
Economic Secretary
Sir P Middleton
Mr Byatt
Mr Cassell
Miss Sinclair
Mr Instone
Ms Hay
Mr Cropper
Mr Tyrie
Mr Call

Mr McGivern - IR
Mr Elliott - IR

TAX TREATMENT OF PRIVATE RENTED ACCOMMODATION

Papers: Mr Cropper's minute of 11 December to the Chancellor; Financial Secretary's minute of 9 December to the Chancellor; PS/Chancellor's minute of 23 November to PS/Financial Secretary; Mr Cassell's note of 19 November to the Chancellor, and enclosed report.

2. The Chancellor was most grateful to Mr Cassell for chairing the Inter-departmental Group, and for producing such a lucid report. He noted that the Financial Secretary had held a meeting on the report, and had concluded that targetted grants were preferable to tax concessions as a means of encouraging the development of the private rented sector. His own preliminary view was that there was a case for taking some action. But he was extremely reluctant to follow the grant route, since it was

uncertain where this might lead. His own preference was for the tax route.

3. Continuing, the Chancellor noted that the true objection to writing down allowances lay in their cost. Writing down allowances were the logical solution, should the tax route be followed. But if they were introduced, would it be possible to hold the line and not extend them to commercial property?

4. Mr McGivern estimated that in the shorter term the cost of extending writing down allowances to commercial property might be in the £100 million range. He would look further at this. But he saw a more substantive objection to this proposal, in that extending this relief to dwelling houses would provide a tax incentive for investing in an asset which would be likely to appreciate in real terms over the first 25 years or so.

5. Mr McGivern said that one way of holding the line would be to make the allowance available only for new buildings or "substantial reconstructions". But the owner might dispose of his property rather than continuing to rent it out. The Chancellor noted that this risk existed under the present system. Confining the relief would reduce overall and deadweight costs, and relieve pressure for further extensions. It might, on the other hand, be attacked on grounds of unfairness.

6. In further discussion, the following points were noted;

(i) if a writing down allowance were pursued, thought would need to be given to its schedule. A straight line allowance seemed the most appropriate method;

(ii) attaching a writing down allowance to "new lets" would cause difficulties because of the need to determine historic cost;

(iii) a writing down allowance would replace the existing allowance linked to the assured tenancy scheme.

7. The Chief Secretary said that the tax route was preferable to the public expenditure route. Few of the tax options in the paper were attractive, but writing down allowances were defensible. The Economic Secretary noted that any proposal would, to be fully effective, need to offset the central bias in the housing market, ie the absence of taxation under schedule A.

8. Mr Cassell said that if a writing down allowance were introduced it would only half close the yield gap. Mr Ridley would be likely, therefore, to press for sideways relief also to be introduced. This would go too far. If the tax route were pursued, therefore, he would prefer to make use of the BES.

9. Mr Tyrie noted that exemption (up to a fixed ceiling) of rental income from letting a room in one's own home was one option. This seemed the right psychological gesture to make to encourage a change in sentiment towards the idea of letting property. If it were thought desirable to go further, the BES seemed sensible: BES concessions could always be removed at a subsequent stage. The Economic Secretary suggested that a "half BES" might be appropriate. It could be more attractive than a 4 per cent writing down allowance, because of the front loading of tax relief. The Chancellor noted that the shortage of accommodation would be at its worst in about 5 years. A "front loaded" relief, such as BES, had advantages in dealing with this.

10. Summing up, the Chancellor concluded that though a writing down allowance seemed best in logic, it would be unlikely to suffice and would also lead to pressure for extension to commercial property. It should therefore be ruled out. There might be some attractions in a (suitably circumscribed) extension of the BES. The exemption for rental income shall also be examined further. He invited Mr McGivern to take these options forward, consulting with FP, LG and Mr Byatt as appropriate. This further work should consider both a full BES, and a half BES, as suggested by the Economic Secretary. Limits on BES relief should also be explored. Mr McGivern undertook to provide advice by the end of the year. The Chancellor would discuss the possibilities with Mr Ridley early

in the New Year. If a package along these lines were included in the Budget, the Revenue would need to prepare suitable publicity.

J M G TAYLOR

14 December 1987

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Mr Scholar
Mr Culpin
Mr Painter - IR
PS/IR

TASK FORCE SECRET

Copy 3 of 4

FROM: J M G TAYLOR
DATE: 24 December 1987

MR TYRIE

cc PS/Financial Secretary

A FRINGE BENEFITS TAX

The Chancellor has seen and noted your minute of 11 December.

J M G TAYLOR