UNMANSIONABLE

THE CASE FOR AN EFFECTIVE REFORM OF BRITAIN'S UPSIDE DOWN PROPERTY TAXES

London First

CONTENTS

EXECUTIVE SUMMARY

London is the one of the most successful cities in the world, with more high skilled workers and more European headquarters than any other city. A range of factors contribute to this attractiveness as a business destination, but one of the most crucial is taxation.

London First advocates an internationally competitive tax system across all areas, but we are particularly concerned about recent calls for a so called ‘Mansion Tax’ on our most expensive properties.

This paper argues that the proposed “Mansion Tax” is ill-conceived and unnecessarily damages London’s competitiveness.

We propose instead that a competitive property tax system should include:

1. **updating the valuation of residential properties from 1991, together with**
2. **the introduction of new high end Council Tax bands**
3. **any net increase in taxes in the London retained by London to reinvest in growth in the capital**
4. **a progressive application of Stamp Duty tax, rather than a flat rate levy.**

Residential property taxes in the UK principally comprise of:

- a transaction tax on purchases, in the form of Stamp Duty, which is high compared to our international competitors (7.1% compared to 1.4% in New York, on a property worth £2 million); and
- an annual recurrent Council Tax on ownership, which is comparatively lower (0.1% compared to 9.3% in New York on the same property).

So, while, in tax terms, it is relatively cheap to own a property in London, it is conversely expensive to buy one – a tax structure that is the wrong way around to encourage fluidity and flexibility in the market.

In addition, there are flaws in the way both taxes work. Stamp Duty is applied in such a way that an increase in just £1 in sale value can give rise to a substantial change in tax payable – for example, depending on which side of £500,000 the value falls the tax payable can change by £5,000[1].

However, the current debate around property tax reform focuses mainly on the recurring charges paid by occupiers. Property valuations on which Council Tax is levied are outdated, having been set when the tax was introduced in 1991. Furthermore, the highest Council Tax band currently applies at only £320,001. Even if this were updated for house price inflation, many would argue that the system would still fail to tax the highest value properties fairly.

1 Stamp Duty on a £500,000 property is currently 3%, or £15,000. At £500,001, the property falls into a 4% tax bracket and would be subject to Stamp Duty of £20,000.

This perceived sense of unfairness around the Council Tax has led to calls for a so-called Mansion Tax: both the Liberal Democrats and Labour parties have called for an annual property tax on homes worth over £2 million[2].

We believe that this tax is ill-conceived and harms London's competitiveness in three key areas:

1. **A Mansion Tax would fall mainly on London**; 71% of homes in the UK worth more than £2million are in the capital

2. **A Mansion Tax would not tackle existing problems in a proportionate way**, instead signalling that it is, in fact, a 'wealth tax'. This would in turn damage London's attractiveness as a global talent hub

3. **Any additional tax raised by the proposed Mansion Tax would go to national government**, rather than supporting London government in investing to support the city's growth.

In this report, London First proposes that a more productive solution to residential property tax reform would include:

1. **A full revaluation of properties** so that the taxes set by councils reflect today's market. It is important to note this may not result in any more tax being collected, but it would redistribute the current Council Tax collection amount more fairly between homes within each council area

2. In parallel with revaluation, **the introduction of new bands at the very top of the structure** to reintroduce proportionality

3. **Any net increase in taxes in London should be retained by London**. The 2013 London Finance Commission recommended the devolution of property taxes to the Mayor in return for a pound for pound reduction in government grants. In an attempt to introduce equality, this would seem reasonable

4. **As a first step in reforming Stamp Duty, we would advocate progressive application of the tax, rather than a flat rate levy**. Such a proposal is already under consultation in Scotland.

2 The precise form of the tax is still under consideration, but the Liberal Democrats proposed 1% of a property's value above £2m in the run up to the 2010 General Election

ENGLISH RESIDENTIAL PROPERTY TAX

There are two principal types of residential property tax in England: transaction tax paid by the purchaser and charged as a proportion of the property value (Stamp Duty); and recurring service charges paid by owner-occupiers and occupiers under lease (Council Tax).

Residential property can also be subject to death duties and an annual charge under the Annual Tax on Enveloped Dwellings provisions where the property is owned through a company structure. Homes which are not the principal residence of the owner are subject to Capital Gains Tax on disposal. (Note that this paper does not address the tax position of investors where tax applies to income and gains).

Stamp Duty

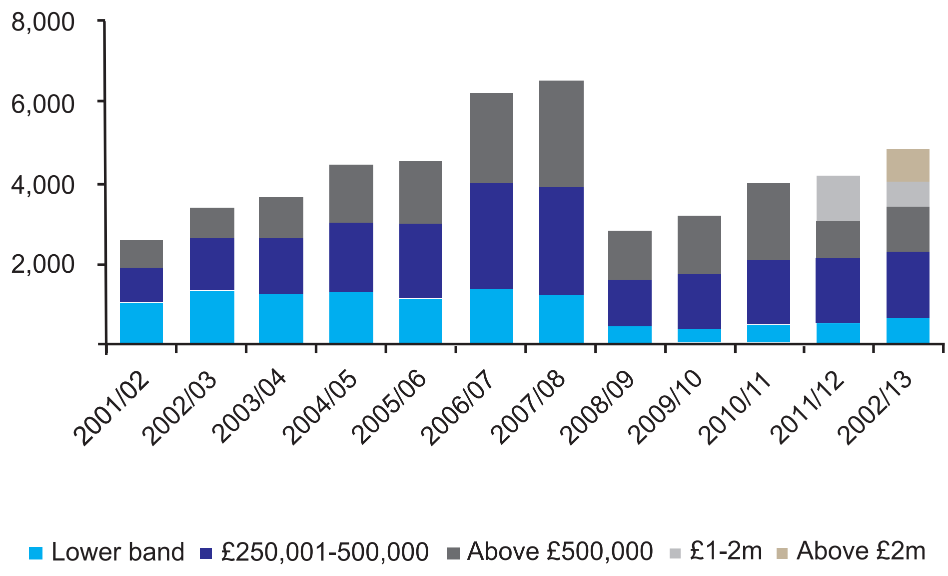
Stamp Duty Land Tax (SDLT) is paid on land transactions of houses, flats and other land or buildings above a certain price threshold.

The revenue raised from Stamp Duty has grown steadily due to the incremental introduction of new rate bands and an increase in both the number of property transactions and house prices, as illustrated in Chart 1[3].

The current rates of Stamp Duty are [4]:

Up to £125,000	0 %
Over £125,000 and under £250,000	1 %
Over £250,000 and under £500,000	3 %
Over £500,000 and under £1,000,000	4 %
Over £1,000,000 and under £2,000,000	5%
Over £2,000,000 `	7% (and 15 %[5])

Chart 1: Yield from residential Stamp Duty, £m
Source: HMRC



SDLT works on a "slab" basis, so the rate paid applies to the whole purchase price. (The 15 % rate applies to certain owners who hold their interest via company structures).

3 Institute for Fiscal Studies, Tax Without Design: Recent Developments in UK Tax Policy, May 2014
4 HMRC, Stamp Duty Land Tax rates and thresholds
5 Purchased by certain persons including corporate bodies. From April 2013, a new annual tax on enveloped dwellings was levied on company owned homes worth over £2 million. There are four bands, with the top band (for properties valued at more than £20 million) paying £140,000 per annum. Also capital gains tax is now chargeable on the disposal of high-value UK residential property applying to companies registered both in the UK and abroad

Council Tax

Council Tax is charged annually on each dwelling in England related to the estimated value of the property as at April 1991.

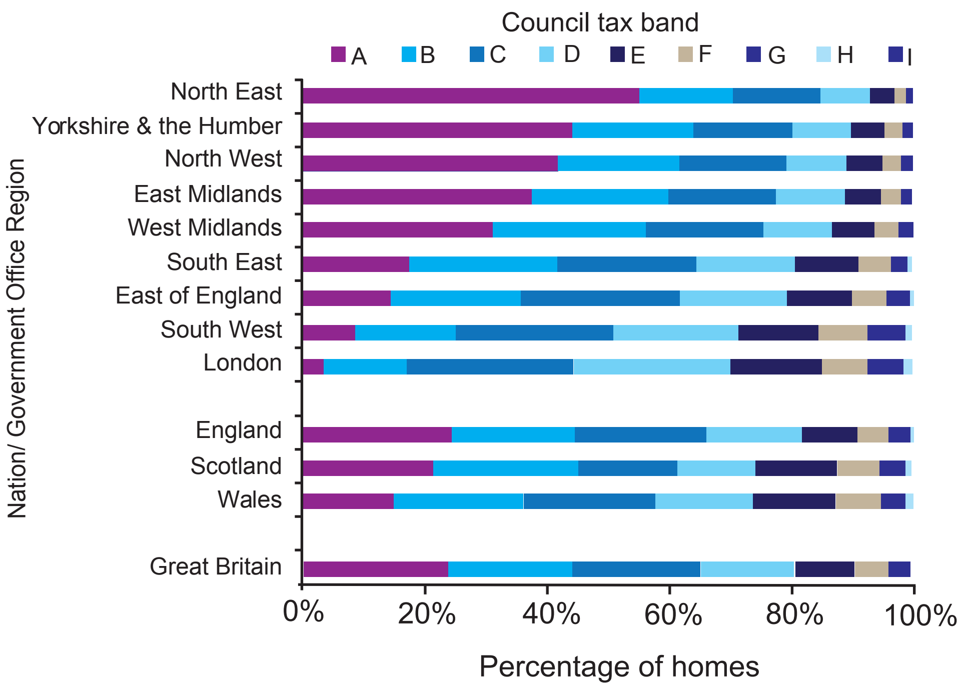
Each property falls into one of eight bands as set out in the table below. Band D is the notional average; properties worth less than D pay a fraction of the Council Tax and properties worth more pay a multiple. Thus a band H property pays three times the band A level.

Band	Value of property on April 1 1991 (£ 000s)	% of band D charge
A	Under 40	67%
B	40 - 52	78%
C	52 - 68	89%
D	68 - 88	100%
E	88- 120	122%
F	120 - 160	144%
G	160 - 320	167%
H	320+	200%

Although each local authority sets its own Council Tax rate, there is very little room for manoeuvre as the average rate is based on: the number of dwellings and their banded value (Council Tax base); the other income it expects to receive - principally the grant from central government; its share of nationally set business rates; and other fees and charges.

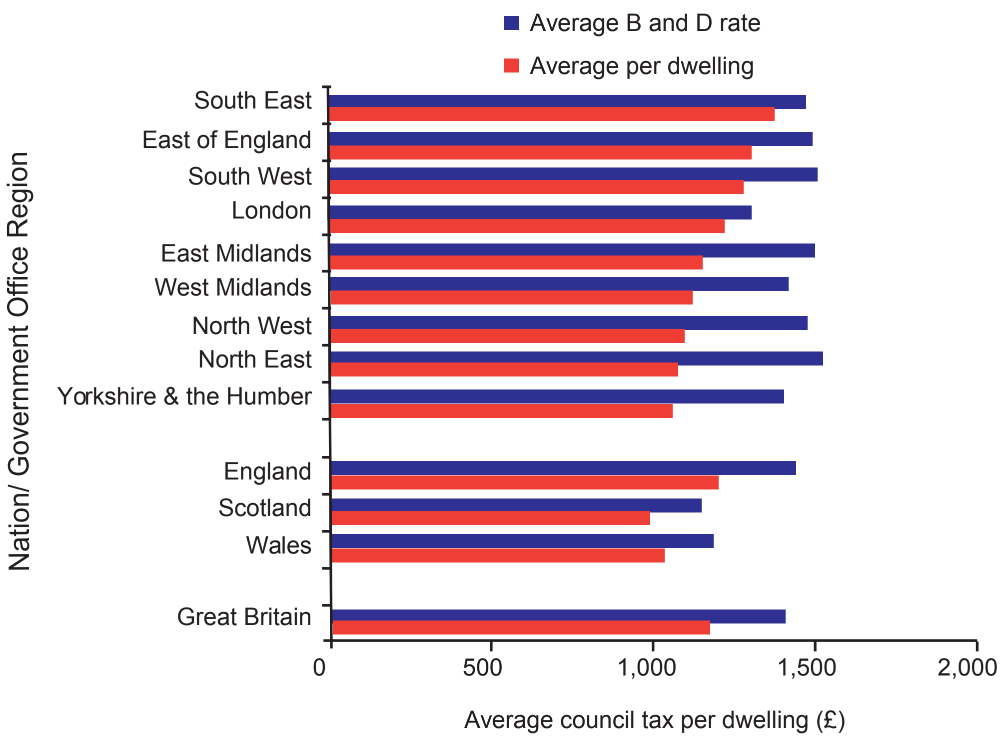
The Council Tax base is the number of Band D homes in the local authority area. To calculate the tax base the number of Band D homes in each Council Tax band is reduced to take account of discounts and exemptions (for example for single person households). An adjustment is made for the collection rate and a variety of precepts are added – principally, in London, the Mayor of London's precept.

Chart 2. Distribution of Properties across Council Tax Bands



But the distribution and density of different types of properties across the Council Tax bands varies considerably; as shown in Chart 2, just 4% of properties in London fall into the lowest Band A, compared with 56% in the North East. The characteristics of the local housing stock, the dependency of the local authority on government funding and the efficiency with which services are delivered all interact to create different average Council Tax charges in different parts of the country. As a consequence, charges across the UK vary considerably: the North East has the highest average band D (£1,525), while London has the lowest (£1,304)[6].

Chart 3: Average Council Tax 2013-13



The total tax take

Most countries impose some form of recurrent tax on the value of residential property, but in comparison to the Council Tax, high value properties in other countries incur significantly higher bills[7]. But while Council Tax payments from high value properties are relatively modest, transaction costs in the form of SDLT in the UK are high by international standards.

UK property tax accounts for 4.1% of GDP, which is the highest in the Organisation for Economic Co-operation and Development, with the burden of Stamp Duty and inheritance tax falling disproportionately on wealthier households. In 2011-12, sales of homes of over £1 million represented less than 2% of UK housing transactions, but generated 26% of all Stamp Duty receipts, while the top 0.7% of housing stock held at death contributed 36% of inheritance tax receipts from residential property[8].

Thus the fairness of UK domestic property taxation is much more complex than simply focusing on Council Tax contribution. But recurring monthly charges are the most visible of property taxes and therefore Council Tax reform is at the centre of the property tax reform debate.

6 Institute for Fiscal Studies, Reforming Council Tax Benefit, 2012
7 In Singapore and Hong Kong, these are set on the annual rateable value of the property (as opposed to the property's total value). Notably, Singapore's rate will be rising significantly, on a progressive scale, in 2014, and again in 2015. In Shanghai, annual taxes only apply on investment property, set between 0.4% and 0.6% of the property's market value.
8 'Taxing mansions: the taxation of high value residential property', Lucian Cook, Centre for Policy Studies, March 2012

COUNCIL TAX – FAIRNESS DEBATE

There are 3 principal criticisms of the fairness of Council Tax.

First, the way in which the Council Tax is calculated on a council by council basis creates some counter-intuitive results. This is a function of the multiple variables – such as the local property mix, council spending levels and receipts from other sources. As noted above, the North East has a higher band D charge, on average, than London.

Second, the assessed value for Council Tax has become increasingly out of date as no-revaluation has taken place since the tax was introduced in 1991. As property values have risen; the relationship between the value, as assessed for Council Tax charges, and real (or market) value of the property has become increasingly disconnected.

Third, the 1:3 ratio between the lowest to the highest value home is too low. Within any council area, the most expensive house only pays three times as much Council Tax as the cheapest.

The first criticism – essentially that charges vary by local council – is a function of having locally set taxes. It can be mitigated by changing other factors (for example around government grants) but is inevitable in a system of property taxation which is locally driven.

The second criticism - that market values are disconnected from Council Tax charging levels – is clearly valid. The longer inequities are allowed to build up, the more likely a revaluation will result in large swings in the distribution of the tax burden[10].

The failure to revalue the previous residential property system, the domestic rates, in the 1980s created pent-up pressures and led to the government deciding to introduce a more radical reform in the form of the Community Charge (or Poll Tax) in 1990. The unpopularity of the Poll Tax, along with low collection rates, led to its replacement in 1992 with the Council Tax.

Such significant shifts undermine the stability and certainty of the tax system, and therefore external competitiveness. Reform should not result in a shock to the system or a large swing in the distribution of the tax burden from one group to another.

The third criticism – that the ratio between homes is too low – is linked in part to the second; house prices have risen significantly but the bands have remained fixed. Determining what the right ratio should be is a redistributive question. However there is a reasonable argument that there should be higher value bands to take account of the growth in the number of very high value properties.

10 The Political Economy of Property Tax Reform, OECD Working Papers on Fiscal Federalism No. 18, OECD 2014

OPTIONS FOR REFORM

There are strong arguments for modernising UK property tax in order to tackle the issues outlined above.

It would clearly be good public policy to carry-out a full revaluation and uprate bands in line with average house price inflation.

Those in properties that have risen relatively within a given local authority might move up through the bands, while those that have risen more slowly relative to the average – or even fallen in value - would drop down. The implications for individual dwellings would be modest – rising or falling a band or two would only affect the fractional multiple that the household pays, while if every house moves in unison no one would pay more or less.

However, there would be considerable uncertainty over the winners and losers and those who fear they would lose out are likely to oppose a revaluation more vigorously than those who hope to benefit. And the very complexities of how the rate setting system works mean that considerable uncertainty would cloud the whole process. To smooth these effects and secure public acceptance changes could be phased; and the longer the reform is delayed, the greater the need for phasing is likely to be[11].

The case for higher charges on high value properties is more complex. As noted above, their owners already pay more in property tax once Stamp Duty and inheritance tax are taken into account.

A number of ways of increasing tax on higher value properties have been suggested:

Mansion Tax

At the 2010 General Election the Liberal Democrats proposed a Mansion Tax based on a levy of 1% on all properties valued over £2 million. A property valued at £2.1 million would pay £1,000 per annum (1% of 100,000), while one valued at £21 million would pay £190,000 (1% of £19 million). There would be exemptions for the asset rich but income poor, allowing them to roll-up the liability and pay it on death or sale of the property.

The coalition government has ruled out such a policy, while the Labour Party has recently given its broad support. Both the Liberal Democrats and Labour propose that central, rather than local, government retain the tax revenue, with Labour stating that the revenues raised would be used to fund a 10p tax band.

Estimates of the yield from such a tax vary depending on the precise formulate proposed; and are hampered by a lack of accurate data (in the absence of a valuation register of homes, assumptions need to be made about the number of homes that would be affected).

From the perspective of London business, such a tax raises several problems.

First, it would in effect be a tax on London. While there are no accurate statistics for the number of residential properties whose values exceed £2 million, if Stamp Duty

11 The Political Economy of Property Tax Reform, OECD Working Papers on Fiscal Federalism No. 18, OECD 2014

receipts reflect the wider housing stock, then 71% of all homes worth more than £2 million are in London[12].

While some of these homes will indeed meet the stereotype of a mansion, many will be ordinary – but expensive - family homes. Some will belong to owners fortunate enough to have seen rising value over decades. But others will belong to heavily mortgaged families seeking to live close to work. So an unintended consequence of such a tax would be to deter the type of talented individuals London wants to attract to live and work in the city, by adding to the already high costs of housing.

Second, Stamp Duty does not set an encouraging precedent. Until 1997 Stamp Duty was paid at 1% on properties sold in excess of £60,000; which at the time exceeded the average house price. Gradually new rates and bands have been introduced to the extent that the rate now ranges from 1% to 7% (with higher rates for homes purchased using some corporate structures).

With average house prices in London already heading towards half a million pounds, large numbers of people could fall into the Mansion Tax bracket either by price inflation, or as a result of deliberate government policy to extend the thresholds.

Finally, the messaging matters. A Mansion Tax would look to many like a tax on wealth, which would send an unhelpful message about London's international competitiveness.

Reforming the Upper Council Tax Bands

There is an argument that, even revalued, Council Tax bands are too closely bunched; and, as such, the Council Tax should be made more progressive through the introduction of new higher Council Tax bands.

As noted above, such arguments need to be seen in the context of the total tax collected from high value property once Stamp Duty and inheritance tax are taken into account.

However if new bands were proportionate with the existing bands, and firmly rooted within its structure rather than a new tax altogether, then such a reform could simultaneously tackle the fairness issues around the level of tax paid by high value property without creating the perceptions of a wealth tax raised by a Mansion Tax.

Ideally, such new bands would be introduced as part of a full revaluation exercise. Alternatively properties in the top, or top two, bands (G and H) could be revalued and put into new bands, with possibly a higher charge for properties worth more than £2 million, £5 million and £10 million.

Provided that the new multiples were proportionate to the current band D this would raise more revenue and reduce the sense of unfairness associated with the current system, without causing new inequities (current Council Tax rebates would apply to discounts for single people and those on low incomes) or resulting in a shocks to the property market and international competitiveness.

12 Taxing Mansions: The Taxation of High Value Residential Property, Pointmaker. Centre for Policy Studies, 2011

NEXT STEPS

In government, the Liberal Democrats have recently argued for the introduction of new top rate Council Tax bands starting at £2 million, as opposed to their earlier Mansion Tax proposal[13]. Labour has also now stated its support for a higher rate band system over a standalone tax.

Such an approach – providing it was proportionate to the existing Council Tax framework – would avoid many of the pit-falls associated with a Mansion Tax. But while locally administered, the revenue will accrue centrally, and so it would remain effectively a tax on London.

One way to mitigate this would be to allow the boroughs authority over all matters relating revaluation, banding and discounts, while retaining the income. But this would not address the variance of average Council Tax rates across the boroughs; in fact it may detrimentally affect inter-borough inequities.

To work as a settlement for London, this would need to be part of a wider a reform debate as addressed by the Mayor's London Finance Commission's 2013 report Raising The Capital. The report concluded that in order to provide the infrastructure and associated investments necessary to support population and economic growth, Council Tax along with other property taxes, should be devolved to the London government[14].

To remain fiscally neutral, there would be a parallel cut in government grant in the first year of such a devolved settlement. London would receive no additional money but would benefit from the certainty around revenue flows and from future growth.

The cut in grant in year one could include an element of the revenue that central government would expect to raise from the new Council Tax bands. Central government would thus be better off, while London would benefit from devolution.

13 Lib Dems scrap mansion tax plans in favour of new Council Tax bands for homes worth over £2m, Independent 9 April 2014
14 Raising the capital: the report of the London Finance Commission, May 2013

Contact us:

London First,
3 Whitcomb Street,
London,
WC2H 7HA

T +44 (0)20 7665 1500

E inquiry@londonfirst.co.uk

londonfirst.co.uk

London First