Memorandum

4 March 2010

To: Mike Nutsford
Olivia Williams

From: Geoff Leggett

Comment on Paul Dyer's paper on effective tax rates and interest deductibility

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You have asked for comment on Paul Dyer's paper recommending that consideration be given to limiting interest deductions. This memo provides our initial high-level comments. Further detailed comments can be provided if needed.

The issues associated with limiting interest deductions are in many respects the same as those relevant to ring-fencing.

The proposal aims to address the fundamental problem that the investor is, generally, only being taxed on part of the economic return they are getting from the property. More specifically, the taxpayer is currently able to claim full deductions for expenditures incurred in respect of the rental property investment, while only being taxed on the rental income and not the capital gain.

The best way to address this problem is by fully taxing the return and the Tax Working Group considered various ways of achieving this, such as an RFRM and a capital gains tax. Given that these options have been ruled out, less direct options that focus on investors' deductions are now being considered.

Limiting interest deductions will not achieve the objective effectively as capital gains arise irrespective of whether or not investment is highly leveraged. The current tax treatment is, in fact, relatively neutral between debt-financed investment and equity-financed investment[1]. Limiting interest deductions is likely to result merely in a switch in the composition of investors, with high tax rate investors with adequate equity likely to replace those low equity investors driven out of the market by the interest deduction limitation. As a result, high-equity investors may invest less in other assets, so that limiting deductions may lead to not only a reduction in national borrowing but also a reduction in both housing and non-housing assets.

[1] Mr Dyer's paper focuses on effective marginal tax rates and how these differ with the level of gearing. However, there can be very different amounts of taxes paid for lightly-geared and heavily-geared investments in rental property without this affecting the incentives to invest.

Even though removing depreciation on property would also focus on deductions, a key difference is that it would apply equally to all property investors irrespective of their level of gearing.

Limiting interest deductions is likely to further distort investment behaviour. In addition to the distortions created between investing through debt and investing through equity, limiting interest deductions could distort decisions about the types of assets to invest in, depending on whether it applied just to rental housing investment or to all property investments, including those associated with businesses such as farming and industry. We assume that interest deductions on funds borrowed to finance other investments, which are also capable of making capital gains, would not be limited.

Conversely, a wider application, while possibly less distortionary, could impede entrepreneurship if small businesses considered that it would reduce their capacity to borrow against their property assets to fund business start-ups.

As is the case with any tax measure that reduces the tax benefits of an investment, limiting interest deductions is likely to put some (modest) upward pressure on rents and, at least initially, downwards pressure on house prices.

As noted in our comments on loss ring-fencing, there are a number of design issues regarding practicality, which would equally apply if interest deductions were limited. It may be difficult, for example, to prevent taxpayers structuring around any interest deduction limitations due to the fungibility of money and the difficulty in tracing and matching borrowing to particular investments. As mentioned above, many small businesses are funded through loans against property owned by the business owner. Likewise, there are boundary issues, such as how to treat mixed use properties. A form of interest limitation, along with ring-fencing, applied between 1982 and 1990 and there was concern at that time that those rules constituted an arbitrary and incomplete way of taxing capital gains, and that they could be circumvented by larger and more sophisticated taxpayers.

There are transitional issues around how to deal with existing properties. The cash flow implications could be, depending on the level of gearing, more significant than with loss ring-fencing. A highly geared investor may move from a position of a sizeable tax loss on their rental investment property to a position of having to pay tax on that investment, creating cash flow problems. (This is illustrated in the table in paragraph 18 of Mr Dyer's paper.) We note that the Prime Minister in his 9 February statement to Parliament ruled out RFRM, one of the other potential options, because it would create cash flow problems for taxpayers.

We have not attempted to cost this interest limitation option.