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Justification For A Residential Property Tax

All taxes are onerous, though in different ways. It is important, therefore that any tax has a clear justification in principle to guard against the imposition of arbitrary and unfair levies.

The principles underlying a good tax system are that it be fair, efficient and simple.

A major defect in equity of the present tax system is that imputed rent from owner occupied residential property is exempt from income tax. In principle, this rent forms part of the household's income and should not be ignored for tax purposes. A property tax can remedy this defect.

Moreover, the present tax treatment of residential property favours owner occupation over other forms of housing tenure. This departure from efficiency or neutrality is likely to have contributed to the housing bubble, which has led to our current economic difficulty. The Nyberg Report states "tax reliefs relating to property distorted resource allocation and undoubtedly contributed to overheating in the property market" (Nyberg Report para 4.5.4).

This issue was analysed by the Commission on Taxation (See First Report (1982) paras 10.3 to 10.28 and 4th Report (1985) Chapters 5 and 6).

The Commission concluded that there were two possible methods of achieving equal tax treatment between those who rent houses, those who occupy the houses they own outright and those who occupy the houses they own subject to a mortgage. (See Appendix 1).

"The first method would charge owner occupiers to income tax on the imputed rental income of their house while allowing a deduction for mortgage interest. No deduction would be allowed for rent paid.

The second method would disregard imputed rent and allow a deduction for mortgage interest and payments of rent as well.

The first method is neutral between those who hold their assets in the form of housing or in other forms. The second favours investment in housing but is neutral as between owners and renters" (Fourth Report Para 5.7).

The Commission recommended either a local or national property tax designed as follows.

- Valuations should be self-assessed but based on open market capital values classified into broad bands.
- There should be unrestricted allowance for mortgage interest
- Property tax should be allowed as a credit against income tax liability where income from the property is liable to income tax.
- Payment should be made in instalments and a waiver scheme should be available for those on low incomes operated through the social welfare system.

Growth Friendly Taxes

In addition to the equity considerations noted above, weight should also be given to the OECD conclusion that property taxes, and particularly recurrent taxes on immovable property, seem to be the most growth-friendly, followed by consumption taxes and then by personal income taxes. ("Do Tax Structures Affect Aggregate Economic Growth ? Empirical Evidence from a Panel of OECD Countries", Jens Arnold, OECD Economics Department Working Papers No 643, October, 2008)

Basis of Assessment

The basis of assessment for a property tax includes the following options; site value, market value or floor area.

- **Site Value**: The Commission on Taxation (2009) noted the potential benefits of a site value tax, namely that by taxing the value of the site, land was likely to be used more efficiently, and this would also have dividends in terms of more efficient use of infrastructure. However, the Commission also noted the likely difficulties in arriving at values that were evidence based, understandable and acceptable by the general public, and the wider difficulty in achieving a step change in how property is assessed and taxed. Despite a site value tax having these advantages as a resource tax, the Commission recommended against it; in particular their view that it would be very difficult to gain public acceptance for this basis is persuasive (See P 158).

- **Floor Area** has the advantage that it is generally easy to ascertain although many people may not know their current floor area. Unless there was an adjustment factor large rural houses would pay a higher tax than smaller well located and more valuable dwellings in urban areas and this would militate against public acceptability. Any adjustment factor would in the final analysis involve matters of judgement which could be perceived to be arbitrary.

- **Market Value.** The Commission on Taxation (2009) recommended that property tax be on self-assessed market value using 8 valuation bands (P165). It considered using floor area in addition to market value but concluded that this would add undue complexity to a tax which should be as simple as possible to allow taxpayers to calculate their tax.

The Commission's approach is recommended.

Mortgage Debt

Mortgage interest relief for income tax purposes is being phased out and will not apply for tax years 2018 and following.

Based on the analysis of the Commission on Taxation (1982) noted above, the correct treatment in principle is to allow relief for mortgage debt assuming that there is no allowance for mortgage interest in the income tax code.

This would also deal with the following problems

- Mortgages in distress
- Negative equity cases
- Payments of substantial stamp duties in recent years by certain purchasers.

In the event of this treatment not being recommended by the Group, it will inevitably require ad hoc measures to deal with these difficulties.

Administration of the Tax

The options are that the tax be administered by local authorities, a central agency or the Revenue Commissioners.

Despite the fact that any new property tax could be regarded as a replacement for domestic rates which were abolished in the late 1970's, and which were once the main source of revenue for local authorities, the Group's terms of reference appear to rule out the local authority option. This seems appropriate in so far as the collection level for non-domestic water charges by local authorities averaged 52% in 2010 (PwC Report) and indicates a dismal performance in this area.

The second option is a central method such as the NPPR.ie used for the second home charge. There is no indication of the level of compliance with this charge and the level of enforcement action to deal with non-compliance. Before this option could be recommended evidence would need to be available that this method was the most effective. It would also have to be borne in mind that the task of collecting a tax on second homes is less daunting than that of collecting a broadly-based tax on all dwellings.

The third option is that the tax should be administered by the Revenue Commissioners which was recommended by the Commission on Taxation 2009 (para 4.11). This seems the best approach in that the Revenue Commissioners already have the most robust audit function in the State and already have strong enforcement and penalty provisions for non-compliance. Using the Revenue Systems also provides the most user friendly payment systems.

Payment of Tax

A major criticism of the old rating system was that rates were generally payable in two relatively large installments.

The Commission on Taxation (2009) recommended (Para 4.18) that a range of payment options be provided including the use of the PAYE (by restricting tax credits) and ROS systems.

OECD Reports indicate that deduction of tax at source and information reporting help achieve very high compliance rates [1].

The evidence supports the approach recommended by the Commission on Taxation (2009).

Other Issues

Rental Property

Since the income from rented property is liable to income tax the correct treatment in principle would be to exempt rental property from the new tax. This assumes full compliance with existing tax law.

At present, 75 per cent of interest on money borrowed to buy or improve a rental property is allowed as a deduction against the rental income.

An alternative approach to the taxation of rental property would be to

- Abolish mortgage interest on rental property as a deduction through the income tax system.
- Allow mortgage debt as a deduction against the market value of the property.
- Allow property tax paid as a credit against income tax on rental income.

Second Home Charge and Household Charge

To maintain the second home and household charges in addition to the new property tax would constitute a clear case of double taxation. If it is desired to have a progressive rate structure the most equitable course is to levy the rate on the combined value of all residential property owned by the same individual.

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[1] Governments have evolved a number of instruments to ensure a high degree of compliance is achieved n relation to income-related taxes. The key instruments are: 1) *withholding of tax at source obligations* of payers; and 2) *systematic reporting* to revenue bodies by payers *of income paid to payees*, hereafter referred to as information reporting obligations'. In practice, these instruments are deployed almost universally for employment and/or investment income. Research findings from a number of countries indicate that, subject to effective administration, these instruments result in very high levels of voluntary compliance in practice, often well over 95%. http://www.oecd.org/dataoecd/45/43/48449751.pdf

Rate of Tax

The Commission on Taxation (2009) illustrated the charge per property on the basis of a tax rate of 0.25% on the midpoint of their proposed valuation bands. This gave rise to a charge of €938 on a house in the valuation range € 300,001 to €450,000.

The question arises what is an appropriate level of charge. To achieve neutrality between housing and other forms of investment the tax charge should be related to the amount of income tax that would be paid on the rental yield from the property. For example, assuming a rental yield of 6 per cent the tax due at a rate of 30 per cent would amount to €675 on a house worth €375,000 assuming there was no mortgage.

It is suggested that the Group should provide some guidance on the method of arriving at an appropriate level of charge and that the charge should not be based on a predetermined target revenue yield with the rate of tax determined on an arbitrary basis to achieve that target.

Local Tax

The Group's terms of reference require it to provide a stable funding base for the local authority sector in the medium and longer terms incorporating an appropriate element of local authority responsibility subject to any national parameters.

The defining characteristic of a local tax is that the local authority can vary the rate to provide a greater or lesser level of public services as they think fit. Unless this flexibility is provided the new property tax will be a national tax and the revenue may be assigned to local authorities on some basis.

There seems to be little advantage in assigning the revenue from a national property tax to local authorities. The overall spending needs of local government would be better determined on an objective basis and the appropriate level of transfers paid from central funds to achieve this taking into account the needs and resources of different local authorities.

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Appendix 1

Extract from First Report of Commission on Taxation July, 1982 on the Tax Traetment of Housing.

Owner-occupied Housing

10.9 Owner-occupied houses are not subject to any tax on their annual value although they are, as it were, houses which the owner as private landlord rents out to himself as tenant. Consider three people, each with £40,000 to invest and wishing to live in a £40,000 house. We assume that the return on all capital is 5 per cent. R decides to rent and invest his money in shares. As shown in Table 13, he receives £2,000 in dividends. Assuming a rate of tax of 35 per cent, he pays tax of £700. O decides to buy his house outright and pays £40,000 in cash. He buys no shares and receives no dividend income but benefits from imputed rent of £2,000. Since this is not counted as taxable income, he pays no tax. M buys a £40,000 residence by taking out a mortgage, while using the £40,000 to buy shares. He receives

TABLE 13

Comparisons of Tax Treatment of Renter, Equity Owner and Mortgage Owner of House

	Renter R	Equity Owner O	Mortgage Owner M
	£	£	£
1. Owner's imputed rent	0	2,000	2,000
2. Interest paid	0	0	2,000
3. Dividends	2,000	0	2,000
4. Taxable under present law at 35 per cent	2,000	0	0
5. Tax under present law	700	0	0
6. Tax under Scheme 1	700	0	700
7. Tax under Scheme 2	700	700	700
8. Tax under Scheme 3	0	0	0

£2,000 in interest. Since mortgage interest may be deducted in computing taxable income he has no addition to his taxable income. We compare the three in line 5 of Table 13. They all have the same net worth and live in similar houses, but R pays £700 in tax, while O and M pay no tax. The problem is to determine how the three can be placed in an equal position. Removal of the interest deduction (Scheme 1) would not do. While M would lose his advantage and be placed in the same position as R, O would remain free of tax. In order to treat all alike, imputed rent would have to be charged to tax while a deduction for interest would continue to be allowed (Scheme 2). Alternatively, imputed rent could be disregarded and a deduction given for interest and for payments of rent as well (Scheme 3). Under Scheme 2, all would pay the same tax while under Scheme 3 none would pay tax. Both solutions would be neutral as between the various types of housing tenure. However, Scheme 3 would favour expenditure on housing while Scheme 2 would be neutral between expenditure on housing and other expenditure. Scheme 2 clearly offers the best solution. In principle, equal treatment should apply not only to people who use different forms of housing but also between those who choose to spend a high proportion of their income on housing and others who prefer to consume different items.