Politics trumps economics

JULY 2015

It is two months since my last post during which time very little happened, until last week.

The post election euphoria had failed to translate in to the buying bonanza so keenly predicted by the sales agents. In fact it was the majority of sellers who responded to the surprise election result with elation only to be heavily disappointed by the stubborn refusal of the market to respond in kind. May, June, July are traditionally the optimum selling months but this year they have been very subdued.

The election effectively acted as a huge traffic calmer and the closer to May 7th the more pronounced the slow down became. With the looming uncertainty many buyers had deferred their decisions by 3-6 months as they waited to see what higher property taxes, most notably in the form of the feared 'mansion tax', were likely as part of the election outcome. The response to the surprise Conservative majority was one of relief (more on that shortly) as opposed to an immediate unlocking of pent up demand. The drop off in momentum appeared to prompt buyers to stand back and realise that in many cases prices were unsupportable and London residential might not necessarily offer a one way ticket to profit.

The timing of this rational reassessment has coincided with a material number of completions of many luxury new build schemes, most of which had been sold off plan over the previous 2-3 years. During the past couple of years I have highlighted what I believe to be a high degree of hype surrounding the Vauxhall/Nine Elms/Battersea regeneration as being a case study of speculation potentially on par with the Docklands debacle 25 years ago. An article in last week's FT focused on the growing number of 'nervous investors' looking to flip uncompleted units but failed to also mention the huge number of now completed units which are already being reoffered for sale or rent.

We have therefore seen a clear shift during the course of this Spring as a result of a marked slow down in transactions and the start of a realisation that the luxury new build sector *(NB luxury being a distinct segment characterised by properties at values of approx £1,400psf +)* , most notably in periphery locations to accepted prime central London, is potentially a huge speculative bubble. However this is far from being a market where everyone is affected similarly. As a case in point, at two extremes, in May the penthouse at One Kensington Gardens, a new build scheme opposite Kensington Palace, achieved £6,200psf and four flats have sold in the infamous One Hyde Park in excess of £5,000psf just in the past 8 weeks. Meanwhile, most noticeably, last weekend 208 of 230 flats in a more mainstream development in Canary Wharf (with sizes averaging around 550sq ft for a 1 bed unit and 750 sq ft for a 2 bed a unit) were reported to have sold out off plan in 4 hours @ at just over £1,000psf.

Against this backdrop, we then had the summer budget last week.

Radical but basically fair

The following were the key relevant announcements in George Osborne's first Conservative budget for 19 years;

- Non domicile status to be removed by 2017 for those resident more than 15 out of previous 20 years.
- Buy to let relief on mortgage interest to be reduced over 4 years to basic 20% relief allowable
- Inheritance tax nil rate band increased over course of next 4 years up to max £1m for a couple leaving a family home to direct descendants.
- Corporation tax, currently 20% to reduce to 18% by 2020 (down to 19% in 2017)

Making amendments to an already over complex tax system is nothing new sadly , but the past three years have seen a radical overhaul of taxation on residential property. To put where we are today in some context, a simple summary of the past 5 years could read as follows;

- Global financial crisis is followed by massive Government intervention to stimulate growth through QE
- Falls in house prices across the UK are stemmed with transaction levels falling to an all time low.
- Construction of new homes, already running below minimum requirements, drops by two thirds.
- Access to borrowing rates at an historical low available to the wealthy leads to sharp asset inflation, most notably high end property.
- Construction of luxury high end property in central London takes off (24,000 units planned in Nine Elms/Vauxhall/Battersea alone).
- Nationwide property ownership drops to an all time low and average age of first time buyers an all time high. Sharp growth of lifetime renters.
- Penalty taxes introduced for buying through corporate vehicles for own use. 15% Stamp Duty and Annual property tax (ATED) based on property value
- Removal of Capital Gains exemptions for non resident individuals and companies.
- Restructuring of Stamp Duty. For high value properties this effectively has gone from 5%, then to 7% to 12%. For properties under £937,000 this has reduced.
- Gradual removal of full interest relief on buy-to-let loans and removal of Non Dom status for life.
- Raising of Inheritance tax threshold to £1m for properties passed on to children.

As unwelcome as these changes are to those who prefer unfettered free markets and benign taxation, few can stand up and argue that the majority of these new measures are not fair at the end of the day. The scale of foreign investment these past few years has served to highlight a tax system that had for decades been heavily biased to non residents. The contrast in ease of available funding to the 'top 1%' against the challenges facing 'normal' buyers in the mainstream mortgage market also revealed an unhealthy imbalance.

George Osborne's changes to taxation on residential property are intended to address the inherent unfairness or as he puts it, shifting the balance from Landlords to Home owners (for Landlords read 'non resident home owners' as well). In contrast to Labour's blanket tax on the 'rich' through its proposed mansion tax, this Tory Government has singled out a fairer approach by raising taxes on income and gains.

Buy to Let remodelled

As clients of ours will know, when assessing a buy to let investment we would look past the market gross yield and drill down to the net income. We followed a basic principle that a geared investment (typically at 60% LTV) showing a positive cash flow was a performing investment. Net income generally attracted a relatively nominal tax payment. The gradual removal of all mortgage interest relief, save a basic 20% allowable, means that achieving a positive cash flow will become an increasing challenge. To many these changes are more about principle rather than practicality. Residential, certainly at the upper end, has never been an income play and so the new rules are of less significance than one might think. For those looking to achieve neutral cash flow, the emphasis will likely shift to lower value properties as the following table shows. Readers are advised to seek proper independent tax advice and this is purely for illustration. NB the removal of full interest relief is staged over the course of the next 4 years.

ILLUSTRATION OF NET INCOME AFTER BUY TO LET INTEREST RELIEF BY 2020/21

Purchase @ £750,000		
GROSS ANNUAL INCOME	**24,700**	
Less :		
Letting & Management fees	4,446	
Service charges & Ground Rent	1,750	
Insurance & Maintenance	520	
Furniture depreciation	0	* the 10% of annual rent rule has been removed
NET INCOME	**17,984**	only actual replacement costs are deductable
Tax payable @ 20%	3,596	
Gross interest charges	13,500	**Assumes 60% LTV @ 3%
Add back basic rate tax relief on loan interest	2,700	
NET INCOME AFTER ALL DEDUCTIONS	**3,588**	
Pre July 8th	*3,588*	
OR, if already higher rate tax payer		
NET INCOME	**17,984**	
Tax payable @ 40%	7,193	
Gross interest charges	13,500	
Add back basic rate tax relief on loan interest	2,700	
NET INCOME/LOSS AFTER ALL DEDUCTIONS	**-9**	
Pre July 8th	*2,152*	
Purchase @ £2,000,000		
GROSS ANNUAL INCOME	**61,750**	
Less :		
Letting & Management fees	11,115	
Service charges & Ground Rent	4,000	
Insurance & Maintenance	1,300	
Furniture depreciation	0	* the 10% of annual rent rule has been removed

NET INCOME	**45,335**	only actual replacement costs are deductable
Tax payable @ 20% on first £32k and 40% above	11,734	
Less interest	36,000	**Assumes 60% LTV @ 3%
Add back basic rate tax relief on loan interest	7,200	
NET INCOME AFTER ALL DEDUCTIONS	**4,801**	
Pre July 8th	*7,468*	
OR, if already higher rate tax payer		
NET INCOME	**45,335**	
Tax payable @ 40%	18,134	
Gross interest charges	36,000	
Add back basic rate tax relief on loan interest	7,200	
NET INCOME/LOSS AFTER ALL DEDUCTIONS	**-1,599**	
Pre July 8th	*5,601*	
Purchase @ £5,000,000		
GROSS ANNUAL INCOME	**148,200**	
Less :		
Letting & Management fees	26,676	
Service charges & Ground Rent	10,000	
Insurance & Maintenance	3,120	
Furniture depreciation	0	* the 10% of annual rent rule has been removed
NET INCOME	**108,404**	only actual replacement costs are deductable
Tax payable @ 20% on first £32k and 40% above	52,880	
Less interest	90,000	**Assumes 60% LTV @ 3%
Add back basic rate tax relief on loan interest	18,000	
NET INCOME AFTER ALL DEDUCTIONS	**-16,396**	
Pre July 8th	*11,042*	

NB For those earning over £150k the upper end tax rises to 45%.

I cannot help but think that Osborne's tax tinkering risks further diverting investor interest towards lower value housing where taxes are lighter. In addition to issues of potential negative cash flow, Stamp Duty is more attractive with a £750k purchase costing £27,500 (3.66%) vs £2m costing £153,750 (7.68%). We had already seen this taking place as a result since March when the Stamp Duty was overhauled with larger sum investors opting for multiple lower value purchases. Far from supporting first time buyers and young professionals, the changes to Stamp Duty simply increased competition from investors. The developers of the Canary Wharf scheme, referred to earlier, reported that 50% of buyers were foreigners and one can only guess how many of the balance were likely to be domestic investors rather than mortgage challenged local end users.

In 2012 Osborne set about discouraging ownership of residential property through corporate vehicles etc. or a non natural person as it was described, on the spurious argument that buying through a company avoided Stamp Duty. His latest move on removing mortgage interest relief makes buying through a company once again attractive due to the low corporation tax (currently 20% and reducing to 18% by 2020) on income where 100% mortgage interest is a legitimate business expense. Tax will be due on dividends (this budget has also narrowed the gap between tax on dividends and tax on income), but from a cash flow point of view corporate ownership would appear to have a distinct advantage. There are certain limitations and therefore professional tax advice should be sought.

A new growth cycle for the UK

Investment in UK residential property, assuming the right locations and markets were picked, has been a golden ticket for many. Most eye catching has been the super prime markets of London which have nearly quadrupled in value over the past decade. The UK Government is not alone in looking to apply taxes to the top end and on inward investment from foreign buyers. From Stamp Duty increases to the withdrawal of tax breaks, the effect of these changes has been to check the momentum at the upper end of the market.

The UK residential market tends to be a story of three parts;

PRIME CENTRAL LONDON
Inherent long term supply constraints with growing domestic and international demand

GREATER LONDON & SOUTH EAST
Critical lack of new supply with increasing domestic demand on back of economic recovery and rising interest from overseas

BROAD UK
Pockets of under supply with domestic demand linked to wage growth (until recently absent in the economic recovery)

Outside of Prime Central London, the domestic market looks to be in the early stages of a new cyclical recovery. Until recently the missing piece in the recovery has been wage growth and the signs point to this now changing. The Greater London and South East markets have kicked in to life over the past 12 months and we expect the traditional ripple effect to take hold.

In Prime Central London the sellers no longer hold all the cards .

A combination of steep rises in Stamp Duty and uncertainty over a possible mansion tax had seen a loss of momentum in the prime markets this year. It is likely that the market will record zero growth for the year at best, coming on the back of close to double digit growth year on year over the previous 5 years. A more forensic look at transactions shows up some material differences with strong pricing support at the lower levels and meaningful price falls in the mid market with a mixed picture for the higher end with the best of the best achieving premiums and the mediocre struggling.

Transaction levels are down and supply levels are up, partly as a result of sellers having deferred until after the election . Buyers now have a greater degree of choice than we have seen for many years and with this comes more negotiating power. We are entering a phase where buyers no longer need chase a rising market and we see a period of pricing stability as the prime London market enters one of its periodic plateaus, the last being experienced in 2001 – 2004.

Over the past 4-5 years, the prime residential market has been like a boat sailing along a fast flowing river. In these past months it has had to negotiate some testing rapids and the nearer term outlook would appear to offer a rather more sedate journey.