

Research Blast

UK Real Estate Market, December 2017, Budget surprise

Chancellor delivers another tax change with potentially major implications for UK Commercial Real Estate



The proposed changes to Capital Gains Tax may have far-reaching consequences for the UK property industry

Out of the blue

With changes to first time buyer stamp duty grabbing the headlines as “Box Office Phil” actually lived up to his ironic nickname, a tax change with potentially significant implications for the UK commercial real estate market has slipped under the radar somewhat. But sifting through the details after the speech revealed plans to end the exemption from capital gains tax (CGT) for foreign buyers of UK commercial real estate, bringing it in line with the policy for residential assets which was changed in 2013.

The impetus behind the move is fairly clear – it should create a level playing field between foreign and domestic investors, and with foreign capital pouring into UK commercial real estate it would, in theory, create additional tax revenues from a politically uncontroversial source. A number of high profile transactions to Asian buyers in 2017 including purchases of the Walkie Talkie and Cheesegrater office buildings in London for a total of around GBP2.5 billion have focused media and public attention on foreign ownership of UK real estate assets. If anything given the recent negative media on tax avoidance and off-shore holdings, it is surprising that the chancellor didn't draw more attention to these reforms in his speech. But whilst there are undoubtedly political benefits to introducing such reforms as we will discuss in this paper, the structure of the UK property fund industry and dependence upon global capital to support the market may make implementation rather more complex than initially thought, which a lengthy consultation period is likely to unearth.

The brief proposals and potential implications to UK funds

A brief summary of the proposals are that from April 2019, capital gains made by non-UK residents on the sale of UK property will be subject to UK tax. This brings the policy in-line with other developed countries which impose a similar tax on foreign investors. Asset values will be rebased to April 2019 i.e. only gains from that date will be taxable it will not affect historic gains. REITs will retain their current exemptions and investors which have tax exemption such as sovereign investors, charities and pension funds will also retain their current exemptions on disposal of (indirect) interest.

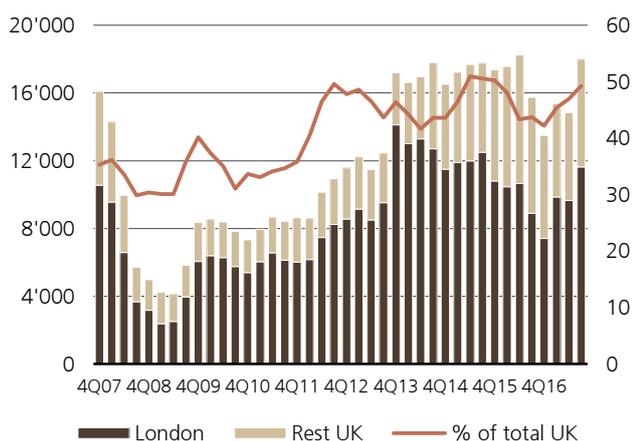
Whilst there is likely to be broad based support for the underlying principal of the reforms, there is an issue with the structure which domestic UK investors (including those which are tax exempt) invest in UK Property Funds. Many of these funds are registered offshore and operate through structures such as a Jersey Property Unit Trust (JPUT). The investors in these funds are largely domestic in origin, including the largest UK pension funds. But the changes would mean that taxable and non-taxable domestic investors could get penalized with double tax as the JPOT itself as a foreign owner of property would pay CGT at the point of any property sale, and the investors would then pay tax on any capital gains when they come to sell their units in the property trust.

We would expect that inconsistencies such as this get ironed out during the consultation period. But inevitably whilst investors and managers await to hear the outcome from the consultation period, there will be an hiatus in activity – for example, any new fund launches are likely to be delayed until there is further clarity and any assets in the pipeline to be purchased by UK funds out of offshore structures may see the deals fall through

Potential impact on foreign buyers and the market

Then there are the foreign direct buyers themselves. As figure 1 illustrates, this group of buyers have been increasingly active in the UK market and whilst activity levels from domestic UK buyers has dropped away markedly since the EU referendum, foreign capital flows have continued to support the market particularly in Central London.

Figure 1 Annual foreign buyer investment volumes
(GBP million)



Source: Propertydata November 2017

These buyers are attracted to the UK for wide-ranging reasons, not limited to the relative stability of the UK legal and political system (until recently at least), high levels of liquidity and transparency, the status of London as a global city and it's attractive features to foreigners as both a destination and investment market. While many expected that the uncertainties created by the EU referendum and potential pressure on the financial sector occupational market would subdue volumes from foreign buyers, the reverse has been true helped along by factors including an influx of Chinese capital and a pricing boost from the depreciation of sterling. Against all these factors would a change in tax legislation that brings UK policy in line with the majority of other developed economies make a huge amount of difference?

Only time will tell – we would, however, note that foreign capital is, by definition, footloose and can choose to locate elsewhere, and on a relative basis the reputation of the UK as a destination for this capital is likely to undergo some damage. Favorable tax structures are by no means the only or definitive reason behind the UK's attractiveness to foreign buyers, but it

is a factor and this is the last in a series of policy changes which can be deemed as an attack on the UK property industry and the foreign capital which targets the market. The UK market has held together well so far but we expect some negative movement particularly in Central London rents in 2018 and if sentiment was to start to take a hit we may see these changes as a particularly unhelpful additional drawback at a time when the market is still relatively fragile.

But perhaps the biggest drawback to the new proposals would be that the new tax structure would intuitively penalize value-add or opportunistic investments, which are riskier and therefore, target a much higher capital growth return than more defensive income producing assets. There is plenty of demand already for core income producing assets from both domestic and foreign buyers, but what the markets really benefit from particularly at a time of economic stress is capital coming in which can replenish, improve or create new commercial real estate and in turn jobs. But with any potential profit from such schemes being penalized, the risk-adjusted returns for foreign buyers to enter into this type of investment will be dented, which particularly outside of London, can bring significant local benefits and regeneration.

We would suggest that a sharp drop in development activity within the UK market and any implications for pricing should be far more pressing concerns than the potential revenues raised from CGT from foreign buyers capital gains. If we see a marked drop in foreign investment, particularly into value-add or opportunistic schemes, the consequences will reach much further than tax revenues in areas which will need to see investment for rejuvenation, construction jobs and all associated property related employment.

The industry has been surprised that the treasury would introduce such potentially wide sweeping changes to tax regulation without an initial consultation for this very reason. Investors will undoubtedly be hopeful that the consultation period will clarify some of the issues and lead to some clear and sensible outcomes. But the period of uncertainty in the interim places an additional strain on a commercial property market which has defied expectations in the post-referendum period, yet remains heavily dependent upon the foreign capital, particularly in Central London, which is ultimately going to be penalized by the new legislation.

Data Sources: Propertydata, MSCI, UBS Asset Management Global Real Estate Research & Strategy

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