Property Tax and Policy Update

October 2015

An ever changing landscape

Under the previous Conservative-led coalition government, property owners became used to regular changes to tax policy. Following their outright election win in May the Conservatives have continued their reforming zeal, says Liam Bailey, Knight Frank's Head of Research.

In the run up to May's General Election the highest profile policies affecting housing tended to be those promoted by the Labour and Lib Dem parties – in particular the proposed "Mansion Tax" and promised reforms to rules governing private tenancies.

When the Conservatives won the election there was a belief that this would mark an end to property tax reform.

However, Chancellor George Osborne's July budget included changes to Inheritance Tax (IHT) and the tax treatment of buy-to-let properties. All this while the market is still absorbing the impact of the reforms to Stamp Duty announced last December in Mr Osborne's 2014 Autumn Statement.

In this update we assess the recent changes announced by the Chancellor and consider their potential impact on market activity.

Taking a step back from this shorter-term view we can ask a wider question: what strategy is underpinning the changes being made to property taxation? There appear to be three broad areas of focus.

Firstly, there is the obvious aim of raising more tax revenue. The strength of the prime market, especially £1m+ sales in London, since 2009 appears to have convinced the Chancellor that

he could raise more revenue without affecting transaction volumes.

Through adjustments to Stamp Duty Land Tax (SDLT) he has sought to achieve this. Buying a £2m property in May 2010 (when the previous coalition came to power) would have cost £100,000; buying at the same value now would cost £153,750.

Unfortunately for the Chancellor there is more than a suspicion in the property industry that December's SDLT reform may have slightly overdone the rate of tax for properties worth over £1m. If correct, transactions could be held at artificially low rates as owners stay put and improve rather than move. It will be another year before sufficient data is available to test this theory in detail.

Secondly, the Chancellor has been making a clear statement that he wants residential transactions to take place between people – not companies, especially not off-shore companies. The introduction of the Annual Tax on Enveloped Properties (ATED) and related legislation confirms this drive.

Finally, there is an indication of a desire to level the playing field between different groups of residential buyers. This has been most obviously expressed by the removal of non-resident investors' exemption from Capital Gains Tax, which came into effect in April this year.

The future limitation placed on buy-to-let mortgage interest tax relief will be welcomed by first time buyers – who don't benefit from similar perks.

It may be tempting to claim that Mr Osborne is coming to the end of the road for the reform of property taxation; we suspect that it would be a brave statement to make.

Scotland

In April, a new Land and Building Transaction Tax (LBTT) replaced stamp duty in Scotland. This was the first tax to be introduced by the Scottish Parliament in 300 years.

Under the new rules, purchase costs have risen for those buying a home in the country valued at more than £333,000. Early indications suggest that transaction levels above this threshold have fallen following the introduction of the levy.

Buying a £1.5m property prior to the change would have cost £93,750; buying at the same value now would cost £138,350, a near 50% increase. There is likely to be an ongoing period of adjustment at the top-end of the market as individuals factor in the increased cost of moving.

The Scottish government originally forecast the tax would raise £235m in 2015-16. It will be telling to see what impact the introduction of LBTT has on overall revenues at the end of this tax year.

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Overview of tax changes

Reduction in tax relief on buy-to-let (BTL) mortgage interest

This policy change means that in future BTL mortgage interest will only qualify for tax relief at the lower, basic rate of income tax (20%, rather than the higher rates of 40% and 45%). This change is being introduced from 2017 and will be fully implemented by April 2020. The next election is due in May 2020.

This is a significant change in tax status for those with a rental property, although the staged introduction between 2017 and 2020 will help landlords plan their investment strategy.

Those planning a buy-to-let investment will factor the new rules into their calculations, which could lead to lower pricing.

There will be a temptation for some landlords to raise rental levels - but their ability to achieve this will be constrained by rental market affordability and competition between landlords to minimise voids.

Elsewhere in the Budget the government signalled its support for maximising the use of property by increasing the rent-a-room relief from £4,250 to £7,500 with effect from 6 April 2016.

Reform of “wear-and-tear” tax relief on BTL properties

The existing “wear-and-tear allowance”, which provided a standard 10% allowance against income on BTL properties, is to be replaced with a new relief that allows residential landlords to deduct the actual costs of replacing furnishings.

While not welcomed by landlords, this reform is unlikely to lead to a significant change in investor behaviour on its own. Added to the wider restriction on offsetting mortgage interest costs against tax, this will add pressure to some landlords with high loans.

Increase in Inheritance Tax (IHT) nil-rate band

The new reform increases the nil-rate band for IHT from £325,000 to £500,000 per person (£1m for married couples/civil partners). Any unused nil-rate band is transferable to a surviving spouse/civil partner.

There will be a tapered withdrawal of the additional nil-rate band for estates with a net value of more than £2m at a rate of £1 for every £2 over this threshold.

This expansion of the nil-rate band has the potential to drive house prices higher, although any impact is likely to be minimal.

The reality is that from 2017, a primary residence valued at up to £1m can be passed on to children tax free, and there is at least some relief on properties up to £2m. As a result, and despite the measure to protect downsizers, some older people may be persuaded to tie up more capital in their homes for longer - increasing demand for housing and reducing supply, liquidity already reduced by SDLT.

The next step for policymakers will be to focus on delivering housing suitable for downsizers – properties in the right location and with the right specifications for older residents - to encourage this step, and to increase the supply of family housing.

Non-dom reform

The Government made good on its promise to look at non-dom rules. From April 2017 anybody who has been resident in the UK for more than 15 of the past 20 tax years will be deemed to be domiciled in the UK for tax purposes. In addition, individuals who are born in the UK to parents who are domiciled here will no longer be able to claim non-domicile status whilst they are resident in the UK.

On their own, the changes to the non-dom tax rules will not have a profound impact on the prime London market, which is where most commentators expect their impact to be most keenly felt. Demand in the central London market is driven by a number of factors, and non-doms form only a part of demand.

An additional reform which will impact on this group is that from April 2017 all UK residential property held by a non-dom, whether directly or indirectly, including UK residential property held by offshore companies, offshore trust and company structures and non-UK partnerships, will be subject to UK inheritance tax. This change is likely to lead to non-doms considering the best structure in which to hold their properties.

These reforms follow a series of changes in recent years that make it increasingly difficult to argue prime residential property is under-taxed. The relatively subdued nature of the prime London market since December’s stamp duty changes highlights the risk of higher taxation on market demand and also government revenues.

Vox Pops

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Q - How will the reform to mortgage interest tax relief impact on landlords?

If you're planning on buying a property, make sure you factor interest rate rises into your calculations when you consider what is a sustainable level of borrowing.

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Q - Will the extension to IHT relief lead to more people holding family properties for longer?

The new rules will allow housing wealth to flow back down the generations. While they may encourage some couples with homes or estates to continue living in their homes for longer, the allowance for downsizers will enable many to move to a more manageable property without losing the extra tax relief.

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Q - Are you seeing more demand for valuations as people attempt to plan for the future in a more complex tax environment?

The definitive result on 7 May following the General Election has led to greater activity and demand for valuations for a number of reasons. This is evident if one compares Q1 2015 with Q1 2014. The Mortgage Market Review has affected the lending market for those seeking mortgage finance and the greater confidence post the election has led to more activity. Valuations for CGT purposes as a rebasing as at 6 April 2015 seem to be much in demand.

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Q - How are investors likely to react to the budget?

The most unsettling news for investors is likely to be the reduction in tax relief on BTL mortgage interest; this will likely impact portfolio landlords with multiple units.

Contact us:

If you have questions about changes to property taxes and policies and how they could affect you and your property assets please contact one of our experts

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