Autumn 2015

haysmacintyre
chartered accountants & tax advisers

PROPERTY BRIEFING

Letter from the Editor | Chancellor gives property a double thump | 2016: a risky year for the UK | The outlook for UK property | VAT Groups and pitfalls | London Stalling? | Look out…when objects fall off buildings

LETTER FROM THE EDITOR

Welcome to the Autumn edition of our Property newsletter which considers a range of current issues facing the property sector.

With a Budget deficit to reduce, the property sector has not escaped from further taxation in the July Budget and the Autumn Statement. Tax raids from removing wear and tear allowances, increasing SDLT on second homes and reducing tax relief on buy to let residential properties have all helped to increase the underlying tax rate on property. Headline grabbing tax rates may not have changed but the tax take from property is undoubtedly a target for the Chancellor. Our article summarises the major tax events since the May election.

In early October we held a very successful seminar on the economic outlook for the property sector. I am delighted that both of our speakers have contributed articles to this briefing. Jeremy Cook, Chief Economist at World First, looks at the macroeconomic outlook and James Thornton, Chief Executive at Mayfair Capital, considers the outlook for UK property.

With the autumn chill arriving there are signs that the heat in the London property market is also reducing, with investors finding it increasingly difficult to find attractive opportunities in London. Michael Reeves looks at the market outside of London and explains why iconic buildings are being developed in Birmingham.

Last time we reported that it was expected that entities eligible for forming a VAT group might be widened. Whilst the Court of Justice of the European Union agreed with the Advocate General's earlier opinion, HMRC have not, as yet, changed the law to comply with the ruling. Our VAT article explains what an entity might do if it wants to bring a non-body corporate into a VAT group. The article also explains a potentially costly pitfall for buy to let residential landlords.

With more than cheese gratings having fallen off the "Cheesegrater" building in Leadenhall since it was completed, it begs the question, just who is liable if buildings start to shed bits and pieces? Ian Chappell, partner at Gordon Dadds, sets out some thoughts on how property owners might be liable for accidents.

Finally, I would like to thank Jeremy Cook, James Thornton, Michael Reeves and Ian Chappell for their articles and insight.

I hope you find this newsletter interesting and, if you would like further information or to discuss any of the issues raised, please contact me or your usual haysmacintyre adviser. The team's contact details are on the final page.

We look forward to hearing from you.

Ian Daniels, Head of Property

CHANCELLOR GIVES PROPERTY A DOUBLE THUMP

In the last six months the Chancellor has had another two bites at grabbing tax revenue from the property sector. The first bite was in the July, post-election, Budget and this was followed up with another visit in last month's Autumn Statement. In particular, it seems that the small property investor has been targeted as the Government seeks to shift the property market towards the home owner.

So where, and how, has George had his hand in the biscuit tin?

JULY BUDGET

Alothough the proposal that received the most attention was the plan to restrict tax relief for individuals on finance costs for residential property, purhaps the removal of the 10% wear and tear allowance may prove to be as significant for residential landlords

However, the route by which these changes will be implemented is illustrative of the confusing ways in which tax changes are now given effect.

The restriction on tax relief for finance costs represents an "imposed" change - one that arose without any prior consultation, even if the effect is to be "phased in". Currently, individuals can deduct finance costs when calculating their annual profits on residential property letting, thereby achieving tax relief at their marginal tax rate. For additional and higher rate taxpayers, this means obtaining tax relief at their marginal rate of income tax of 45% and 40% respectively.

As from April 2017, tax relief on finance costs incurred on residential property, except those qualifying as furnished holiday lettings, will begin to be restricted to basic rate tax relief ie 20%. This measure is to be introduced on a phased basis over four years, with 25% of the total finance cost being restricted to basic rate tax relief in 2017/18, 50% in 2018/19, 75% in 2019/20 rising to a restriction of 100% of the finance cost to basic rate from 2020/21. This change was included as part of the legislation in the Finance (No 2) Act 2015.

The Budget also announced the withdrawal of the wear and tear allowance, which provided for a deduction of 10% of net rentals in arriving at the annual rental profit on furnished accommodation. The allowance is to be replaced by one reflecting the cost of replacing furnishings and other chattels. Relief will not be available for the initial acquisition of such items, only for the costs of their replacement. Where the replacement reflects some improvement then the relief is to be restricted to the cost of a direct replacement and the improvement element disallowed as a tax deductible item.

However, although announced alongside the withdrawal of relief on finance costs, this removal has been the subject of a consultation exercise over the summer. It is expected that the enabling legislation will be included as part of what, will become, Finance Act 2016 and will take effect from April 2016.

AUTUMN STATEMENT

The Autumn Statement saw another visit to the "biscuit tin" and a further increase in the tax burden on the property sector. This time the stealth tax was an additional "3% SDLT surcharge" on individuals who purchase a second property, such as buy to let properties or second homes.

The surcharge of 3% above the current SDLT rates for residential property will apply to properties with a sale price in excess of £40,000 - a limit of no practical significance! Although the earlier reform of the SDLT rates for residential properties, away from the old "slab system", was, generally, welcomed, the effect was to increase the marginal rates of SDLT. The 3% surcharge will see marginal SDLT rates of 15% applied to residential properties costing above £1.5 million. The new charge will be effective from 1 April 2016.

However, significant consultation, after the decision has been made, will now be needed in order to provide a practical basis for implementing and policing these changes. Simple questions, such as what actually constitutes a second home must now be addressed.

Significantly, the surcharge will not apply to properties acquired by corporates or "significant investments" made by Funds into residential property.

The restriction on interest relief, plus the rise in SDLT costs, may again see some property investors considering the comparative merits of incorporating their businesses. However, as ever, the wider commercial considerations should be carefully considered before taking such a step especially given the, seemingly, ever shifting sands of comparative tax advantage.

Neil Simpson, Tax Partner

2016: A RISKY YEAR FOR THE UK

The performance of the UK economy through the past 12 months has been relatively decent; nothing to panic about and yet little to make one overly optimistic for the future. Foundations were set in 2014, as unemployment began to fall, and that has continued into 2015. With a few weeks of 2015 left, we like to think that the UK economy is a 'could economy' – consumers could be more confident, investment could be more plentiful, growth could be more balanced and policy communication could be less confused, but it all could be a lot worse!

WORK HARD, PAY HARD?

The labour market revival has been the hallmark of the UK recovery but wage pressures have been slow to emerge. We know that wage growth in the UK has been poor as employment levels have recovered, since the majority of jobs that were created during that time were low-paid, zero hours contracts.

The Bank of England believes that this is starting to come to an end, however, and that the narrowing of slack in the labour market should continue this. If it does and the Bank of England begins to see wages boosting inflation, then we are in for an interesting policy discussion.

We have long called real wage increases a "silver bullet" for the UK recovery. Real wage increases come from optimistic employers happy with business conditions, they allow consumers to re-balance spending figures from credit uptake and promote growth in generalised output with a central bank more comfortable to normalise monetary policy.

MAKING A MEAL OF IT

Manufacturing is frequently the canary in the coalmine for the global economy and recently, global measures of manufacturing strength have started to decline. The UK's own PMI measure has been in a downward trend for the past two years, peaking in 2013 and sliding into relative stagnation ever since.

My focus on manufacturing should not come as a surprise; it is the first industry that sees slowing demand in a commodity driven downturn, as we are experiencing, and therefore is the first that has to reorganise contracts, employment and pricing as a reaction. The stagnation in the UK's manufacturing sector in recent months has been driven by price falls but also slowing foreign demand for products that are overly expensive courtesy of the pound.

Adding to the negatives, the UK is an economy that seems set for a fair bit of fiscal retrenchment through the upcoming parliament and - as the CBI has pointed out many times in the past few months - for an EU referendum that is the top topic in boardrooms.

HOPE FOR THE BEST, PLAN FOR THE WORST

Much like the Scottish referendum and the 2015 election, political instability is all but assured from the EU referendum, especially with doubts over Jeremy Corbyn's stance. Some analysts expect anywhere between a 3% and 12% decline in GDP in the year following a Brexit. Economists and politicians both agree that austerity was a self-imposed wound – what would a Brexit be?

With the UK's membership of the EU in doubt, our thoughts must turn to trade and we have long highlighted the UK's problematic current account as something that will hamper the UK moving forward.

The UK's own current account position – the level of our trade accounts with the rest of the world – is pretty poor. We are in a deficit of around 6.2% of GDP – the worst on record – having not been in a surplus since 1986. Why does this matter? Simply put, if a great deal of your financing and investment is coming from abroad and you import more than you export, then you are much more at the whim of foreign economic headwinds. Those could be headwinds from China, Europe, commodities or political instability.

And while a current account deficit in itself is not dangerous, currency market participants will always take it into account, especially when the proverbial hits the fan. You only have to look at the currencies benefiting from this period of market peril – the euro, Swiss franc and the Japanese yen – to see who is in a current account surplus.

As it stands, as we head through the last quarter of 2015, the UK is being insulated by the persistent low inflation and some strong wage growth. If either of those influences starts to diminish – lower wages or higher prices – then the support and insulation will start to fall away, and the headwinds that are starting to build will chill even more.

Jeremy Cook, Chief Economist and Head of Currency Strategy at World First

THE OUTLOOK FOR UK PROPERTY

THE LAST 12 MONTHS

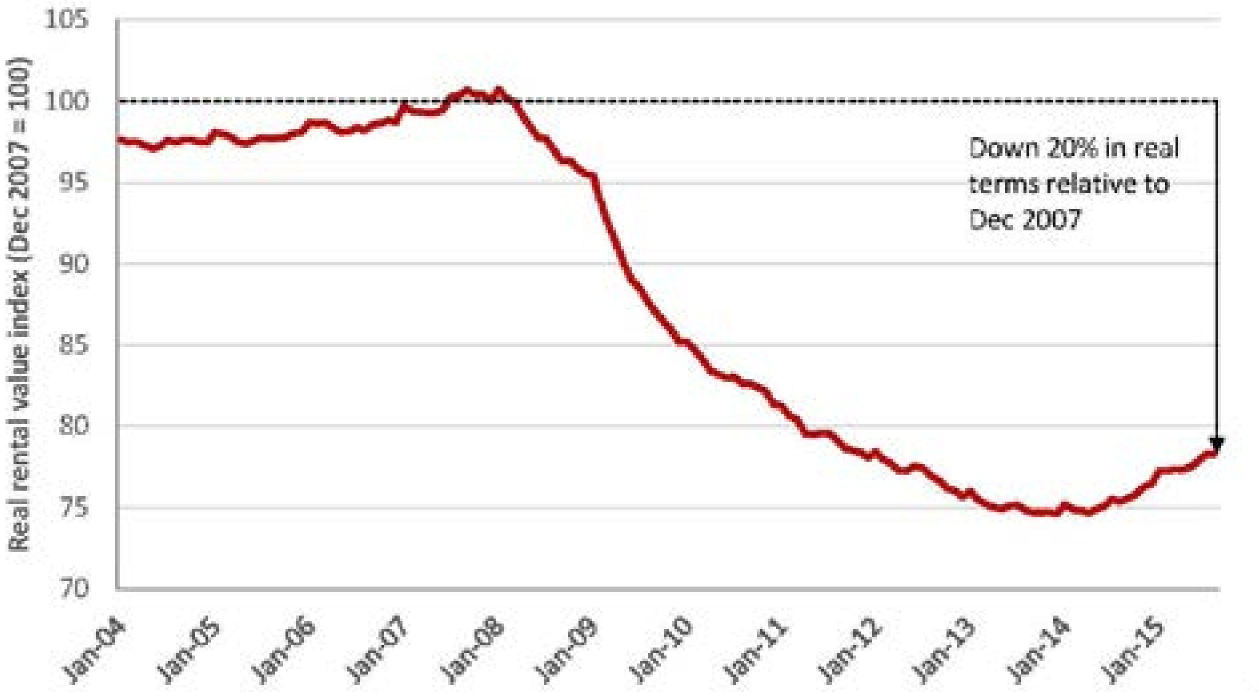
UK real estate has performed strongly over the last 12 months, primarily due to yield compression. It remains the highest-yielding asset class and, importantly, the gap between real estate yields and gilt yields and the cost of debt is still wide.

In the first eight months of this year nearly £50 billion of property was transacted in the UK which suggests the year-end figure could be the highest ever. Overseas investors, particularly from North America and Asia, and UK institutions are driving activity.

Interestingly, however, there has been significant variation in the performance of the three major sectors. The office and industrial sectors are currently far more popular than retail, where the effect of online shopping and the subsequent decline in the high street are deterring investors.

THE FUTURE

In our view growth in the next phase of the cycle will be driven by rising rental values; rents have fallen overall by 20% in real terms since December 2007. The graph below demonstrates the scope for the pick up in rents.



Source: IPD Monthly Index August 2015; Real rents calculated using CPI inflation (Office for National Statistics)

Further yield compression could be constrained by the upward movement in bond yields and Britain's possible exit from the European Union, which will influence investor sentiment.

Consequently, our strategy at Mayfair Capital is focused on identifying those sectors and locations that are best placed to capture rental increases.

We are monitoring several macro trends which are shaping our investment strategy and search for future hot spots. These trends include the growth of the creative sector, the contraction of the public sector, urbanisation, infrastructure changes and the rise of e-commerce. As such we are negative on supermarkets whilst central London offices are now looking fully priced. We are positive towards offices, retail warehousing, retail in the "big" towns, industrial, restaurants and also certain niche sectors, such as budget hotels and student housing.

OFFICES

In the office sector we have identified a greater confidence from occupiers to commit to relocation and expansion, an improving outlook in the major regional cities and a reduction in the amount of Grade B and C space, due to the number of office buildings that are being converted to residential use. We are focused on assets in urban locations that have strong or improving transport connections. Cities with a large "knowledge" economy and a low relative exposure to the public sector look most attractive.

INDUSTRIAL

In the industrial sector there is a lack of supply of Grade A space and consequently development activity is increasing. Rising land and construction costs mean that design and build schemes will need to set new rental levels, driving rental growth across the market. Demand will be supported by e-commerce companies looking for space in well-connected transport hubs or in close proximity to urban areas.

RETAIL

The retail sector however looks less promising. We see a high volume of lease expiries over the next two years, which will impact rents, and the high street market remains highly fragmented. On the plus side, retail parks are expected to benefit from the recent growth in the housing market and the expansion of "click and collect".

"ALTERNATIVES"

In the so-called "alternative" property space demographic trends support growth in the student housing and healthcare sectors. Growth in consumers' disposable incomes will benefit the leisure sector, notably restaurants, gyms, and hotels. In general, alternative property is attractive because of the proliferation of long leases with index-linked rent increases and the low volatility of returns.

THE SIX TO WATCH

Here are our six markets to watch: emerging creative sector clusters, well-connected distribution locations, smaller logistics units in urban areas, infrastructure-led regeneration (but investors also should consider which areas will see a negative impact), healthcare and the private rented sector.

CONCLUDING THOUGHTS

At the property level the market is mispricing letting risk relative to standing investments. Where previously we were targeting index-linked leases, secure income and tenant covenant strength, we are now seeking property which requires repositioning and active asset management and where there are shorter leases and the prospect of new open-market lettings.

In summary, the market is robust and prospects are good. We are forecasting a total return of between 13% and 15% in 2015. We expect total returns to slow in 2016 as yield compression eases, but the underlying fundamentals are supportive of rental growth which will drive performance.

James Thornton, Chief Executive at Mayfair Capital

VAT GROUPS AND PITFALLS

VAT GROUPS

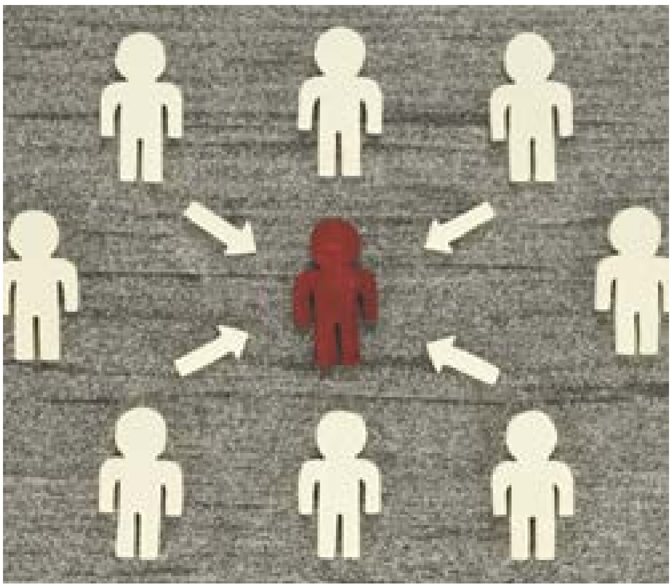
In the last newsletter, we mentioned that a recent Opinion from the Advocate General ("AG") of the Court of Justice of the European Union ("CJEU") indicated that the UK's view of who could join a VAT group was incorrect and that we awaited the CJEU judgement. The CJEU has now delivered its judgement.

The UK has always taken the view that, even though a VAT group can be controlled by an individual or a partnership, the members of the group must all be bodies corporate. The AG's Opinion said that there was nothing in the EU VAT legislation which limited VAT groups to a specific form of company or entities which had a legal personality. However, it did say that such restrictions could be imposed, but only where necessary and proportionate to prevent tax avoidance, evasion or other abusive practices.

The CJEU's decision on 16 July 2015 agreed with the AG's Opinion in that EU law did not permit the blanket exclusion of non legal persons from joining VAT groups. However, it went on to say that, it was a matter for the domestic courts to determine whether the exclusion of non legal persons was necessary and appropriate for seeking to prevent VAT avoidance or evasion.

Interestingly, the CJEU stated that the principle of "direct effect" did not apply. This principle applies when a Member State has failed to correctly implement an EU Directive and allows a taxpayer (but not HMRC) to rely on the direct effect of EU law, i.e. to ignore the incorrect domestic law.

The direct effect principle applies whenever the provisions of a Directive are unconditional and sufficiently precise. However, in this case the principles behind the formation of a VAT group are subject to the existence of close financial, economic and organisational links and the Court went on to say that the existence of such links had to be determined at the national level.



What this means is that, although UK law is defective, taxpayers cannot simply start adding non legal persons to VAT groups until such time as HMRC amends UK law. The only way to challenge this, before HMRC seeks a change in the legislation, would be to apply to include a non legal person in a group then await HMRC's refusal. Once HMRC refuse the application, leave to appeal would need to be sought to prove the existence of close links before a domestic court. This situation is far from satisfactory and is not certain of success.

So whilst the door has not been closed on extending VAT grouping, we are now dependant on HMRC finding the time to amend the legislation. We suspect that initiating this change will be low on their priority list.

PITFALLS

We are aware of possible challenges to the non VAT registered status of buy to let landlords with certain types of residential accommodation.

Whilst it is correct that buy to let residential landlords will normally be exempt from registering for VAT, there are exceptions to the exemption. One particular exemption, which can catch the unwary, is "the provision in a hotel, inn, boarding house or similar establishment of sleeping accommodation or of accommodation in rooms which are provided in conjunction with sleeping accommodation". In these situations the accommodation is standard-rated.

HMRC take the view that serviced flats, which are used or held out as being suitable for use by visitors and travellers, are "similar establishments". Therefore in establishing the VAT status of buy to lets it is important to consider how the property is actually used.

For instance, if instead of the property being let on a medium or long term lease to an individual, it is let on short term arrangements to corporates to house their employees, rather than accommodating them in hotels, such circumstances can create the "similar establishment" situation. This would make the provision of the accommodation standard-rated.

The accommodation maybe occupied almost continuously but, if by a succession of travellers or visitors, its VAT status might be changed.

Whilst there is little relevant case law it seems likely that HMRC, in these circumstances, would take the view that instead of making exempt supplies, the landlord was actually making taxable supplies and had an obligation to register for VAT. The level of "service" need not be particularly great; in one of the few cases that looked at this point, it was held that even nothing more than cleaning between hires was sufficient to make the premises "similar" for these purposes.

The two points to watch out for are: firstly, that this risk exists if you let your property to a corporate tenant, and secondly that, if you use a letting agent, it is important that both you and the agent identify the relevant VAT treatment.

Phil Salmon, VAT Partner

LONDON STALLING?

LAST TWO YEARS

As far back as early 2014, there were the beginnings of general investment undertones in commercial regional property markets that sentiment was moving away from London as yield compression started to 'bite' in the capital. The year produced unleveraged returns of close to 20% for UK Real Estate. This trend was due to a number of reasons, namely, weight of money, low inflation, low interest rates, strong GDP and general feel good factor compared to other G7 Economies. Something not taken for granted in 2013, but very apparent in the upswing of the 2014 London Market.

The growth in London in 2014 was also started by the emergence of the Capital as a 'magnet' for international accountancy, law, media, financial and tech companies, resulting in office vacancies pushed down to pre-crisis levels as supply constraints and demand fuelled increased prices.

Normally this would lead to firms relocating to London fringe and regional markets for cheaper space, but, with a highly trained skill force centrally, companies relocated to the centre to take on these skilled workers even if it meant increased occupancy levels. Developers would normally 'feed' on this demand, however they were curbed by the banks' inability to lend due to capital adequacy rates. And finally, office stock was diminished by profitability of residential as opposed to office schemes underpinned by foreign money.

Central London residential rents are also climbing, as young professionals are choosing to live in inner London rather than the previous generation move to the suburbs.

In 2015, the 'trickle' to the regions in previous years has surged as occupiers and investors are seeking better quality of life, cheaper accommodation and investors no longer want to pay yields of 2/3% for commercial investments leaving the feeding frenzy to overseas demand for the Capital's property.

The regional cities of Manchester, Bristol, Leeds and Edinburgh have enjoyed increased inward investment. Directly elected Mayors, HS2 and the "Northern Power House", all signal the Government's desire to build up the regions outside of London and the South East; as the economy grows and risk appetite increases, so will the provincial cities.

WEST MIDLANDS

If HS2 does go ahead, Birmingham would be the first stop and for some years, the only stop, on the northbound service from London cutting the current 85 minute train journey to 50 minutes.

The headquarters of the personal and business arm of HSBC bank will relocate from London to Birmingham. Antonio Simoes, of HSBC, described Birmingham as a "growing city" with the "expertise and infrastructure" to support the bank.

City planners have also given their backing to the first three phases of construction work on the £500 million Paradise development in central Birmingham. An office-led project, due to be completed in the mid-2020s, will comprise a hotel and eight separate buildings geared towards serving Birmingham's growing reputation as a key destination for corporate occupiers.

The demolition of the landmark NatWest Tower will change Birmingham's skyline forever. A new 26-storey block will be built by 2018. At 105.5 metres (346 feet) high and with the apex to stand 246 metres above sea level, the new tower will be the tallest office building under construction in the UK outside London. Work is also due to start next year on One and Two Chamberlain Square, which will together have more than 350,000 sq ft of office space.

Michael Reeves, Director at Reeves MG Limited, commercial property advisers

LOOK OUT...

When objects fall off buildings causing damage or injury, the liability faced by the property owner (and its insurer) can potentially be significant. There are, of course, many reasons why masonry or cladding, bits of steel or glazing might fall from a building and usually expert investigation will be able to show why it happened. The courts then decide (with the assistance of the parties' lawyers) who is liable for the loss and damage by establishing whether a contractual and/or other duty of care was owed, who owed it and whether there was a failure in that duty.

Consider for example the tiles of a roof on a new-build house which fall off and cause extensive damage to a neighbour's property. Who should be liable to pay damages to the neighbour in those circumstances? The owner of the house from which the roof tiles fell? The house builder? The house builder's roofing sub-contractor? The manufacturer of the tile?

Was it a maintenance issue (unlikely if a new build)? Did the builder or roofing contractor negligently install the roof? Was there a latent defect in the manufacturing process of the tiles? Did the property owner carry out his own work which either contributed to, or was the sole cause of, the failure of the roof tiles?

It is impossible in the space afforded by this article to cover all the different bases upon which claims might be made in the circumstances described above, not least because, as with so many things involving the law, the answer very much depends on the individual facts of the case.

Some examples of possible claims are as follows.

The adjoining owner who has suffered the damage may make a claim in tort against the owner of the house from where the roof tiles fell. Such claims will be founded in tort of nuisance and/or trespass.

Claims for damages for nuisance have to be reasonably foreseeable. If they are not, the court will not allow them. A claim might be made under trespass, as the tile would have unlawfully entered the neighbouring land. Damages for trespass are compensatory. A Claimant is usually only entitled to recover money in respect of the loss which has been suffered.

The Claimant might also consider a claim against the home owner in negligence if it can be shown that the home owner did something, or allowed something, to happen on his land which was negligent and which caused the roof tiles to fail. Claims in negligence might also be made against the house-builder (if it built the roof itself) or the house-builder's subcontractor (if the sub-contractor built the roof).

What is the position, however, if the cause is not obvious or ascertainable?

In some instances, the mere occurrence of an accident can indicate negligence without the need for any concrete evidence of negligence itself. This principle is known as res ipsa loquitur, meaning "the thing speaks for itself". This doctrine dates back to 1863 and the case of Byrne v Boadle in which Byrne was unfortunately hit by a flour barrel which fell from a building owned by Boadle and sustained significant injuries. In the legal proceedings that followed, Byrne did not present any specific evidence of negligence of the property owner. The court decided in Byrne's favour holding that a presumption of negligence can arise from an accident and that a Claimant need not present direct evidence of negligence when the mere manner and facts of the accident show that it could not have happened without negligence on the Defendant's part. The court ruled that there was, in this instance, a rebuttable presumption that Boadle was negligent and he had the burden of proving that he was not.

It follows that the doctrine of res ipsa loquitur cannot be relied upon when there is direct evidence of the cause of the injury and facts and circumstances surrounding it.

Claims under the Occupiers Liability Act 1957 and Defective Premises Act 1972 may provide certain claimants with possible avenues of claim for property damage and loss but not in my example above. The Occupiers Liability Act only applies to damage or injuries sustained by those invited (or in certain cases merely present) on the property from where the roof tile fell. The duty of care afforded under the Defective Premises Act is not to adjoining owners but to the person who commissioned the building and to every person who acquires an interest (whether legal or equitable) in the dwelling. The Claimant must then show that the inadequate work or inadequate materials (or both) have led to a defect (or defects) that means the dwelling is not fit for habitation.

Claims in this area are therefore often very fact specific with more than one basis of claim. Although it may be difficult to imagine a situation where a property owner in my example would not be held liable, it is very difficult to say "why" they might be liable without ascertaining all the facts of the case. Legal advice is generally essential to establish what rights exist and who owes them to whom.

Ian Chappell, Partner at Gordon Dadds

TEAM

Ian Daniels, Head of Property
T 020 7969 5502 **E** idaniels@haysmacintyre.com

David Riley, Partner
T 020 7969 5506 **E** driley@haysmacintyre.com

Katharine Arthur, Head of Tax
T 020 7969 5610 **E** karthur@haysmacintyre.com

Neil Simpson, Tax Partner
T 020 7969 5512 **E** nsimpson@haysmacintyre.com

Phil Salmon, VAT Partner
T 020 7969 5611 **E** psalmon@haysmacintyre.com

GUEST WRITERS

Jeremy Cook, Chief Economist and Head of Currency Strategy at World First
T 020 7801 9080 **E** jeremy.cook@worldfirst.com

James Thornton, Chef Executive at Mayfair Capital
T 020 7495 1929 **E** jthornton@mayfaircapital.co.uk

Michael Reeves, Director at Reeves MG Limited, commercial property advisers
T 07789 412083 **E** michael.reeves@reevesmg.com

Ian Chappell, Partner at Gordon Dadds, law and professional services firm
T 020 7493 6151 **E** ianchappell@gordondadds.com

haysmacintyre
chartered accountants & tax advisers

Should you wish to receive an electronic version of our briefing in the future, please email our Editorial team on marketing@haysmacintyre.com

haysmacintyre
26 Red Lion Square
London
WC1R 4AG

T 020 7969 5500 **F** 020 7969 5600
E marketing@haysmacintyre.com
www.haysmacintyre.com
@haysmacintyre