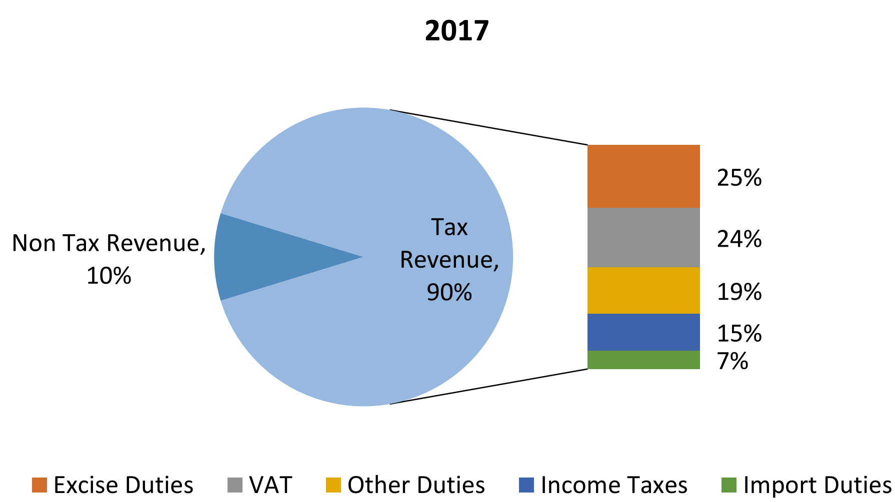
RIU REPORT: Reintroducing VAT on condominiums; what can we learn from other countries?

In the last article the Research Intelligence Unit (RIU) presented a few of the findings from its recent study which looked into the likely socio-economic impact of the VAT on apartments. As per the findings, if the policy is to be implemented, the industry stands to lose LKR14bn in next 5 years, a dip of 19% in potential sales for developers. RIU warns the policy makers that the move is 'a tread on thin ice' and the if the apartment sales depressed, the entire industry can collapse sending shockwaves throughout the economy. All of this is only to see the government revenue from the tax to be less than 1% of the annual VAT revenue. In this article we focus on few country case studies that have implemented similar policies and their repercussions. Finally, we will propose few alternatives for the government to achieve a better balance of fiscal objectives while preserving the industry.

Fiscal Position

Country's fiscal position is no doubt in a critical juncture than ever before. Closing the budget deficit is a need of the hour. Budget for 2019 is targeting a deficit of 4.8% of gross domestic product. The government revenue is expected to be increased to 15% of GDP this year. In this context it is understandable that the government may tap into all available revenue sources it can get its hands on. As evident below, 90% of the state revenue comes from taxes.



Source: RIU compilation based on CBSL

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Tax Structure

Variety of taxes are applicable at each step of the way in the value chain of the condominium market from inputs to the final product. Construction material is one of the heavily taxed commodities in the market today. Some examples are steel bars and rods (taxed at 89.66%), ceramic tiles (107.6%), and sanitarywear (72.4%) (source: Advocata). In addition to that contractors pay NBT (2%) and VAT (15%) when rendering their services. 4% Stamp Duty will also be applicable at the point of sales. Therefore, substantial tax component is already embedded in the final product, the apartment. This tax component is significant and have been driving the cost of construction up giving less space for developers to absorb more costs.

Country Case Studies

RIU conducted a case study analysis of countries who have implemented taxes on immovable properties such as apartments. By doing so we hope to learn from these experiences and propose alternatives to current proposal.

Indonesia made a huge policy blunder by revising luxury tax on apartments to 20%. JLL have previously published newspaper article showcased how this luxury tax has dampened the market. The tax caused the sales to drop over 60% post amendment.

Sri Lanka's neighboring India provides another case study. The real estate sector in India is estimated to account for about 5% of the GDP and is considered to be the second-largest employer in the country (Source: Earnst & Young, 2015). India implemented GST reforms on 1st of July 2017. Currently, the GST is levied at 12% with input tax credit (ITC) on payments made for under-construction property or ready-to-move-in apartments where completion certificate has not been issued at the time of sale. Affordable housing units are taxed at 8%. Apartments worth up to INR4.5mn, measuring 60sqm carpet area in metro cities, and 90sqm in non-metro cities, fall under the affordable residential units. The impact of this tax lead to the smaller players who have to rely on the pre-sales for cash flow to complete the project suffer loss in sales. In 2014, 6.42 lakh under construction houses on all major metropolitan cities registered while in 2018, these under construction houses inventory gone up 8.64 lakh (Source: Liases Foras). Understanding the detrimental impact of this tax, India announced that it will be bringing the rates down to 1% for affordable range and 5% for others in this April. This will give a boost to the under-construction housing segment which has not been attracting customers as such properties had become costlier as compared to finished ones.

Similar to Sri Lanka, Philippine decided to remove the 12% VAT exceptions on luxury apartments under its new tax reform policy TRAIN (Tax Reform for Acceleration and Inclusion) in 2017. At that time upcoming supply surpassed 49,000 units. But the market recovered as TRAIN involved simplifying the tax structure. Not only that Philippines enjoys lower construction cost which helps the developers to counterbalance the tax component.

A much prudent application of VAT can be found in UAE. One of the top and thriving real estate markets in the world, UAE introduced VAT in 2018. 5% VAT is only applicable for 15% of components in the total real estate sector. As per the law the first supply of residential buildings within three years of completion is subject to the 0% tax rate, which helps developers to recover the tax related to the expenses incurred on construction. Any person either renting or purchasing residential property as a "first time" tenant or "first time" purchaser will not pay VAT on the lease amount or the purchase price. Two implications; firstly, the VAT is mild (5%) compared to applicable rate in Sri Lanka (15%), secondly, the whole idea is to impose VAT without impeding the first time home ownership.

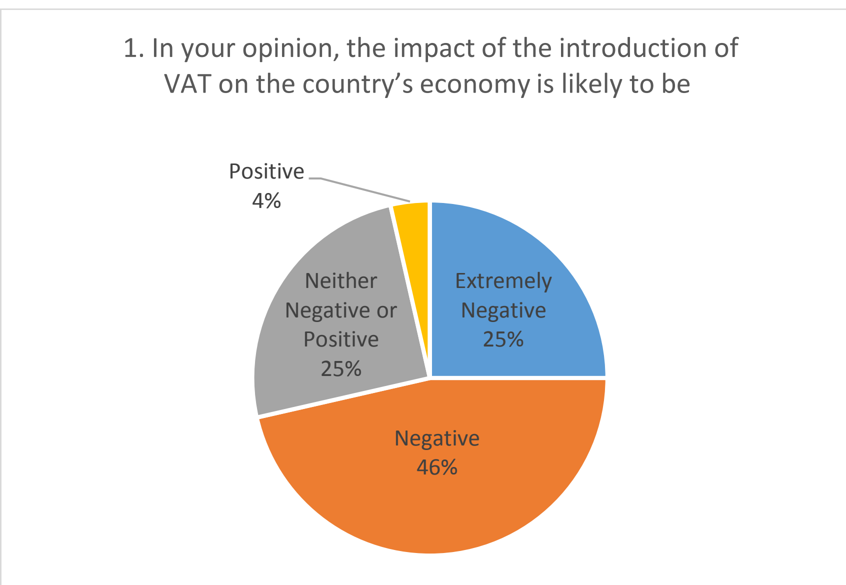
Another example of a mild VAT is Malaysia. Malaysia's government implemented a new GST scheme on 1 April 2015. The standard rate was 6% and was lowest in the Asia at the time of introducing. In Malaysia residential properties was exempted from GST but the construction material was not. Due to this reason the housing prices went up by 5 to 10% (source: Propertyguru). This caused sluggish condition in the high-end residential market. Malaysia abolished GST in September 2018. Now all residential properties including apartments are subjected to a more regressive stamp duty which varies from 1 to 4%. Malaysian real estate market recovered following that.

In Thailand, 0.5% Stamp Duty is applicable on apartments. Unlike Singapore and Hong Kong, foreign buyers aren't with taxes in Thailand. There's huge demand from foreign buyers of to purchase luxury apartments in Thailand which generates massive foreign exchange revenue to the country. 20% of the purchases are by the foreign nationals. luxury and ultra-luxury apartment supply increased by 135% increase year-on-year from 2016 to 2017 and 50% increase last year (Source: Propertyguru).

United Kingdom has adopted a different approach to residential property taxation. Properties are VAT exempted. Instead a stamp duty is charged on the value of the property. The tax structure comprises of 5 bands with maximum rate of 12%. The buyers are required to pay higher tax rates for additional properties. Having the bands helped the UK government to have a progressive taxation on properties. But the bands have created distortion owing to the fact that sellers pricing their homes just below the threshold for higher taxes. In addition, the housebuilding stocks in exchange were hit by the stamp duty.

Industry Opinion

RIU conducted a survey of developers, banks, real estate services were conducted to gather their views on the impact of VAT, and the key outcomes have been discussed below.



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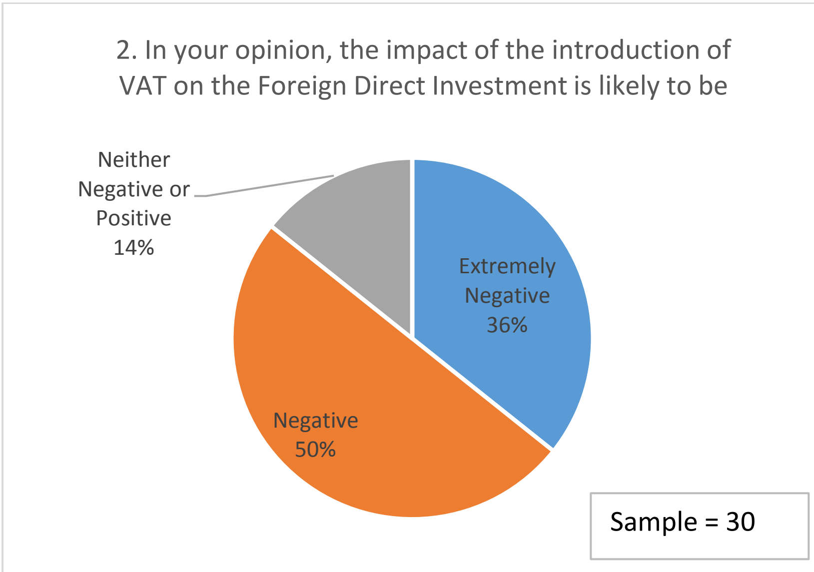

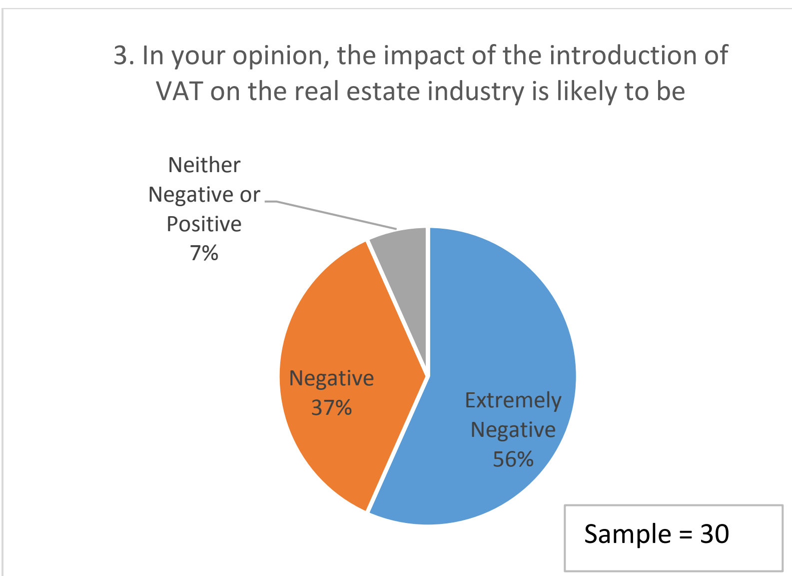

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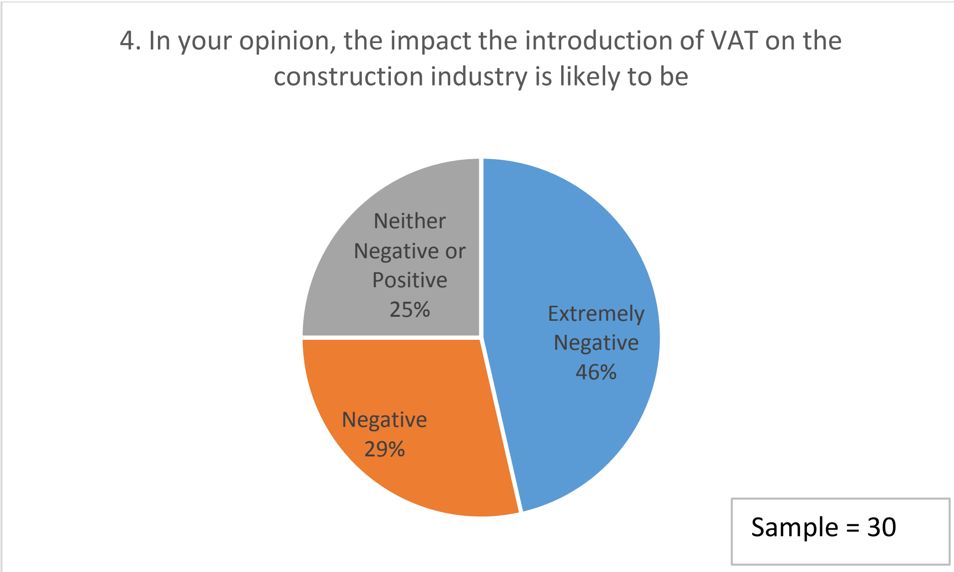

In the previous article we showed how VAT may affect sales and foreign direct investment. In line with this, overwhelming number of respondents negatively expressed their views on the impact of VAT on overall economy, FDI, real estate industry as a whole, and construction industry.

In addition to above we asked the respondents what alternatives they can suggest. There were comments to increase the threshold to except mid-range apartments and impose standard rate to premium apartments. Some spoke in favor of a mild VAT ranging from 4 to 6%. As per one comment the government should start with a lower rate and progressively increase over the years. Following are some of the notable quotes from this survey.

“The government should let the industry grow, then they can impose taxes to earn income. Imposing VAT at this juncture will kill the industry before even it begins to mature”

“If condominium market is hit, it will also affect financial institutions and there will be a cascading effect”

“I hold an extremely negative view of the impact of VAT. This will affect the FDIs, and as a developing country we need this FDIs”

Way Forward

Most in the industry including RIU is in the opinion that imposing VAT on apartments will not only affect the condominium market but the economy in terms of loss in business activity and foreign direct investment. Given the tight fiscal position of the government it is less likely the government will continue to exempt condominiums. In this context based on this study, RIU lists out few alternatives as given below;

Policy Option	Developer's Perspective	Government's Perspective
To make apartments zero-rated	This allows developers to recover some costs while maintaining the prices.	Government will
Imposing a milder (4 to 6%) VAT across the board	as evident by the case studies and opinion survey, a flat rate in the range of 4 to 6% across the board will not hurt the industry.	The government can earn tax revenue from the unsubdued market.
Introduce multiple tax bands with maximum tax rate around 6%	With this structure, apartments with higher prices will pay a higher tax rate. The tax rates corresponds to ability to pay thus developers will not experience a reduction in sales.	The government can earn tax revenue from the unsubdued market. The tax is progressive thus will be perceived by public as fair.
Exempt the "first time" apartment purchase from VAT and apply a standard rate which does not exceed 6% from subsequent purchases.	Developers can continue operating without subdued market condition.	This policy will not discourage buy-to-live market and it will help government objective to increase home ownership.
Impose VAT and exempt apartments from NBT/ Stamp Duty or any other taxes.	Developers can continue operating without subdued market condition.	Taxation is simplified and the government can achieve its revenue objectives.

As evident from the case studies setting threshold limits (For example the current proposal to exempt apartments units below LKR15mn) will distort the market therefore cannot be considered an efficient method. We believe any of the above options or combination of options will be more favorable to both the industry and the economy than what's being proposed.

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