Executive

Taxing tax reforms

New measures could collapse the real estate sector

With little official communication about the government's proposed tax reforms and no public discussions with civil society or concerned professionals, confusion and misinformation about the proposed tax law have run rampant. In an attempt to clarify the debate, we have examined the six proposed tax reforms pertinent to the real estate sector and their possible implications for the industry.

There are two findings: The majority of the proposed taxes are fair and are commonly applied in most developed countries. However, in Lebanon, burdening a stagnating sector with new taxes could risk its collapse.

Taxing sales contracts

The new law proposes a 2 percent tax on the value of any sales contract, whether it is signed privately between the seller and the buyer, or in front of a public notary. Payment is due within five days of the signature of the contract.

The proposed law allows for this tax to be deducted from registration fees, provided the sale is registered within one year of the date of the contract. This new tax will force buyers to register new purchases within a year of acquisition – existing law gives them the right to register the sale up to 10 years from this date.

If the sale is not registered within a year, in effect the buyer pays a penalty of 2 percent, on top of the 5.6 percent in registration fees imposed under current law.

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Forcing buyers to register a property within 12 months of its acquisition will have a corrective impact on data available to the government, as transactions and the tax revenue they generate will be reflected in the fiscal year in which deals are concluded.

But the net impact of the tax would be much more damaging, as it forces investors to register the purchases of property they acquire and intend to place on the sales market. Under current law, investors have 10 years to dispose of a property without incurring registration costs, but with the new law, they will have only one. The tax will deter real estate investments, which to date have benefited from the effective exemption of registration fees for intermediaries, as only the end-user registers the property.

Taxing vacant residential apartments

Under current law, apartments that have been officially declared vacant are not counted for the purposes of real estate fiscal tax paid to the Ministry of Finance. The new tax law proposes to tax all residential properties, whether or not they are occupied. Individual owners are exempt for six months from the date of acquisition, after which they must start paying real estate tax. Developers have an exemption period of 18 months from the date apartments are completed and property deeds are issued.

The proposed measure would further deter potential investors looking to place their money in Lebanese real estate, driving capital to international markets, other forms of investment, or cash deposits.

It would be particularly disastrous for developers left with unsold apartments in completed developments. The market has been at a virtual standstill for five consecutive years, and the new tax could potentially bankrupt an incalculable number of professional developers, large and small.

Developers have traditionally been cash-rich, self-financed individuals or companies, with very little leverage. This has so far allowed them to withstand the pressures of the market and avoid a total crash of the real estate sector by absorbing drastic drops in sales ratios.

According to market data collected by the RAMCO Research Department, residential projects post an average sales ratio of 65 percent upon completion across Municipal Beirut, down from near 80 percent during the boom years between 2005 and 2011. This means that of roughly 10,340 residential units under construction at the end of 2016, around 3,620 will still be on the market when the projects are completed.

It is this huge stock of vacant apartments that the new law proposes to tax. The bill would be significant. Real estate fiscal taxes are roughly between $7-15 per square meter, calculated incrementally at between 7-10 percent of the estimated rental value of the property. The above vacant stock would correspond to roughly 780,500 square meter of unsold residential space, resulting in a tax bill of somewhere between $5.4 million and $11.7 million.

Supposing a development company ends up with 4,000 square meter of unsold residential space on its hands after the completion of the building, it has 18 months before it starts paying a tax of around $40,000 per year for the vacant, unsold residential units.

Taxing construction permits

The proposed law would increase the cost of construction permits by around 50 percent. Today, construction permits cost about 1 percent of the estimated fair market value of the land on which the project is developed; the new law proposes to tax it at 1.5 percent.

Construction permits currently account for about 10 percent of the total cost of construction. If this new law is applied, they will account for 15 percent. The additional cost will be reflected in an increase in the asking prices or by shrinking of the developer's profit margin. Either option is disastrous – a hike in prices would stall an already stagnating market, and developers are already working with very narrow margins and cannot absorb more losses.

Many developers have already begun taking measures to help defuse some of the pressure off the market, cutting a sizeable chunk from their profit margins. Over the past several years, profit margins have dropped significantly, from around 30 percent per year to less than 12 percent in some instances. They have also begun offering larger and larger discounts, as high as 30 percent on certain properties.

Requests for construction permits are already dropping year on year, as per official data published by the Order of Engineers and Architects in Beirut. Imposing higher taxation and driving up construction costs will further shrink the number of new permit applications.

Taxing capital gains

An income tax has also been proposed on the capital gains realized upon the sale of a property. Capital gains are calculated as the difference (increment) between the purchasing price of a property and its selling price. All sellers will be taxed at 15 percent, even individuals who are not registered with the local authorities and those who are normally exempt. Companies will be taxed at 17 percent instead of the current 15 percent income tax rate. Additionally, companies will still be taxed 10 percent upon the distribution of profits to shareholders. The proposed capital gains tax would be applied across the board, to individuals and companies, on the sale of any property – residential apartments, plots of land, shops, offices, warehouses, buildings, etc. It is payable within two months from the date of sale and would further deter real estate investment.

Additionally, the proposed increase to the value-added tax (VAT) from 10 percent to 11 percent will mean less disposable income for potential real estate buyers, but even higher property costs. Indirect taxes on the sector (such as increased tax on the services of notary publics and a hike in the stamp duty on contracts) will further burden contractors, developers, investors and individual buyers.

Taxing perception

Taxing income and profits is natural and fair. However, introducing new taxes to the real estate sector could threaten one of the last working sectors of the local economy. The market is already burdened by more than 17 different taxes and fees, and corruption traps everyone – from developers to investors to individual buyers – under a very heavy yoke. Real estate investments have traditionally been seen as a safe haven in an otherwise highly volatile, insecure economy. Taxing developers, investors, and buyers – at a time when the entire Lebanese real estate industry is hanging on by the sheer will of these players – could mean its demise.

The biggest question is how the government will employ the additional tax revenue. Will increased taxation translate into better infrastructure, better quality services, the eradication of corruption, or reduced bureaucracy? Or will it come as yet another burden to be borne by an overwhelmed population?

When will real estate developers, who generate 18 percent of the gross domestic product, according to 2015 figures published by the Central Administration of Statistics, and who employ hundreds of thousands of people, stop being labeled by officials as financial pariahs, amassing fortunes on the backs of unsuspecting customers?

The reality is very different. Developers made good money and sizeable profits when the market was booming – as did everyone else. However, since the economy has stagnated, so have their businesses, their incomes, their profit margins, and their liquidity. If they do not drop their prices further, it is largely because the price of land has remained stable. Many cannot afford to sell at depressed prices because they simply will not be able to afford to buy the next plot of land they need to build a new project.

Developers are part of this economy, and main players behind its growth. Taxing them into bankruptcy can only be detrimental to the economy as a whole. Real estate investments have been a major driver of the local economy, and lenient taxation has attracted investors across property types, from residing locals, the large Lebanese expatriate community, to regional investors, mainly from Saudi Arabia and the Gulf countries. Today, foreign investors are divesting from the market, leaving only local buyers. Further taxation will drain even that last remaining market driver.