# Study of the Potential Effects of Commencing the Section 110 Provisions of the Finance Act 2007 Relating to Stamp Duty

**Final Report**

**November 2007**

**Goodbody Economic Consultants**
Ballsbridge Park, Ballsbridge, Dublin 4
• Tel: 353-1-6410482 • Fax: 353-1-6682388
www.goodbody.ie/consultants/ • e-mail – econsultants@goodbody.ie

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## Executive Summary

Currently, property developers can reduce their Stamp Duty liability when acquiring development land through mechanisms such as resting on contract and licensing. Section 110 of the Finance Act 2007, which has not yet been commenced, would effectively limit the attractiveness of these arrangements by providing that, in general terms, where 25 per cent of the consideration/market value of the land or lease is paid to the landowner, a Stamp Duty charge will arise within 30 days after the payment has been made. The Department of Finance commissioned Goodbody Economic Consultants to undertake a study of the economic, fiscal and social impacts of commencing Section 110.

The property sector is experiencing a down turn, the first evidence of which dates back to 2006. The residential sector is most affected. Commencements in the residential sector, as indicated by data for the summer of 2007, have declined year on year by some 40 per cent. House prices are experiencing a modest decline, after a period of very rapid price inflation.

While there are no comprehensive data on house sales, market intelligence suggests that they are currently (Autumn 2007) significantly below the very high peak levels experienced in 2006. There is an overhang of residential units and developers will be reluctant to commence new activity, until existing stocks are sold and market sentiment improves. Housing affordability has declined and the recent reduction in house prices has made consumers hesitant about entering the market, as they anticipate further price reductions.

There is a very real prospect that house completions could fall to some 50,000 units in 2008. If this downward trend were to continue, market supply could drop below long term housing demand needs.

The commencement of Section 110 will give rise to increases in the costs of land purchase of about 10 per cent for those affected. There is also the possibility that developers will react more strongly to the Stamp Duty than to a general increase in land purchase costs. This is because Stamp Duty increases will tend to raise the equity financing requirements of developers very substantially.

However, the scale of impact of the commencement of Section 110 on land transactions is likely to be less than the 10 per cent increase. This is because it is estimated that only approximately 40 per cent of land transactions (by value) currently make use of Section 110 type arrangements so that, for some land purchases, costs will not increase.

In addition to the above impacts, Section 110 will reduce the liquidity of the land market to some extent, by raising the cost of land transfer, the cost of entry to the market, and the cost of site assembly and break-down.

If land costs are some 30 per cent of property prices, the follow through impact on house prices of a 10 per cent land cost increase will be some 3.3 per cent. Again, the impact on house prices will be mitigated to the extent that land transactions currently do not currently incorporate Section 110 type arrangements and developers make us of existing land banks.

It is estimated that Section 110 could have provided a Stamp Duty revenue gain of c. €251m in 2006 market values, if Section 110 had been commenced to apply fully in that year. Because of the downturn in the property market, a much lower yield would have arisen in 2007. In contrast to these revenue gains, implementation of Section 110 will also raise the cost to the State of some projects procured on a PPP basis.

Section 110 provisions, which would be regarded in very negative vein by developers, could further affect confidence at a time when it is relatively fragile. Thus, the impact of Section 110 could be in excess of the price effects and could help drive activity levels significantly below long-term housing market requirements. Such an outcome would be undesirable in terms of housing price and output stability. It will also impact negatively on property-based tax incentive schemes, which could add to the downturn in activity in the commercial property sector.

If Section 110 were to be commenced, the Stamp Duty charges arising would to some extent be passed through to first time house buyers in the form of higher property prices. This would run counter to recent policy changes, which sought to relieve the Stamp Duty burden on this group of buyers.

It is recommended that Section 110 provisions should not be commenced at this time. To do so, would run the risk of exacerbating the down turn in the property market

There are arguments for maintaining the current arrangements in the long term. These relate to the negative impacts of Section 110 on land market liquidity and the supply of housing. Government will need to assess the strength of these arguments, relative to the benefits of the tax revenues that would arise from introduction of Section 110.

# 1. Introduction

## 1.1 Background

Currently, property developers can reduce their stamp duty liability when acquiring development land through mechanisms such as resting on contract and licensing. Section 110 of the Finance Act 2007, which has not yet been commenced, would effectively limit the attractiveness of these arrangements by providing that, in general terms, where 25 per cent of the consideration/market value of the land or lease is paid to the landowner, a stamp duty charge will arise within 30 days after the payment has been made.

The major issue arising with regard to the Commencement of Section 110 is the potential for a negative impact on the property and, particularly, the housing market. As the Section would raise the costs of developing property, its commencement could potentially add to the current downturn in the housing market. The Department of Finance commissioned Goodbody Economic Consultants to undertake a study of the economic, fiscal and social impact of commencing Section 110.

## 1.2 Approach of the Consultants

The Consultants undertook the assessment of impacts by:

- Consulting with departmental officials;
- Interviews with developers and financial advisers in the property market;
- Assessment of the current state of the property market;
- Review of economic literature on the effect of property tax changes; and
- Simulation of tax impacts on property demand and supply and on Exchequer tax revenues.

The Report is laid out as follows. Section 2 discusses Stamp Duties as they apply to property and outlines the provisions of Section 110. Section 3 analyses the state of the property market. In Section 4, the impact of Section 110 on land transactions is assessed. The impact of Section 110 on house prices, property development and Exchequer tax returns is considered in Section 5. Section 6 considers issues relating to the introduction of Section 110, while conclusions and recommendations are presented in Section 7.

# 2. Overview of Stamp Duty on Property

## 2.1 Introduction

Stamp Duty is payable on a wide range of legal and commercial documents. With regard to property transactions, both conveyances and leases of property attract stamp duties. Property includes both dwellings and sites.

Stamp Duty is assessed on the consideration or value of the property exclusive of VAT. There are a number of exemptions and reliefs available, including those relating to transfers of property between spouses, divorced couples and certain relatives.

## 2.2 Stamp Duty on Residential Property Purchases

The amount of Stamp Duty on the purchase of residential property depends on whether the property is new or second hand and whether the purchaser is a first time buyer, an owner occupier or an investor. A first time buyer is a person who has not previously purchased or built a house or apartment anywhere in the world and who is also an owner occupier. An owner occupier is a person who purchases a dwelling for use as their only or principal place of residence and no rent (other than rent under the rent-a-room scheme) is derived from the property.

**First Time Buyers**: Following the changes put in place in summer 2007, first time buyers (FTBs) are exempt from Duty on both new and second hand houses with effect from 31st March 2007.

**Owner Occupiers:** Owner Occupiers (OOs), who are not FTBs, but who are purchasing a newly built house, are exempt where the floor area does not exceed 125 square metres. Otherwise they are charged with duty at the rates set out in Table 2.1. Where the dwelling is new and the floor area exceeds 125 square metres, Duty is charged on the site value (exclusive of VAT) or on one quarter of the total value of the dwelling including the site (exclusive of VAT), which ever is the greater.

**Investors:** Dwellings purchased by investors, whether new (under or over the 125 square metres threshold) or second hand, are charged Duty on the full price paid (exclusive of VAT), as per Table 2.1.

**Table 2.1: Full Rate of Stamp Duty on Residential Property**

| Aggregate Consideration (€) | Full Rate (%) |
|---|---|
| Less than €127,000 | Exempt |
| €127,001 - €190,500 | 3.0 |
| €190,501 - €245,000 | 4.0 |
| €245,501 - €317,500 | 5.0 |
| €317,501 - €381,000 | 6.0 |
| €381,001 - €635,000 | 7.5 |
| Over €635,000 | 9.0 |

The above rates apply to the entire consideration or value of the property. That is, once the property price passes each of the thresholds, the entire value of the property and not just the increment over the threshold is subject to the higher rate.

## 2.3 Stamp Duty on Non-Residential Property Purchases

Non-Residential Property includes land, offices, factories and other business premises. The Duty rates that apply are set out in Table 2.2. These rates also apply to sites.

**Table 2.2: Rate of Stamp Duty on Non-Residential Property**

| Aggregate Consideration (€) | Full Rate (%) |
|---|---|
| Less than €10,000 | Exempt |
| €10,001 - €20,000 | 1 |
| €20,001 - €30,000 | 2 |
| €30,001 - €40,000 | 3 |
| €40,001 - €70,000 | 4 |
| €70,001 - €80,000 | 5 |
| €80,001 - €100,000 | 6 |
| €100,001 - €120,000 | 7 |
| €120,001 - €150,000 | 8 |
| Over €150,000 | 9 |

However, where an individual purchases a site with a connected agreement to build a dwelling, then duty is charged on the aggregate amount of the site and building costs, at the residential rate of Table 2.1, subject to the exemption/relief for FTBs and OOs to which reference was made in Section 2.2.

## 2.4 Stamp Duty on Leases

A lease is subject to Duty on both the premium and the rent payable under the lease. A premium is a consideration for granting a lease. The Duty chargeable on the premium is at the rate for residential or non-residential property as appropriate as per Tables 2.1 and 2.2. The Duty on rent is set out in Table 2.3. However, a lease on a dwelling house for a term of not more than 35 years or for an indefinite term and where the rent does not exceed €19,050 per annum is exempt.

**Table 2.3: Rate of Stamp Duty on Leases**

| Terms of the Lease | Rate as a Proportion of Annual Rent (%) |
|---|---|
| Lease for a term not more than 35 years or an indefinite term | 1 |
| Lease for as term more than 35 years and not more than 100 years | 6 |
| Lease for a term of more than 100 year | 12 |

## 2.5 Recent Changes in Stamp Duty Rates

In recent years, the burden of stamp duty on residential purchases has been alleviated, with a view to favouring the FTB. For example, prior to the 31st March 2007, FTBs were not fully exempt from Duty. Duty was payable at reduced rates up €635,000 where the property was second hand and the value of the dwelling was more than €317,500, or where the property was new and the floor area exceeded 125 square metres and the greater of the site value or one-quarter of the total value of the house including the site was more than €317,500. This €317,500 threshold had been raised from €190,500 in January 2002.

With regard to non-residential purchases, however, the trend has been in the opposite direction. Prior to Budget 2003, the maximum rate of duty was 6 per cent as against the 9 per cent rate now in place. [1]

## 2.6 Trends in Tax Revenue Yield from Stamp Duty on Property

In the ten years to 2006, the tax revenue yield from Stamp Duty on property has increased almost tenfold, from €247m in 1996 to €2,989m in 2006. This huge increase has been driven by the rapid increases in the volume of transactions in the market, the rapid property price inflation, and the tendency for that inflation to push property, and particularly residential property, into ever higher Stamp Duty rate bands.

### Table 2.4: Tax Revenue Yield from Stamp Duty on Property

| Year | Residential (€m) | Non Residential (€m) | Total (€m) |
|---|---|---|---|
| 1995 | 119 | 79 | 198 |
| 1996 | 149 | 98 | 247 |
| 1997 | 194 | 128 | 322 |
| 1998 | 213 | 174 | 387 |
| 1999 | 263 | 288 | 551 |
| 2000 | 282 | 392 | 674 |
| 2001 | 265 | 406 | 671 |
| 2002 | 349 | 317 | 666 |
| 2003 | 528 | 547 | 1,075 |
| 2004 | 752 | 709 | 1,461 |
| 2005 | 945 | 1,056 | 2,001 |
| 2006 | 1,311 | 1,679 | 2,989 |

Source: Revenue Commissioners

With regard to non-residential yields, it is clear that there has been a significant divergence from trend of revenue yields in the period from 2003 onwards. This, no doubt, reflects in part the introduction of higher rates of Duty in the 2003 Budget.

[1] Some very limited relief was given in Budget 2003 by raising the thresholds for lower value properties.

## 2.7 Arrangements to Limit Stamp Duty Liability

Currently, property developers can reduce their stamp duty liability when acquiring development land through a number of mechanisms:

- Resting on contract arrangements occur where a builder or developer[3] contracts to purchase land from a vendor, without taking legal title to it. Because a conveyance is not taken, a Stamp Duty liability does not immediately arise.
- Under licensing arrangements, a developer obtains a licence from a land vendor to build on the land, without taking ownership of it.
- Entering into an agreement for a long lease is also used a means of avoiding the Duty.

Under these arrangements, the entire consideration/market value is usually paid over to the land owner, when the developer takes possession of the land.

The usual way in which these arrangements are implemented is for the land vendor to grant a power of attorney to the developer, which allows him execute a conveyance of the legal title to the ultimate purchaser without further recourse to the land vendor. When the land is used to develop a new property, Stamp Duty will become payable by the purchaser of such a property, according to the provisions outlined in Sections 2.2 to 2.5 above. If such transactions are exempt, then no Stamp Duty is paid. By virtue of these mechanisms, multiple layers of stamp duty are not paid, and this reduces the cost of both bringing land to the market and of the supply of property and housing in particular.

Section 110 of the Finance Act 2007 would effectively limit the attractiveness of these arrangements by providing that:

- In respect of resting on contract, the full stamp duty charge will arise in respect of a contract or agreement for sale where 25 per cent or more of the consideration has been paid under the contract or agreement
- In respect of licence arrangements, where 25 per cent of the market value is paid to the landowner, a Stamp Duty charge will arise within 30 days after the payment has been made; and
- In respect of leasing arrangements, an agreement for lease for more than 35 years will be liable for the full stamp duty, where 25 per cent of more of the premium for the lease has been paid.

[3] For ease of presentation, this report will use the term developers to refer to builders also.

The impact of these restrictions will be to increase the costs of purchasing land in instances where one of these arrangements would otherwise have been used. If land changes hands a number of times before development then it will attract multiple charges, so that, in these circumstances very considerable increases in cost would occur. The impact of such cost increases depends on the state of the property market, an overview of which is given in the next Section of the Report.

## 3. Property Market Overview

### 3.1 Introduction

The Irish property market comprises two sectors, the residential and the commercial. The Department of Environment, Heritage and Local Government's Review and Outlook estimates that the output of the new building sector was €21.8bn in 2006, of which €19.5bn or 89 per cent was in respect of residential building, with €2.3 or 11 per cent being commercial.[4]

Overall construction employment stood at 285,600 (seasonally adjusted) in the first quarter of 2007, representing 13.6 per cent of total employment.[5] It is estimated that residential construction accounts for approximately 70 per cent of these jobs.

The impact of any changes to current Stamp Duty arrangements will, in part, depend on conditions in the property market. Importantly, the introduction of tax changes at a time when sentiment in the housing market is weakening and levels of construction activity are falling could exacerbate problems and temporarily push the market further away from its long run equilibrium. This section reviews conditions in the Irish property market and the construction industry as a whole. It commences with an analysis of price trends and activity levels in the property market, before considering short term and long term housing supply requirements.

### 3.2 Prices in the Property Market

#### 3.2.1 Residential Prices and Rents

While residential property price growth has been strong since the mid 1990s, prices have faltered in recent months. There are two sources of data on house prices, the Permanent TSB ESRI National House Price Index and the DEHLG Quarterly Housing Statistics Bulletin. The Permanent TSB ESRI house price data shows that national average house price growth has reduced consistently since mid 2006 and became negative by early 2007. These data indicate that, by July 2007, national house prices have fallen some 3.2 per cent since their peak at the start of the year (see Table 3.1). The DEHLG data show a slightly different picture, with new house prices continuing to increase until Q2 2007, but with a downturn in both new and used prices was observed by the Q3 2007. Despite the data differences, it is clear that house prices have softened since late 2006/early 2007.

[4] Department of Environment, Heritage and Local Government. Review of Construction Industry 2006 and Outlook 2007 to 2009. DKM Consultants. The total values include building in the tourism sector.

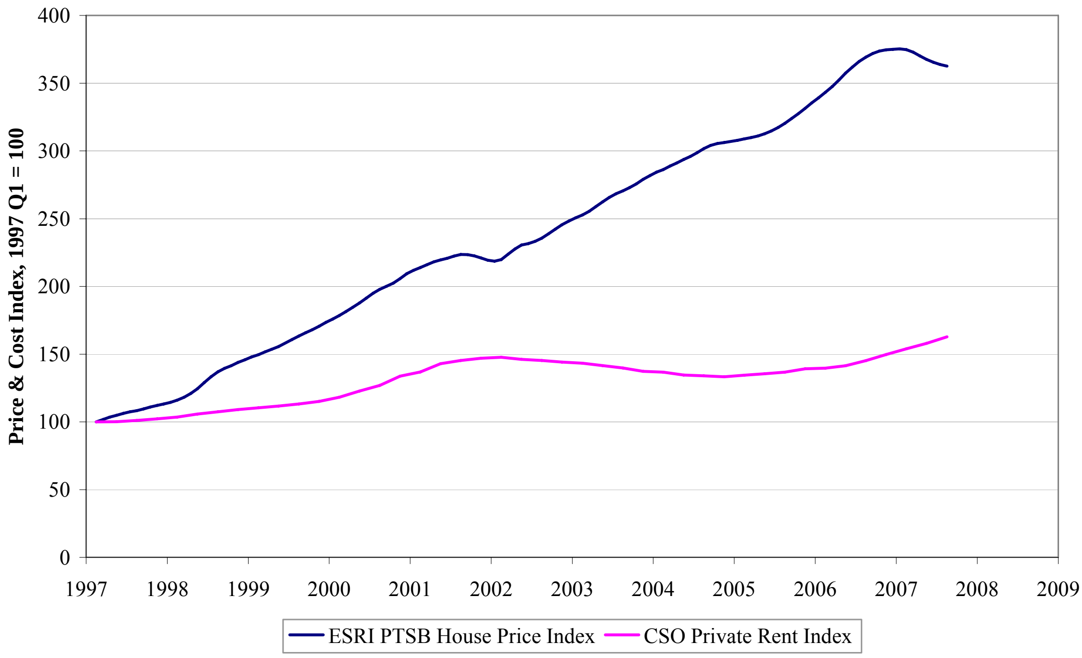
[5] Department of Environment, Heritage and Local Government. Review of Construction Industry Indicators, Issue 10, August 2007. DKM Consultants.

### Table 3.1 Index of National Average House Prices, 2005 Q1 = 100

| | | Department of Environment | | ESRI Permanent TSB |
|---|---|---|---|---|
| | | New Houses | Second Hand Houses | |
| 2005 | Q1 | 100 | 100 | 100 |
| | Q2 | 104 | 109 | 101 |
| | Q3 | 104 | 108 | 104 |
| | Q4 | 109 | 115 | 107 |
| 2006 | Q1 | 111 | 114 | 111 |
| | Q2 | 117 | 124 | 116 |
| | Q3 | 117 | 128 | 120 |
| | Q4 | 118 | 123 | 121 |
| 2007 | Q1 | 121 | 125 | 121 |
| | Q2 | 127 | 126 | 119 |
| | Q3 | 123 | 121 | 117 |

Source: Department of Environment & ESRI Permanent TSB

### Figure 3.1: Index of National House Prices and Private Rental Costs




Source: ESRI Permanent TSB & CSO.

Figure 3.1 above summarises the ESRI Permanent TSB house price data and includes annual residential rental cost growth as measured by the CSO. Both are depicted as indices with a base of 100 in Q1 1997. The Figure shows that house price growth has been significant and sustained for most of the period. House prices did fall briefly around the start of 2002, but price growth recovered quickly. The Figure also illustrates the moderation in prices since late 2006 early 2007 as measured by the ESRI Permanent TSB index, and indicates that rents have been increasing since the start of 2005. Rental costs increased by over 11 per cent per annum during the first three quarters of 2007.

A number of institutions including the Central Bank and the OECD consider Irish house prices to be overvalued. There also appears to be disparity between house prices and rental costs, as currently the rental values of properties are below the cost of financing them. This implies that either rents are currently too low or prices are two high. While recent reductions in prices and increases in rents will reduce this disparity, significant further changes are still required if rental yields are to match mortgage servicing costs.

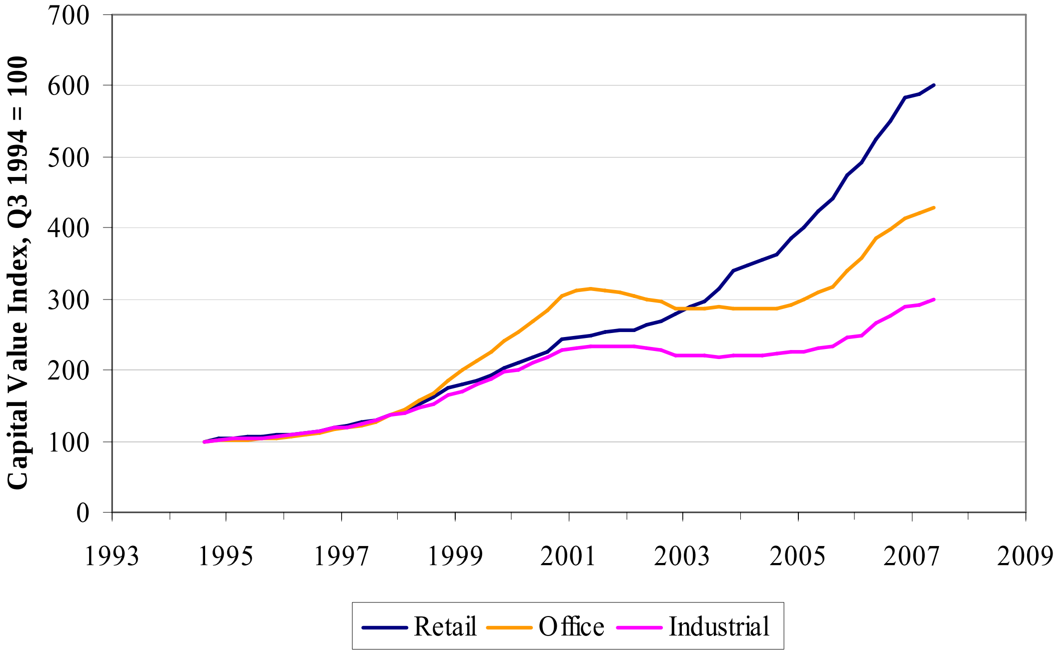
There is widespread expectation of some correction to the market, either in terms of a sharp fall in values or a more moderate "soft landing". While the hopes are for an orderly process of adjustment, it is possible that the market may not achieve this. In particular, there is the possibility that potential buyers will postpone purchasing decisions because of the prospect of continued price falls, which could reduce market demand and precipitate further price falls.

Observation of the market would support this view. There is evidence that the downturn in activity levels, which is discussed further below, is focused primarily on the speculative house building market. In this market, consumers have greater visibility on house prices and an expectation that further tranches of supply will be forthcoming, perhaps at lower prices. However, to date the rate of decline in house prices has been relatively modest, supporting the view that a soft landing is the most likely outcome at present.

### 3.2.2 Commercial Prices and Rents

The price and rental growth trends in the commercial sector have been markedly different to those seen in the residential property market. Data collated by IPD Global in conjunction with Ireland's Society of Chartered Surveyors (SCS) on capital values and rental growth are illustrated as indices in Figures 3.2 and 3.3 below. The overall trends in both the capital values and rental costs are very similar.

**Figure 3.2: Index of Commercial Property Capital Values**

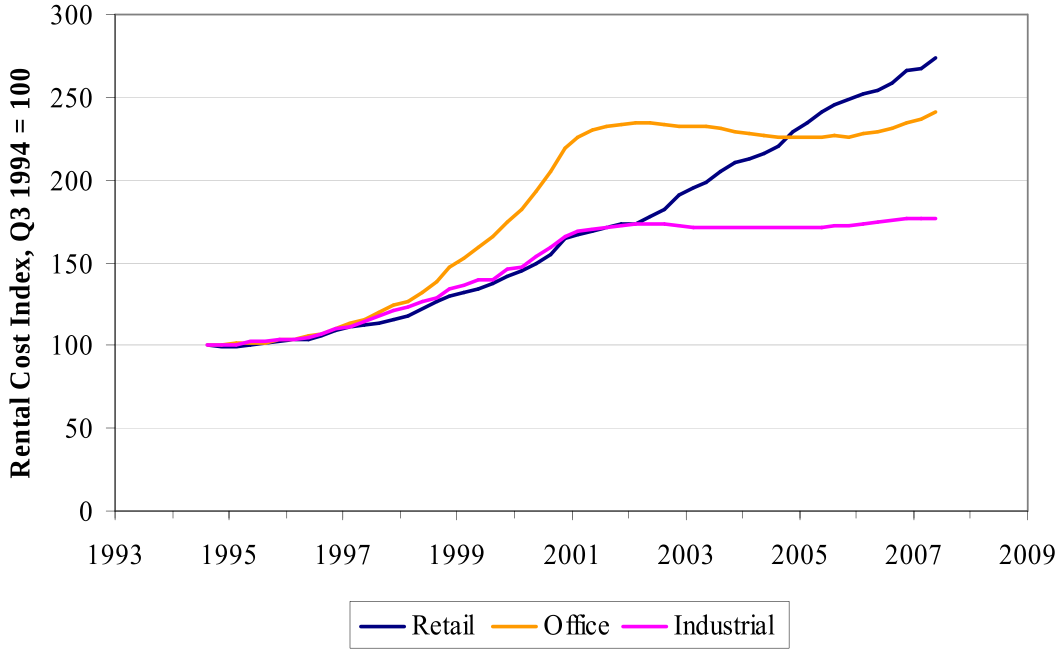



Source: IPD-SCS

It is clear that property price and rental price growth have not been uniform across the different sectors. While the retail sector has seen consistent property price and rental price growth over the period illustrated, the growth in the office and industrial sectors has been more variable. The rapid inflation in the price of office space between 1999 and 2001 reflects a period of considerable business expansion, at a time when the supply of office space was constrained. Following this, there was a phase of rapid office development, which resulted in stagnating prices and high vacancy rates. However, prospects in the office market have improved in recent years, resulting in reaccelerating prices and lower vacancy rates. The outlook for demand for office space remains good, as Ireland's office-based service sector is expected to sustain strong growth.

The strong growth of the retail property prices and the relatively weak performance of prices in industrial property reflect recent growth trends within the Irish economy. Ireland has experienced a significant and prolonged consumer boom, which has resulted in increasing demand for retail space. While the expansion in the manufacturing sector, especially high-tech production, was central to Ireland's rapid economic growth in the 1990s, the sector has not performed so strongly in recent years. The waning economic significance of the manufacturing sector in recent years is manifest in its contribution to employment growth, which has been modest compared to other sectors in recent years. The slower growth in the manufacturing sector also explains the more moderate increases in industrial property prices over the period.

**Figure 3.3: Index of Commercial Property Rental Costs**




Source: IPD-SCS

## 3.3 Activity Levels in the Property Market

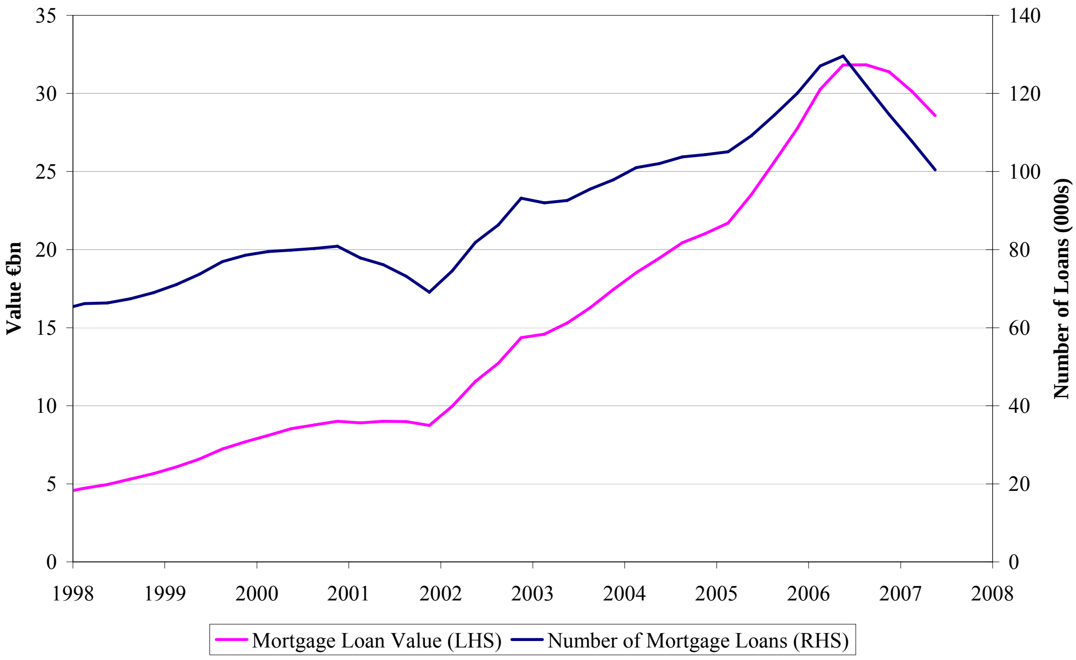
### 3.3.1 Introduction

There are a number of indicators of activity levels in the property market. These relate to different phases or aspects of property acquisition.

### 3.3.2 Residential Market: Mortgage Borrowing

Evidence of a slowdown in the residential market is apparent from mortgage borrowing data. Department of Environment data on the number and value of new mortgages is represented in Figure 3.4 below. The graph shows the total number of new mortgages and their total value on a year to date basis by each quarter. These data include re-mortgages, so the number of mortgages does not necessarily represent the total number of mortgages used for the purchase of a home. Furthermore, an estimated 30 per cent of homes are typically purchased without mortgage finance.

**Figure 3.4: Number and Value of New Mortgages**




Source: Department of Environment, Heritage and Local Government

The Figure reveals that both the number of new loans and the total value of new loans have fallen sharply since mid 2006. The reduction of total value has been largely due to the decrease in the number of new loans, as the average value of loans did not fall in the same period. Mortgages for new homes, which typically accounted for 40 to 50 per cent of all mortgages over the period illustrated, demonstrated a very similar trend of reduced numbers of mortgage loans since mid 2006 and a consequent fall in the total value of new mortgages.

This downward trend in mortgage borrowing is corroborated by Central Bank data on the level of outstanding mortgage debt. Central Bank data indicate that the growth in mortgage borrowing for principal residences grew by 18 per cent between 2005 and 2006 but increased only 7 per cent year on year for each of the first two quarters of 2007.

The Central Bank data also reveal that mortgage borrowing for buy to let purchases, which now represents more than a quarter of all outstanding mortgage debt, has been growing much more rapidly than that for owner-occupier purchase. However, like the mortgages for home purchase, the buy to let segment has also seen annual mortgage growth slowing recently, moderating from 45 per cent between 2005 and 2006 to 29 percent in the first two quarters of 2007.

Despite the definitional issues mentioned above, the sharply falling level of new mortgages is indicative of significantly reduced levels of transactions in the residential market in 2007.

### 3.3.3 Residential Market: Planning Permissions

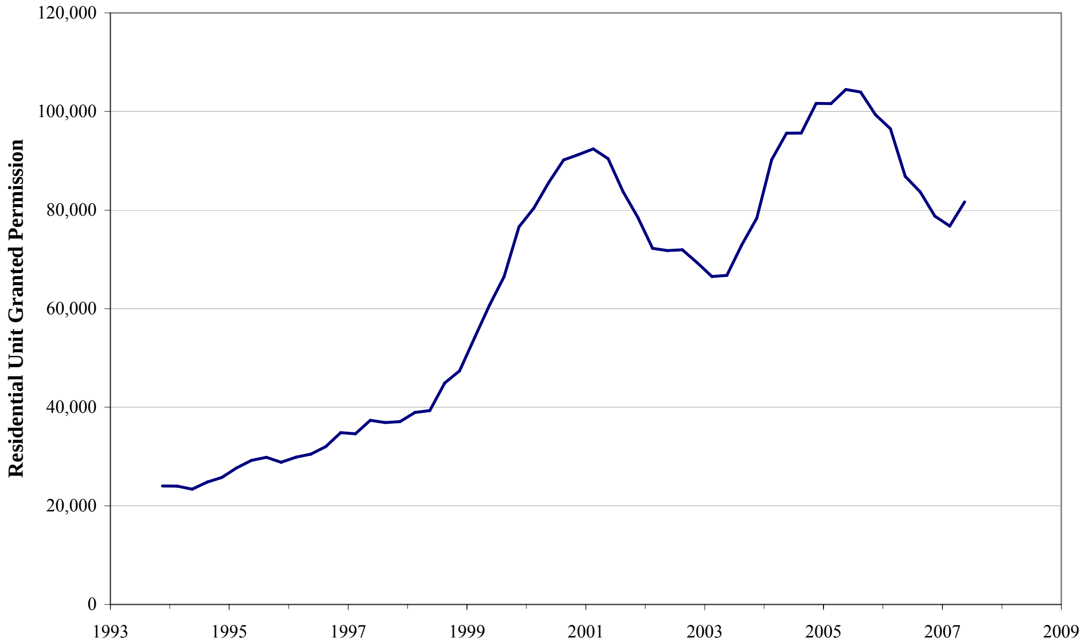
There are a number of indicators of the level of new house building activity in Ireland. A key distinction between the measures is the phase of building activity that they represent. These differing measures are useful, as they offer an indication of activity levels at different phases of the building, planning and implementation cycle.

The first source of data relates to planning permissions. As planning permissions are valid for five years, they do not necessarily translate directly into activity or completions. However, planning permissions data are useful as they provide the most long term indicator of possible building output and developer sentiment.

Figure 3.5 below illustrates the moving annual total of planning permissions. It shows that the total number of units for which planning was granted peaked at over 104,000 in the second quarter of 2005. Since then, the number of units granted planning permission has fallen sharply, but showed an increase in the second quarter of 2007.

The Figure shows that there was similar volatility in the number of planning permissions between 2000 and 2003. However, actual housing output figures, which are discussed below, did not demonstrate such volatility, highlighting the ability of the building industry to spread output over time.

## Figure 3.5: Residential Planning Permissions - 4 Quarter Cumulative Total




Source: CSO

### 3.3.4 Residential Market: Housing Starts

Housing starts are a more direct indicator of activity in the residential market. The primary source of information on this subject comes from housing bond registration data reported by the Dept of Environment, Heritage and Local Government. Housing registrations do not represent all housing starts, as they do not include one-off houses and local authority construction. Despite these omissions, the registrations data are useful as they illustrate the overall trends.

Figure 3.6 below shows the number of residential units for which registration bonds were received between 1993 and Q2 2007 on a moving 4 quarter total basis. The Figure shows a fall off in housing starts followed by a sharp recovery between 2001 and 2002. It also shows a sharp reduction in housing starts since the end of 2006, which has continued in 2007. In the second quarter of 2007, housing starts, as measured by registrations, were 40 per cent below the figure for the same quarter in 2006.

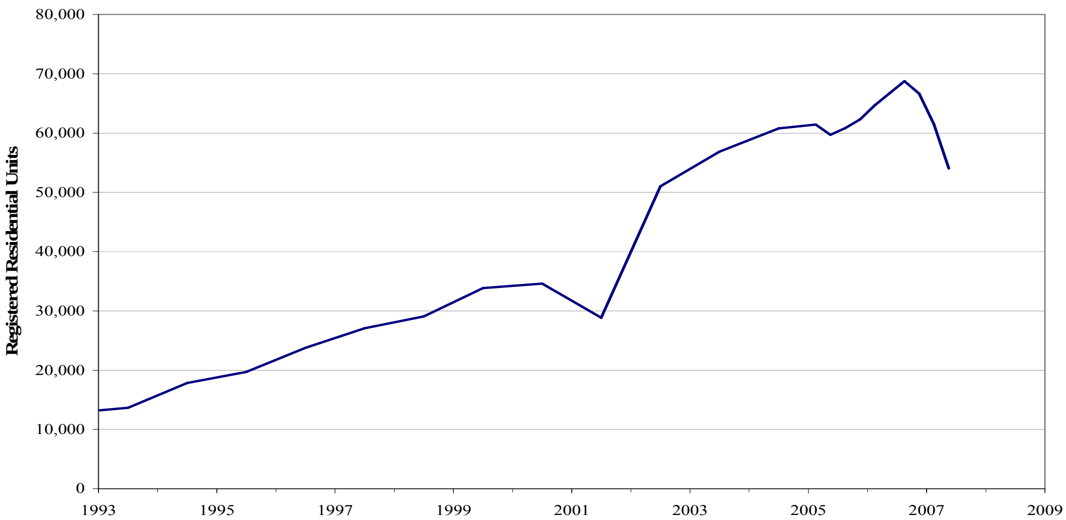
There is a second data source on housing starts that includes once-off housing, the housing commencement notices, which are also compiled by the Dept. of Environment. This data series only extends back to 2004. However, these data also indicate the same dramatic reduction of housing starts of about 40 per cent (See Table 3.2)

### Table 3.2: Recent Trends in Housing Starts Indicators

| Indicator | Number | Growth Rate (%) |
|---|---|---|
| Housing Registrations: | | |
| Quarters 1 and 2: 2006 | 36,715 | |
| Quarters 1 and 2: 2007 | 24,109 | - 35.3 |
| Quarter 2:2006 | 18,276 | |
| Quarter 2: 2007 | 10,832 | - 41.7 |
| Housing Commencements: | | |
| Jan – July 2006 | 47,345 | |
| Jan – July 2007 | 35,226 | -26.6 |
| May- July 2006 | 22,221 | |
| May –July 2007 | 13,758 | -39.1 |

Source: DEHLG

### Figure 3.6: Residential Units Registered – 4 Quarter Cumulative Total

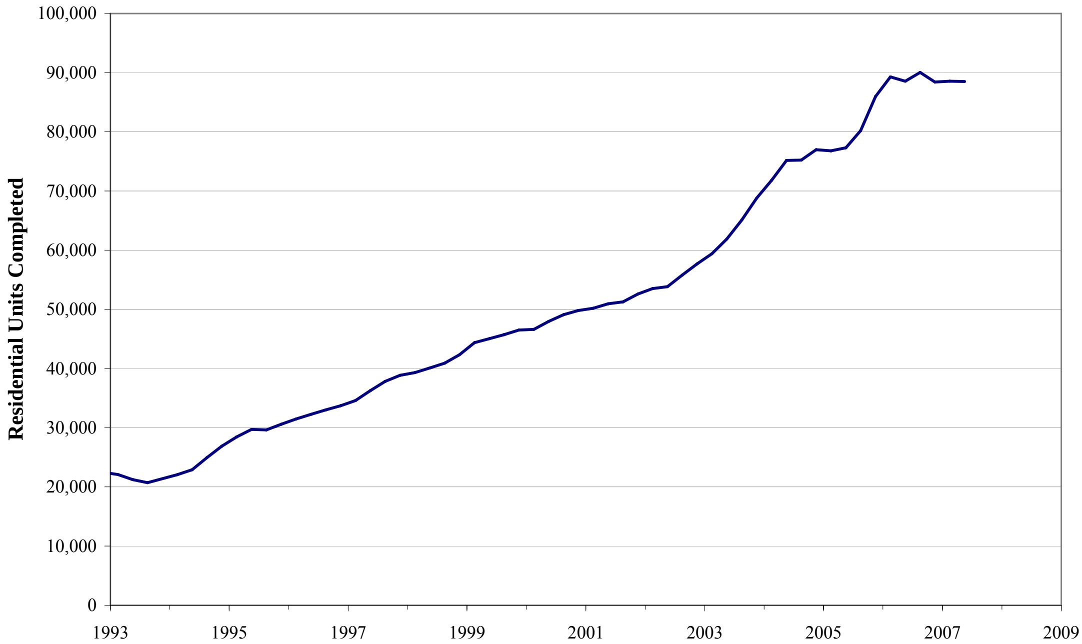



Source: Department of Environment, Heritage and Local Government

### 3.3.5 Residential Market: Housing Completions

The final important data source on housing supply is the housing completions data, also reported by the Dept. of Environment. Figure 3.7 below illustrates housing completions on a 4 quarter cumulative total basis. Annual housing output peaked in the year to the third quarter of 2006, at just over 90,000 units. Since then, the total number of completions has declined modestly, to approximately 88,500 over the year to the second quarter of 2007.

**Figure 3.7: Residential Units Completed – 4 Quarter Cumulative Total**




Source: Department of Environment, Heritage and Local Government

The lag between housing starts and completions is assumed to be around 9 to 12 months. This lag may depend on conditions in the housing market, as developers may advance or delay the arrival of their units depending on prices and their appetite to engage in other developments elsewhere. In particular, in times of weakening sentiment, developers may be expected to delay completion.

Comparison of Figures 3.5 to 3.7 reveals that planning permissions numbers were the most volatile, the housing starts data showed less fluctuation, and the housing completions data revealed the least dramatic variation. Such an attenuation of the volatility of the various housing supply indicators through the housing productions process is consistent with the house building industry's ability to vary activity according to market conditions.

### 3.3.6 Non-Residential Construction

Output in the non-residential sector is harder to measure compared to house building. The highly differentiated types of output make it difficult to build unified and consistent measures of production.

The Department of Environment, Heritage and Local Government's (DEHLG) value of production output figures provide a measure of the size of the various components of the non-residential construction sector. Table 3.3 below reports the value of construction output by non-residential sub sector which includes new construction and repair, maintenance and improvement (RM&I) works as estimated by DKM in constant 2005 prices. The table also reports the year on year growth in the value of output for each sector. Estimates for residential and productive infrastructure are included in the table to aid comparison.

**Table 3.3: Value and Growth of New and RM&I Construction by Sector**

| | Estimated Output Value, €m 2005 Prices and Annual Growth in Value, (%) | | | | |
|---|---|---|---|---|---|
| | 2003 | 2004 | 2005 | 2006 | 2007E |
| Residential | 17,272 | 19,142 | 21,456 | 22,431 | 20,314 |
| | 10.8 | 10.8 | 12.1 | 4.5 | -9.4 |
| Commercial Of which: | 2,238 | 2,207 | 2,597 | 3,015 | 3,412 |
| | -25.0 | -1.4 | 17.7 | 16.1 | 13.2 |
| Industry incl. Semi-state | 812 | 834 | 897 | 919 | 1,046 |
| | -5.3 | 2.7 | 7.6 | 2.5 | 13.8 |
| Office | 773 | 620 | 816 | 1,029 | 1,253 |
| | -23.8 | -19.7 | 31.5 | 26.1 | 21.8 |
| Retail & Wholesale | 653 | 753 | 884 | 1,067 | 1,113 |
| | -12.5 | 15.4 | 17.4 | 20.6 | 4.4 |

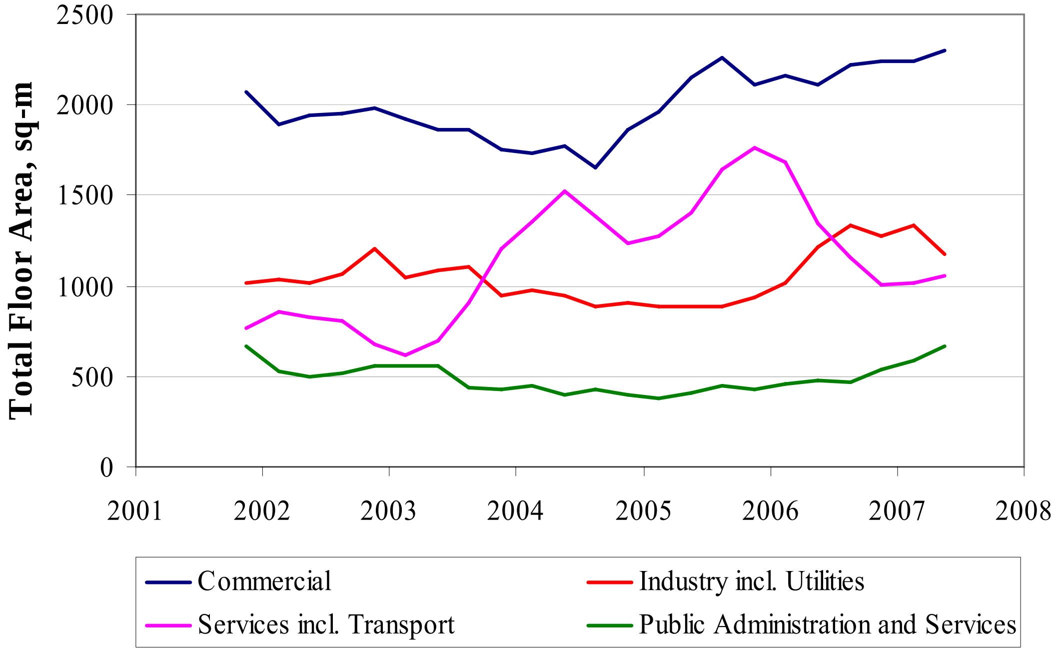
Source: DEHLG

The table shows the very large relative size of the residential sector compared to commercial development.

The growth rates reported in the Table show that while construction in the office, tourism and retail and wholesale sectors is of relatively small value compared to house building, the growth rates that have been achieved in recent years are very strong. The growth performance of the industry and social infrastructure sectors has not been so robust, although both of these sectors are expected to exhibit strong growth in 2007.

Planning permissions do not necessarily offer a reliable indicator of development activity, as noted above. However, they do provide some indication of likely trends and market sentiment. Figure 3.8 below shows the total floor area for which planning permission was granted on a four quarter cumulative total basis between Q4 2001 and Q2 2007.

**Figure 3.8: Planning Permission – Total Floor Area by Sector**




Source: CSO

The Figure indicates that, in general, the overall volume of planning permissions has not fallen over the period. While it is not possible to disaggregate between retail and office development in the commercial sector, the volume of development granted permission has grown significantly in this sector since mid 2004. Importantly, with the exception of the industry sector, there appears to be no reduction in the volume of development awarded planning permission in the first two quarters of 2007 when residential planning permissions have been far below their peak.

The view that the commercial market is not suffering a decline equivalent to that of the residential sector is borne out by feedback from developers and from the somewhat patchy data available. For example, research on the Dublin office market indicates that office demand will reach record levels in 2007 and that vacancy rates remain low in the city centre if not in the suburbs.[6] While sales of development land are estimated in 2007 to be less than 30 per cent of 2006 level, the appetite of developers for large sites for commercial development remains strong. [7]

## 3.4 Short Term Output Expectations and Long Term Requirements

### 3.4.1 Short Term Output Expectations

Market expectations are for a sharp fall in housing completions in 2008. Most market commentators expect total output in 2007 to be in the range of 75,000 to 77,000. Most current expectations of 2008 output are between 60,000 and 65,000 units. However, housing starts were declining by about 40 per cent in late summer 2007. If this trend were to continue, completions could be as low as 50,000 units in 2008. There are a number of factors at work here. The strong growth in house prices in the recent past coupled with the upward trend in mortgage interest rates has reduced housing affordability. More recently, the reduction in house prices has made consumers hesitant about entering the market, as they are anticipating future price reductions.

There are no data on sales of houses and apartments. Market intelligence suggests, however, that sales are currently (Autumn 2007) significantly below the very high 2006 peak levels. In such circumstances, developers will be reluctant to commence new activity, until existing stocks are sold and market sentiment improves.

As residential building accounts for a significant proportion of total construction employment, a reduction in house building could result in a significant number of job losses in the sector, which may be too large for the rest of the construction industry to absorb. Table 3.4 below illustrates a series of projections of the number of possible job losses in the building sector associated with different housing completions in 2008. The table also reports the anticipated job losses from the construction industry as a whole, after the non-residential sector has absorbed some of the surplus. The projections are based on comparisons with the

[6] Savills HOK. Office Watch: Dublin Office Market Report Spring 07.
[7] Savills HOK. Property Outlook, Summer 2007.

level of residential building employment at the end of 2006, estimated to be 211,000.

**Table 3.4: Potential Employment Impact of Residential Downturn**

| 2008 Housing Completions | Reduction in Building Employment | Reduction in Construction Employment |
|---|---|---|
| 70,000 | 17,000 | 3,000 |
| 65,000 | 25,500 | 14,500 |
| 60,000 | 40,000 | 26,000 |
| 55,000 | 51,000 | 37,500 |
| 50,000 | 63,000 | 49,000 |

Source: Goodbody Equity Research

The figures in Table 3.4 above only account for the direct impact on employment within the construction sector. It is possible that some of the surplus labour could be absorbed elsewhere in the economy, so the actual affect on joblessness may be mitigated. Conversely, consideration needs to be given to the fact the construction sector accounts for many jobs indirectly in other sectors. Reduced demand in these dependent sectors could bring second round job losses, the potential volume of which is difficult to anticipate.

### 3.4.2 Long-Term Demand Requirements

While short-term expectations are for a significant reduction in housing output, the concern is that the market may over-correct and that output in the short to medium run could be below long-run fundamental demand. Such undersupply in the market in the short to medium run could again result in a tight housing market with resulting price fluctuations and affordability problems. In order to assess the possibility of such an over correction, it is necessary to review the possible long term level of housing demand.

Housing demand is fundamentally based on population growth and patterns of household formation. While Ireland's young demographic will ensure strong housing demand, the most rapid changes in population in recent years came not through natural increase but through migration. Migration feeds into housing demand quickly, as large numbers of adults requiring accommodation can be added to the population in short space of time. Accordingly, forecasts of housing demand need to pay particular attention to migration patterns, as well as the underlying demographic profile.

Another element of housing demand is the need to replace obsolete stock. Given that a high proportion of Ireland's current housing stock is relatively young, the rate of obsolescence is assumed to be modest at around 9,000 units per annum.

Table 3.5 below details estimates of annual housing demand for the 2007- 2011 and 2012-2016 periods based on three different migration scenarios. While the level of immigration in the high scenario is similar to that experienced recently, it is highly unlikely that this will materialise. Given the expected moderation in economic and employment growth, migration will probably be between the levels of the mid to low forecasts.

**Table 3.5: Long Term Housing Demand Scenarios**

| Annual Net Migration | Housing Demand | |
|---|---|---|
| | 2007-2011 | 2012-2016 |
| 70,000 | 74,000 | 68,500 |
| 50,000 | 68,000 | 65,000 |
| 30,000 | 59,000 | 56,000 |

Source: Goodbody Equity Research

The Table shows housing demand ranging between 56,000 and 74,000 units. It is anticipated that demand will moderate slightly in the second projection period compared to the first. The projections indicate that the long term demand is likely to be at the level of housing completions being realised at the start of 2003. They also indicate that if output in 2008 were to fall any lower than the range of consensus estimates, then undersupply in the market could result.

Similarly, the strong growth in house completions in recent years when set against the long term demand indicates that a substantial excess of housing supply now overhangs the market.

## 3.5 Conclusions

The property sector is experiencing a down turn, the first evidence of which dates back to 2006. The residential sector is largely responsible for this down turn, with the commercial sector less affected.

The extent of the decline in the residential sector has been masked somewhat by the fact that building activity is continuing to take place of foot of decisions made some time ago, when market prospects were better. Thus, residential completions, while falling, have not suffered a major decline as yet. However, commencements in the residential sector, as indicated by data for the summer of 2007, have declined year on year by some 40 per cent. House prices are also in decline. While there are no comprehensive data on house sales, market intelligence suggests that they are currently (Autumn 2007) below the very high peak levels experienced in 2006. Developers will be reluctant to commence new activity, until existing stocks are sold and market sentiment improves. Housing affordability has declined and the recent reduction in house prices has made consumers hesitant about entering the market, as they anticipate further price reductions.

There is a very real prospect that house completions could fall below 50,000 units in 2008. If this were to continue, market supply could drop below long term housing demand needs. The result could be a return of rapid inflation in house prices.

# 4. Impact on Land Transactions

## 4.1 Introduction

The commencement of Section 110 would result in Stamp Duty becoming payable in circumstances where developers previously used resting on contract or licensing arrangements to avoid payment. This will impact on their willingness to acquire land for development purposes. If land is not acquired, then building starts may stall and output and employment in the building sector may falter. This Section of the Report examines the extent to which Section 110 provisions will impact on the land market. In order to do so, there is a need to first identify the extent to which Section 110 will increase land purchase costs.

## 4.2 The Impact of Section 110 on Land Purchase Costs

Table 2.2 has indicated that the rates of Duty vary with the value of the land transaction, but that where the latter is over €150,000, a 9 per cent rate of duty applies. There are no precise data on the distribution of land transactions by value. However, it is likely that the bulk of transactions are at the upper end of the rate scale. Land acquisition for commercial premises is likely to have large lot sizes as would land for speculative house building. Land acquisition for single site one-off housing building would be on a smaller scale. However, with urban land prices in excess of €1m per acre, individual plots are likely to be in excess of €100,000 as a matter of routine. In fact, the Revenue Commissioners estimate that in excess of 90 per cent of transactions are at the 9 per cent rate.

In addition to the immediate Duty charges, there would be knock-on costs for the land purchaser. The first of these are the financing costs associated with carrying the land until it is fully developed. Even if the land was ready-to-go and only a two year period between land purchase and sale elapsed, this could add an extra 12 per cent in financing costs, raising a 9 per cent rate to an effective 10 per cent.

Another point to be considered relates to the extent to which Section 110 would give rise to multiple Stamp Duty charges. This would arise where land passes through a succession of owners before acquisition by the developer. This could occur, in particular, where sites are being assembled. In the context of Section 110, this type of multiple impact would only occur in the medium term, once Section 110 was in place for some time. The extent of this is unknown. In the analysis set out below, the central assumption is made that this type of activity does not occur.

Finally, the impact of Section 110 on purchase costs is mitigated to the extent to which developers would not have availed of resting-on-contract and similar arrangements in any event. Use of such arrangements is, as will be demonstrated in Section 5, less than universal, so that developers in aggregate would not suffer the 10 per cent addition to land acquisition costs. However, for the purposes of considering and simulating the impacts on the land market, the 10 per cent rate is assumed. This is then nuanced in Section 5, which considers the impact on building activity generally.

## 4.3 Factors Determining the Incidence and Impact of Section 110

If Section 110 were to be commenced, the key impact to be considered, in the first instance, is that on the number of land transactions, as these are an essential step in the development of properties, both residential and commercial. In this regard, the first point to be noted is that, although Stamp Duty is a charge on the land purchaser, the land vendor could end up incurring part of the charge. This is because, developers faced with the charge could reduce their demand and vendors faced with falling demand could react by moderating their prices.

The extent to which transactions are affected by the changed policy will depend on the extent to which both purchasers and vendors are prepared to absorb the tax without altering their purchasing and selling behaviour. This in turn depends on the price elasticity of demand and supply. Price elasticity is a measure of the percentage change in demand (supply) to a percentage change in the price. Appendix 1 explores how price elasticities determine both the proportion of the tax paid by purchasers and vendors and the impact on quantities sold. The vendors will pay a high proportion of the tax where they are forced to accept lower land prices. In contrast, the purchasers will pay a greater proportion of the tax where land prices are relatively unaffected. The conclusions of this analysis are:

- Where the elasticity of demand exceeds that of supply, the vendors will pay a higher proportion of the tax than the purchasers. In this scenario, land prices will be forced down.
- The lower the elasticities of demand and supply, the smaller the impact on land transactions; and
- Unless both elasticities are high, the proportionate impact on transactions will be less than the proportionate increases in land purchase costs.

This means that the size of both demand and supply price elasticities is crucial to determining the impacts of the increase in land purchase costs.

## 4.4 Elasticities of Demand and Supply of Land

Price elasticity estimates of the demand and supply of land are not plentiful and refer largely to North American experience. With regard to the price elasticity of demand there is a consensus that it normally lies in the range of 0.5 to 1.0.[8] This means that demand for land is price inelastic and that price rises have a less than proportionate impact on demand. The research on price elasticity of supply is even patchier. However, the usual assumption is that it is less than the demand elasticity. While it is not possible to determine precise demand and supply elasticities, a range within which they are likely to lie can be discerned. Given the information to hand, it would appear that these elasticities are unlikely normally to exceed unity in each case.

## 4.5 The Scale of the Possible Market Impacts

A simulation exercise was undertaken to assess the impacts of a 10 per cent increase in land purchase costs, including the maximum likely impact, based on a range of assumptions regarding the elasticities.

The analysis developed in Appendix 1 was used to estimate three impacts as follows:

- The extent of the increase in Duty paid by purchasers;
- The extent of the increase in Duty paid by vendors; and
- The proportionate decline in land transactions.

The results are set out in Table 4.1. Under High Elasticity Scenario 2, the maximum decrease in transactions is 3.8 per cent. In this situation, demand is so price elastic that the bulk of the tax burden (6.2 of the 9 percentage points) is shouldered by land vendors, but they are also so price sensitive that they withdraw from the market in large numbers.

In contrast, if both elasticities are as low as 0.2, then only a negligible decrease in transactions of 1 per cent will follow the 10 per cent increase in Duty charges.

[8] J Gyourko and R Voith. The Price Elasticity of the Demand for Residential Land. Real Estate Working Paper 329, Wharton 2000
A.D.Witte. An Examination of Various Elasticities for Residential Sites. Land Economics Volume 53(4) November 1977.
D.M.Nowlan. Economic Implications of the Proposed City of Toronto Land Transfer Tax, 2007.

**Table 4.1: Range of Impact of a Ten Per Cent Increase in Land Costs**

| Scenario | Elasticity Assumptions | | Price (% points) | | Percentage Reduction in Transactions |
|---|---|---|---|---|---|
| | Demand | Supply | Increase Paid by Purchasers | Decrease Received by Vendors | (%) |
| High Elasticity (1) | 2.0 | 1.0 | 3.3 | 6.7 | 6.7 |
| High Elasticity (2) | 1.0 | 0.6 | 3.8 | 6.2 | 3.8 |
| Medium Elasticity (1) | 0.6 | 0.3 | 3.3 | 6.7 | 2.0 |
| Medium Elasticity (2) | 0.3 | 0.6 | 6.7 | 3.3 | 2.0 |
| Low Elasticity | 0.2 | 0.2 | 5 | 5 | 1.0 |

Source: Goodbody Economic Consultants

## 4.6 Elasticity of Demand and Supply and Market Circumstances

From the point of view of the commencement of Section 110, it is important to know the approximate level of the elasticities. These are likely to vary over time and location. For example, in a situation where serviced land is relatively plentiful, then purchasers have a range of alternative sites and so could drive a hard bargain – they would thus exhibit high price elasticity. In contrast, vendors (say, farmers) may have only one or at most a few sites in their possession and may be unwilling or unable to withdraw this land from the market and thus have relatively lower sensitivity. Thus, on the urban fringe, the Duty will be borne more by the land vendor, but there will only be a moderate negative impact on transactions. This would be the situation depicted by the Medium Elasticity (1) Scenario of Table 4.1.

In the suburbs and urban centres, the situation will be different. There will be fewer sites available and these are more likely to be in the hands of speculative land dealers. Thus, demand is likely to be price insensitive. However, supply is more price sensitive, as land dealers will have the financial clout to hold out for their target prices. This is a situation akin to the Medium Elasticity (2) Scenario of Table 4.1, where the purchaser pays the bulk of the tax and there is a moderate impact on transactions.

Thus, it is clear that the impact of the tax will vary by location. It will also vary over time, depending on market conditions and risk. As has been demonstrated in Section 3, the market is at a particularly sensitive juncture. This will impact on developers' price sensitivity in a number of ways.

- The demand for land is a derived demand in that it relates to the demand for buildings. In current circumstances, both house buyers and renters of commercial property will tend to be price sensitive, reducing the capacity of developers to pass on the Duty, and thus increasing their own price elasticity of demand;
- Developers are facing other cost increases and constraints. The price of credit is on the rise and it is also more difficult to acquire; and
- Finally, whereas, in the past, the escalation of property prices created a cushion to offset the impact of cost increases, this is largely absent from the market. Thus, market risks have increased.

In these circumstances, developers will be very price sensitive and may withdraw from the market rather than shoulder the tax burden. This argues for the view that price elasticity of demand will tend to be at the upper end of the estimates quoted in Table 4.1 and that the impact on transactions will tend to be on the high side.

There also remains the possibility that developers will not react to Stamp Duty in the same manner as they would to a general increase in land purchase costs. Developers rely on loan finance for the major share of funding of their activities. In the past the banks have tended to lend up to 80-90 per cent of property value. This means that developers have to find the remaining 20 per cent plus the costs of Stamp Duty. Thus Duty can amount to a significant proportion of the equity that developers must provide. In the current economic climate, there is evidence that banks are becoming more risk averse and will be less likely to provide loan finance up to limits that they previously operated. Thus, the imposition of Stamp Duty may impact on developers' investment decisions, making them much more price sensitive than normal. Whereas a general increase in land prices, for example, would be covered by additional loan finance, an increase in Stamp Duties would not. The commencement of Section 110 could, therefore have a more substantial impact, than would be indicated by the standard price elasticities of supply and demand. The High Elasticity Scenario 1 illustrates the impact of the 10 per cent increase as market price sensitivity rises. A reduction in land transactions of almost 7 per cent is predicted.

It is clear that, in such circumstances, the commencement of Section 110 in the current market conditions will lead to more negative impacts on land transactions than would be the case if it were deferred to a period when market conditions were better.

## 4.7 Stamp Duty and Land Market Liquidity

The analysis presented above is at an aggregate market level. There is scope, however, for Stamp Duty to impact on the market in a manner not fully captured by the above analysis. Stamp Duty is a tax on transactions and thus has potential to impact negatively on market liquidity in a number of ways:

- Because it raises the price to be paid for land, it represents an additional cost that has to be recouped before land can be sold on. The higher the level of the tax, the more likely it will lead to a reduced availability of land in the market, particularly in an era when land price growth is slowing down;
- Section 110 could reduce access to the market by new players. In order to access the market, developers have to bridge the gap between land financing and the property value plus Stamp Duty. With loan finance ratios falling, the barriers to entry are rising and Section 110 would exacerbate this situation.
- The small developer could also be affected in circumstances where the land lot size is too large for him to handle, requiring an onward sale of a portion of the site. Such onward sales would be increased in price by Section 110;
- Arrangements e.g. a property sale by a sports club, whereby the vendor of a property requires finance up front to fund an alternative location and facilities could be disrupted by the 25 per cent provision of Section 110; and
- Site assembly could be adversely affected by Section 110, in that the individual lots would incur Stamp Duty at initial purchase and also when the aggregated site is sold on. Such sites are thus likely to increase in price.

## 4.8 Conclusions

The commencement of Section 110 will give rise to increases in the costs of land purchase of about 10 per cent.

The burden of this increase will be shared among land vendors and purchasers. To the extent that land vendors share the burden, there will be a fall in land prices. The sharing of the burden will vary by location of the land, with vendors shouldering less of the increase where prime land is concerned.

The scale of impact of commencement of Section 110 on land transactions will be less than the 10 per cent increase. In normal market circumstances, a relatively small impact on transactions of some 2 to 4 per cent could be expected. Current market conditions are likely to increase the price sensitivity of developers, so that a decrease in transactions of about 7 per cent could be expected. There is also the possibility that developers will react more strongly to Stamp Duty than to a general increase in land purchase costs. This is because Stamp Duty increases will tend to raise the equity financing requirements of developers very substantially.

Section 110 will reduce the liquidity of the land market to some extent by raising the cost of land transfer, the cost of entry to the market, and site assembly and break-down.

# 5. Impact on Tax Revenues and the Housing Market

## 5.1 Introduction

This Section of the Report examines the impact of Section 110 on tax revenues and the housing market. In order to assess these impacts, there is a need to establish the proportion of land transactions that are likely to be affected and the value of land sales generally. This is followed by assessments of the impact on tax revenues and the housing market. To assess the latter impacts, the impact of land price increases is first established. This is followed by a discussion of the impact on consumer and developer confidence.

## 5.2 Proportion of Land Transactions Affected

The impact of the commencement of Section 110 will be determined by the extent to which resting on contract and licensing arrangements are currently being used. This issue was explored with developers interviewed as part of this study.

Use of these arrangements has increased in recent years. This is because the buoyancy of the market has tended to shorten the time from land purchase to development. The introduction of Part V affordable housing policy also gave an impetus to their use. This policy provided that planning permission for residential development could be conditional on the transfer, at existing use value, of not more 20 per cent of land to the local authority to be used for social and affordable housing. As Stamp Duty paid on land purchase could not be recouped from the local authority, resting on contract type arrangements represented a means of reducing the overall cost to the developer of compliance with Part V conditions. Finally, the introduction of the higher rate of 9 per cent in late 2002 was a factor, as it also increased the incentive to find ways of avoiding the duty.

It is used extensively in the ready-to-go market, which involves purchases of land with full or outline planning permission. In these circumstances, both the developer and the vendor know that the development will take place within a limited timeframe, thus reducing the risks of resting on contract. It is also used by companies that have a group structure, with companies in the group specialising in different aspects of the development process such as land acquisition, construction and marketing.

In contrast, it is not used intensively by firms that are land banking. This is because of the length of time and uncertainty involved in bringing such land though the planning process, or waiting for the demand for it to arise. Similarly, where the land deal is a modest one, the developer may feel that it is not worth while suffering the legal and management costs associated with these arrangements. In situations involving large deals for land for commercial purposes, special purpose companies are often used to reduce Stamp Duty, so that resting on contract or licensing are often not the favoured arrangements. This arrangement is more advantageous in office development, where the properties developed are not sold on but are let out. Where the vendor is elderly, there is a perceived risk that death or illness may hinder ultimate completion of the contract and that the arrangements are too risky. Finally, the agreement of the vendor is required to proceed with such arrangements but vendors may want a "clean deal".

It is clear, therefore, that the use of Section 110 arrangements is widespread but is far from universal. While no precise figures emerged from the consultations with developers, a view that such arrangements comprise significantly less than 50 per cent by value of land transactions emerged. A best estimate would be that it would lie in the range of 30 to 40 per cent of transactions by value.

The Revenue Commissioners have also conducted two analyses aimed at estimating the extent of the use of these arrangements. The first comprised a questionnaire to 100 developers, which yielded 89 responses. Of the 89, 34 indicated that their company had, within the two years ended December 2005, structured the agreement with the land vendor so that a Stamp Duty liability was not created. The total value of the Stamp Duty avoided was €39m. In the year ended December 2005, the 100 developers paid €42m in Duty, equivalent to €84m over a two-year period. This suggests that at a minimum one-third of land transactions by value fell under these arrangements. This must be regarded as a minimum estimate, as developers who are heavily engaged in these practices may have been more likely to be non-respondents.

The second analysis undertaken by the Revenue Commissioners was based on the requirement for vendors of land to return a certificate (CG50A). The Revenue examined 200 CG50A forms where the land value was €5m or more. These forms were then cross matched with the Revenue's Stamp Duty database to establish whether a conveyance had been taken out. In 91 of the 200 cases (46 per cent), it had not yet resulted in a conveyance. This is likely to be an overestimate of the proportion of transactions by value for two reasons. Firstly, some of these transactions may have been subsequently conveyed and, secondly, lower value transactions are less likely to use these arrangements.

In light of the evidence obtained from our consultations and the investigations of the Revenue, a conclusion that at most some 40 per cent of land transactions by value employ these arrangements could be supported.

## 5.3 Value of Development Land Sales

There are no official data sources on the value of development land sales. However, a number of indirect measures can be devised.

Firstly, an estimate based on the value of new building activity can be devised. In 2006, the value of such activity was €19.5bn in respect of residential activity and €2.3bn in respect of commercial, yielding a total of €21.8bn. Discussions with developers and previous analyses indicate that land costs as a proportion of output value are typically approximately one-third (see next Section). This suggests that land purchases of c. €7bn would be required to service this scale of activity. Of course, in any one year, land sales could exceed or fall short of this level, as land holdings are built up or run down.

Secondly, an independent estimate has been developed by Savills HOK. This industry source has estimated the development land market at €7.5bn in 2006.[9]

Thirdly, the Revenue Commissioners report that in the year to 30th September 2006, developers paid in excess of €435m in Stamp Duty. If 40 per cent of total land sales are availing of Section 110 type arrangements and the remaining transactions are paying Duty at the 9 per cent rate, then this implies a total value of development land sales of €8bn.

These estimates are quite close and indicate a total development land market value of c. €7bn to €8bn in 2006.

## 5.4 Impact on Stamp Duty Revenues

The impact on Stamp Duty Revenues depends on four factors:

- The proportion of land deals for which Section 110 type arrangements were used;
- The rate of Duty applied;
- The impact of the Duty on land sales;
- The value of development land sales

While it is impossible to be precise, analyses indicate that Section 110 type arrangements would apply to approximately 40 per cent of land deals. Using 40 per cent as a reasonable approximation, a rate of Duty of 9 per cent, and a reduction in transaction volumes of 6.7 per cent (High Elasticity (1) assumption of Table 4.1), the revenue yield of the duty per €1m of land transactions can be estimated as follows:

[9] Savills HOK. Property Outlook, summer 2007.

Revenue yield = value of land (€1m) x proportion in Section 110 arrangements (0.40) x adjustment for reduction in transactions (0.93) x duty rate (0.09) = €33,480. Applying this figure to the value of the development land market, yields a Stamp Duty revenue gain of c. €251m in 2006 market values market values, if Section 110 had been commenced to apply fully in that year. Given the number of assumptions and estimates necessary, this figure should be viewed as indicative. It is also clear that in the current (2007/2008) property market environment the yield would be considerably less, as the value of transactions is likely to be considerably lower.

This estimate assumes that measures to avoid the Duty will not be taken. In practice, the yield is likely to be somewhat lower, as developers introduce avoidance strategies. This could include greater use of SPVs and partnerships with land owners.

## 5.5 Impact on House Prices and Housing Output

This sub-section of the report examines the impact of the commencement of Section 110 on house prices and housing supply. With regard to house prices, it first evaluates the impact if the costs arising from Stamp Duty were to be fully passed through to the house purchaser. This is followed by a discussion of the factors that would mitigate this impact.

The impact of Section 110 depends largely on the proportion of final house prices that are land acquisition costs. Economic theory would suggest that this would vary with the scarcity of land resources, with the land cost proportion being higher in urban areas, where supply is restricted.

There are no comprehensive data in this regard. However, the DEHLG's Review and Outlook assumes that site costs are 25 per cent of house prices on average. In their review of area based tax incentives, Goodbody, partly on the basis of data acquired from the Institute of Auctioneers and Valuers of Ireland, assumed that land acquisition costs represented between 30 and 40 per cent of both residential and commercial developments.[10] The consultations with the industry, which were conducted as part of this study confirmed that latter range, with a view that one-third was a typical proportion for land costs.

Table 5.1 illustrates the impact of Section 110 on first time buyers. It starts by postulating a site price and deriving the house price on the basis that sites costs account for one-third of the price. As indicated in Section 2, FTBs are currently

[10] Goodbody Economic Consultants. Review of Area Based Tax Incentive Renewal Schemes. 2006

exempt from Stamp Duty, so that no Stamp Duty is currently paid if resting on contract or similar arrangements are employed.

The Table then considers the impact of Section 110, which would mean that the developer would pay Duty. Allowance is also made for the financing costs associated with a Stamp duty payment. The Table shows that Section 110 would increase house prices by just over 3 per cent, with the exception of lower price housing where an increase of under 3 per cent occurs. This lower rate of increase is caused by the fact that, in our analysis, lower priced houses have lower site costs and thus attract a lower Stamp Duty rate. A similar analysis, which is not reported here, indicated that other buyers, including owner occupiers and investors, would face similar price rises.

This impact on price assumes that developers pass on the full impact of the Duty. However, as Table 4.1 illustrated, depending on the elasticities of supply and demand for land, a proportion of the tax will be absorbed by land vendors. In current market circumstances, developers will meet resistance from house buyers, so that their price elasticity of demand for land will be high. The conclusion is that only some part of the price increase projected above will occur, and Section 110 is thus unlikely to have a very significant effect in terms of raising house prices. This conclusion is reinforced by the view that only a proportion of land deals use the Section 110 type arrangements, in any event.

Table 4.1 also indicated that the impact is more likely to be felt in a change in land transactions. Again, the maximum effect considered is less than a 7 per cent decrease in land transactions. The immediate impact on the supply of housing will be much less due to two factors. Firstly, as mentioned above, only a proportion of land transactions will be affected, and, secondly, to the extent that developers have land banks, they do not need to enter the land market and incur the Duty. The latter factor would of course operate in the short term only and assumes that there would be no element of retrospection in the application of Section 110.

## Table 5.1 Impact of Section 110 on First Time House Purchase

| Before Section 110 | | | After Section 110 | | | | % Change |
|---|---|---|---|---|---|---|---|
| Site Cost (€000) | Build Cost (€000) | House Price (€000) | Stamp Duty Rate (%) | Stamp Duty (€) | Additional Financing Costs (€) | House Price (€000) | Percentage Change (%) |
| (A) | (B) | (C) = (A)+(B) | (D) | (E)= (D)x(A) | F= (E/8) | (G) = (C) + (E) + (F) | (H) = ((G-C)/(C))*100 |
| 90 | 180 | 270 | 6 | 5 | 1 | 276 | 2.1 |
| 140 | 280 | 420 | 8 | 11 | 1 | 432 | 2.9 |
| 190 | 380 | 570 | 9 | 17 | 2 | 589 | 3.4 |
| 240 | 480 | 720 | 9 | 21 | 3 | 744 | 3.3 |
| 290 | 580 | 870 | 9 | 26 | 3 | 899 | 3.4 |
| 340 | 680 | 1,020 | 9 | 30 | 4 | 1,054 | 3.3 |
| 390 | 780 | 1,170 | 9 | 35 | 4 | 1,209 | 3.4 |
| 440 | 880 | 1,320 | 9 | 39 | 5 | 1,364 | 3.3 |

Source: Goodbody Economic Consultants

## 5.6 Compatibility of Section 110 with Recent Stamp Duty Policy Changes

In summer 2007, as indicated in Section 2, the Minister for Finance introduced measures to relieve all first time buyers of Stamp Duty, with effect from 31st March 2007. The impact of this change was to benefit FTBs (see paragraph 2.5) and one of the impacts of the commencement of Section 110 would be to reverse the effect of this policy to some degree.

This is illustrated in Table 5.2 which was calculated on the same basis as Table 5.1. For example, a house with a site value of €190,000 and a house price of €575,000 would face a price of €570,000 thus saving €5,000 on the house price after the March 31st changes. Section 110 would remove this gain and raise the house price to €589,000, or €14,000 above the original price. Once again, this impact is based on full follow through of Stamp Duty into house prices and this overestimates the effect because of the factors mentioned above.

**Table 5.2: Impact of Section 110 on Recent Stamp Duty Changes for First Time Buyers of Larger Houses.**

| Site Cost (€000) | House Prices Before March 31st 2007 Stamp duty Changes (€000) | House Prices After March 31st 2007 Stamp duty Changes (€000) | House Prices After Section 110 Stamp Duty Changes (€000) |
|---|---|---|---|
| 90 | 270 | 270 | 276 |
| 140 | 424 | 420 | 432 |
| 190 | 575 | 570 | 589 |
| 240 | 729 | 720 | 744 |
| 290 | 884 | 870 | 899 |
| 340 | 1,040 | 1,020 | 1,054 |
| 390 | 1,199 | 1,170 | 1,209 |
| 440 | 1,353 | 1,320 | 1,364 |

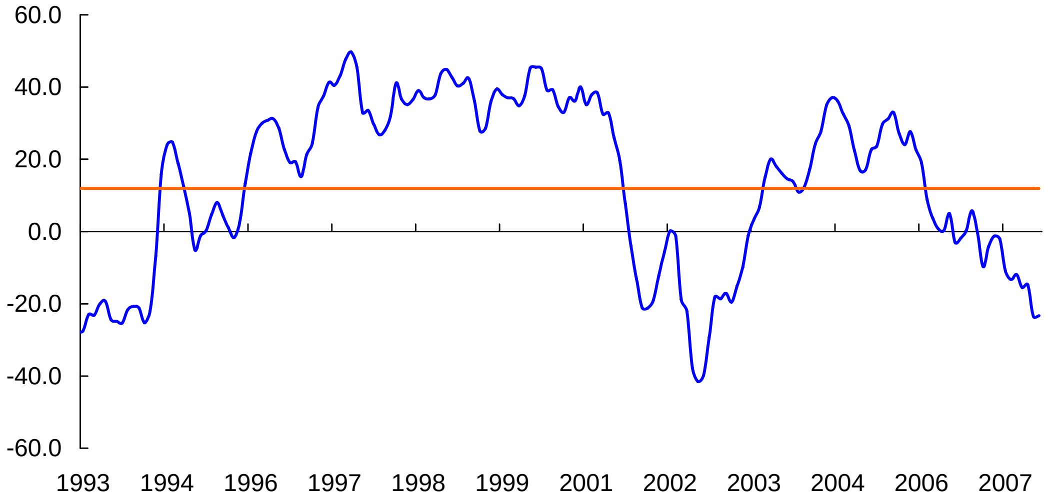
Source: Goodbody Economic Consultants

## 5.7 Impact on Confidence in the Housing Market

While the scale of the direct price impacts of Section 110 on the housing market is relatively limited, there is scope for much more significant effects through the impact on developer confidence. As was demonstrated in Section 3, the residential market is suffering price decreases and severe reductions in commencements. Developers themselves emphasise that sales of dwellings are particularly low compared to the equivalent level in 2006. Current sales are the most relevant indicator of market performance and are the major influence on developer's future investment decisions. Developers say that they have lost confidence in the residential market, a view corroborated by recent surveys.

Figure 5.1 presents an overview of the confidence of the construction sector as a whole. Confidence is falling rapidly and is at its lowest ebb since the post 9/11 decline in 2002. Developers indicate that, unless market sentiment is boosted by interest rate reductions or similar exogenous effects, the downward spiral in confidence and activity levels will continue. Section 110 provisions which would be regarded in very negative vein by developers could further affect confidence at a time when it is relatively fragile. Thus, the impact of Section 110 could be far in excess of its price effects and could help drive activity levels significantly below long term housing market requirements. Such an outcome would be extremely undesirable in terms of housing price and output stability.

**Figure 5.1: Confidence in the Construction Sector**




*Source: European Commission*

## 5.8 Conclusions

The impact of the commencement of Section 110 on tax revenues and the housing market will be determined by the extent to which resting on contract and licensing arrangements are currently being used. The best estimate is that at most some 40 per cent of land transactions by value use these arrangements.

There are no official data sources on the value of development land sales. An indicative estimate is that the total development land market value was c. €7bn to €8bn in 2006.

Based on these data, it is estimated that a Stamp Duty revenue gain of c. €251m in 2006 market values would have occurred, if Section 110 had been commenced to apply fully in that year.

Section 110 could typically raise land costs by some 10 per cent. As land costs are some 30 to 40 per cent of property prices, the follow through impact on house prices will be some 3.3 per cent typically.

Section 110 provisions which would be regarded in very negative vein by developers could further affect confidence at a time when it is relatively fragile. Thus, the impact of Section 110 could be far in excess of its price effects and could help drive activity levels significantly below long term housing market requirements. Such an outcome would be extremely undesirable in terms of housing price and output stability.

If Section 110 were to be commenced, the Stamp Duty charges arising would, to some extent, be passed through to first time buyers in the form of higher prices. This would run counter to recent policy changes, which sought to relieve the Stamp Duty burden on this group of buyers.

# 6. Other Issues

## 6.1 Introduction

This Section of the Report considers a number of other potential impacts that Section 110 could have. It also considers aspects of its manner of implementation.

## 6.2 Local Authority PPP Contracts

In recent years, local authorities have embarked on a number of urban renewal/social housing projects using PPP procurement approaches. There are 16 such projects underway at present, of which three are under construction and the remainder are at procurement stage. They include the Fatima Mansions project and St. Michaels Estate in Inchicore. It is understood that many of these projects incorporate a licensing approach, whereby the private contractor is licensed to enter local authority property for the purpose of building the proposed facilities. This approach removes the costs of Stamp Duty from the contract. Under Section 110, with the requirement for Stamp Duty to be paid once 25 per cent of the consideration is paid over, Stamp Duty would generally become payable on such contracts. This would raise the cost of the PPP contracts and some element of the increased costs would fall on the local authority.

## 6.3 National Roads Authority PPP Contracts

PPP road projects involve the granting of a concession to a private entity to construct and operate a new road for a period, which is normally 30 years. The PPP operator is given a licence to enter land on which the road is built and operated. At the end of the period, the facility is transferred back to the local authority for no payment. No conveyance of land or property occurs as part of this arrangement.

As part of these arrangements, the National Roads Authority usually requires that part of the toll revenues be shared with the State once traffic volumes exceed a certain threshold. In most cases, the Authority anticipates that this revenue share will be a very substantial amount of money that will at least part repay the subvention payments that the Authority will have. There is a probability, therefore, that such payments could exceed 25 per cent of the value of the land. If, in those circumstances, the payments were construed as a charge for access to the land, then Stamp Duty would become payable. This would raise the subvention payments that the NRA has to make to the PPP operator, as the latter would seek to recoup these additional costs.

A counter argument can be made that the sharing of toll revenue could not be construed as a consideration for access to land or that, in any event, the local authority/NRA could have regard to Section 111 of the Stamp Duty Consolidation Act, 1999. This states that Stamp Duty shall not be chargeable on any instrument where the amount of such duty chargeable on the instrument, but for the section, would be payable solely out of moneys provided by the Oireachtas. As the subvention from the State would increase, it is argued that the State would in fact be paying the additional Duty. While the validity of the latter would require a legal opinion, the indirect nature of the payment by the State could make this unlikely.

The key point is that unless the uncertainty surrounding this issue is removed, the cost to the State of PPP road projects would rise, as operators seek to cover the perceived risk.

## 6.4 Property and Area-Based Tax Incentives

There have been a number of property and area based tax incentive schemes in place for a number of years. Following the Finance Act, 2006 the majority of these schemes will come to an end in July 2008. However, some schemes particularly those in the health area for private hospitals and nursing homes, will continue to operate.

The evidence is that the property-based schemes, which provide tax reliefs on the basis of capital allowances, utilise Section 110 type arrangements to a significant degree. On the other hand, such arrangements have not been generally in use with regard to area-based schemes, where Section 23 relief is availed of, but are now becoming a feature of such schemes also.

Resting in contract would appear to be the most prevalent mechanism with regard to property schemes. Generally speaking, these schemes provide investors with tax relief for a number of years as fixed by legislation. Investors exit the arrangement once the tax life is expired, receiving an agreed price for their investment. To avoid paying Stamp Duty, the initial investor does not take legal title to the property. This also means that the operator in buying back the property does not incur a Stamp Duty charge.

There is evidence, from contacts with scheme promoters, that the current difficulties in the property market are affecting such deals. It would appear that some schemes are finding it difficult to attract investors. There may be a number of reasons for this. However, one particularly salient reason appears to derive from that fact that, with the decline in market values, some investors feel that they are over-invested in the Irish market. As a result, they anticipate that they may divest themselves of Irish property and thus find mechanisms of reducing tax liabilities on rental income less attractive.

## 6.5 Implementation Issues

### 6.5.1 Retrospection

There is concern among developers that Section 110, if it were to be introduced, should apply to new contracts or licences only. At present, because of the downturn in the residential property market, some projects are being delayed. This means that the stock of land that is resting on contract or under licence arrangements is higher than heretofore. If Section 110 were to apply to existing contracts, then the burden on individual developers would be substantial.

### 6.5.2 The 25 Per Cent Threshold

This is regarded by the industry as restrictive on two counts. Firstly, where an individual purchases land for housing and incurs the Stamp Duty, but then finds that their circumstances change and they have to sell the land, it will have attracted Stamp Duty twice.

More generally, some lands are acquired through a process of staged payments. This affords the developer relief from having to pay for the land up front. The vendor may gain from arrangements that allow him to share in appreciation of land values as different payments are triggered. Very often land vendors hold land back to achieve higher prices later. This arrangement obviates this effect and encourages the supply of land.

The 25 per cent threshold would reduce the scope for these arrangements and thus reduce the supply of land and the scope for smaller players to enter the market. Developers recognise that these arrangements have been less prevalent of late because of the scramble for land and the willingness to pay high prices. However, they envisage that this will become a more important issue in the more muted market of the next few years. The 30 day limit is seen as restrictive for broadly the same reasons.

### 6.5.3 Uncompleted Contracts

Developers are concerned that the 25 per cent threshold will trigger payments in situations where no transaction ultimately takes place

## 6.6 Conclusions

Implementation of Section 110 will raise the cost to the State of projects procured on a PPP basis. It will also impact negatively on property-based tax incentive schemes, which will add to the downturn in activity in the commercial property sector.

# 7. Conclusions and Recommendations

## 7.1 Property Market Background

The property sector is experiencing a down turn, the first evidence of which dates back to 2006. The residential sector is most affected.

The extent of the decline in the residential sector has been masked somewhat by the fact that building activity is continuing to take place on foot of decisions made some time ago, when market prospects were better. Thus, residential completions, while falling, have not suffered a major decline as yet. However, commencements in the residential sector, as indicated by data for the summer of 2007, have declined year on year by some 40 per cent. House prices are also in decline. While there are no comprehensive data on house sales, market intelligence suggests that they are currently (Autumn 2007) significantly below the very high peak levels experienced in 2006.

There is an overhang of residential units and developers will be reluctant to commence new activity, until existing stocks are sold and market sentiment improves.

Housing affordability has declined and the recent reduction in house prices has made consumers hesitant about entering the market, as they anticipate further price reductions.

There is a very real prospect that house completions could fall below 50,000 units in 2008. If this were to continue, market supply would drop below long term housing demand needs. The result could be a return of rapid inflation in house prices.

## 7.2 Impact on Land Markets

The commencement of Section 110 will give rise to increases in the costs of land purchase of about 10 per cent. The burden of this increase will be shared among land vendors and purchasers. The sharing of the burden will vary by location of the land, with vendors shouldering less of the increase where prime land is concerned.

The scale of impact of commencement of Section 110 on land transactions will be less than the 10 per cent increase. In normal market circumstances, a relatively small impact on transactions could be expected. Current market conditions are likely to increase the price sensitivity of developers, so that a more substantial decrease in transactions could be expected.

There is also the possibility that developers will react more strongly to Stamp Duty than to a general increase in land purchase costs. This is because Stamp Duty increases will tend to raise the equity financing requirements of developers very substantially.

Section 110 will reduce the liquidity of the land market to some extent by raising the cost of land transfer, the cost of entry to the market, and site assembly and break-down.

## 7.3 Impact on Tax Revenues

The impact of the commencement of Section 110 on tax revenues will be determined by the extent to which resting on contract and licensing arrangements are currently being used. The best estimate is that at most some 40 per cent of land transactions by value use these arrangements.

There are no official data sources on the value of development land sales. An indicative estimate is that the total development land market value was c. €7bn to €8bn in 2006.

Based on these data, it is estimated that a Stamp Duty revenue gain of c. €251m in 2006 market values would have occurred, if Section 110 had been commenced to apply fully in that year. Because of the downturn in the property market, a much lower yield would have arisen in 2007.

## 7.4 Impact on the Housing Markets

Section 110 could typically raise land costs by some 10 per cent. As land costs are usually one-third of property prices, the follow through impact on house prices will be some 3.3 per cent typically.

If Section 110 were to be commenced, the Stamp Duty charges arising would to some extent be passed through to first time buyers in the form of higher prices. This would run counter to recent policy changes, which sought to relieve the Stamp Duty burden on this group of buyers.

Section 110 provisions which would be regarded in a very negative vein by developers could further affect confidence at a time when it is relatively fragile. Thus, the impact of Section 110 could be far in excess of its price effects and could help drive activity levels significantly below long term housing market requirements. Such an outcome would be extremely undesirable in terms of housing price and output stability.

Implementation of Section 110 will raise the cost to the State of projects procured on a PPP basis. It will also impact negatively on the involvement of investors in property-based tax incentive schemes, which will add to the downturn in activity in the commercial property sector.

## 7.5 Recommendations

It is recommended that Section 110 provisions should not be commenced at this time. To do so, would run the risk of exacerbating the down turn in the property market.

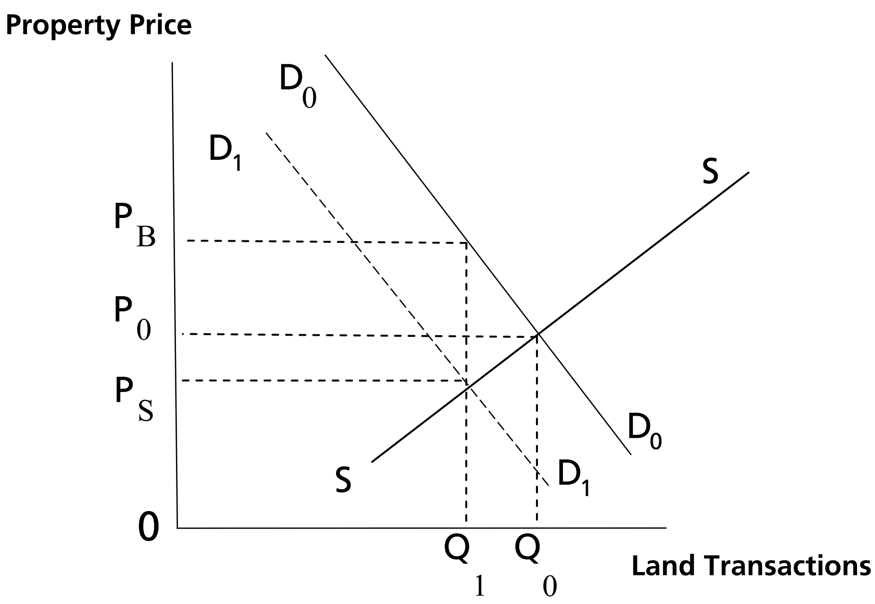
There are arguments for maintaining the current arrangements in the long term. These relate to the negative impacts of Section 110 on land market liquidity and the supply of housing. Government will need to assess the strength of these arguments relative to the tax revenues that would arise from introduction of Section 110.

## Appendix 1: Assessing the Impact of Stamp Duty on Vendors, Buyers and Transactions.

This Appendix develops the relationship between demand and supply elasticities and the proportion of tax paid by vendors and buyers and the change in land transactions.[11]

Figure A1 depicts the impact of Stamp Duty. Initially, in the absence of the Duty, the price of land is set at $P_0$ and the land transactions are $Q_0$. The duty shifts the demand curve downwards, so that at the volume of transactions falls to $Q_1$. At this level of transactions, the buyer pays $P_B$ inclusive of the tax and the vendor receives $P_S$.

**Figure A1: Impact of Section 110**




Of the total tax ($P_B$ - $P_S$), the buyer pays ($P_B$ - $P_0$) and the vendor pays ($P_S$ - $P_0$).

$$E_D = \frac{-\%\Delta Q}{\%\Delta P_B}$$

Where $\%\Delta P_B = (P_B - P_0)/ P_0$ and

[11] It is based on the analysis contained in D.M.Nowlan. Economic Implications of the Proposed City of Toronto Land Transfer Tax. 2007

$E_D$ = the price elasticity of demand

$$E_S = \frac{-\%\Delta Q}{\%\Delta P_S}$$

Where $\%\Delta P_S = (P_S - P_0)/P_0$ and

$E_S$ = the price elasticity of supply

$$E_D \%\Delta P_B = -E_S (\%\Delta P - \%\Delta P_B)$$

$\%\Delta P_B = \%\Delta P \, E_S / (E_S + E_D)$ and

$$\%\Delta P_S = \%\Delta P \, E_D / (E_S + E_D)$$