Northwestern Kellogg School of Management

KE1128
May 24, 2019

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# A Landlord's Certainty:
## The Taxation of Property Investment

December 16, 2015, was an exciting day for 32-year-old Heather Wilson. After years of painstaking savings, she had finally reached an agreement to purchase her first buy-to-let property, a one-bedroom flat in London's sought-after Kensington and Chelsea neighborhood. She looked forward to a lifetime of building wealth through property investments. Of course, some of the income the property would generate would be owed to Her Majesty's Revenue and Customs (HMRC). But such was the nature of life. Unfortunately, the tax laws had recently become less favorable for property investors, but Wilson expected to negotiate a lower purchase price as a result and so she felt confident that her investment remained solid.

## Heather Wilson

Wilson had always been intrigued with real estate. Living in London her entire life, she had experienced a period of time that witnessed tremendous swings in real estate prices (**Exhibit 1**). After prices collapsed in 2008 and 2009, she took what little savings she had amassed and bought a small two-bedroom flat in the Kingston upon Thames area. The rebound in property prices lifted the value of her home over the following years, so when she remortgaged the flat, she was able to extract substantial equity. When combined with diligent savings out of her management consultant paycheck, this meant that now Wilson had approximately £300,000 she could invest elsewhere. She viewed real estate as a way to build lifetime wealth, and so she began looking for buy-to-lets. Because she was relatively risk averse, she looked for investment property closer

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to central London, which ultimately led her to discover the property in the Royal Borough of Kensington and Chelsea.

## The Property

Wilson's buy-to-let property was located on Cromwell Road, a few minutes' walk from the Earl's Court and Gloucester Road tube stations (**Exhibit 2**). It was a one-bedroom flat located at the back of the property, away from the noise of Cromwell Road, with south-facing views, approximately 43.9 square meters in size (**Exhibit 3**). From the property, her tenant would be able to be in Central London in 10 minutes via the Piccadilly line, and in East London in less than 30 minutes via the Circle line. The property was also within walking distance of London's internationally renowned Victoria and Albert Museum, the Royal Albert Hall, and the lovely Kensington Gardens. The property was listed for sale at £565,000, and so, as a benchmark, Wilson assumed this would be her acquisition price. However, she was still in negotiations with the seller, and in light of the new tax rules Wilson thought she might be able to achieve a lower price.

With such a great location, the property was expected to be very easy to let. In fact, the property already had a tenant paying £425 per week, implying a gross rental yield of 3.9%.[1] Although this yield was low, it was actually higher than the average yields in the Kensington and Chelsea area. The neighborhood was among the city's most attractive, and therefore it was not unusual that yields in the area were among the lowest in London (**Exhibit 4**). By comparison, the 3.9% yield on Wilson's property looked rather generous. Of course, there would be expenses associated with property ownership, and with a few additional assumptions (**Table 1**), Wilson was able to calculate that the property would deliver a net rental yield of approximately 3.2%.[2]

**Table 1:** Costs of Investment Property Ownership

| | |
|---|---|
| Vacancy allowance | 1 week/year |
| Property management (as % of gross rental revenue) | 8% |
| Monthly maintenance expense | £100 |
| Annual insurance premium | £675 |
| Capital expenditures as a share of net operating income (NOI) | 10% |

Of course, Wilson expected that the investment would deliver returns in excess of its yield due to price appreciation. After reviewing historical data (**Exhibit 5**), she assumed that the annual increase in the rent she could collect would be 3% per year, which was the approximate average growth rate of rents over the previous ten years. Property expenses would probably grow at a similar pace. Looking at historical property prices (Exhibit 1), she calculated that the average growth rate of property prices in the Kensington and Chelsea neighborhood was 10%. This seemed like a very high number, especially since she knew that home prices had been falling recently. Looking only at the most recent five years, house prices in the neighborhood had increased at an annual rate of

[1] The gross rental yield is calculated as the weekly rent × 52, divided by the purchase price.

[2] The net rental yield is calculated as annual rental income less operating expenses, divided by the purchase price.



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