Live above the shop

Housing continues to be a thorn in the government's side, but, says *Anthony Ratcliffe*, a partial answer to the problem is all around us

The government's ambitious new housing target is to provide 240,000 new homes each year over the next 12 years.

However, nationwide, potential housing for around 500,000 people already exists but is going to waste. Every high street in the UK has redundant upper floors above ground-floor shops that are either disused or only partially used as ancillary storage.

These surplus premises could provide good-quality low-cost flats, often reinstating what had originally been built as residential accommodation, at a present-day cost of approximately £30,000-35,000 per unit.

So why is the government not implementing a national programme of restoration and conversion?

Positive benefits

This question can be best answered by Anne Petherick, founder of the Living Over The Shop (LOTS) project.

Since 1989, she has persistently campaigned for such a programme to be implemented. Her lobbying of various housing ministers and housing associations has failed to garner the necessary fiscal and legislative support.

The proposals in the government's latest Housing Green Paper are disappointing. They detail the release of surplus Ministry of Defence sites; building on floodplains; the pressure on and erosion of green-belt land; the siting of residential developments on possibly contaminated brownfield sites, with the increased commuter traffic that new settlements will generate, thereby increasing pollution and carbon emissions; and the South East bias of development proposals for an already overcrowded region.

The conversion of unused retail upper parts, on the other hand, can be achieved without having to build on the green belt, floodplains or contaminated brownfield sites. Commuter traffic will barely increase, since most of the occupiers will work in or close to the town centre and either walk or bus to their places of employment. Carbon emissions will be minimised; the built structures already exist and internal conversion, with external works to provide self-contained access where necessary, can be carried out simply, cheaply and quickly.

This type of development would have positive social benefits. It would restore urban residential life and could help to reduce the instances of, for example, vandalism, graffiti, alcoholism and street crime. An active residential community would make town and city centres safer and more vibrant, creating, according to the 1999 report of the Urban Task Force, "the critical mass vital to economic and social regeneration".

Property owners would benefit from having their buildings refurbished. Moreover, occupiers would maintain the property and security for the ground-floor commercial premises would be enhanced.

Local authorities would receive increased council tax revenues, thus bringing additional funds into the community. The potential reduction in street crime resulting from greater residential occupancy would mean that councils would be able to spend less in combating anti-social behaviour.

As LOTS says: "Everyone benefits – and no one loses." Why, then, is it not a priority?

Negative factors

Various vested interests must first be brought on board: the freeholders, leaseholders and local and central government. Moreover, many of the suitable properties fall under remote centralised management control. LOTS estimates that around 80% of the UK's high street shops are occupied by national multiples and only 50% of the freeholds are locally owned.

All landlords, whether they be a major institution, a small pension fund, a property investment company or a private investor, will prefer to own a singly tenanted retail investment, preferably let to a national multiple organisation.

A multiple retailer's sole interest is to derive maximum turnover and profit from the retail accommodation. The easy option, therefore, is to mothball the surplus upper part and evade, delay and contest any works of maintenance and repair required by the full repairing covenant in the lease. National retailers increasingly require minimal ancillary storage accommodation, deploying instead the "just-in-time" strategy of frequent restocking from a central warehouse facility.

So neither the landlord nor the tenant has an interest in fragmenting the property. Commercial landlords have traditionally avoided direct residential tenancies. They do not want a tenant whose transient occupation on an assured shorthold tenancy involves reletting the premises every year or so. Neither do they want the bother of refreshing the accommodation on a frequent basis; a short-term tenant is unlikely to maintain the property with the same degree of pride as an owner. The retailer will not expend capital on creating residential accommodation if its interest is merely leasehold and the landlord would capture most of the income benefit at rent review.

Change in structure

However, if the tenancy structure were to be changed so as to free the upper part of a property for owner-occupation, market dynamism would transform the equation. The landlord would be able to take possession to convert and resell the upper part and the tenant would be happy to relinquish its interest, motivated by the removal of a repairing liability on space for which it no longer has use.

Ratcliffes manages more than 100 high street shop properties. Within that portfolio are many underused upper parts that once were, or could easily be converted to, high-quality residential accommodation. The firm is undertaking three projects where, following the expiry of overriding leases, clients have taken back the upper parts and are creating two- and three-bedroom flats, thereby providing 10 units where none previously existed.

Following conversion, it is preferable to sell the flats on a long leasehold interest, since this is economically attractive. The retailer will be happy to renew its lease of the retail and minimal ancillary accommodation at a similar or higher rent as it previously paid for the entire building. Since the landlord already owns the property, it needs only to fund the cost of the building works and consultants' fees. At a conversion cost of approximately £30,000-35,000, the potential resale price will be almost threefold in the quality market towns of east and south-east England.

Such flats have a wide appeal for people who want to live in the town or city centre and benefit from the local amenities and a short commute.

Ratcliffes initially tried to grant 20-year leases to housing associations in order to avoid fragmenting the property interests. However, the attempt was not successful.

Reburbishing unused premises above shops will bring new life and vitality to our town centres and may help to lower crime levels

As the commercial property investment market becomes more sophisticated, there has been a concomitant decline in investors' traditional reluctance to own a freehold retail investment where the upper part has been sold off on a long lease. If necessary, the developer can slightly reduce the price on the retail sale, having achieved an attractive return from the sale of the upper part. The freehold separation of upper and lower parts has been long-established practice in Scotland.

Fiscal problems

The Finance Act 2001 introduced a tax concession to encourage the development of residential units in redundant upper areas above shops, with 100% capital allowances in the first year. The government had hoped that the scheme would yield 1,000 low-rent flats each year over the first five years.

However, in 2006 HM Revenue & Customs (HMRC) confirmed that take-up of the allowances had been much lower than was originally anticipated, with only 1,126 claimants in the first three years of the scheme. It concluded that the allowances had "not produced any significant regenerative impact".

The initiative has not been successful because it is restricted to lettings, prohibiting sales for seven years, and because so many high street properties are held in the tax-free environment of a pension fund. However, if the concession were to be extended so that it applied regardless of whether the created residence was let or sold, take-up would improve significantly.

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More importantly, the April 2006 pension regulations (Pension Schemes (Taxable Property Provisions) Regulations 2006), which prohibit private pension schemes from direct residential investment, need to be amended to allow conversion where the residential element would form the lesser part by value of a larger commercial investment holding.

Under the regulations, a self-invested personal pension (SIPP) that owns a commercial property can apply for residential planning permission but, on the grant of this, must dispose of its interest. It cannot implement the conversion works and then sell to reap the entire reward, but must pass the development profit to another party. Schemes cannot be implemented where properties are in pension fund ownership.

So, on the one hand, the Treasury gives a 100% tax write-off to encourage residential conversions, which is ineffectual because it precludes sales. On the other hand, myopic HMRC pension regulation negates residential conversion above commercial property investments for those thousands of SIPP investors who would be incentivised by the attractive profit margins on resale and at no cost to the Treasury.

Revised regulatory framework

Why the prohibition? Because the HMRC has an irrational fear that the trustees and beneficiaries might use the residential accommodation for their own benefit, although any such abuse would jeopardise the tax-free status of the entire pension scheme.

Even if a trustee/beneficiary tried to do so, is not the positive benefit of creating thousands of low-cost town-centre housing units, with all the social and economic benefits that would ensue, worth this unlikely risk?

A first step towards the government's ambitious target of three million new homes by 2020 could be a revised regulatory framework to encourage the creation of those upstairs low-cost homes that Anne Petherick tells us can house 500,000 people.

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