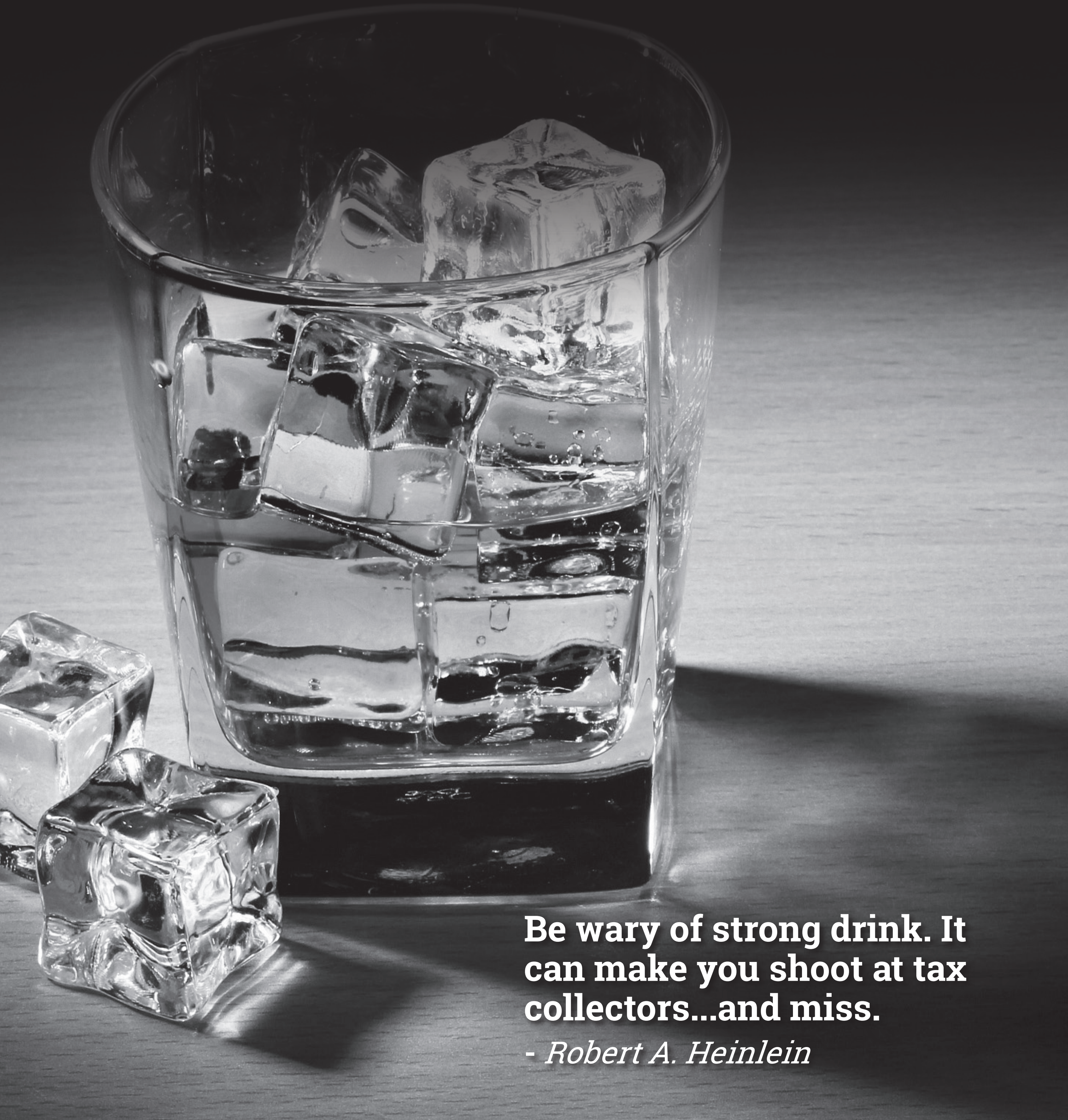
The Schmidt Tax Report

Tax, Money & Property

November 2016



Be wary of strong drink. It can make you shoot at tax collectors...and miss.

- *Robert A. Heinlein*

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Tax, Money & Property

All articles this month by Jonathan Self

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The password is all lower case: str

Tax

News

The gap is closing

The UK tax gap – the gap between tax collected and what the government believes it would be collecting were it not for the black economy and criminal evasion – is closing. Newly released figures suggest that in 2014/15 it fell to its lowest ever level of 6.5%. To put this into perspective, some 10 years earlier it was running at 8.3%. The figures show record revenues of £518bn being collected from 2014 to 2015.

Parliament put HMRC under pressure

The Public Accounts Committee has been putting HMRC under severe pressure over its contract with Concentrix, the company responsible for managing tax credit checks. MPs called on the government to conduct a "comprehensive" investigation into Concentrix's performance under the contract, to include consideration of the potential effect on other HMRC services, and approved a motion calling for urgent action to compensate people who have had tax credits withdrawn incorrectly. HMRC chief executive Jon Thompson said the department "will not be going back to the market" for support in order to deal with tax credit claims.

Making tax digital

Plans by HMRC to "make tax digital" have been severely criticised by small-business experts. Witnesses called to give evidence to MPs on the Commons Treasury Committee said the proposals would impose significant additional tax compliance costs on small businesses for little or no medium-term benefit. The proposed project will impose quarterly digital tax reporting upon SMEs. While free software has been promised for the smallest businesses, others could expect a cost of £20–£30 a month.

EU transaction tax update

The European Commission has been instructed to draft a directive authorising an EU financial transaction tax that would apply to 10 of the EU's 28 member states. The new tax would initially be introduced in Austria, Belgium, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain. The EU taxation and customs commissioner, Pierre Moscovici, welcomed the decision and explained that the tax would be imposed on a "broad base, at very low rates" (still to be defined) to preserve the competitiveness of European financial products against those of the UK. It is planned to levy it on equities, bonds, derivatives and possibly share trading.

Tax-efficient investment up

A record £1.8bn was invested in tax-efficient Enterprise Investment Scheme (EIS) funds last year with the highest percentage going to companies based in the north of England. The region secured 50% more funding in the year to April 2015 than the previous year. Technology and business services companies dominated the fundraising. Venture capital trust (VCT) investments did less well overall, attracting just £435m inflows in 2015/16. Seed EIS (SEIS) is proving a small but growing sector – increasing to £175m in the year to April 2015, up from about £155m a year earlier.

Capital gains tax takeup

Thanks to soaring property values and a sell-off by buy-to-let investors HMRC's annual take from CGT grew by 25% to £6.9bn in the year 2014/15. This represents the highest yield since 2007/08, the year of the credit crunch.

Good news for US multinationals

The US government is reviewing its plans to crack down on US companies using inversion deals to reduce their American tax bills, as they feel it may result in collateral damage to other businesses. The US Treasury secretary, Jack Lew, has stated that he will be modifying the proposed rules because they had heard from businesses that they "could unduly constrain ordinary business practices". The IRS had intended to limit the way companies lend money between their subsidiaries ('earning stripping') in order to substantially reduce US tax liabilities. Non-inverted businesses pointed out that the proposed crackdown would severely inhibit their ability to make ordinary intra-company loans.

Irish vulture fund tax crisis

In 1997, the Irish government introduced tax rules designed to attract the global investment fund industry to establish itself in Dublin. Today, that sector has €1.8tn of assets based in the country. However, the same rules are now being used by foreign investors – mainly US hedge funds and private equity groups – to avoid all tax on their profits. This has caused political uproar and the government is being pressured to close what is seen as an unacceptable tax loophole. There is a lot of money at stake. The foreign investors – technically referred to as non-bank entities but called 'vulture funds' locally – now own 5% of the €100bn of outstanding Irish mortgages.

Editor's Notes

The strategic start-up

Nowadays, our tax legislation is so written that if someone decided to give up smoking not for health reasons but in order to reduce his or her personal tax bill it is possible it would be deemed unacceptable tax avoidance. So, in all tax planning, one has to be extremely careful. Not to put a tooth in it, from the moment you start discussing any sort of tax plan with a third party – which could include a colleague or employee or a specialist tax adviser – choose your words carefully and make sure that everything is not just within the letter of the law but can be justified on commercial grounds. A good example of a commercial activity that will produce accidental, but doubtless welcome, tax benefits is what I would call a strategic start-up. I will explain the concept with a real-life example.

Rodney is the director of a construction business that specialises in installing commercial lavatories and bathrooms. The company mostly supplies pubs, restaurants and hotels. Rodney has no equity in the business, and until two years ago was on a salary of £250,000 a year. In 2013, he sought permission from his employers to set up a business of his own selling domestic bathrooms – a market his employer had never penetrated that was wholly separate to its existing trade – and it was agreed that he would be given three days' unpaid leave a week to launch and build this new venture. So he took a substantial pay cut to £100,000 a year. The new venture was a complete standalone operation – starting in Rodney's home to begin with and later in separate offices – and he was able to work for the existing business and build up the new business at the same time. Indeed, after two years his new business was really flourishing and this year his employers offered to buy it for £600,000. It was agreed that the money would be paid to him over three years. So, for the next three years Rodney will be receiving £200,000 a year in the form of a capital gain. He will pay just 10% tax on this money, thanks to entrepreneurs' relief.

Rodney's business venture succeeds – from a tax perspective – because he was not a shareholder in the purchasing business and because he was not a connected person (i.e. none of the owners of the purchasing business were immediate family members). One may suspect that Rodney was able to make such a success of his business by taking advantage of knowledge, suppliers and facilities supplied by his main employer. One may even suspect that Rodney gained other advantages from his main employer – an informal, off-books loan, for example, or an informal credit arrangement. One may suspect. But providing the evidence says otherwise, one's suspicions must remain just that: suspicions.

This, then, is what I mean by the strategic start-up. It is the starting of a strategic business that has the welcome side effect of being eligible – should it ever be sold – of allowing its owner/directors to take welcome advantage of entrepreneurs' relief. It requires careful thought, but it can be done.

How not to be employed

Sometimes, it makes much better tax sense not to be an employee. Employees pay PAYE, National Insurance and benefits in kind. There are all sorts of work-related expenses that employees can't claim. There are all sorts of extra tax costs that employers have to pay. So, it isn't surprising that, when the situation isn't entirely black and white, HMRC is inclined to argue for employee status. In general, tax specialists advise their clients that the best way to prove they are not employees is to demonstrate that they are clearly self-employed. While this can help, it misses the real point. All the law demands is that the individual concerned doesn't fulfil the 'pre-requisites of employment'. These are: the obligation to provide a personal service, the obligation to be controlled in relation to the manner of the task to such an extent that the worker becomes a servant and that there is mutuality of obligations. If just one of these factors is missing the worker will not be an employee. Of course, it can help to show that someone has their own business, but it isn't necessary.

Incidentally, while I am on the subject, a quick reminder to readers that HMRC recently published a *Consultation on Salary Sacrifice for the Provision of Benefits in Kind*. In a nutshell, it is yet another attempt to make salary sacrifice even less attractive to both employers and employees. The latest proposals are likely to be included in the next Budget. If you are remunerating your employees using salary sacrifice (or if you are benefiting from the current legislation) now might be a good time to review the situation and take professional advice.

Unexpected VAT savings

You aren't registered for VAT but you are about to incur some property-related expenditure below the capital goods scheme threshold that will be VAT-able. Could you get away with registering for VAT, claiming the input tax and then deregistering? The answer is – very possibly. The fear is that any VAT you have had repaid to you by HMRC will be clawed back. However, the mechanism to claw back input tax on services only applies where services are purchased for the purposes of the business but are then put to "private use" or "for a purpose other than a purpose of the business". This is not the case where the business use continues but the business has deregistered. There is, therefore, no possibility of a clawback once the input tax has been claimed, if input tax recovery is due on general principles. This is a complicated area but recent correspondence in *Tolley's Taxation* suggests that a good VAT adviser can achieve wonders in this particular situation.

Sorting the woodlands from the trees

There are fantastic tax breaks to be had from investing in woodland, but ironically when you sell the forest even if there is still timber to be cut and you can show that it is an active business it is very difficult to claim entrepreneurs' relief on the actual land. To quote one expert: "Unfortunately, where commercial woodland is sold the capital gain arising on that disposal is calculated in the normal way, but the part of the disposal proceeds which relates to the trees growing on the woodland is ignored." Is there any way around this? The answer is that where the woodland is part of a larger, agricultural enterprise, it is. Imagine a farmer with 1,000 acres. Of this land 700 acres is turned over to sheep and 300 acres is turned over to the growing of timber. In these circumstances a sale ought to result in entrepreneurs' relief being applied to the whole. There are other tax reasons to consider an investment in farmland – not least the inheritance tax (IHT) benefits. Moreover, the price is currently falling.

Ask The Experts

Q. In the October issue you deal on page 21 with property tax, touching on IHT on land, mentioning "the ideal position is to trigger BPR". In the same issue you kindly answered a question telling me I was trading on my land by growing Christmas trees, also my sons' warehouse goods for their shops in a large barn on site but no rent is charged, only maintenance charges. Self and husband live in the farmhouse attached. My husband is quite ill, and I therefore would like to know what impact both of these trades will have on the IHT treatment of the site. We have other assets, but they are just below £650k as long as the farm is excluded.

J. W., via email

A. The value of assets used in a trading business qualify for business property relief. So that part of the land used in the Christmas tree business would qualify for business property relief (BPR). But that part of the land used by your sons is not in the same ownership as the business: the sons own the business but you own the land. So the land is not being used by you and your husband in a business.

Q. I recently took the plunge and followed your advice and purchased (hire-purchase) a plug-in hybrid vehicle as a company car for my wife to use for non-business related journeys.

I am now in the process of completing my VAT return and was on the verge of re-claiming 50% of the VAT back as per normal rules relating to the private use of capital purchases, when I decided to check the rules as I am signed up to the Flat Rate Scheme for VAT.

Under VAT Notice 733 (FRS) Section 15 seems to state that I can reclaim the VAT, but I am unclear on the statement in Section 15.8 relating to Private Use. The statement says it "assumes" the purchase is wholly for taxable supplies, but the examples provide cases where there is private use and the VAT is still claimable.

My question therefore is can I still claim the VAT back on the capital purchase over £2,000 where the purchase will be used for non-business use as well as some business use. If I can then I assume for this the amount I can reclaim is the full VAT paid.

For information I am an IT Consultant running a personal service company of which my wife is Company Secretary and Director.

P. W., via email

A. It is a good job you checked, because there is a general prohibition on claiming back the VAT on company cars. The only businesses which are allowed to reclaim are ones like driving schools or car hire companies.

Pension Protection

When 'pensions simplification' came into effect in April 2006 there were two main protection measures put in place to ensure that individuals who had already built up substantial pension rights would not be penalised by the introduction of the new lifetime allowance (LTA).

The first of these was 'enhanced protection', which was aimed at those:

- whose pension benefits at 5th April 2006 exceeded the new LTA for 2006/07 of £1.5 million; or
- who believed that they might exceed it in the future and who were prepared to cease all future defined contributions to registered pension schemes and/or limit future accrual within defined benefit schemes to a limit known as 'relevant benefit accrual'.

Anyone could apply for enhanced protection, regardless of the value of their funds, as long as they did so by the deadline of 5th April 2009.

Enhanced protection had the effect of eliminating any LTA charge, so effectively an individual could take an unlimited amount from their pension arrangements after April 2006 and, provided that the protection had not been lost or revoked, no test against the LTA needed to occur and there would never be an LTA charge payable.

The second form of protection was 'primary protection'. This was aimed at those who:

- wanted to continue in pensionable employment or accrue benefits in a registered pension scheme after 5th April 2006; and
- were already over the LTA and likely to be so when they took their benefits.

Under this form of protection, the individual LTA was based on how much the member's benefits at 5th April 2006 exceeded the value of the 2006/07 standard LTA. This individual LTA was intended to increase at the same rate as the standard LTA.

Those who applied for enhanced protection could also apply for primary protection, and where this applied the primary protection would remain dormant and would not apply unless and until the enhanced protection was lost or revoked.

In addition to protecting the value of the pension fund from the LTA charge, the tax-free lump sum (renamed the pension commencement lump sum, or PCLS) could also be protected. The introduction of the LTA on 'A Day' (6th April 2006) limited the maximum tax-free cash at that point to 25% of the LTA (i.e. £375,000). However, for those whose accrued benefits already exceeded the LTA, a higher level of tax-free cash could also be protected.

At the time, not everyone who applied for enhanced and/or primary protection applied for protection of the tax-free lump sum as well and consequently the maximum PCLS they are able to take has been restricted to 25% of the LTA.

When the LTA was reduced from £1.5m to £1.25m on 6th April 2014, the government chose to include within the legislation protection for those who had enhanced or primary protection (but no lump sum protection) and would therefore have been entitled to a PCLS of 25% of the higher amount, £1.5m having been the LTA at A Day. The actual wording used was:

Individuals with existing A Day primary or enhanced protection but who do not have lump sum protection will retain a right to a tax-free lump sum of up to 25 per cent of £1.5 million when the standard allowance is reduced to £1.25 million. This change ensures that individuals in this position do not have a reduced tax-free lump sum when the lifetime allowance is reduced.

The issue here is that, at the time, the government did not foresee the LTA being reduced again, which it was – from £1.25m to £1m on 6th April 2016. As a result, this wording no longer applies as intended and needs to be reworded.

HMRC is aware of this issue, and it is hoped that the appropriate wording will be included in the 2017 Finance Bill. However, there is no guarantee this will happen.

Anyone who is currently thinking about vesting their pension benefits (in full or in part), who holds enhanced and/or primary protection without any lump sum protection and whose total PCLS would be greater than £375,000 when the benefits are vested should therefore seek professional advice before taking any action.

It may be best to consider deferring benefits until the issue has been resolved.

Carolyn Gowen is a Chartered Wealth Manager and Certified Financial Planner at award-winning City-based wealth management firm Bloomsbury. She has been advising successful individuals and their families on wealth management strategies for over 25 years. Carolyn can be contacted on email at truewealth@bloomsburywealth.co.uk or by calling 020 7965 4480.

Employed Or Self-Employed?

Fred gets up in the morning, puts on his working clothes and goes to work at Sid's office/factory/building site. Is he an employee of Sid's or is he self-employed?

This question is as old as the hills in legal and tax terms, but it's just as important now as it has ever been. Why is it so important?

Well, for starters, it's important from the point of view of what rights Fred has against Sid legally. If he's an employee, he's protected by a massive corpus of employment legislation – overprotected, some would say. He immediately gets entitlement to things like workplace pensions and the right not to be simply given his marching orders. The self-employed have no such protection.

But this is a magazine about tax first and foremost: so what we're going to talk about here is the importance of being self-employed, or paying self-employed individuals, from the tax point of view – or, rather, the National Insurance (NI) point of view.

Because it's in the arena of NI that the difference makes the most impact. From the tax point of view, a self-employment relationship doesn't really have any, or much, effect on the amount of income tax the individual pays. It's merely a question of mechanics, with employees being subject to the pay-as-you-earn scheme, and self-employed people having the privilege of being paid gross, and settling up in two six-monthly instalments every year. It's true that a self-employed person has different, and in most ways more favourable, rules relating to the deduction of expenses: but in a typical scenario where someone is supplying not much more than their own personal services, this isn't, in fact, a very important difference in practice.

But the NI regime is completely different between employment and self-employment – goodness knows why, and the government probably has long forgotten. If you are an employee, your pay suffers two separate and distinct NI contributions: the employer's contribution and the employee's contribution. The so-called employer's contribution (because it doesn't actually give rise to any state benefits) is 13.8% on the gross above a fairly low threshold, and with no upper limit. This is no more and no less than a payroll tax. The employee's contribution is 12% between thresholds roughly equivalent to the personal allowance and the higher (40%) income tax bands, and 2% above that. No doubt it will soon occur to some spendthrift and grasping Chancellor of the Exchequer that he can soak the rich by abolishing this upper limit, and charge 12% (or more) on the whole of an employee's earnings. But that's the way things are at the moment.

Self-employed individuals, on the other hand, pay a lower rate of NI (called Class 4) and have no equivalent of the employer's contribution, or payroll tax. So one could sum up by saying that a self-employed relationship gives rise to 15 or 16% less in the way of NI contributions than an employee relationship does.

The front line

In most cases, the distinction is clear-cut in practice. If you are a small cog in the wheel of a large company or organisation, and you go to work every day from 9 to 5, there's no real scope for arguing that you could be dealt with under the self-employed NI code. On the other hand, an accountant or a solicitor in public practice, with his own office, is very unlikely to be anything other than self-employed vis-à-vis clients.

Shareholders/directors of private companies are a special case, and in the past it's been quite popular, whether deservedly so or not, for directors to send invoices to their own companies for payment of their services rather than allowing that payment to go through the payroll. We have to say we think this is a very dangerous game to play, and indeed always has been. A director's pay as such, for acting as director, is specifically within the employed tax and NI code. To pay gross on the argument that the director is not supplying his services as director but is effectively an independent contractor to his own company is asking for trouble, in the form of arguments from the next visiting HMRC inspector. So, as advisers, we're never happy to see clients of ours taking this risk, and most, if not all, heed our advice.

No, those in the front line on this question of the distinction between employment and self-employment are individuals who tend to provide little or nothing other than their own services, and whose time is very much taken up with a small number of clients, or even with only one client. Those who provide their services through a company are also in the front line because of *IR35*.

This dreaded acronym is very well known to those in the industries concerned, including in particular the computer software industry. The rule basically says that if you are providing your services through an intermediary (normally a company) that intermediary has to account for full pay-as-you earn and NI deductions if the relationship between the individual and the person he's working for is really one of employee and employer: if you disregard the existence of the intermediary entity. So this is actually exactly the same test, in effect, as the test applied to the subcontractor on the building site or the computer software engineer working directly for a large organisation.

Who cares?

Is this just the payer's problem or is it just the payee's problem? With *IR35*, it is just a problem for the worker, because the PAYE obligation is slapped on to his company, and the payer, unless it's a government-funded body, will get off scot-free even if *IR35* is found to apply, perhaps some years after the event.

The boot goes on the other foot where a person is being paid directly, that is not through an intermediary. Here the problem very definitely rests with the payer, because the obligation to deduct PAYE and NI contributions rests with the employer.

As we've already said, the big difference between the two statuses is the absence of employer's NI with a self-employed relationship. This is an obligation of the payer, so would it be right to assume that the payer is most concerned in situations where he is not protected by the existence of an intermediary company, which will take all of the flak if the relationship turns out to be an employment relationship?

Superficially, the answer to this would seem to be yes. However, looking beneath the surface, somebody who is looking to pay for a service has a breaking point beyond which he will not pay a greater amount for that service. If he must find employer's NI from somewhere, that inevitably means he's going to be able to pay less to the individual concerned. So being self-employed is potentially of major advantage to the payee as well, even in the direct-payment situation.

How to be self-employed

Having answered the question "Why be self-employed?" we now come on to the question of "How?" Typically of our law in this country, there's no easily understood set of rules written down in one place. Instead, you have to piece together the effects of myriad cases, some of which appear to contradict each other, or even do contradict each other. From the point of view of evidence, it's a very good idea, if you feel you may be somewhere in the grey area between employment and self-employment, to have a written contract, and if you want to show that you are self-employed (or the person you are paying is self-employed) this contract should obviously say as many of the right things as possible – and the contract should be what actually happens in practice as well.

Here's a checklist, then, from the point of view of the payer and payee who want to establish that this is a self-employment situation:

- The payee should have discretion as to how he does his work.
- The payee should have discretion as to where he does his work.
- The payee should have discretion as to when he does his work.
- The payee should be paid by results rather than by the hour.
- The payee, where appropriate, should use his own assets or equipment, e.g. cars or computer equipment, rather than that of the payer.
- The payee should explicitly have no sick pay, maternity/paternity pay or holiday entitlements.
- The payee should not be 'part and parcel' of the payer's organisation.
- The payer should be able to send a substitute to do the job, preferably at his sole discretion.
- While the look of the situation is much less important than the above, the payee should preferably have his own logo, letterhead, trading name etc., and should obviously be registered with HMRC, both for self-assessment and for VAT, if his income goes over the threshold and is within the standard rate of that tax.

Clearly, it's not going to be possible, in many cases, to tick all of the above boxes. Where some indications point towards employment and some towards self-employment, the cases tend to be decided on the basis of adding up the factors pointing in each direction and seeing which prevails. Some of these factors are, of course, more important than others, and really the first three capture the essence of the distinction, if any do.

Do-It-Yourself EIS Companies

Despite its fairly amazing tax benefits, there's nothing particularly magic about an EIS company, that is a company which qualifies for relief under the Enterprise Investment Scheme. Anyone can set one up and, where applicable, tap into these benefits. The main restriction is the type of business the company is allowed to carry on to qualify for the EIS, and we'll come on to this in just a minute. However, here's a summary of the benefits you get from investing in an EIS company:

- If you're not connected with the company (i.e. if you and your family have no more than 30% of the company, you can claim an immediate 30% income tax reduction; in the case of the Seed Enterprise Investment Scheme, or SEIS, this is a 50% reduction.)

- If you qualify for this income tax relief, you're also completely exempt from capital gains tax (CGT) when you sell your shareholding, so long as this is after at least three years.

- Even if you own more than 30% of the company – even if you own 100% – you can roll over any kind of capital gain you have made in the previous three years into shares newly issued to you in the EIS company.

So, for example, if you have made a gain of £100,000 on selling an investment property, which is nothing to do with any trade, but at any time in the next three years you subscribe £100,000 into an EIS company – which can be your solely owned company – the gain can be offset and no tax will be payable, or any tax paid will be refunded. EIS is, in fact, almost the only automatic get-out-of-jail-free card for all kinds of CGT.

If things go wrong, as unfortunately they sometimes do, EIS status is also a way of easily making sure you get relief against your other income for the loss you have sustained on your share subscription.

As we've said, an EIS company can be any company. It just has to tick a few boxes, including that it is an unquoted trading company, not a subsidiary of another company, and so on. But the most important catch to what otherwise looks like an unbelievably generous tax relief is the fact that only companies carrying on qualifying trades need apply. A qualifying trade is basically any trade which doesn't include the following activities:

- dealing in land commodities futures shares, etc.
- dealing in goods otherwise than in an ordinary trade of wholesale or retail distribution
- banking insurance or other financial activities
- leasing or letting or receiving royalties or licence fees
- providing legal or accountancy services
- property development
- farming or market gardening
- woodlands or forestry
- ship building
- coal or steel
- hotels and similar establishments
- nursing homes and care homes
- generating electricity, heat or any other form of energy
- producing gas or fuel
- other subsidised energy-related businesses
- providing services or facilities for any businesses in the above.

The Business Column

The joys and perils of diversification

Fashions come and go in the world of business, as in other worlds. In the 1960s, diversification was the name of the game, and companies such as Lonrho went fully in for this. Even today, supermarkets tend to diversify more and more, selling fresh fruit and veg and banking services from the same premises.

But I'm not here to talk about big business and plc's. If the managing director of Tesco, or a modern-day Tiny Rowland, is reading this, he won't find any advice relating to these areas, because tax planning for large quoted companies is a completely different ball game from the planning appropriate to owner-managed businesses.

I'm not even, you'll be glad to know, planning a comprehensive treatise on how to structure a diversified business: anything lengthy like this is likely to command comparatively little attention, and we at this august organisation have no wish to have our readers stifling yawns or skipping whole articles.

No, what I'm looking to concentrate on here is one or two specific practical points where, in my experience, business people usually get it wrong. And I'm going to start from one big assumption: the business concerned is currently in a limited company.

The default position

Stephen Spender has just inherited from his father the controlling shareholding in the family company, which has manufactured toothpicks successfully for more than a century. He decides that money is to be made from providing motor insurance, that is he is looking to diversify the company. In answer to his critics, he says that the big requirement for an insurance company, which operates in a heavily regulated industry, is that it should have a lot of money. Toothpicks Limited passes this test, because his predecessors in the family have been very prudent, and have neither spent the company's money nor paid it out to themselves as fat, juicy dividends.

What is the default position with regard to setting up this new, and rather different, line of business? In practice, without thinking about it people such as Stephen tend to start the new sort of business in the existing company. If there's a significant reason, perhaps owing to the specific regulatory or commercial requirements of a particular type of trade, for that to be set up in its own separate limited company, this will be so set up: and the company may either be a freestanding company owned by the same shareholders or a subsidiary of the original company. The one thing people almost never think about when diversifying in this way is tax. But the way you set up a new business structurally can have a huge impact on the tax liabilities you face, and this impact can make itself felt in particular at both the beginning and the end of the business's life span. I'm thinking here about relief for start-up losses in the early stages – and tax payable on ultimate sale of the business at the other extreme.

Start-up losses

This is where it's difficult to make any general rule, applying across all businesses, but it's necessary to look separately at each case. Some businesses can be set up without incurring any significant initial expenditure, and therefore they won't, or at least it is to be hoped, be incurring any start-up 'losses'. These losses can derive not from unprofitable trading so much as from initial expenditure, which is available for a tax deduction before the business has really taken off.

The worst way you can structure things – you couldn't think of anything less tax efficient – is to set up a freestanding limited company alongside your existing company, and fund this start-up expenditure with loans from the existing company. It's not the loans that are the problem: it's the fact that these start-up losses have 'nowhere to go' in the newly formed company. All that you can do with them is carry them forward and use them against the profits that you hope will arise in the future.

An improvement on this is to put the new trade into another group company, or even to go back to the default position of setting it up in the existing company itself. At least in this way initial losses are automatically relievable against the profits being made from the existing trade – assuming they are.

But in my view you should always consider another option as well, which is setting up the new trade outside the limited company envelope altogether. Yes, I am talking about LLPs (limited-liability partnerships), but the same effect can also be enjoyed, as far as tax is concerned, with an ordinary partnership or even a sole tradership.

The point is that losses which arise in these vehicles, subject to certain caps and restrictions, are available for offset not just against current profits elsewhere in the limited company envelope but also against all the income of the individuals concerned. And losses which you are using to offset against income being taxable at 40 or 45% are clearly much more lucrative than those merely reducing your 20% corporation tax charge, which is the best you can get if they are incurred within the limited company envelope.

In the first four years of a new business, it's even possible to carry back losses three years, so that income tax you thought was sunk and permanently made over to the government to pour into the black hole of its finances can be recovered by the simple expedient of making sure these are personal losses and not company losses.

My message here is: think about it. Don't just go down the default route.

Freestanding or group?

Moving on completely from the losses point, which is most likely to apply in the early years of a new business, we move on to planning for ultimate sale.

Here, again, business situations tend to be different: and to different questions you obviously are likely to get different answers. But let's put this tax-planning problem in a nutshell.

Fast-forwarding to the end of a business's life, at least as far as its current owner is concerned, let's suppose that the ABC Group is looking to sell one of its trading subsidiaries, A Limited. Following the sale of A, B and C will continue to trade.

At first glance, this sale seems to be extraordinarily well served by the tax system, because the gain which the group company makes on selling A Limited is exempt from tax. This is due to the so-called Substantial Shareholdings Exemption, a politically motivated set of rules designed to make the UK attractive as a place to have your holding company in an international group.

But while this is all very well in the context of a quoted group, in an owner-managed group the situation is a bit different. What if the shareholders, that is the real people who own the group, want to actually get some benefit from these sale proceeds? As A Limited was a member of a group, it isn't possible for them simply to take the proceeds and spend those proceeds on their own personal lifestyle. To do so would be effectively to take a dividend out of the holding company, chargeable, no doubt, at very high rates of tax because the proceeds would come out in a single lump. It's at this point, perhaps, that the family who own ABC Holdings Limited look back on their earlier structuring decisions and regret them. If A Limited, instead of being owned by a holding company, and hence being part of the group, had been a freestanding company whose shares were held directly by the individuals, the sale, it's true, would not have been tax exempt: assuming CGT entrepreneurs' relief applied, there would have been 10% tax to pay. But the money, post 10% tax, would have been freely available for the individuals to spend on whatever they liked.

And the important point is that this is a structuring decision which needs to be made early on, before A Limited has acquired any significant value. To de-group later is much more difficult.

Where all the companies in your group are trading, there is, it's true, a relief known as 'demerger relief' under which you can split up the ABC group into three separate limited companies, A Limited, B Limited and C Limited (or whatever). But demerger relief will be almost certainly refused by HMRC where it is taking place in immediate contemplation of a sale.

What do I do?

You'll remember that I started off, when considering the opening loss position, by commenting that a freestanding company is the worst possible structure to diversify into, from the point of view of loss relief. And now, you will say, here am I advocating the freestanding company as the best structure, because of its CGT effects.

I plead wholly guilty to the mixed message here: the two tax considerations do indeed fight against each other. But remember two things: first, in some circumstances the ultimate sale situation is more important than using start-up losses, and vice versa and, second, with care it may well be possible to have your cake and eat it by restructuring after the benefit of the start-up losses has been enjoyed. You do need to tread very carefully indeed here, because there are specific rules to discourage arrangements that milk a start-up or other company of its losses, and then move on to another arrangement. But if, at the very least, this article has got the point across that structuring a new diversified business is all important from the tax-planning point of view then I will have achieved what I set out to.

Alan Pink FCA ATII is a specialist tax consultant who operates a bespoke tax practice, Alan Pink Tax, from offices situated in Tunbridge Wells. Alan advises on a wide range of tax issues and regularly writes for the professional press. Alan has experience in both major international plcs and small local businesses and is recognised for his proactive approach to taxation and solving tax problems. Alan can be contacted on (01892) 539000 or email: alan.pink@alanpinktax.com. His book, The Entrepreneur's Tax Guide, is on sale from Head of Zeus for £20 and from all good bookshops.

The Offshore Column

America welcomes entrepreneurs

The US government has announced that it is keen to attract international entrepreneurs. In order to facilitate this, it is proposing to grant suitable candidates temporary residence while they start or grow a US-based business. The objective is to attract entrepreneurs whose presence in America would bring about "significant public benefit through the substantial and demonstrated potential for rapid business growth and job creation". Entrepreneurs who wish to apply must have a minimum of 15% equity in any qualifying start-up and be central to its operations. The start-up must have been established within the past three years and it must show potential for major expansion. It is intended that the entrepreneurs should be able to stay for at least two years with the potential to extend it for up to three further years. If the planned concession goes ahead, it should be in place by the end of 2016. Interested parties are advised to contact their local US embassy in the new year.

Information must be given to offshore customers

The International Tax Compliance (Client Notification) Regulations have been brought into force in the UK. These apply to financial institutions and advisers – such as accountants, IFAs and solicitors. The new regulations mean that customers and clients must be told what information HMRC will be receiving automatically from 2017 under the OECD Common Reporting Standard (CRS). Professional advisers must notify individuals who they provided with either general personal tax advice or specific offshore tax advice. They must also notify clients where they have made referrals to connected overseas advisers. Banks and other financial institutions must notify individual account holders who were UK resident for the tax years 2015/16 or 2016/17 and held an account with the institution on 30th September 2016, which was either worth more than $1 million or held in a participating overseas jurisdiction, including referrals by another financial institution. If you are such a customer or client, you must be sent the notification before 31st August 2017.

Double Dutch problems

The Swiss Supreme Court has ruled information about Dutch holders of Swiss bank accounts should be sent to the Dutch government. The Dutch tax authorities are seeking details about any Dutch national who has more than €1,500 in a Swiss account and has not provided their bank with evidence of tax compliance. The request has been made as part of the 2010 double-tax treaty between the two countries. The French tax authorities have also asked Switzerland to hand over client information for some 45,000 bank account holders. The assets concerned are believed to total more than $11 billion.

Israel court upholds FATCA

The Israeli Supreme Court has rejected an attempt by a group of US/Israeli dual nationals to stop Israel from implementing the US Foreign Account Tax Compliance Act (FATCA). The Israeli tax authority must now start sending information on all accounts with a balance of $50,000 or above controlled by US persons to the IRS immediately. Legal action was filed by the Republicans Overseas Israel, an organisation of expatriate Republican Party supporters who hold dual US/Israeli citizenship.

Bahamian leak

The International Consortium of Investigative Journalists (ICIJ) has published 1.3 million files leaked from the Bahamas Corporate Registry. The stolen data relates to 175,000 Bahamian companies, trusts and foundations registered between 1990 and early 2016. The information – which includes the names of directors, trustees and shareholders – is now available, free of charge, on an online searchable database. The Bahamian Shadow Finance Minister Peter Turnquest told the Nassau Guardian: "We must now reconsider our tax structure as it relates to international financial centre clients as well as domestically. We must look at our immigration policy to ensure we steer clear of the claim of being a jurisdiction of convenience, and we must look at our openness to transparency as defined by the OECD and others. We must redefine our value proposition based on clarity, transparency and compliance today with full anticipation of the next OECD moves." Bahamian banks are believed to hold deposits worth £172bn. It is expected that HMRC will start analysing the stolen data as soon as it has the resources available.

Denmark buys taxpayer data

The Danish tax authorities have announced that they have purchased a vast cache of data relating to Danish citizens who hold offshore bank accounts, offshore companies and other offshore vehicles. They paid $900,000 to an anonymous seller for the information. The material is supposed to have come from the same source as the Panama papers.

New Cyprus citizen scheme

The Cypriot government has revised its citizenship-by-investments scheme, making it easier for entrepreneurs and investors to reside in Cyprus and obtain Cypriot citizenship. The new scheme means that those wishing to apply for a Cypriot passport must make an individual investment of €2 million and purchase a residence worth at least €500,000. The applicant's parents may now apply for citizenship through the same application. The new scheme costs substantially less than the previous scheme, which required fixed bank deposits worth at least €5 million.

Do you have significant control?

A reminder to readers that since the beginning of this tax year all UK limited companies and LLPs have been required, by law, to keep and maintain a people of significant control (PSC) register. Moreover, since 30th June the information being held must also be disclosed to Companies House as part of the annual confirmation statement. Directors should be aware that failure to comply with the PSC register rules is considered a criminal offence. Also, directors should be aware that Companies House will be receiving information on the same subject from other sources, such as banks, so it is important to be 100% accurate and to verify sources. The whole purpose of the PSC register is to ensure that there is total transparency regarding the way UK businesses are owned and structured. A person of significant control is an individual who meets one or more of the following conditions:

- direct or indirect possession of more than 25% of the company's shares;
- direct or indirect possession of more than 25% of the company's voting rights;
- direct or indirect possession of the right to dismiss or appoint the majority of the directors;
- the right to or actual exercise of significant influence or control; and
- the right to or actual exercise of significant influence or control over the activities of a trust or firm, such as a limited partnership, that is not a legal entity but would satisfy any of the first four conditions if it were an individual.

Crucially, where a UK company has non-UK shareholders, including a non-UK company, the directors need to pursue the directors or trustees of the offshore vehicle in order to ensure that they have correctly ascertained who controls such vehicle or vehicles. In plain English, someone who controls a UK business through a foreign company or trust is also caught by the rules. Note, too, that a PSC is an individual who meets just one of the conditions.

The whole situation is made more complicated by the fourth money-laundering directive. The aim of this directive is to identify who the individuals are behind corporate structures and hold them accountable for what is happening within those structures. The fourth money-laundering directive has not yet been fully implemented in the UK or, indeed, elsewhere in the EU. What's interesting is that there are some discrepancies between what is required under the directive and what is required under the new PSC register rules.

Is there any way to hold shares in UK companies that would allow you to escape both the fourth money-laundering directive and the new register rules? The answer is maybe. At the moment, there are a number of discrepancies that could allow individuals to avoid being registered. For example, the whole emphasis of the register is on control. So, if the equity in the business were divided between voting and non-voting shares and the individual concerned had only non-voting equity (in other words purely an economic interest) then it is possible that they could escape having to be listed. By the same token, certain sorts of trusts may be exempt and so if an individual is a beneficiary of an offshore trust (in particular a discretionary trust) and the trust is managed in an appropriate way it is, also, possible that they could escape being included in the register.

Ultimately, the news is probably bad for those who wish to keep their personal affairs confidential. The very wealthy may be able to argue with their advisers that their names need to be kept secret for reasons of security. So, too, may those whose businesses are considered to put them at substantial risk (e.g. those involved in Life Science enterprises). In general, however, individuals are going to have to look for more subtle ways to maintain their confidentiality.

A final note, as the rules currently stand most property holding companies are excluded. However, it is likely that such companies will have to register in some other way in the near future.

Offshore centre: Hungary

VAT is 27%, which is the highest rate in the EU and probably the world. Certain industries also suffer extra taxes, including banking, financial services and advertising. However, in all other respects the Hungarian tax system favours the taxpayer. To begin with, personal income tax is a flat tax of 15%. Moreover, inheritance and gift tax are 0% between direct-line relatives and spouses. What about corporation tax? For the first €2 million or so of profit the rate is 10%, after which it jumps to 19%.

There is also a favourable intellectual property (IP) box regime. A Hungarian company can be used in order to ensure a 0% tax rate. This is particularly useful as Hungary IP rights include trademarks, patents, copyrights and software. In fact, you can apply intellectual property rights to almost anything.

What about trusts? Well, interestingly, Hungary introduced something very akin to that of the English trust into law about two years ago. However, there is an important difference. The Hungarian courts do not believe in dual ownership. In other words, there is no difference between the legal owner and beneficial or equity owner. This makes Hungarian trusts a contractual relationship. Once a settlor signs a trust deed, there is a contract. Under the contract, the settlor must transfer the assets to the trustee. In doing so, he also transfers the ownership. This makes the owner the trustee. Providing a professional trustee is used, there is no need to register or notify the government or tax authorities. This is because the trustee itself is registered as a financial institution. The transfer of assets into the trust is not taxed but the trust itself pays tax at the corporate tax rate of 10%. Of course, it only pays this on profits. Before I say anything else, I must re-stress that because of the way the law works in Hungary there is no need for trust accounts to be published and no need for any other information to be provided to the tax authority. This offers complete privacy to beneficiaries. What about distribution? Well, the trustees must distribute from taxed profit. Rather, it must distribute from taxed profit first. Depending on where the beneficiary of the trust is located, distributions could be completely tax-free.

Confidentiality. A low tax rate. EU membership and lots of dual tax agreements. Fantastic flexibility. Hungary has a great deal to offer the international entrepreneur or business. Locating there is a bit like hiding something in full sight.

Money

Alternative Investment: Private Equity

"Be fearful when others are greedy," said Warren Buffett, "and greedy when others are fearful." It is a good investment philosophy and one that I believe will shortly become relevant to the private equity market. Investment in start-up and growing businesses has fallen dramatically – despite the recent craze for equity crowdfunding platforms – and this could result in some very interesting and lucrative profit opportunities.

What is private equity?

Private equity is the least alternative of the alternative investment options that I normally write about, primarily because it doesn't involve purchasing a tangible asset. On the other hand, it has many features in common with other alternative investments, including illiquidity, lack of correlation to traditional markets (such as bonds), the need for expert knowledge before investing and so forth.

The plain-English description of private equity is shares in unlisted (i.e. private) companies but the technical definition is: "The asset classes consisting of equity securities and debt in operating companies that are not publicly traded on any stock exchange." Private equity investment would generally be made by a private equity firm, a venture capital firm or an angel investor. Each of these categories of investor has its own set of goals, preferences and investment strategies; however, all provide working capital to a target company to nurture expansion, new product development or the restructuring of the company's operations, management or ownership.

Private equity/venture capital firms

There are now thousands of private equity/venture capital firms – companies that specialise in identifying and investing in private limited companies – in the world. They have earned themselves a reputation for generating substantial profits for their own investors. How? An article in the *Harvard Review* suggests:

Private equity firms' reputation for dramatically increasing the value of their investments has helped fuel this growth. Their ability to achieve high returns is typically attributed to a number of factors: high-powered incentives both for private equity portfolio managers and for the operating managers of businesses in the portfolio; the aggressive use of debt, which provides financing and tax advantages; a determined focus on cash flow and margin improvement; and freedom from restrictive public company regulations.

But the fundamental reason behind private equity's growth and high rates of return is something that has received little attention, perhaps because it's so obvious: the firms' standard practice of buying businesses and then, after steering them through a transition of rapid performance improvement, selling them. That strategy, which embodies a combination of business and investment-portfolio management, is at the core of private equity's success.

In other words, how well they perform depends on skill: skill at choosing investments, skill at managing and improving those investments and skill at finding appropriate exit strategies.

One way to get into private equity is to invest in a private equity firm. Another is to replicate their approach on a smaller scale by becoming a business angel.

Be an angel

Investors who buy into unlisted companies are usually referred to as 'angels'. They are, for the most part, affluent individuals who provide capital in exchange for convertible debt or ownership equity. A small but increasing number of angel investors invest online through equity crowdfunding or organise themselves into angel groups or angel networks to share research and pool their investment capital, as well as to provide advice to their portfolio companies. Angels are often retired entrepreneurs or executives who may be interested in angel investing for reasons that go beyond pure monetary return. These include wanting to keep abreast of current developments in a particular business arena, mentoring another generation of entrepreneurs and making use of their experience and networks on a part-time basis. Thus, in addition to funds, angel investors can often provide valuable management advice and important contacts. Because there are no public exchanges listing their securities, private companies meet angel investors in several ways, including referrals from the investors' trusted sources and other business contacts, at investor conferences and symposia and at meetings organised by groups of angels where companies pitch directly to investors in face-to-face meetings.

High risk, high returns

Private equity investments bear extremely high risks and are usually subject to dilution from future investment rounds. As such, they require a very high return on investment. Because a large percentage of angel investments are lost completely when early-stage companies fail, professional angel investors seek investments that have the potential to return at least 10 or more times their original investment within five years, through a defined exit strategy, such as plans for an initial public offering or an acquisition. Current best practices suggest that angels could do better setting their sights even higher, looking for companies that will have at least the potential to provide a 20 or 30 times return over a five- to seven-year holding period. A *Harvard Report* by William R. Kerr, Josh Learner and Antoinette Schoar provides evidence that:

Angel funded start-up companies have historically been less likely to fail than companies that rely on other forms of initial financing.

This is due to the fact that before any angel puts their money into a business they do their research.

The importance of research

If there is one characteristic that all successful angel investors share (apart from luck!) it is an enthusiasm for research. It falls into three main categories, being:

- finding suitable companies to invest in;
- market research, to understand the sector the company is operating in;
- competitor research, to understand what the company is up against.

It is also important to really study the company's business plan, its financials and its management. The CEO of Burger King once said: "When you finish writing a business plan you know that it describes the one scenario that is never, ever going to happen." The business plan should give you a feel for how the management team will deal with what actually happens when the business starts. Will they, for example, be able to come up with a viable Plan B (C, D, E, F etc.) if things do not go well? Three areas to look at hard are (1) the founders' previous experience (check Companies House) and personalities (check social media), (2) the marketing plan and (3) cash flow forecasts.

Bear in mind, too, that if the business takes off it may be as disastrous as if it fails. A well-known angel investor joke refers to the telegram reputedly despatched (this is in the days of telegrams) by someone in Monte Carlo to his bank: "System working. Send more money." Growing businesses tend to suck up cash!

You don't necessarily have to be entrepreneurial to be a successful angel but you certainly have to be able to assess the entrepreneurial capabilities of others.

My favourite source of investment research

Everyone has their own way of finding investment opportunities. One of the most popular is angel investment clubs and platforms, which I will come on to in a minute. For those who are serious there are various research organisations that track the private equity market and sell data. Typical of this, in the UK, is a company called Beauhurst, which offers a platform that lets you access rich information on UK high-growth companies. In a nutshell, a Beauhurst subscription allows you to search through companies, funds and transactions instantly. You can filter by hundreds of variables and conditions to find what you need in seconds. Having found companies you are interested you can create deep company profiles. This allows you to view an interactive time line of notable events, giving immediate access to verified investment amounts, valuations, key contacts and financial history. You can then go on to monitor companies (or sectors) you are interested in to see how they are progressing.

To give you an example, in late October it was announced that Time Out had acquired the event app YPlan for just £1.6 million despite the company's previous valuation of just over £40 million. The deal meant that YPlan exited for a fraction of its promised value. Four previous funding rounds saw it raise £24.3 million from a string of ventures including Octopus Ventures, Nokia Growth Partners and Qualcomm Ventures. Indeed, its last fundraising (in an unannounced deal) valued the company at a whopping £41.6 million.

The exit was clearly not a sign of success. The business had struggled with its value proposition, structure and financials, laying off about a third of its staff at one point and pivoting from direct sales to a self-service model – where event organisers managed their own listings. Anyone who invested in the Beauhurst platform would have been able to watch what was happening at YPlan from day one. Moreover, they would have benefited from an analysis of the other unsung event apps currently being launched in the UK. Indeed, they highlighted a company called Velocity – a restaurant and venue recommendation app that also allows users to make bookings. It also mentioned a destination curation app called Dojo, a venture stage live music ticketing app called Dice and many others.

Beauhurst is not a cheap platform to buy into but if you are serious about investing in potentially fast-growth businesses it is probably a must. If you can't afford direct access yourself, you may be able to find someone else who will let you access it through their subscription.

Joining other angels

Prior to the launch of equity crowdfunding (see below), many angels joined together into groups in order to find and assess opportunities. These groups would often pool research, circulate prospectuses and even offer times when companies looking for finance could come and meet/present to them. Interestingly, despite the growth of equity crowdfunding, many angels still belong to such groups – so clearly they have a very real value. The largest group in the UK is the UK Angel Investment Network (www.angelinvestmentnetwork.co.uk), which now has 30 branches and 689,413 registered members of which 126,099 are investors and 563,314 are entrepreneurs. It actually claims to be the largest angel investment community in the world and there is no reason to doubt this. Another organisation to consider joining is the UK Business Angels Association (ukbusinessangelsassociation.org.uk), which is the national trade association representing angel and early-stage investment. It represents some 18,000 investors across the UK and has done much to raise awareness and promote the asset class as well as to promote good practice and establish standards.

Equity crowdfunding

The single-most-popular way to search for private equity investment opportunities is through one of the new equity crowdfunding sites. Equity crowdfunding is the process whereby people (i.e. the crowd) invest in an early-stage unlisted company in exchange for shares in that company. The shareholder has partial ownership of the company and stands to profit should the company do well. Equity crowdfunding has helped democratise investment into early-stage companies by opening the door to a larger pool of potential investors, more specifically to individuals that the Financial Conduct Authority (FCA) terms sophisticated investors and/or high-net-worth individuals. In the UK a sophisticated investor must be at least one of the following:

- A member of a network or syndicate of business angels and must have been one for at least six months.
- Someone who has made more than one investment in an unlisted company in the past two years.
- Someone who is working, or has worked, in the past two years in a professional capacity in the private equity sector, or in the provision of finance for small and medium-sized enterprises.
- Someone who has been in the last two years, or is currently, a director of a company with an annual turnover of at least £1 million.

In the UK, a high-net-worth individual must have one of the following:

- An annual income to the value of £100,000 or more.
- Net assets to the value of £250,000.

The top-ten crowdfunding platforms

The best way to understand crowdfunding is to visit a few of the many sites that have been set up both in the UK and overseas. Below is a list of the top-ten European equity crowdfunding platforms.

1. Crowdcube is an award-winning, investment crowdfunding platform, and one of the longest-established UK sites. It provides a variety of firms – from motor companies to pizza delivery firms – the opportunity to pitch for funding. Many of the businesses seeking finance through Crowdcube are already established and seek investment to expand their footprint in a particular market. Investors can view a business plan and a video, which details why the company is seeking funding and the potential rewards on offer. Crowdcube offers the opportunity for anyone to invest alongside professional investors in start-up, early-stage and growth businesses through equity, debt and investment fund options.

2. Seedrs is more focused on start-ups. Angel investors and venture capitalists invest alongside friends, family and tribes of supporters. Their model offers support before, during and after fundraising. With a global community, Seedrs has connected with active investors and entrepreneurs from 48 countries.

3. SyndicateRoom is a newer entrant to the crowdfunding space. Pitched as the UK's only investor-led equity crowdfunding platform, a different model is offered. Listed are companies already backed by professional business angels, who invest their own money and take an active role in evaluating the strength of the deal. Members who are not business angels are offered the same economic terms if they decide to invest alongside the professionals. Syndicate Room's vision follows a transparent approach allowing its members access to a more sophisticated set of investment opportunities.

4. Funding Circle UK, based in London, is a leading marketplace for business loans in the UK, US, Germany, Spain and the Netherlands. Its model allows people and organisations to lend directly to small businesses. With almost 50,000 people having invested in over 15,000 small businesses via Funding Circle, it is supported by the British Business Bank, a development bank wholly owned by the UK government.

5. LendInvest is not involved with raising private equity but is the UK's first peer-to-peer lending platform specifically for residential and commercial mortgages. A very unique debt crowdfunding company, LendInvest allows investors to find and invest in new loans.

6. Companisto, a Berlin-based equity crowdfunding platform, offers investment opportunities of anything from €5 to €500,000. It has funded companies and start-ups from various industries such as real estate, food, toys and digitech.

7. FundedByMe, a Swedish early entrant crowdfunding platform, offers a combination of reward- and equity-based crowdfunding for intelligent growth, allowing you to invest in products and services that you love or are passionate about.

8. Invesdor, a Helsinki-based equity crowdfunding platform, is the first to operate and provide financial alternative investment services in northern Europe. It serves as a matchmaker between investors and businesses.

9. Seedmatch is Germany's leading crowdfunding platform for start-ups. It offers investments from as little as €250. To date it has funded 82 projects to the tune of more than €24 million.

10. Symbid (aka the Funding Network) is a Netherlands-based equity crowdfunding platform that allows both traditional and new ways of providing finance to small and growing companies. The minimum investment is €20, and to date they have raised over €417 million for a wide range of businesses. The platform has 35,515 registered private investors.

The disadvantages of crowdfunding

It would be wrong to view all equity crowdfunding platforms as being equal. The best allow investors to find a wide range of suitable opportunities and make the actual investment process easy and straightforward. It is still early days, of course, but to date there have been remarkably few successes in terms of profitable exits. One commentator, Rob Murray Brown, points out that:

To date investors in all the UK equity crowdfunding platforms have lost in excess of £5 million. Without fail pitches on a platform like Crowdcube promise returns in three or four years, so we really should be seeing some by now. There is absolutely no evidence that we will. My research, based on Crowdcube and a few pitches from other sites since 2011, show that 99.9% of the companies that have raised money this way have missed their projections for all years since. These are the projections promoted by the platforms that persuaded the punters to decide to invest. Under the current regulations this is all totally legal. Given the illiquid nature of these shares and the poor performance of these businesses, the chances of realising any return look very remote, as they are locked in for eternity or until closure. Throw into this mix the dilution offered by B shareholders, when the inevitable unscheduled second and third raises occur, and you have a gloomy picture. Moreover the reporting systems for businesses with a turnover of less than £6m only require them to file a very sparse balance sheet for their annual accounts.

Mr Murray Brown believes that many private companies are seeing equity crowdfunding as an easy source of cash and as a result are overtrading – with the usual dire consequences. A more responsible approach, in his opinion, to promotions and to due diligence with the financials would help alleviate these problems.

Making money from private equity

A report by Nesta (the National Endowment for Science Technology and the Arts) showed that business angels who invested in businesses and industries they knew something about, and created a portfolio of investments (not putting all their eggs in one basket, so to speak), were more likely to see a positive return from their investments.

It generally takes between three and seven years for a company to find out whether it will sink or swim, although failures usually happen earlier than successes. There are three main ways you may see a return on your investment:

- Dividends: the company sometimes pays a percentage of its yearly profits to shareholders.
- A trade sale: the company is sold to another company for a lump sum, which is divided proportionally between shareholders.
- Public offering: the company is so successful that it is listed on a stock exchange and shareholders can sell their shares at a price determined by public demand.

Incidentally, many private equity investment opportunities in the UK offer tax reliefs through either the Enterprise Investment Scheme (EIS) or the Seed Enterprise Investment Scheme (SEIS). The government has designed these schemes to provide tax relief covering from 30 to over 75% of an investment into an eligible company. Regarding eligibility, investors should check that a company has received an advance assurance from HMRC to offer SEIS or EIS relief as this indicates the company meets HMRC's criteria to do so.

What is happening to the private equity market?

At the beginning of this article I mention that private equity investment volumes have fallen all year. I don't think it is an exaggeration to say that 2016 has been dominated by political and economic upheaval. Brexit, the economic woes of countries like Brazil and China, the possible break-up of the EU, the American presidential election, the war in Syria, global warming, Russian aggression and many other factors have contributed to a general feeling of market uncertainty. Nor does anyone expect a sudden turnaround. Whether some of these issues are resolved soon or not, the general mood of the market is that we are in for a long period of turmoil. It is, therefore, unsurprising that there is a notable decline in investment in high-risk (and potentially high-growth) businesses across the UK.

Beauhurst (see above) tracks all the equity funding secured by UK private companies and compiles it into a quarterly report. As the authors of the most recent edition point out: "The picture is somewhat bleak for equity investment in the UK's high growth businesses." Overall, the number of deals has fallen by 10% and the amount being invested has fallen by 29% when compared to 2015. The amount of money being raised by crowdfunding has also dropped – by 17% – and the average amount involved in each deal is down, too. Interestingly, every sector saw a fall in deal numbers. The biggest loser by percentage was retail, falling by 43%. But in terms of pure numbers it is technology companies that suffered the biggest decline. Within technology – which still makes up the majority of the high-growth companies tracked by Beauhurst – software companies have experienced the starkest fall, with a 20% drop.

Examining the geographical data, investment has plummeted in London, with deal numbers falling by 28% – a steeper fall than in the UK as a whole. Interestingly, a few clusters outside London have defied the national trend. Cambridge, Manchester and Oxford all saw growth compared to the previous year. Their modest growth, however, is not enough to counteract the impact of the decline in deals.

But the news is not all bad

There have been some spectacular exceptions this year, most notable of which is probably Magic Pony Technology. Magic Pony is in the business of enhancing images. It has created an app and software that can take an existing photograph or video and make it look much, much better. Being able to enhance image quality is something that has become incredibly popular amongst the users of social media and it is considered something that every social media platform must be able to offer its visitors. The company was founded by two postgraduates from Imperial College in 2014. In May 2015, they received £1.25 million in funding, valuing the young business at just shy of £2.5 million. In April 2016, another investment was made of just over £3 million with a valuation of £16.7 million. In June 2016, just three months later, Twitter acquired the company for £102 million. Another example of a company that was snapped up by a US multinational is Two Big Ears, an Edinburgh-based virtual reality company. Two Big Ears was bought by Facebook last summer in a multi-million-pound deal. Clearly, some companies are managing to buck the overall trend.

Back to Buffett

Which brings us back to Warren Buffett's investment philosophy. There is a feeling that investors are becoming fearful. It could be, therefore, an extremely good time to become greedy.

Brazilian Adventure

In 1933, Peter Fleming, brother of the better-known Ian Fleming, wrote a book called *Brazilian Adventure* about his search for the lost Colonel Percy Fawcett in the Brazilian jungle. Fawcett, along with his son and another companion, had disappeared while searching for the lost city of Z in 1925. Fleming was working as the literary editor for *The Times* when he answered a small ad asking for volunteers to join an expedition to find out what had happened to Fawcett. Despite a great deal of fanfare, the expedition seems to have been very poorly organized and Fleming and his companions do not seem to have done much preparation, not even bothering to learn Portuguese. The expedition, commanded by an eccentric American, Major George Lewy Pingle, eventually made its way to the Araguaya River and proceeded down it, blasting away at any creatures that moved.

The book, which was a firm favourite of mine when I was younger, came to mind when I was reading a *Financial Times* report about the state of the Brazilian economy. Under the headline "Brazilian bankruptcies create opportunities for debt investors" the *FT's* correspondent in São Paulo, Samantha Pierson, reported that:

From apartments and cars to coffins, liposuction and toilet roll, there are few things that cannot be bought in instalments in Brazil – a legacy, in part, of the country's past struggle with hyperinflation. While Brazilian shoppers have made the most of this credit culture to pile up on debt over the past decade, the country's companies have also borrowed heavily, encouraged by public banks and state development lender BNDES. As Brazil sinks into its deepest and longest recession on record, the country's credit bonanza has come to a spectacular end, prompting a wave of bankruptcies but also creating some of the best opportunities yet for distressed debt investors.

Most recently, the telecoms operator Oi filed for bankruptcy protection – Brazil's largest on record. It is believed that Oi will manage to recover but many of its suppliers are now expected to go into liquidation.

Once an emerging-market darling and part of the famous BRIC (Brazil, Russia, India and China) club, Brazil's fall from grace has been astounding. Last year, it shrank by nearly 4% and it is expected to contract more or less by the same amount this year. In September 2015, the country's credit rating was downgraded by Standard & Poor's to junk status. "Without a sustained economic recovery and a turn round in political conditions, access to credit should prove difficult for Brazilian companies," wrote analysts at Fitch Ratings in a recent report. "In Brazil, the lowest-rated companies are expected to encounter the highest hurdles to refinance with suitable terms, if at all."

However, as Brazil's new interim government begins efforts to push through long-awaited labour and pension reforms, there are signs that the country's crisis may be easing. According to Bloomberg data, the cost to insure against losses in Brazil's bonds with credit-default swaps has fallen by nearly a third over the past six months – the largest decline among the world's major economies.

I mention all of this because I have become extremely interested in investing in distressed securities, aka distressed debt. Distressed securities are securities of companies or government entities that are experiencing financial or operational distress, default or under bankruptcy. Purchasing or holding such distressed debt creates significant risk because of the possibility that bankruptcy may render such securities worthless – a term that the industry ominously refers to as 'zero recovery'. A Harvard Report article on the sector said:

The deliberate investment in distressed securities as a strategy while potentially lucrative has significant levels of risk as the securities may become worthless. To do so requires significant levels of resources and expertise to analyse each instrument and assess its position in an issuer's capital structure along with the likelihood of ultimate recovery. Distressed securities tend to trade at substantial discounts to their intrinsic or par value and are therefore considered to be below investment grade. This usually limits the number of potential investors to large institutional investors – such as hedge funds, private equity firms and investment banks or specialist firms.

In plain English, some investors have deliberately used distressed debt as alternative investment, where they buy the debt at a deep discount and aim to realise a high return if the company or country does not go bankrupt or experience defaults. The major buyers of distressed securities are, typically, large institutional investors who have access to sophisticated risk management resources. Firms that specialise in investing in distressed debt are often referred to as 'vulture funds'.

JPMorgan points out that history shows the most attractive returns in distressed debt are generally earned during the period of spread tightening around peak levels of default. Distressed opportunities can be found across the credit cycle whether driven by macro developments, secular downturns or idiosyncratic credit events. In JPMorgan's view, the opportunity cost of committing capital too early in the distressed debt cycle is less than the cost of being late. Spreads tend to tighten much faster in a recovery, thus providing a limited period for capturing peak returns.

Interestingly, JPMorgan says that since 2004 they have managed to produce a return of between 14 and 18% a year.

My guess is that Brazil is about to become the distressed debt capital of the world (possibly followed by the UK and Europe). As someone who is interested in high returns and willing to take relatively high risks, I'm starting to look round for opportunities, basically funds, that will allow me to invest this way.

Inflation Report

At the end of September, the Office for National Statistics (ONS) announced that inflation had risen to an annualised rate of 1% – the highest it has been in two years. The analysis of the figures indicates that the three biggest causes of inflation were the increased cost of fuel, clothing and hotel stays. When Bloomberg asked a panel of leading economists to predict what would happen to inflation in the future, all anticipated that it would rise steadily over the coming months until it reached around 2.2% by the summer of next year. Most believed it would peak at between 3 and 4% in 2018.

The two predominant underlying causes were believed to be sterling's weakness against the dollar and the euro and the rising price of oil. It is believed that the weakness of the pound is not yet showing up fully in inflation figures as retailers and supermarket chains are still selling stocks of imported goods from their warehouses. Once these stocks have run out, they will have to pay new, higher prices to import goods from overseas.

Although prices are rising, most experts do not believe it will be reflected in an increase in interest rates. As reported elsewhere in this issue of The Schmidt Tax Report, it is expected that August's cut in interest rates to 0.25% is likely to be followed by a further cut before the end of the year. This is because it is the Bank of England's only real way of stimulating the UK economy. What is worrying is that Britain will return to the sort of economy that we suffered in the 1970s – a toxic combination of high inflation and a stagnating economy.

What will happen to the stock market? Russ Mould, investment director at retail stockbroker AJ Bell, pointed out that: "A little inflation is good, but lots of inflation is bad – at least if history is any guide." He suggests that investors should consider buying shares of companies that have the most power over their prices. Also, possibly, businesses involved in luxury goods and services as these do not generally follow the usual laws of supply and demand.

Interestingly, Bank of America Merrill Lynch believes that now is the time to start buying alternative assets such as property, commodities and collectibles. This is because tangible assets generally rise in line with inflation, with prices going up alongside consumer prices.

If certain shares and alternative assets make good sense in a period of inflation, bonds do not. Because their coupons are fixed, any inflation erodes income. Cash, of course, is one of the worst ways to hold one's wealth. If inflation runs at between 2 and 3% and interests don't rise, £100 cash could be worth as little as £86 in five years' time.

Economists, incidentally, do not believe that price inflation is likely to lead to wage inflation. The Bank of England predicts unemployment will rise as a result of the Brexit vote, which may well dent employees' ability to demand higher pay. Moreover, the national living wage is due to increase from £7.20 to £8.60 an hour by 2020. Of course, this may change if Britain leaves Europe.

And, of course, with rising prices in the offing, now could be the time to replace any big ticket items such as cars or to buy anything else that has to be imported (such as fixtures and fittings for your house). It may also be a good time to opt for a fixed-rate mortgage. While bank rates are going down, it is possible that the Bank of England will try to control inflation by raising interest rates.

Property

Property Tax Tips

Keeping good company

According to the latest statistics published by Companies House, a growing number of private property investors are incorporating property management companies. We have discussed the tax advantages of doing this in recent issues of *The Schmidt Tax Report*, so we won't cover the same ground again. Suffice to say that while substantial tax savings are possible incorporating in the wrong circumstances could result in a very substantial tax loss. Again, although we have covered this subject before, we feel it is vital to re-emphasise the core point. If you wish to transfer your privately held properties into a limited company it is vital that you can show HMRC you are running the properties as a business and not as an investment. This is because, following the decision in *Elizabeth Moyne Ramsay* versus *HMRC (2013)*, a property business can qualify for incorporation relief under TGA 1992, s 162, if it amounts to a business. One of the easiest ways to prove that what you are transferring is a business is to form a partnership or a limited-liability partnership (LLP). An LLP can only be formed for the purposes of carrying on a business and a general partnership is defined as the relation which subsists between two or more persons carrying on a business in common with a view to profit. Do not believe, however, that simply describing yourself as a partner to HMRC will turn joint ownership of assets into a partnership. Moreover, it isn't just capital gains tax (CGT) that you need to be mindful of. For stamp duty land tax (SDLT) purposes, it is possible to transfer properties from a partnership to a company without any charge, but planning is required to do so. One has to be careful because various anti-avoidance provisions mean that the transfer from original owners to a limited company can result in an SDLT charge.

All advisers point out that there is no point in reducing your tax bill if you end up with higher finance charges. If your properties are encumbered with debt, you may find that your lender is not prepared to simply let your company assume the existing loans. Another thing to watch out for is that if the company needs to raise its own debts on the properties and uses these to pay the existing proprietors for the business in order for them to repay their debts this will constitute additional consideration – causing certain gains to be liable to CGT.

What sort of other problems could you encounter? The first, and largest, hurdle to overcome is whether the letting of property is tantamount to a business or just a passive investment. In *Moyne Ramsay* the court decided that the definition of a business was: "an occupation or function actively pursued with reasonable or recognisable continuity, whether the activity has a certain amount of substance in terms of turnover, whether the activity was conducted in a regular manner and on sound and recognised business principles, and whether those activities were of a kind which, subject to the differences of detail, are commonly made by those who seek to profit by them."

In that particular case the taxpayer spent 20 hours a week tending to the property rental and while this by no means set a precedent for the threshold it gives an idea at what point HMRC and the courts will agree that the act of renting property could become a business. Remember, however, each case will be considered on its own merits.

Once you have managed to convince your tax adviser that you are in fact running a business, the next thing he or she needs to deal with is any potential liability to SDLT. For a landlord who is not in partnership, the charge to SDLT on a transfer to a connected company will be based on the market value, irrespective of consideration. Where a partnership incorporates, the transfer of a property from a partnership to a limited company should not suffer SDLT. Do remember, incidentally, that HMRC is particularly suspicious at the moment of any partnership that is formed shortly before a property portfolio is transferred to a company. It is especially important not to set up a partner with a pre-agreed decision that you will be incorporating at a later date. This will be viewed as tax avoidance.

The benefits of holding property through a limited company are the lower tax rates on rental profits and capital gains. Both will be subject to 20% corporation tax (to be reduced to 17%) as opposed to 45% income tax on rental income and 28% on capital gains. Of course, these rates are slightly illusory as income paid out of the company as a dividend or on liquidation of the company will be taxed again in the hands of the shareholder. It is more a delaying tactic and, of course, it may also be of assistance for other tax planning (such as inheritance tax, or IHT) purposes.

Gardening leave

Last month, we discussed the fact that if a house has been your main residence throughout your period of ownership then no CGT liability will arise on the disposal of part of the garden. The assumption we made was that the garden and house were owned on a single title. In fact, of course, in many cases gardens are held under separate title. It must be stressed that this is not automatically a barrier to the necessary relief. The law does not require a single title. An HMRC interpretation states that: "in general the revenue accepts that the land surrounding the residence and in the same ownership is the grounds of the residence, unless it is used for some other purpose."

Incidentally, in most cases it is not advantageous for the owner of a home with a garden to develop part of the garden into housing themselves. This is because the development value of the land will be taxed, as will any profit on the development.

Don't forget IHT

If you are in the process of reorganising your property investments or if you are about to start investing in property and haven't yet made any irrevocable decisions, don't forget to consider the punitive effect IHT will have on any property held in your estate. True, you can settle IHT on property over a ten-year period providing your estate has other meaningful assets. Otherwise, the cost will be 40% of anything worth over £325,000.

That's the bad news.

The good news is that for IHT purposes there are certain situations where it is possible to avoid some or all IHT. In particular, business property relief (BPR) can be available at 50 or 100%. The crucial types of business property for property businesses are an interest in a trading business or shares in an unlisted trading company. Regrettably, a business that substantially includes investments (including investments in rental properties) or dealing in land does not qualify for BPR. The types of business that may qualify for BPR are:

- property development
- furnished holiday accommodation
- agricultural farmland and associated buildings.

If you don't need the income being generated from your property and if you trust the person that you wish to benefit you could also consider giving him or her your property outright now. Such gifts are considered potentially exempt transfers (PETs) and, providing you survive for seven years, will be eligible for 100% IHT relief.

Property Companies: Avoid The 7.5% Surcharge!

We don't know what your view on politicians is, but personally we think the adjective 'sneaky' describes many present-day examples of the species. Here's a classic example in the field of taxation: did we, or did we not, receive a solemn promise, enshrined in legislation even, that the government elected in 2015 would not increase the rates of income tax?

OK, now our second question: what was one of the first things Chancellor George Osborne did after being elected? Answer: he placed a whacking 7.5% surcharge on the income tax paid by individuals who received dividends from companies! The sneakiness in this resides particularly in the fact that a £5,000 tax-free band was introduced, meaning that all the small voters on whom the government relies to give it its electoral mandate would not actually be affected by this barefaced example of a broken electoral promise. That only leaves the small, and statistically unimportant, section of society known as people in business – on whom the whole of the UK economy, and therefore the well-being of all of its people, depends.

Dividends or remuneration?

Let's put the subject in context. Most owner-managed businesses of any size are run through limited companies, and the owners (shareholders) of those companies tend to be the same as the directors, that is the people who are working in and running the business from day to day. So, one of the most basic pieces of tax planning comprises the question of whether these shareholders/directors should take their personal income out of the company in the form of remuneration on the one hand or dividends on the other. (There are other minority methods of profit extraction, but we won't discuss these for the moment.)

In the ever-shifting sands of company and personal taxation, the profit extraction strategy of a shareholder/director has had to change a number of times over the last few years. Currently, however, it is generally accepted that in most cases the dividend route is going to be the most tax-efficient way of a shareholder/director taking his income from the company. Why?

If you take your income from the company by way of remuneration, you've got both income tax at your marginal rate to pay and national insurance (NI), which comes in two different varieties: employer's NI and employee's NI.

As we have said many times in the past, employer's NI is nothing more than a swingeing 'payroll tax': a strong disincentive to employing staff at all. Because a director of a company is treated as if he were an employee for tax purposes, payment of remuneration involves the allied payment of 13.8% of the gross salary as a so-called employer's contribution to the bottomless pit which is the government finances. On top of this, there is an employee contribution, deducted from gross pay, of 12% up to a certain figure, roughly comparable to the higher-rate income tax band, and 2% above that.

The new dividend surcharge

Dividends, by contrast, until 5th April of this year (2016), involved payment of income tax only, at broadly equivalent rates to those applying to remuneration, and absolutely no NI. So it was a bit of a no-brainer, really.

What has changed with effect from the current tax year is that dividends are now subject to an extra 7.5% tax charge, which has been (thinly) disguised as a mere 'removal of the tax credit' on dividends. We won't go into detail about this mythical tax credit, which effectively had ceased to be such in 1997 when Gordon Brown undertook his famous raid on pension funds and charities. But the effect is that a basic-rate taxpayer, who before 6th April 2016 paid no tax at all on dividends (because the company had already paid 20% corporation tax) now pays 7.5% tax. A higher-rate taxpayer, who previously paid 25% on dividends, now pays 32.5%. And a person in the top rate of income tax (i.e. receiving gross income over £150,000) is on 38.1%.

We don't think we're being unduly cynical in assuming that this 7.5% or thereabouts additional tax has been very carefully set, at a rate where individual shareholders/directors will still want to take dividends rather than remuneration, because 7.5% extra tax is still better than the employer's and employee's NI that they would be paying on remuneration. All it is, in effect, is the government helping themselves to a little bit more of the owner-managed business sector's income.

Property investment companies

Having set the scene, let's now focus on the target audience for the tax-planning idea which is at the heart of this article: the privately owned property investment company. Many of these have existed for a great many years. Indeed, many were formed before the current major tax drawbacks of holding a property investment portfolio through a company were introduced in a previous swathe of tax changes. Leaving aside these disadvantages, which relate largely to the tax penalty of selling properties and spending the proceeds, under the immediately prior tax regime a property investment company didn't really compare too unfavourably with owning the property portfolio direct, as individuals. The tax rate applying to companies, including property investment companies, had reached a flat 20%, which is equivalent to the basic rate of income tax for individuals. So, to take a simple example, if you had a property investment company with three basic-rate taxpaying shareholders that received net rental income each year of £120,000, the tax would be pretty much the same as the tax that would have been paid if the three individuals had owned the same property portfolio themselves directly. That's because, after the 20% tax, a dividend of the remaining amount would not give rise to any tax liability in the hands of the shareholders. Result: an overall 20% tax rate between the company and the shareholders.

Things are rather different now! Using the same example, and effectively making the same assumptions, the individuals would now be paying 7.5% income tax on top of the 20% corporation tax paid by the companies. On a broad-brush basis, because the 7.5% applies to the net of corporation tax amount, this equates to an overall tax charge of 26%. Comparing this with the situation where a property portfolio is held direct, we have an at least 6% penalty for using a property investment company.

Get rid of the company?

A naive observer may then say: "OK, why don't we just get rid of the company then? Let's wind it up and pass the ownership of the property portfolio out to the individuals, where they won't be paying this 6% surcharge any more!"

Of course, it's not as simple as that. Unless the company was formed very recently indeed, or has made disastrous investments in property, there will be a capital gain to deal with, or rather a capital gain to deal with twice. If the properties are worth more than they cost, there will be corporation tax to pay on the 'gains' that the company would be treated as making on disposal of the properties, in liquidation, to its shareholders. There would also be a gain, based broadly on the same increase, in the hands of the individuals, who would be receiving more for their shares in the company, again in liquidation, than they paid for those shares.

So there could easily be a thumping great tax liability to meet when you add these two layers of tax together. And, since all you've done is change the name of the owner of the properties on the land registry from the company to the names of the shareholders, no one's actually got any cash proceeds to pay the tax out of. So, in most cases, we'll have to just forget that idea.
But that's where the idea at the heart of this article comes in.

The property investment LLP

Let's illustrate this structure by way of a very simple example. Mr A owns A Limited, which owns a property portfolio. He forms an LLP of which he and the company are members, and the company introduces its property portfolio into the LLP as equity capital.

When the first year's accounts for the LLP are done, let's say there is a rental 'profit' from the portfolio of £100,000. Mr A, who has no other income, allocates (using suitably flexibly worded LLP agreement terms) £42,000 of the rental profit to himself, and the balance of £58,000 goes to the company. If we assume that this is broadly equivalent to what he would have done under the old regime, with the rental profit going to the company initially and then the equivalent of a gross figure of £42,000 being paid out to Mr A as dividends, then you'll see that there is an immediate advantage here to the extent of the 7.5% that Mr A is not paying, this way, on the income he is receiving. Rather than passing the income through the company, and in so doing attracting an unwelcome 7.5% tax charge on the way through, he is taking the income 'direct' from the portfolio, in which he now has a kind of interest as partner.

Surely, though, you'll say, it can't be as easy as that? Isn't the company effectively paying some kind of dividend or other distribution of its assets to Mr A, and doesn't this dividend/distribution trigger income tax in the same way as the old dividend idea would do?

We don't think so. First, the company isn't, of course, distributing anything to Mr A simply by introducing the portfolio into the LLP. It retains all future capital profit sharing rights (or probably does – but that's another story) and is credited anyway, in the LLP's books, with the full value of what it is putting in. So the company is just as wealthy after the introduction of the portfolio as it was before – hence there's no distribution out of the company on which HMRC could claim tax from the shareholder. What's more, there's also no tax legislation acting to treat income on which an individual is paying income tax to his company for the purposes of taxation. So we can't see any means HMRC has of counteracting this planning, even if it were minded to.

The interesting bit

Fine, so we found a way of reducing Mr A's tax charge from 26 or so to 20%. But the advantages of the property holding LLP don't end there: this is hardly more than a beginning, in fact.

Let's look, first of all, at the potential this structure has for spreading income round the family. Taking our straightforward situation of Mr A and his property portfolio, what about introducing Mrs A to membership of the LLP? Although it looked, a few years ago now, as though HMRC was intent on attacking the sharing of income between husband and wife, it's been all quiet on the western front as far as this is concerned since 2008. So we think that, in practice, if a share of the rental income were allocated to Mrs A, perhaps in order to use up her approximately £42,000 basic rate income tax band, this isn't something that would be counteracted by HMRC. But the potential of the LLP for income 'spreading' certainly doesn't stop there.

Perhaps Mr A has been in the habit of helping out the younger generations of his family as well: perhaps his adult children and grandchildren. Well, why not introduce them as members of the LLP as well? A profit share allocated to any other family member, other than a minor child of the person making the arrangements, will, we think, be effective in transferring the entitlement to that income for tax purposes, meaning that you can utilise personal allowances and lower income tax bands across a wide range of people, potentially, if these people exist.

One example of this is the very frequent situation you find where children who are at private schools have their fees paid not by their parents but by their grandparents. Introducing these children, or a trust for them, as LLP members (partners) seems like an easy and flexible way of allocating income to cover the school fee liabilities. So the grandparents don't have to pay higher-rate tax first, and then pay over what's left to the school for the benefit of their grandchildren: instead, the income is that of the grandchildren under the division of LLP profits. So each child, for example, could receive up to about £10,000 of the rental income tax-free, because of the availability of income tax personal allowances. In an extreme case, the whole income of the portfolio, held within the LLP, could be free of income tax if it can be allocated amongst enough members who have no other income to bring about the result that the whole income is covered by personal allowances.

CGT planning

The property investment LLP, funded initially by the company, also provides a possible escape route from the capital gains 'prison' which property holding companies so often represent.

We've already touched on the 'double tax charge' that afflicts investment holding companies. If one of the individuals behind the company wants to enjoy the benefit of the proceeds from selling an investment asset, the first stage is for the company to sell the asset, which is likely to give rise to the first level of tax, which is CGT within the company itself. The net proceeds, within the company, have then to be distributed to the shareholder so that he can enjoy them personally. This gives rise to a second level of tax, which could be as high as 38% if he is a top-rate income taxpayer and the distribution takes place other than in the complete winding-up of the company.

Overall, then, it seems to us that limited companies are generally a very bad idea for holding appreciating assets of this kind. Of course, there will be exceptions to this rule, depending on the level of appreciation and the plans for use of the money; however, if there were a way of taking future profits out of the corporate 'net' and putting them into the hands of the individual shareholders/directors, this would obviously be excellent.

As it happens, there is! This is acquiring new properties, perhaps bought out of retained rental income from the portfolio, in the LLP, on such terms that future gains on those properties will accrue to the individual members of the LLP rather than to the company member.

Remember, in this context, every individual has a CGT annual exemption (which is something that limited companies don't have). So if you share the future gains out amongst enough people, you could have a number of annual exemptions to offset against any future gain, which may even completely eliminate the gains tax. The choice, and the flexibility, is yours.

Lastly...

Remember that we're talking, here, about a property investment LLP with a limited company as one of its members. An additional flexibility that you have is that the company can be allocated the residue of net rental profits, that you aren't allocating to basic-rate taxpaying individual members, but the actual cash resulting from the company's rents can be drawn down by the individuals – with no further tax charge. This applies if the individuals have credit balances on their capital accounts with the LLP, which can be drawn down as such (i.e. capital drawdown) and therefore do not give rise to an income tax charge in the hands of the individuals.

We could go on at great length, here, about how the individuals acquire these credit balances for tax-free drawdown, but that would be both complex and, potentially, provocative!

Property News

Farmland prices fall 8%

According to estate agent Knight Frank, the average value of UK farmland has fallen by 8%. The average value of British farmland in 1966 was £161 per acre.
It reached a high of £8,300 per acre in September 2015 but since then it has been slipping. Long-term growth was caused by institutional investors, such as pension funds and insurers, who bought in search of safe, income-producing assets. It was also considered a safe haven asset after the last financial crisis. This is why over the last ten years the value of farmland has risen by 145%, beating both the FTSE 100 and prime central London property. Interestingly, very little land comes on to the market every year – normally between 100,000 and 150,000 acres. Why are prices coming down? One of the reasons must, Knight Frank points out, be the impact of Brexit. However, it attributes the real reason as being falling agricultural commodity prices. Of course, there is a great deal of variation in performance between the most efficient and the least efficient farms. For example, in the area of arable farms the top 25% earn around £301 per hectare versus a loss of £223 per

hectare for the poorer performing farms.

Black property

The *Financial Times* recently reported that over the last few years: "The exterior of hundreds of period houses in Hackney and Shoreditch, home to London's silicon roundabout, have undergone a dramatic Goth makeover." The newspaper is referring to a trend whereby more and more houses are being painted black. Why? Apparently it helps properties stand out on social media (the modern equivalent of the estate agent's window) and can "definitely boost value" according to Edward Taylor, who manages Foxton's Hackney branch. "Some of the more expensive properties that we have sold in Hackney tend to be painted dark on the outside," he said. "There is a very finite window of attention from buyers before they swipe on to the next property and it does immediately grab your attention." Black is, apparently, the new black. However, owners are warned that if black ceases to be so popular it is a very difficult colour to remove.

Planning permission in principle

A reminder that the Housing and Planning Act 2016 includes a fundamental change to the planning regime. In particular, it introduces a new route for obtaining planning permission for housing-led development: permission in principle, or PIP. Created by the government to hasten housing delivery and provide greater certainty of the development potential of residential sites (including for small-scale builders), the objective is to boost investor confidence in the development of land by separating decision making on 'in principle' matters (e.g. land use, location and amount of development) from technical details.

The thinking behind the new legislation is to give developers confidence that it is worth pursuing detailed planning permission. After all, many developers find that they have spent a considerable amount of time and money investigating a site, preparing proposals and lining up finance only to discover that planning permission will never be granted.

Under the new legislation, sites which have been identified for housing in Local Development Plans and Neighbourhood Plans, plus suitable brownfield sites, could essentially have automatic planning permission subject to agreement of the technical details. Developers will be able to pursue projects and invest money in plans with greater confidence knowing that permission is virtually in the bag. Moreover, local authorities are now required to create a register of suitable brownfield or previously developed sites – which means that developers can now access a readymade directory of sites that already have planning permission for development.

Short-haul commuting

Are there profits to be made by investing in property within low-cost air travel distance of London? Could investors sell such property to London buyers with a year's worth of airfares thrown in? The online estate agent eMoov has published an interesting survey into the cost of buying property in eight different UK cities, taking into account (1) the cost of a weekly return airfare to London, (2) four night's accommodation in London and (3) all the property costs of the main home. It compares this to the cost of a comparable property in the Greater London area. The researchers assumed that the commuter would be able to book both flights and accommodation six months in advance. They also calculated the average mortgage cost after deposit and the annual payment for both London and the other locations. What they found was that seven cities outside of London offer an annual mortgage saving when commuting by plane. The city offering the biggest annual mortgage saving was Glasgow. With an average house price of just £155,195 the annual mortgage saving compared to the capital is £21,275. The cost of a weekly round trip into London is just £53 via Ryanair for an 80-minute flight with accommodation, bringing the total to just £205 a week.

Bank of England cuts base rate

The Bank of England has cut the base rate from 0.5 to 0.25%. This is the first cut since March 2009, when it was reduced from 1%. The reduction brings to an end the longest period of no change in rates since the Second World War. Many experts believe that the Bank of England will reduce the rate even further to 0.1% before the end of the year. The Council of Mortgage Lenders director general, Paul Smee, said: "Since the last change in the official rate in March 2009, the average mortgage rate has already fallen from 3.8 to 2.9%. This confirms that the bank rate is not the only influence on mortgage pricing; we feel that the mortgage market is at present well capitalised, resilient and open for business. Housing market fundamentals are sound. So we see the cut as a wider reaction to the economic effects of recent political uncertainty."

New-build crisis in London

Research recently published by the London Central Portfolio (LCP) has revealed a worsening new-build crisis in London. The number of new developments approved for construction has surged again this year, with a 20% increase in the planning pipeline since 2013, representing 106,208 new units. This pipeline is largely made up of projects in the mega cluster areas around Tower Hamlets and south of the river in the Battersea/Nine Elms area, where there is already a proliferation of new developments. Despite the increased number of new developments, statistics have shown that the attraction of these new properties, where prices now average £914,532, is waning. Interestingly, property prices in the two most expensive London boroughs (Kensington and Chelsea and the City of Westminster) have been falling faster than anywhere else in London. Meanwhile, Rightmove reported that average asking prices in England fell by 1.2% during August and that London property prices were down by 2.6% in September. According to LCP's analysis of the government land registry data, only 1,491 new units have been sold so far this year, a substantial 43% decrease on the same time last year. This compares with older properties in central London where transactions have remained static, 13,194 in 2016 compared with the same number over the same period last year.

Saving VAT On Property Investment

Question: VAT is meant to be a tax on the final consumer, or so you would have thought. So why is it so often such a major problem for people in the business of property investment?

Answer: Because VAT isn't just a tax on the final consumer! Amongst other things, it can be a tax on the ill advised, and there is almost no area in the whole of taxation where such large unforeseen liabilities can suddenly pop up, scuppering deals and even ruining investors.

So here's your 'cut out and keep' guide to avoiding the nasty surprises, and making your property investments anything up to 20% cheaper.

Saving 20% on self-build

We'll start off with the trials and tribulations – and opportunities – of those who build property which they then go on to hold as an investment. This is quite common in building firms who establish a reasonably sized rental portfolio over the years by these means.

Our first 'trap' comes with the situation of the builder of houses and flats. There's a common view out there that new houses and blocks of flats are VAT zero-rated and therefore you don't need to worry. In fact, if you are building new dwellings to rent out you have every need to worry!

The VAT you incur on materials, subcontractors etc. building a new dwelling is only reclaimable if you are going to sell the freehold or a long leasehold of the completed units. If you are going to let them out, the VATman can come along and claw all of the VAT back. The solution to this problem is to crystallise a disposal of the property from the building entity to a connected person. That sale will then be zero-rated (rather than VAT exempt) and all of the input VAT perversely that you incurred on building the units is reclaimable.

Alternatively, you could make the building contractor and the owner separate entities, no doubt both under your control. That way, the building company can zero-rate its services, including the goods that are incorporated in the buildings, and the investing entity has no input VAT to be clawed back. Even though it is charging exempt rent to the tenants, this isn't a problem so long as it has no input VAT itself.

Which of the above alternatives is better depends on all kinds of other factors, including direct tax, so we'll move swiftly on.

If you are building a commercial unit for letting, the situation is arguably more straightforward. You can 'opt to tax' the rents received from the tenant when he moves in, and as a result all of your input VAT will be reclaimable. The only drawback to this is if your tenant or ultimate purchaser is not VAT registered. This will then make the property more expensive for them. However, normally speaking there is no alternative, in practical terms, to entering into the option to tax. If it's any comfort, an option to tax can be revoked after 20 years!

Property purchasers

Moving on from the particular problems facing those who build their own investment property portfolio, we will now consider the planning issues where you are purchasing second-hand buildings.

The first thing to say is that the residential property purchaser need not read this particular section of the article. If you are buying residential property it is either zero-rated if it is new or exempt if it is old. In neither case do you, as the purchaser, have any VAT to pay and therefore you have no worries about trying to reclaim it. The seller cannot effectively opt to tax a residential property.

For the purchaser of non-residential property, on the other hand, there's every need to have the VAT planning principles at your fingertips. The first problem is a practical one.

To this day, very few professionals involved in getting property transactions over the line consider VAT until the last moment. A very typical scenario, in our experience as advisers, is where the solicitor acting for the buyer is told, the day before exchange of contracts, that VAT is going to be added to the agreed purchase price. If cash flow is tight for the buyer (and it normally is) this sudden requirement to find an extra 20% on top of the agreed price can blow the deal out of the water. Even though this VAT can no doubt be reclaimable in due course, the actual refund by HMRC could be many months away. So the moral is: pin down the vendor's advisers right at the outset on the point as to whether VAT will be charged, and get them to put it in writing. Then at least you can plan for the actual amount of cash you are going to have to come up with. There is a way, which works in most circumstances, of avoiding this being charged, but more of that a little later on.

First of all, the important question arises as to whether you are going to be able to get the VAT back that the vendor is charging. If you are a property investor, rather than buying the property to carry out the VATable business yourself, the normal rule is that the rents you charge to your tenants will be VAT exempt. But that's precisely where the option to tax comes in. Similarly to the situation where you've incurred VAT on the building costs as the self-build investor, the VAT you incur on the purchase price when you are buying a property from someone else can be reclaimed if you opt to tax the rents, preferably before you start receiving any exempt rent from a tenant. So, providing you've the cash flow, as we say, to shell out this extra 20% on purchase, you need have no fear: it won't be a permanent cost but will be refunded.

But we talked just now about avoiding having the 20% extra charged on top of the purchase price in the first place. If you are a pure property investor, and intend to let the property out with an option to tax, you can actually avoid the imposition of the tax on the transaction if you opt prior to exchange of contracts. That is, you opt to tax a property you don't actually own yet. There's nothing in the rules against this, and the effect of such a precocious option is that the transaction becomes the transfer of a business as a going concern. VAT doesn't apply to such transfers, and therefore the vendor mustn't add the 20% tax charge to the purchase price.

Incidentally, this very useful device can even be adapted to situations where you aren't a 'pure' property investor but are actually planning to occupy the property for the purposes of your own business activities. If you own a trading company, for example, which is going to buy the property, the purchase can't be treated as the transfer of a going concern (TOGC), free of VAT, because what is being acquired is not a property investment business, which was what the vendor was carrying on.

But you can turn it into the acquisition of a property investment business by having two entities, one 'a landlord entity' that you control and one the trading entity which acts as your landlord entity's tenant. By splitting things in this way, you are ensuring that both the purchaser (your landlord entity) and the vendor are carrying on the same sort of business, which is one of the conditions for TOGC treatment to apply. So you can claim to have the VAT excluded from the purchase price in this situation provided you opt to tax prior to exchange.

Conversion/improvement work

After you've bought the property, it may be that you plan to spend significant amounts of money on it, converting or otherwise improving it.

If you are a commercial property investor, again, this is no problem. If you have an option to tax the rents in place, all the VAT on the improvement work can be reclaimed. Once again, you have the issue of making the property more expensive to non-VAT-registered tenants or purchasers, but that's something that just has to be lived with.

The real fun begins where one is talking about residential property investors who incur improvement expenditure.

In the case of these unlucky investors, there's no option to tax available. You just can't tax residential property rents and that's that. So VAT incurred on the expenses can't normally be reclaimed. But that's by no means the end of the story.

First of all, there's a special relief from this otherwise rather harsh rule for those who convert non-residential property to residential. All over the country, oast houses, barns, pubs and former office and warehouse buildings are being turned into houses and flats, on the back of the much better values that apply in the residential property market as compared to the commercial. But, for whatever reason, a few years ago the government decided it wanted to add some encouragement to this process through the tax system.

Hence we have the zero-rating relief for properties converted from commercial to residential use. (It actually also applies to formerly residential properties which have not been used as dwellings for a certain period.)

But the form of the relief is a little odd. What it does is to zero-rate (rather than exempt) the sale of a property that has been converted from commercial to residential. So a person who converts a property to residential and then lets the resultant house or flats still faces an un-reclaimable input VAT charge on all of his costs of the conversion, because the rents are exempt.

One solution is therefore similar to the person who is building new residential property: trigger a supply of the freehold or long lease to a connected entity, and this supply can be zero-rated, with resultant reclaimable VAT.

Incidentally, it may be wondered how it is that HMRC let property owners get away with this fairly straightforward bit of tax avoidance. At the moment it appears that the Revenue does accept that this sort of planning works, but it's important we keep our ears to the ground to see whether there is any sign of a hardening of the Revenue's attitude here.

The other available relief works completely differently. Rather than you being charged the full 20% VAT on materials and services (possibly) and then looking to reclaim it as being attributable to an onward zero-rated sale of the property, those who convert properties so that they are a different number of dwellings within the same property from what there were before are eligible for the reduced 5% rate of VAT to be charged to them on the services of a builder and the associated supplies of goods.

There are two planning points here, one technical and one practical.

The technical planning point is to ensure that your conversion of the property, if at all possible and commercially viable, fits within the criteria for a 'changed number of dwellings conversion'. (There are other types of conversion eligible for the reduced rate as well which are less common in practice.) We can envisage a lot of plans being drawn up by investor and architects precisely with a view to ensuring that there are a different number of dwellings after the conversion from what there were before.

The practical planning point is to make sure you get the relief. In practice, it seems to be 'default' for builders providing services to charge VAT at 20%, and not a lot of them will willingly volunteer the reduced 5% rate. You can see their point of view: they are the ones in the firing line if they get it wrong and it turns out that your conversion doesn't meet the criteria, so that they should have charged you 20%. But this does mean you need to be fairly insistent on your 5% rate, and if necessary back it up by letters from professional advisers.

This is an updated version of an article which originally appeared in October 2009.

Property Opportunities

HMOs by Jonathan Brooks

What is the least expensive, easiest and most lucrative way to become a UK property investor? Buy a two-, three- or four-bedroom property and turn it into bedsits. Only, nowadays, the technical term is a house of multiple occupancy (HMO) or multi-let. These come in many different forms but generally each bedroom is rented out individually with a shared kitchen, bathroom and living areas. Typically, the yield from such properties for the last five or six years has varied between 9 and (at its peak) 12%. Although, recently, yields seem to have dropped slightly, HMOs still produce a considerably higher return than traditional buy-to-let.

There is huge demand for HMOs from students, young professionals, social benefit tenants and asylum seekers. The long-standing economic principle of supply and demand is the key to this sector. There is limited access for younger people to get on the property ladder, owing to restrictive borrowing from the banks. Couple this with rising rents, bills and expense to furnish whole properties and it makes sole occupancy simply unaffordable for many.

There are also lots of immigrants who are looking for affordable rooms so that they are in a position to save/send back money to their home countries. Students, of course, also like the social aspect of sharing with their friends and areas in close proximity to academic institutions are popular with multi-lets.

I'm going to come back to the figures in a moment. But to put this into some sort of perspective, take a three-bedroom house let to a family under one tenancy agreement or assured shorthold tenancy (AST) in the north of England. You may achieve £500 per month in rent. Instead, rent those three bedrooms on an individual basis in an HMO at £250 per month each and you have achieved £750 per month or a 50% increase. Convert one of the reception rooms into another bedroom and your rent goes up to £1,000 per month. That's double the rent you would have otherwise received. Another financial benefit of renting property in this way, incidentally, is that if one of your tenants is late or fails to pay the rent it has less effect on your total yield. Rent a property to a single tenant and if they don't pay you are completely out of pocket. Obviously, with HMOs you have fewer and shorter voids, too.

For my own part, I prefer not to rent to people on social welfare or to asylum tenants but it has to be said that both local councils and the government incentivise landlords to let to local housing authority (LHA) or asylum tenants by offering a guaranteed fixed rental yield through the various benefit schemes. This does encourage landlords to take in more vulnerable tenants with the security that the rent will be paid directly to them.

Of course, there are catches. To begin with, there is obviously considerably higher running costs, owing to increased management and maintenance work. You may also have to get special planning permission and, if there five or more tenants, over three or more floors, you will have to apply for a mandatory licence with your local council. There are, also, health and safety issues such as fire doors, smoke alarms and so forth. My experience is that, unless you are well established as a property investor, lenders are more reluctant to lend to HMO buyers than to traditional buy-to-let landlords. Why this should be, I have no idea.

Incidentally, once you have set up your HMO and have an income stream coming in, it is usually possible to make a substantial capital gain. There are other tax advantages to doing this since investing in and developing properties in this way can count as a business activity rather than a pure investment. The gains, therefore, if run through the vehicle of a limited company, should be taxed at corporation tax rather than CGT rates.

If you are considering moving into this area, here are a few tips:

- Invest in a high-quality renovation and high-quality fixtures and fittings. Not only will you be able to charge a higher rent and attract better tenants but the extra you spend on making the property fit for purpose will substantially reduce your ongoing maintenance bills. Five or six adults using bathrooms, kitchens, floor coverings, doors, appliances and so forth on a very regular basis means that everything is likely to wear out more quickly than in ordinary circumstances.

- Invest in very regular cleaning. Having a cleaner in to look after not just the common areas but each tenant's room is also cost effective. To begin with, it ensures that the property maintains its capital value. It allows you to stay on top of maintenance issues. And, if you brief your cleaner properly, you will get an early-warning system about tenants who may be difficult.

- Don't be afraid to go for a property that needs a lot of work. In a way it is a lot easier to take a house back to the brick and start again than it is to try and put right work that wasn't done correctly in the first place.

- If you can afford it, go for a property that would allow you to have at least five bedrooms and two bathrooms. It is much more cost effective.

- Don't stint on other facilities such as Wi-Fi (pretty much essential) to having two washing machines, two dishwashers and so forth. The better the facilities the happier the tenants, the fewer voids and the higher rents.

- For my own part, I prefer hard floors (either wood or lino) and rugs since these are much easier to clean.

- A good location close to transport and shops will always repay the investment.

- Personally, I resent the 10–15% one has to give to a management company and prefer to collect the rents myself. Nowadays, thanks to online banking, this is much easier than it was 10 or 15 years ago.
- Don't stint on insurance.

- Remember, in general, all the utilities will be included in the rent you charge. One thing to watch for is metered water. There are areas where water meters aren't necessary and charges are based on the average usage for a particular sized house. An efficient heating system will also save you money.

- Allow for council tax payments. In some areas, council tax valuation officers enforce Band A council tax ratings on individual rooms within an HMO. If each bedroom is classed as an individual dwelling, for the purposes of council tax, it will dramatically increase your costs. This is worth discussing with your council before you make an investment as it can add hundreds of pounds per month to your costs.

- Don't forget to get a TV licence for the house. In theory, every room of an HMO should have its own licence if they have their own TV. In practice I think it is acceptable to have one licence for the communal TV that you provide and then to advise tenants that they will need their own TV licence if they have a TV in their own room as well.

- I would allow 10% of all the rent you collect for ongoing maintenance and voids. This should give you a sufficient buffer in case something goes wrong.

- Don't forget the cost of garden maintenance.

Back to the figures. My ideal property is a four- or five-bedroom house that I can turn into a six- or seven-bedroom HMO. I prefer the house to be in a truly awful condition. Here are a couple of examples of properties I own:

- A seven-bedroom house in Dagenham, Essex. I bought the original four-bedroom, semi-detached house for £240,000 at auction last year. I spent £120,000 extending and renovating it. So, my total investment was £360,000. I receive an average of £420 pcm including bills from each tenant so my annual income is, more or less, £35,000. My cleaning bills, maintenance, Wi-Fi, utilities etc. come to £600+ a month or £8,000 a year. My net income – allowing for 10% for ongoing maintenance – is around £23,000 a year. That's around 6%. However, the property came with a large garden and I am considering selling it as a building plot or even putting some garages on it to rent out. I received an unsolicited offer of £450,000 for the house so I have already made a very substantial capital gain if I want to take it. This has been one of my most successful recent deals.

• A six-bedroom flat in London Fields. I bought two ex-council flats at auction and knocked them together to create a single property with six bedrooms, three bathrooms, a large kitchen and a laundry room. The property, including renovation and decorating, cost me £650,000 in 2014. My total rent last year, including a few voids, was £32,000. My total running costs were £7,400. Allowing 10% for ongoing voids and maintenance I reckon my return is low – just 3.5%. However, the good news is that another similar property is currently on the market and should make £750,000. The rents in that property are a bit higher, too. I plan to sell my own and I expect to make a total return on investment of £140,000 – or 11% a year – over the two years.

HMRC views property as a passive investment. My property investment is a full-time business. I invest my own money, collect my own rents and oversee all the work. I never borrow and I expect to see an overall gain every year of approximately 10% before my own expenses. I pay an effective tax rate of 25% across the board so my 10% is actually worth 7.5%. I also lose about 1% to inflation. I estimate that the £4m I have invested in eight properties brings me a disposable income of around 6.5% or £21,000 a month. I like property because it offers security. The stock market can do what it wants. The bond market can do what it wants. People always need bedsits!

Jonathan Brooks is a US property investor who now lives in London.

Self-storage by Declan Murphy

The self-storage industry started to emerge in Europe in the early 1990s and has established itself across the Continent with around 2,600 facilities totalling nearly 7.5 square million metres of space, albeit with differing levels of maturity in each country. Interestingly:

• Four in ten of the facilities are in the UK and eight of ten facilities are in six specific countries.
• The average amount of storage per capita is 0.015 square metres with the UK, Netherlands and Iceland having three times this level.
• Facility sizes range from less than 1,000 square metres to over 10,000 square metres.
• Average occupancy is increased from 74% to 78% in the last year.
• The largest operators across Europe represent 27% of the total number of facilities.
• There have been around €400 million of transactions in the European market in the last year.
• Three-quarters of operators expect next year to be more profitable than the previous year, although more than half of respondents do not forecast increasing rents.

Why has there been so much growth? The short answer is that 72% of Europe's population live in cities and this is expected to rise to 80% by 2020. The pressure on space in these urban environments is increasing, resulting in smaller living spaces per person and rising residential property prices. London is a prime example of this trend, with its population hitting an all-time high of 8.6 million this year, and projected to rise to about 10 million by 2030. House price growth has been 8% a year over the last five years, causing the percentage of the population renting to rise from 17% in 2001 to over 25% today. In addition, the average size of a one-bedroom flat in London is now only 47 square metres, highlighting the squeeze on space. Areas of high-density housing, particularly in higher socioeconomic areas, tend to be high users of self-storage.

Interestingly, nine out of ten people have heard of self-storage in the UK but understanding the product remains quite low, at around 30%. Six out of ten people couldn't name a single self-storage brand and few had any idea what sort of costs were involved. Supply, however, has increased by more than 5% in the last year and occupancy is also up by 5%. Net rental rates in London are more than twice that in the East Midlands and the north.

Self-storage facilities first appeared in the United States of America in the 1960s and since that time the industry has expanded in that country dramatically so that there are now over 53,000 facilities. It didn't really arrive as a concept in the United Kingdom until the 1990s, but today there are more than 1,000 facilities across the country. The primary reasons why people turn to self-storage are moving home, marriage, divorce, retirement and – for business – a useful way to keep archives, stock or office equipment.

Is it a good investment? Well, quite a few companies offer investors an opportunity to buy units in larger self-storage centres. Many guarantee returns and minimum investment can be for as little as £3,750. Such investments usually come with guaranteed rental income for the first two years and impressive projections of between 10 and 12%. Leaving aside the potential for such high returns, many investors are attracted to the idea because self-storage is considered suitable for self-invested personal pension (SIPP) investment. However, financial advisers warn that after the period of guaranteed returns comes to an end it is likely that the yield will drop. For my own part, I wouldn't touch these collective schemes with a barge pole.

My own experience was that it is perfectly feasible to buy a building and convert it. My first unit was in Cork, Ireland. I paid €180,000 for the site and the same again for a purpose-built building. It took me two years to achieve 70% occupancy and I managed a net yield – after all costs – of 6%. However, I added a serviced office to the facility and boosted my net yield to 9%. I sold the whole facility and I am currently looking for a suitable building in Greater Manchester. My tax advisers have suggested that I should be eligible for the 10% entrepreneurs' relief if I am able to pull off the same trick again in the UK. I also plan to increase my income by offering document shredding.

Declan Murphy is an Irish property investor living in Manchester.

Serviced apartments by Tim Steele

If you are interested in running a more active type of property investment business then consider the advantages of renting out short-term, serviced apartments. While Airbnb has done much to open up this market it would be wrong to think that it is the only game in town. In the UK, there are over 30 different major websites matching serviced apartment owners with people looking to rent. Moreover, although the leisure market is huge, the business market is every bit as valuable and worth more. Pundits believe that business rental is going to fuel much of the future growth. This is because short-term assignments are forecast to grow to over a fifth of all international relocations in 2017, while long-term assignments are expected to fall over the same period.

The best way to explain the attraction of a short-term, serviced apartment business is to take a typical example. For approximately £300,000 you can buy an attractive two-bedroom flat in Edinburgh. If you let that apartment out on a long-term let you can expect around a 5% yield, or £15,000 rent a year. Letting it on a short-term basis, you should be able to achieve a gross yield of up to 15%. In other words, around £45,000 income a year.

Of course, short-term renting does increase your costs. To achieve that kind of rental income you could be servicing as many as ten different tenants a month. You can expect the cleaning bill each time you change tenant to be around £60. You are also going to see higher costs when it comes to maintenance. While most tenants will treat your property with respect, you have to allow for higher breakages and more frequent decoration. Booking fees can vary dramatically but you should allow for up to 15% of revenue.

There are difficulties to overcome, as well. You may need planning permission. In London the rules are quite clear – if you want to rent for more than 90 days a year then you must get planning permission. You also need to check, if you hold the lease, whether your freeholder will allow you to rent in this way. Remember, too, that not all banks are enthusiastic about funding this type of business.

There are other connected property opportunities. If you decide to go into this area and manage the properties yourself, you will almost certainly be able to pick up other landlords interested in paying you to look after their short-term accommodation for them. This can be a very useful stream of additional income. Nor do you necessarily have to buy the properties you rent out. Many people work in this area by 'renting to rent'. You could, for example, take a five-year lease on a property and agree a fixed rent at slightly below market rates in exchange. If you can rent for 5% less of the property's value and rent it out at 15% of the property's value there is obviously a substantial margin to play with. Incidentally, it is sometimes worth listing with a site like Airbnb or Booking.com as they usually have tools that tell you the average occupancy rate in particular areas. If you want your business to be a success, you should aim to choose areas that have an average occupancy of around 70%.

Finally, if this opportunity is of interest to you, consider joining the Association of Serviced Apartment Providers (ASAP). It now represents a growing number of operator members and has a range of services that will help you make your business a success.

Tim Steele lives in Glasgow and has a portfolio of over 20 properties.

The East Midlands

You are interested in investing in property outside London and the South-East. You are a little nervous about heading all the way to the North. Perhaps you should consider buying property in the East Midlands. Price rises in the East Midlands have fallen behind the hotter South and yet have generally done better than property prices further north. There are four core areas you should look at:

• Nottingham. Nottingham is traditionally a city that depended on light industry but recently it has moved much more into the service sector. Financial and business services, logistics and retail are the main employers, while advance manufacturing, clean technology, life sciences and digital are emerging – the city's new creative quarter has created 650 jobs since it was established in 2014. It is anticipated that the Nottingham enterprise zone will create 10,000 jobs over the next few years. There are plans to unite parts of Nottinghamshire and Derbyshire under a new combined authority. This could help to create as many as 50,000 new jobs and will require the building of some 35,000 new homes. One of the interesting property opportunities to watch is that of the growth of the Nottingham tram network. The second phase recently opened, doubling the size of the system. There are plans for further extensions including to Kimberly, the future HS2 station at Totten and to Derby. Research by Notts TV News suggests property price rises in some areas served by the first phase have outperformed rises in Nottingham generally over the decade. It is also worth remembering that Nottingham is one of the UK's largest academic centres. Its two universities have no fewer than 57,000 students and although numbers are falling they still have to offer huge potential for development in the right location and with an appropriate product. In terms of HMO one does require planning consent for conversion of a property into HMO, and additional licensing is required in specific areas. What about prices? The average property price in the city is £123,672.
The average market rent in Nottingham is £856 per month with a two-bed property renting for £710 per month and a four-bed renting for £1,160. Average room rent in Nottingham is £307 per month.

• Derby. Derby is considerably smaller than Nottingham with a population of just 247,000 but it is expected to grow by over a quarter over the next two decades. Traditionally a major railway engineering centre, private sector engineering is still the city's largest industry. The city claims to have the highest average salaries in the country outside of London and the South-East, at roughly £34,600 a year. It certainly achieved major growth over the last five years and has attracted some £3 billion of inward investment. The city is recognised as a top-ten city to start a business in and is a top-ten location for premium retail. It is served by both East Midland's airport and, of course, Nottingham. It has a much smaller student presence compared to Nottingham with only one university of some 11,300 students. It is somewhat easier to establish an HMO in Derby. The average property price is £141,067 and, interestingly, a single room rents for £402, which is higher than in Nottingham. However, the rent on single dwelling properties is somewhat lower. According to one leading rental manager there is a shortage of stock for professional tenants and demand is high.

• Loughborough. Originally, Loughborough was a small manufacturing centre but the town is now a popular commuter location and has a significant university with some 18,600 students. The average property price in Loughborough is £193,000 and the average market rent is £1,069. The average rent for a typical two-bedroom flat is £550. And for a four-bedroom house it is £1,000.

• Leicester. The population of Leicester has grown by 17% over the last decade, faster than anywhere else in the UK except London and Manchester. Traditionally, the city was a major footwear and knitwear manufacturing centre. However, the economy is much more diverse and significant industries include logistics and distribution, professional and business services. There is some advanced manufacturing and engineering. A new enterprise zone has been set up with the intention of creating a science and high-tech manufacturing-themed 'zone of excellence'. It is believed that this could create 25,000 new jobs over the next 25 years. Leicester has a housing shortage, particularly of affordable housing. The University of Leicester has 10,000 full-time students and the larger De Montfort University has 27,000 students. The average property price in Leicester is £146,038 and prices have been rising at close to 9% a year. The average market rent in Leicester is £750 per month and a typical one-room rent in an HMO costs £363 per month.

The Schmidt Tax Report

Web: www. schmidtreport.co.uk Email: info@wentworth-publishing.co.uk