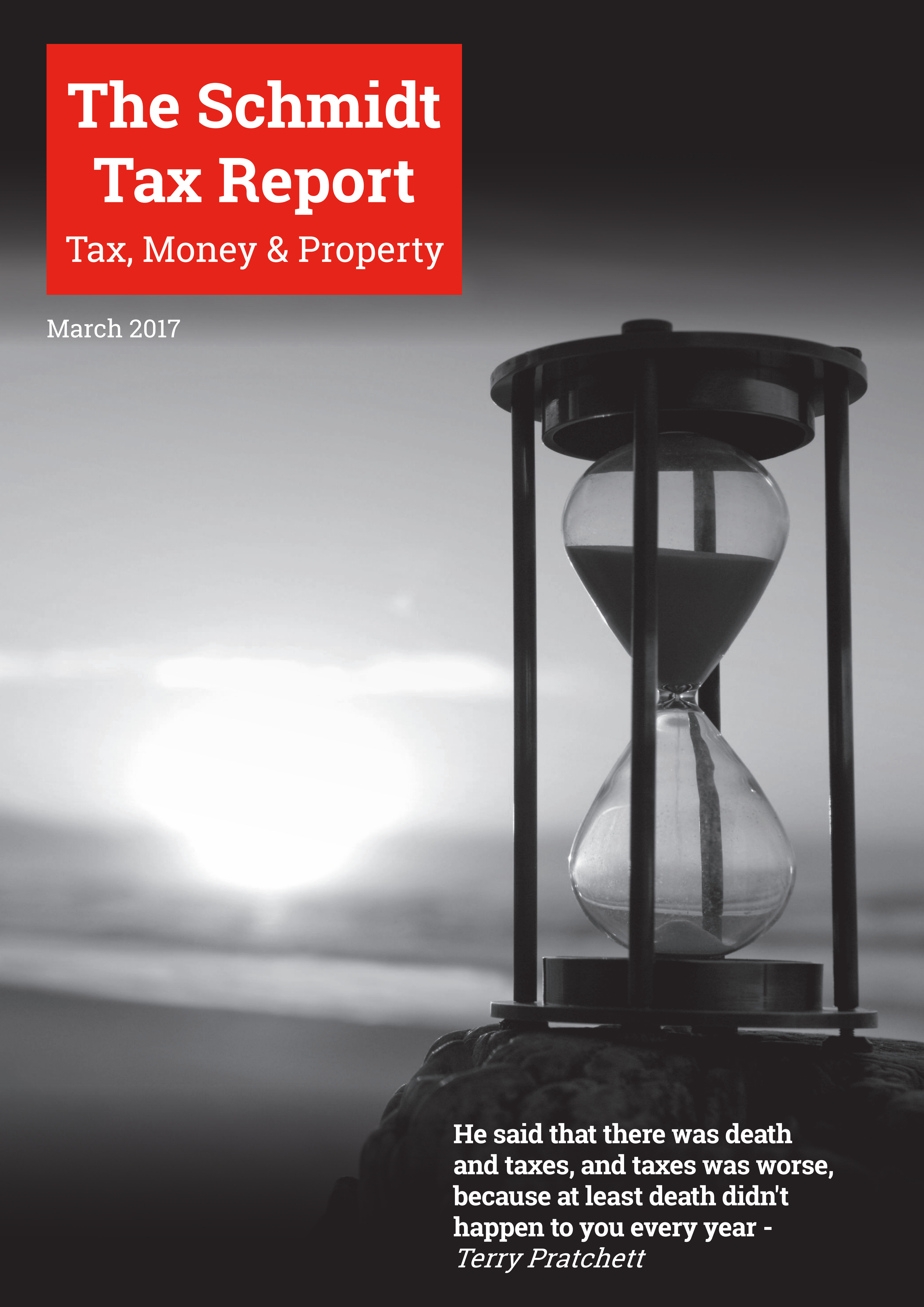
The Schmidt Tax Report

Tax, Money & Property

March 2017



He said that there was death and taxes, and taxes was worse, because at least death didn't happen to you every year -
Terry Pratchett

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Tax

News

Spring Budget

In our experience, it takes a few weeks to understand what threats and opportunities the Budget presents. Accordingly, Alan Pink has summarised the key points, but we expect to comment more in the coming months. As you will see:

- Company directors and private shareholders will have their tax-free allowance on dividends cut from £5,000 to £2,000 from April 2018.
- Class 4 NIC, which is paid by self-employed workers with profits of more than £8,060 a year, will rise to 11% by 2019.
- There's to be a 25% pension charge for many people transferring their pensions overseas.
- Some modest support for businesses being hit by a huge business rate tax increase.
- VAT on call roaming when outside the EU.
- A fine on any professional who uses tax-avoidance arrangements that are later defeated by HMRC.

Interestingly, the Budget did not touch on the costs associated with Brexit.

Sweden doesn't want so much tax

The Swedish government has complained that it is collecting more tax than it should do. While bank interest rates have fallen, Swedish tax rules mean that excess deposits in taxpayers' payment accounts continue to earn at least 0.56% a year. This has led to many individuals and companies using them like bank accounts. As a result, the Swedish government generated a budget surplus of over $9.5 billion last year, of which roughly half came from tax overpayments. Indeed, the government will have to repay more than $3.5 billion to businesses and individuals in the next few months. In order to reduce the amount of overpayment made by taxpayers, the government has removed all interest payments on tax deposits. However, as interest rates in Sweden are now negative, a number of companies and individuals may well decide to keep making the overpayments.

Bumper year for fraud

Last year, HMRC's fraud investigators managed to collect close to £5 billion worth of tax, of which £2.2 billion was a result of criminal investigations and £2.7 billion from civil investigations. Last year, 100 wealthy individuals and corporations were prosecuted by HMRC for fraud.

British tax burden at 30-year high

The Institute of Fiscal Studies (IFS) has announced that the UK's tax burden will rise to its highest level for over 30 years despite further cuts to public service spending in 2019/20. Tax revenues will, that year, be over 37% of national income. The last time this occurred was in 1986/87, when Margaret Thatcher was in office. The IFS is doubtful as to whether the government will be able eliminate the current budget deficit any time before the end of 2025.

Capital gains tax bonus

HMRC collected an additional £140 million of capital gains tax (CGT) in 2016 as a result of investigations into noncompliant UK taxpayers. Last year, HMRC collected a total of £7.3 billion in CGT, which was a 28% increase on the year before. Much of this can be attributed to higher house prices and an increase in the numbers of properties being bought and sold.

Ladbrokes £71m gamble fails

The bookmakers Ladbrokes has lost its appeal over a £71 million tax bill. The case relates to a tax scheme devised by Deloitte and was implemented in 2008 to exploit what appeared to be a loophole in part of the tax code that dealt with the taxation of loans. The loophole was closed in 2008 and the legislation was further revised in 2009. Interestingly, Deloitte sold the scheme to 11 different companies of which nine had conceded before the tribunal hearing and paid the tax owed.

HSBC to be grilled

HSBC's chairman, Douglas Flint, has been called to give evidence to the Treasury Select Committee in relation to the activities of HSBC's Swiss subsidiary. Interestingly, Andrew Tyrie, chairman of the Treasury Select Committee, has decided against calling previous HSBC executives because: "The committee doesn't want to drag up the past, so it will focus on HSBC now and how it has dealt with this problem to ensure that it doesn't happen again." However, Lynn Homer, head of HMRC, has also been called to give evidence. The committee has accused HMRC of being slow to take action against HSBC.

£7m bill for SFO

The Serious Fraud Office (SFO) has been ordered to pay the legal costs of various defendants involved in a failed tax trial. The SFO was unable to prove that a number of defendants – including Alan Whitely, a former director of Cardiff City Football Club – had committed fraud. Last year, the SFO needed extra government funds to help cover the costs of a now settled £300 million damages claim against it brought by the Tchenguiz brothers.

Greater affluence

HMRC has increased the number of full-time employees in its Affluent Unit from 327 to 395 as it ramps up the number of investigations it plans to make into the financial affairs of middle-class taxpayers. Established in 2011, the Affluent Unit investigates the tax affairs of people with an annual income in excess of £150,000 or a net worth of at least £1 million. Various factors are believed to attract the interest of the Affluent Unit inspectors, including offshore bank accounts, offshore property, significant property holdings in the UK, paying a low rate of tax on total income and previous involvement in a tax-planning scheme.

Bill Gates proposes robot tax

Bill Gates, during an interview with *Quartz*, argued that one way of deliberately slowing the advance of the next job-killing technologies would be to tax robots. "It is really bad if people overall have more fear about what innovation is going to do than they have enthusiasm," he said. "That means they won't shape it for the positive things it can do. And, you know, taxation is certainly a better way to handle it than just banning some elements of it." He also points out that a direct levy on robots could match what human workers pay. "Right now, the human worker who does, say, $50,000 worth of work in a factory, that income is taxed and you get income tax, social security tax, all those things. If a robot comes in to do the same thing, you would think that we would tax the robot at a similar level." Mr Gates proposed that the extra money should be used to retrain the people that robots have replaced.

Corporate loss restrictions

HMRC has confirmed that as of 1st April this year the tax treatment of certain types of carried-forward losses for corporation tax purposes will be restricted to 50%. This limit will apply to carried-forward losses incurred at any time. Each stand-alone company or group will be entitled to a £5 million annual allowance of unrestricted profit. According to HMRC, this will ensure that most companies are unaffected. Loss relaxation will be brought into play whereby losses arising after 1st April when carried forward will have increased flexibility and will be able to be set against the total taxable profits of a company and its group members. The loss restriction and loss relaxation will apply to trading losses, non-trading deficits on loan relationships, management expenses, UK property losses and non-trading losses on intangible fixed assets. The legislation has not yet passed into law and therefore certain changes may yet be made.will be brought into play whereby losses arising after 1st April when carried forward will have increased flexibility and will be able to be set against the total taxable profits of a company and its group members. The loss restriction and loss relaxation will apply to trading losses, non-trading deficits on loan relationships, management expenses, UK property losses and non-trading losses on intangible fixed assets. The legislation has not yet passed into law and therefore certain changes may yet be made.

HMRC accused of unnecessary delay

The legal firm RPC has done some research into the amount of time HMRC forced taxpayers to wait until their tax inquiries were closed. Basically, taxpayers under inquiry by HMRC's CSI (Charities, Savings and International) and by pensions units waited 303 days on average last year for their inquiries to be closed, almost a quarter longer than on the previous year, when the average was 243 days. The law firm has suggested that by keeping cases open for long periods HMRC is placing financial pressure on taxpayers and generating increased stress for those taxpayers who find themselves caught up in a lengthy HMRC inquiry. The firm believes, in short, that HMRC is deliberately dragging its feet closing inquiries. The firm points out that taxpayers may apply to the tax tribunal for a direction compelling the taxman to wind things up.

Greater transparency of trusts

The European Parliament is pushing the UK and other EU member states to open up all trusts to greater public scrutiny. Under the new regulations EU member states must operate fully public registers disclosing the beneficial ownership of trusts. Trust beneficiaries would only be able to escape rules if they could show that their personal safety would be at risk if the information were revealed. The idea is that public registers will include details of all the main participants in a trust, including the settlor, trustees, beneficiary and any other people exercising control. However, each EU member state will have to back the measures before they pass into law. The UK has consistently fought against having fully public registers of trusts.

Editor's Notes

Achieving a tax-free transfer

One of the most frequently received queries we receive at *The Schmidt Tax Report* is how to transfer a buy-to-let property from a parent to a child without triggering a CGT bill. The answer will depend very much on the value of the property. However, if it is worth less than the current inheritance tax (IHT) nil rate band (£325,000 at present), there is at least one way in which it may be possible to avoid a tax liability. This is how to do it:

- Let's assume that after your annual CGT exemption and capital costs you have a £40,000 tax bill you wish to avoid.
- The first step is to establish a trust (using a member of the Society of Trust and Estate Practitioners) and to transfer the property into that trust. Normally the transfer of a property into a trust would be chargeable to IHT. However, as the value is less than the IHT nil rate band no IHT is payable.
- A CGT charge can be avoided by making a holdover claim under section 260 of the Taxation of Chargeable Gains Act 1992.
- After a sufficient wait – it should be at least three months – the trust may pass the property to its beneficiary. This transfer is subject to an IHT exit charge, but this will be 0% because of the initial market value of the property.
- After transferring it, a second holdover claim can be made in order to establish a new base price for the property.

Why pay 28% when you could pay 10%?

Imagine for a moment that you were in the fortunate position of owning a property investment company with assets worth some £2 million that would on disposal enjoy a £1 million gain and trigger a £280,000 tax bill.

What could you do about it?

Clearly, it would be advantageous to rearrange your assets so that you were entitled to entrepreneurs' relief, which would reduce your tax bill from 28 to 10% and save you some £180,000.

How?

In order to be eligible for entrepreneurs' relief it is necessary for you to be running a trading company and not one that simply invests in property. One way to achieve this would be to sell the current investment property and reinvest the total amount received into something that would count as a trading business rather than a property investment business. An ideal option would be something like a nursing home. This is property backed, but most definitely a business. Hold on to the newly acquired asset for at least a year and then you can sell it and take advantage of entrepreneurs' relief.

Obviously, you will want to check that you meet all the conditions attached to entrepreneurs' relief with your professional advisor. In summary, shares in a trading company in which the vendor holds at least 5% of the company's ordinary share capital, has 5% of voting rights and is an officer or employee of the company fall within the definition.

Family investment companies v. trusts

I am very grateful to Thomson Snell & Passmore (a well-established legal firm based in Kent) for forwarding me a factsheet on the subject of family investment companies (FICs).

Essentially, an FIC is a bespoke private company that can be used as a tax-efficient alternative to family trusts. An FIC is a flexible structure that allows families to define how specific family members (through varying rights attaching to shares or the number of shares in issue) will benefit.

The directors and shareholders of the FIC are normally family members. As with trusts, the structure of the FIC can enable parents and grandparents to retain control over assets while accumulating wealth in a tax-efficient environment and facilitating future succession planning.

It is preferable to set up FICs with cash (by gift and/or loan), as the transfer of property or shares is likely to involve CGT and stamp duty.

An FIC can help families manage their exposure to IHT in several ways:

- When the FIC is formed, shares can be given to family members without incurring any immediate tax charges, and after seven years the full value of what has been given away will pass out of the estate of the founders, and so avoid any IHT.
- If founders lend initial capital to the FIC, any growth in the value of investments held by the FIC will be outside the founders' estates.
- The founders can retain distinct classes of shares, so enabling them to retain income (and capital if the company is ever wound up).
- If shareholders have a minority interest in the FIC, the value of their shareholding will be discounted on death for IHT purposes, taking into account the size of their holding and their inability to sell shares or demand income from the company.
- Unlike trusts, the FIC will not pay periodic charges to IHT which apply to trusts and up to 6% every 10 years or exit charges if and when the capital is distributed.

An FIC may also provide an element of asset protection. For example, the company can be structured so that the shares can only be held by direct family members, excluding spouses. The assets of the FIC can generally be placed beyond the reach of the family courts. Although the value of any shares held by a divorcing shareholder will be taken into account on divorce, the restricted rights enjoyed should reduce their value to little or nothing.

Obviously, dividend income can be received by the FIC tax-free. Other income and capital gains will be subject to corporation tax, which, of course, reduces to 17% by 2020. What about the extraction of cash? This is probably best done by dividend payments. The first £5,000 can be given tax-free but, of course, there is no obligation to pay dividends, and profits can be reinvested in order to increase the value of the FIC.

It is possible to have different classes of shares within an FIC so that some members have votes and others don't.

It is easy to see why a growing number of comfortably off and wealthy families are beginning to see FICs as a much easier, lower-cost and more flexible option when compared to trusts.

Good money

Finally, a plea to all readers to consider taking advantage of the much-increased tax benefits of social investment. From April this year, the government will allow social investment tax relief (SITR) to be used in much larger transactions. At the moment there is a three-year rolling limit of £293,000, which is about to be increased to £1.5 million. Introduced in 2014, SITR provides tax relief of 30% of the value of a qualifying investment. So, for example, if you were to lend a social enterprise £100,000, you would get a £30,000 reduction in that year's income tax bill, as well as a potential CGT deferral.

Because investors benefit from a substantial tax saving, social enterprises generally expect to pay a much lower interest rate than they would if they were borrowing from banks or some other social provider. According to NPC, a charity think tank for Big Society Capital (BSC), a social investment bank, the average cost of capital for deals struck in the first two years of the relief was 4.8%.

Incidentally, the enterprises are only required to start paying back the principal of the investment after three years. What sorts of projects are available to investors? The options could range from helping a community sports centre to expand to helping a company that mostly employs people with disabilities to build a new factory.

It has to be said that most investments are, by their very nature, relatively high risk.

Quite often, investors end up offering time and expertise to the social projects they back. Incidentally, in the first two years, only £3.4 million was invested in such a way as to take advantage of SITR.

One of the key problems is that many project planners are not aware that SITR exists and, therefore, don't realise that this obvious source of funding is available.

Ask The Experts

Q. I bought a house jointly with my wife for around £135k in January 2015, using funds from an existing offset mortgage on our own house. We let it to my friend on an Assured Shorthold Tenancy for £650 pcm.

The plans to renovate and sell have been replaced with a plan to renovate and remain in the house as he likes the area and is now seeking a home for himself and some of his children, rather than a profit.

His wife is pushing for a 'financial settlement' from the divorce, which will probably give him around £60k later this year (well short of the agreed 50%). Upon receipt, he plans to invest it in the house and we plan to make him a part owner. Ideally, we'd all like him to go on to increase his share of the property until he ultimately owns 100%, but this may take several years.

At the moment his rent is a little bit less than the interest that we incur on the loan plus the money spent on materials for refurbishment, so we're making a small tax loss. This will obviously swing around in the future, if he is to have any chance of full ownership, as his payments to us will need to greatly exceed our outgoings.

What structure do we need to ensure that we and he pay the least tax?

C. B., via email

A. Your friend pays no tax under this arrangement. He is not receiving any income; he is just paying you rent and paying you to acquire the property.

You and your wife have two tax liabilities: one on the rental income and one on the sale of shares in the property to your friend.

On the rental income, be aware that 'refurbishment costs' are not deductible from the rental income. Refurbishment adds to the capital value of the property so is deductible when the property is sold. Only costs associated with the rental (i.e. repairs that keep the property in good order but do not improve it) can be deducted from the rents. So you will pay tax on the rents minus the mortgage interest minus the repairs, bearing in mind the new mortgage interest restrictions that limit mortgage interest relief to just 20%. Over the years as your friend acquires an interest in the property his rent will reduce: if he is paying £650 a month to rent 100% of the property from you, he will not pay £650 once he owns half, because he will only be renting the other half. So your rental income will reduce over the years, which will be lucky given the gradual phasing-in of the mortgage interest relief changes.

As your friend buys the property from you, you and your wife will make a series of capital disposals. So in year one when he has a lump sum he may buy half of the property from you. You will make a capital gain equal to the proceeds received minus half of the original costs and half of the refurbishment costs of the property. If this gives a capital gain, this will be split between you and your wife. You will each have your annual CGT exemption of £11,100 to set against the gain, so you will possibly not pay any tax. If in year two he buys a quarter share from you, you will repeat the exercise and you will again have your annual CGT allowances to offset against the gain. If it takes your friend a number of years to buy 100% of the property from you, this is good news for you as you get to use a CGT allowance each year to offset against the capital gain, as long as you do not draw up a contract in year one which binds him to eventually buy 100% of the property.

Q. I am thinking of buying an investment property, it has live to work permission and consists of a downstairs shop/office unit and a flat on 2 floors above.

Would it be best to buy this through a limited company or hold it in my own name?

If purchased through a company, would this avoid the stamp duty surcharge and other 2nd home penalties that have been recently introduced, or does the live to work category change things anyway with regard to buy to let?

R. M., via email

A. The answer as to whether to hold a property through a company or personally depends on your personal circumstances and what you are trying to achieve: who is to benefit from the property income and when do they want to enjoy the income? Only last week one of our experts went to a meeting with a client to discuss this very subject. She expected to tell the client that a company would not be appropriate but, after the discussion, reached the opposite conclusion.

Buying a property through a company will certainly not avoid the enhanced stamp duty land tax (SDLT) charge. The extra 3% surcharge applies to all residential purchases by companies if the price is in excess of £40,000.

However, in your particular case the enhanced SDLT charge will not apply to the purchase because you are buying a multi-use property (i.e. part commercial and part residential). The enhanced SDLT charges only apply to properties which are solely residential.

So, if you are thinking of a company only because of the perceived SDLT advantage then a company will not be necessary.

You And The Revenue

It's mediation, Jim, but not as we know it!

Some of our readers who are longer in the tooth than others may remember the time when tax offices were to be found in every town of any size; and you would see your local tax inspector waiting for the bus or queuing up at the Sainsbury's checkout at the weekend.

Not any more. HMRC, no doubt at the behest of some accountant seeking the elusive aim of 'efficiency', has gone the same way the banks went about 20 years ago. It's shut all the local branches, and centralised in huge and anonymous offices in random parts of the country – usually hundreds of miles away from the taxpayers it is meant to be dealing with. You can no longer phone up recognisable human beings who live in the area, know its economy and can probably talk to you sensibly about your business. You're now dealing with robotically programmed trainees who may have left school no more than three weeks ago.

As so often, this drive for 'efficiency' often has precisely the reverse effect, and one good example of this is the process by which disputes with the Revenue are resolved.

The trigger-happy taxman

An actual real-life case, which we were involved in ourselves, illustrates the stupidity of the current system to a nicety. An individual bought a property in Northern Ireland, near where he lived, with a view to improving it (by adding an extension at the back) and selling it for a profit. From no fault of his own, the Irish property crash – so much more severe than the corresponding correction which happened in England – happened just as he was on the cusp of his development project.

The result was a large drop in the market value of his property, which necessitated, under accounting standards, him writing down the value of the property in his accounts, and thus creating a substantial trading loss.

The fun began, of course, when he sought to claim the benefit of that loss against his other income, and looked for a tax refund.

Enter the HMRC crack division of robots. Because a trading loss on property is so much more advantageous than a capital loss, the Revenue officer dug his heels in and insisted that the property activity was investment in nature. If you buy a property as an investment, that is to hold it long term for rent, any drop in its value is not claimable as a loss against your other income.

As is so often the case, HMRC was completely impervious to the bombardment of facts and evidence which the individual's accountant bestowed on them. They insisted that it was an investment activity.

The importance of intention

As we've commented before, losses on property, whether realised or unrealised, and relief for those losses, are an interesting example of how hundreds of thousands, or even millions, of pounds can depend on what is going on inside the taxpayer's head. If you buy a property with the intention of doing it up and selling it, you are trading, and any loss, even if unrealised, can be claimed against your total income and gains. If your intention was to hold the property long term, there's no relief.

So don't you think it would have been quite important for the tax officer to try to find out what was going on in the taxpayer's head, in this case? We offered them a meeting so they could talk the issue through with the taxpayer, face to face.

And guess what: the inspector said it was not possible for her to travel to Belfast, where the taxpayer lived, because she was based in an office in Oxford!

We felt so strongly about this, and there was enough money at stake, that we decided to see what the Tribunal judge thought of the issue. Two inspectors therefore had to fly over from Oxford and Milton Keynes respectively, and no doubt stayed in a hotel for at least one night before presenting their case to the Tribunal in Northern Ireland. So much for efficiency!

In the end, it was not very difficult for the Tribunal judge to conclude that our client was trading, and therefore the loss was allowable. All he needed to do was listen to what the chap had to say.

And if anyone can explain to us how the Revenue has gained in efficiency by dealing with a Northern Irish taxpayer in the South-East of England, even though they have plentiful staff in Belfast, we'd be very interested to hear.

HMRC 'mediation'

OK, so we've explained why we think the current system is stupid. But, of course, whether we like it or not (and we don't), this is the system we now have to work with. So the main point of this article is to consider what options are available to a taxpayer who's in serious dispute, about reasonable sums of money, with the Inspector of Taxes.

First, of course, one shouldn't completely write off the idea of trying to persuade HMRC of the justice of one's cause in letters or emails. Even if our strong impression is correct, that HMRC is much less interested in right and wrong now, and far more interested in simply trying to screw the biggest amount of tax it can out of us, no doubt there are occasions where persuasive argument can lead the Revenue officer to climb down. Sometimes, also, you get the phenomenon of the change of inspector: a new inspector, taking over the file in one of the numerous reshuffles of staff which seem to afflict the Revenue on a regular basis, may well take a different technical view from his predecessor. And, of course, he's not bound by any kind of personal pride to carry on banging the same drum he has been banging all along.

If you can't persuade the officer in writing, however – and it's very difficult to get through to anyone in HMRC on the telephone these days – it was, until recently, unfortunately the case that your redress was to be found with the Tribunal or not at all.

The First-tier Tax Tribunal was set up some years ago now to replace the old, more amateurish, system of General and Special Commissioners. The General Commissioners were like magistrates, that is they were lay people whose main function was to decide straightforward questions of fact, where these affected on someone's tax liability. These were replaced by a new system of tribunals, and whatever the intention of this new system, the actual result is that we have a much more stuffy and pompous system for resolving disputes than we had before.

Very often in cases where, in the old days, you could have just turned up at the Commissioners and argued with the tax inspector in front of those Commissioners, you now tend to have the full paraphernalia of statements of case, witness statements, paginated document bundles, etc., etc., which have to be exchanged so many days prior to the hearing, and so on.

It would be fair to say that the new tribunal system is a gift to the lawyers (who devised the system, of course), but a curse to everyone else.

Alternative dispute resolution

Then someone came up with the bright idea of introducing alternative dispute resolution, or ADR.

The term ADR actually covers various types of arrangements aimed at avoiding litigation, but in the context we're talking about it means the Revenue's version of mediation.

Mediation usually works as follows. The two disputing parties meet in a single location, usually the offices of the solicitors for one or the other of the disputing parties. A professional mediator, very often a practising barrister who specialises in mediation, runs the meeting and asks each side to set out their position as briefly as possible.

Following this initial exchange of views, the two parties separate, one sitting in one room, and the other in another. The mediator passes between the two rooms and takes carefully worded messages from one party to the other. The aim of the exercise, of course, is to arrive at some kind of compromise.

Sometimes mediation works very well, because a skilful mediator will be able to see both sides' point of view and will express their own views on the strength of each party's position quite freely. It is an eminently sensible procedure, in fact.

The HMRC version of mediation

ADR, or mediation, is quite a new concept to HMRC, and one of the odd features of the way the tax officers have interpreted the term is that the mediators appointed, in an HMRC ADR process, actually work for HMRC!

Say what you like, somebody who has been brought up and trained within HMRC cannot possibly adopt the same impartial approach to tax disputes as a genuinely uninvolved third party. Once a Revenue officer, always a Revenue officer.

Let's consider two actual mediations that we've been involved with, in our own experience.

The first one was in connection with a disputed information notice which HMRC had issued. This asked for all kinds of information that, in our and the taxpayer's view, could not possibly be relevant to any tax liability which HMRC could assess. It took place as part of what is called a COP9 investigation, which is a heavy form of investigation in which the threat of penalties or even criminal prosecution floats about in the background.

Along came the Revenue-employed mediators. One of them was chosen because he was a specialist in COP9 investigations – from the Revenue's side, of course. It soon became clear that he was so much batting for the HMRC side (for example issuing blood curdling warnings to the taxpayer, who'd been convicted of no actual offence) that we asked the other mediator if we could carry on without him.

In the second case we were dealing with, the mediators were much more even handed, it has to be said. However, one of them, on being asked what she spent her time doing when she wasn't mediating, made clear that she was working in HMRC's counter-avoidance division. Since this was a dispute about what was alleged to be a tax-avoidance scheme, she would have been superhuman to be truly impartial.

The plus side

When might HMRC mediation be useful? We have heard of cases where the taxpayer, or rather his accountants, have insisted on 'proper' mediation, with a genuinely independent third party as the mediator. But are there uses, in fact, for the Revenue's version of the process, even given its obvious shortcomings?

The answer is that, where the only alternative seems to be going to the tax tribunal, mediation could well sometimes be worth trying.

Entrenched positions can easily be reached on both sides in correspondence, and it's surprising how differently a vehement and bigoted letter writer can come over when you meet him face to face. One can even sometimes arrive at the provisional view that your opponent may be human!

But mediation certainly won't work for all kinds of disputes between the taxpayer and HMRC. It's probably easiest to set out the sort of dispute where mediation is unlikely to get you anywhere: and then leave it that in any other kind of dispute, mediation might be worth trying.

Where HMRC will not yield is where it is an argument about a technical point of tax law, on which HMRC has formed and publically expressed a view. Ever since the scandal of sweetheart deals whipped up by ignorant journalists, HMRC has been very cautious indeed about anything which involves any kind of horse-trading.

As a result of those scandals, the Revenue came up with its so-called Litigation and Settlement Strategy. What this basically says is that Revenue officers can't settle any dispute which involves compromising on the Revenue's view of the law.

But this does actually leave a wide range of areas where HMRC is able to compromise. Where there is a dispute about a question of fact, for example what transactions actually took place as opposed to what purported to take place, the analysis of the factual evidence may quite reasonably give rise to more than one possible outcome. In this situation, there is scope for either side to back down on their interpretation of the facts, however provisionally and subject to whatever qualifications.

Where a tax liability depends very much on a question of valuation, this is also something on which different judgements can validly be arrived at without HMRC being accused of favouring anybody with an illegal compromise settlement.

That or the Tribunal

The big attraction of mediation, as an alternative to litigating in the Tribunal, is that you are in control of the outcome. You don't have to arrive at a compromise agreement if what the other side is suggesting is simply outside the range of what is acceptable. If you do, provisionally, arrive at a conclusion, this is not binding on you legally. (In this way, mediation differs from another sort of ADR, called arbitration.)

Another attractive feature of mediation is that the whole process can be 'without prejudice'. What this legal term means is that you can speak freely without anything you say being potentially treated as evidence against you in the future. So it's possible to find out, sometimes, a lot more accurately what the other side is really thinking, as contrasted with the public front they are putting up.

Budget 2017: Edited Highlights

The politicians seem to have realised, after about 200 years, that it's not very sensible to introduce major changes to our tax law with only about a fortnight to go before they take effect. Our crazy legislative system used to involve Budgets being delivered, sometimes even after 5th April in the spring of a year, with changes taking effect from before the Chancellor even stood up.

We now have the signs of a better system, although best of all would be if they didn't keep prodding and changing things in a radical way every year, so some of us could actually, like, plan?

So the last of the old-style spring Budgets, which was delivered in March 2017, was quite light on major changes in comparison with previous Budgets. In consequence, this selection of edited highlights, comprising those parts we think are most likely to be of some interest to our readers, is also shorter.

1. Self-employed National Insurance contributions

It apparently strikes the Chancellor as unfair that self-employed people only pay 9% of their earnings in National Insurance contributions (NIC), whereas employed people pay 12%.

Someone who actually knew about the history and nature of NIC should have briefed him, or his scriptwriter, before he made this frankly ridiculous statement. How about the fact that the 12% employees' contribution actually gives rise to an entitlement to state benefits, whereas the 9% paid by the self-employed gives no entitlement to benefits?

How about, too, the whole outmoded concept of NIC? No doubt when NI was originally introduced, the money did actually go into some kind of pot to provide future benefits – or are we being naive here?

The modern reality is that NI is no more than another tax and one which, perversely in some people's view, taxes earnings more heavily than investment income.

No one in business expects the tax or NI system to be fair, in any event, and the increase announced in this Budget, from 9% self-employed contributions to 10% next year, and 11% the year after, is just yet another hike in what is merely another sort of income tax.

2. The dividend allowance

In the tax year 2016/17, and, indeed, the subsequent year, anyone receiving dividends from a company has a tax-free band of £5,000 to offset against those dividends. It doesn't matter if he or she is a higher-rate taxpayer, or how much the total amount of their dividends is: £5,000 is exempt from tax.

The announcement in the March 2017 Budget, to the effect that this £5,000 allowance is being reduced to £2,000 from next year, is presumably because evil tax avoiders were jumping on the band wagon to 'abuse' (i.e. take advantage of) this tax relief.

The purpose of introducing the £5,000 dividend allowance is clear. Little old ladies, and others, who receive a small amount of dividends on their savings don't need to do tax returns. The tax-free allowance was no doubt considered necessary because, under the old regime which applied up to 5th April 2016, those whose income didn't push them above the basic rate of tax had no liability at all on dividends. With the new 7.5% dividend tax coming in from 6th April 2016, without any kind of allowance or nil band, hundreds of thousands of individuals would no doubt have found themselves having to prepare self-assessment tax returns, with a huge extra strain both on them and on the system.

It seems that someone in Somerset House has decided that they can still keep a reasonable number of people out of the self-assessment system with a £2,000 nil band, and at the same time make 'abuse' of the relief less attractive.

3. Salary sacrifice

Like a lot of this year's Budget announcements, this was old news, having already been made public in last year's Autumn Statement.

Apart from a few mostly piffling sorts of tax-free benefit in kind (including the 'cycle to work' scheme) anyone reducing their salary and receiving benefits in kind instead will end up paying the same tax as if they hadn't done so.

4. Overseas developers

Until the changes originally announced in last autumn's mini-Budget, and reaffirmed in March 2017, it seems that it was possible for non-resident entities to make a packet out of developing sites in the UK without paying any UK tax on those profits.

The way you did this was by setting up your entity in a non-UK jurisdiction and being very careful to ensure that the property development business didn't acquire what's called a 'permanent establishment' in the UK – which could be made the basis for a tax charge on your offshore entity.

In a way, it's surprising that the rules were so loosely drawn up before to enable this to happen, but HMRC and the government are determined to stamp this out now.

The rules are quite complex and obscure, arguably, and no doubt some clever planner will think he has found a way round them. But basically the intended effect of the changes is to bring all such profits within the scope of UK tax.

Whether this will have a noticeable effect on the number of cranes and scaffold poles to be seen all round London, for example, remains to be seen: we suspect it will.

5. The VAT threshold

Moving abruptly from big boy's tax planning to the little boys, the turnover threshold at which a business is required to register for VAT is moving up from £83,000 to £85,000 from 1st April 2017. This continues the trend of the UK having a preternaturally large registration threshold for the tax as compared with other EU countries. I suppose we don't actually care about this any more!?

The practical impact for many is going to be to encourage even more the two specific sorts of tax planning which make use of our comparatively high VAT threshold:

- 'Business splitting', under which a number of different entities are set up by what is basically the same businessman or collection of business people, such that each entity's turnover is less than the threshold, and therefore the businesses don't need to charge VAT. Of course, HMRC has an answer to this sort of planning, but this answer doesn't always apply, by any means.

- Using non-VAT-registered traders, for example to do building work for private individuals or for VAT-exempt businesses, neither of which category of person can reclaim any VAT charged to them.

6. Tax rates

We don't intend to burden these pages with massive tables giving the new tax rates; these are readily available in all kinds of places in any event. But we will pick out just one interesting increase in allowances, in favour of the taxpayer. With a personal allowance at £11,500, and a basic rate threshold of £33,500, individuals will be able to receive gross income of up to £45,000, from 2017/18 onwards, before they go into the higher rate of income tax.

This reverses what seemed before to be a trend towards moving more and more people into the 40% taxpaying bracket: but it looks as though income taxpayers in Scotland are not going to be so lucky, with their parliament imposing a different 40% threshold from the rest of the UK. Perhaps Nicola Sturgeon reasons that 40% taxpayers are a smaller proportion of the total population in Scotland than they are in England?

Apart from this, there is very little in the way of significant change promised us in the way of income tax or, indeed, other tax rates and allowances, as compared with the 2016/17 year.

Offshore Tax News

Goodbye, trusts! Hello, baby!

At present, the government is working to close a loophole that allows non-domiciled families to avoid inheritance tax (IHT) on property located in the UK. The two most common means of avoiding the tax has been to hold it through either an offshore company or an offshore trust. It has been decided by the government that properties held by either means will now be subject to IHT when the owner passes away.

Is there anything that can be done? Some wealthy families are switching ownership away from offshore structures to the youngest members of their family – ideally a child of 18, thus legally able to own property in their own name. By doing this, it should be possible to postpone the IHT tax bill for a substantial period.

How does one avoid the child rushing out and re-mortgaging or spending the money? One way is to put a mortgage in place. Such a mortgage could have interest charged at the end of the term at an unspecified rate. This would potentially allow the mortgage interest to use up part, if not all, of the gain. The security would also mean that the child couldn't sell the property.

Trump under pressure to repeal FATCA

Ever since President Trump was sworn into office, the American media has been full of articles speculating on whether he will decide to repeal the Foreign Account Tax Compliance Act (FATCA). This legislation forces foreign banks and governments to pass over confidential bank data about American customers to the IRS. Non-compliant institutions are not allowed to trade in the US market, so there is little choice but to comply. Moreover, non-US banks worldwide have to know if their US customers are tax compliant in America. Although FATCA seems to have resulted in a certain amount of extra tax being gathered by the IRS, there is no evidence that it has brought in the huge amount of money that it was originally expected to. Many US citizens abroad have been deeply inconvenienced by it. Many non-US banks, for example, are simply refusing to handle US client business for fear of falling foul of FATCA.

Meanwhile, America remains what the chairman of the US Congressional Working Group on Tax called: "The largest tax haven in human history." Because although America has forced every other country in the world to provide it with information about its citizens, it remains extremely slow when it comes to a full exchange. As a result, America appears to have become the largest international location for managing foreign wealth. Ironically, money is believed to be flowing in from Switzerland, Europe, the Bahamas and Bermuda. *Die Zeit*, the German newspaper, actually arrived at the conclusion that for someone wishing to avoid tax America was now a considerably safer haven than Switzerland.

Switzerland rejects tax reforms

Six out of 10 Swiss voters have refused a government plan to cut corporate rates in a recent referendum. The government had hoped to bring the country's corporate tax regime in to line with international standards. Under the proposed plans, the country's 26 cantons could have continued to compete to offer companies the most favourable tax rates, but multinationals would have paid the same rates as other businesses. To avoid imposing much larger bills on multinationals, the cantons announced plans to reduce corporate rates for other companies, while the federal government in Berne would help by making up any shortfalls in tax revenues. To give you an example, Geneva had intended to cut its corporate tax rate from 24 to 13.5%. Interestingly, those who objected to the reforms felt that it would lead to overly favourable treatment of businesses, a reduction in the tax take and a consequent reduction in public spending. What will happen next? This isn't entirely certain. It is possible that some cantons will move ahead with plans to bring corporate tax rates in to line with international standards. It is possible that no one will do anything.

McDonald's leaves Luxembourg

McDonald's, the American fast-food group, has decided to move its European headquarters away from Luxembourg in order to avoid any detailed scrutiny of its tax affairs. It is expected that a large number of other companies may decide to follow suit. This is because the EU is currently investigating the tax arrangements of several multinational companies with Luxembourg operations. This has been part of the G20 initiative to reduce base erosion and profit shifting, or BEPS, which is the term for tax-avoidance strategies that exploit gaps in rules to artificially shift profits to low- or no-tax jurisdictions. Interestingly, by the way, McDonald's has decided to relocate its base from Luxembourg to the UK. Whether it will manage to pay as little in tax while based in Britain as it did in Luxembourg is unclear. Apparently, over the last 10 years or so it has paid an average corporation tax rate of roughly 1.5%.

Growing numbers renounce US citizenship

The US Treasury Department actually names those individuals who decide to give up their US citizenship! In the last quarter of 2016 there were 18 times as many Americans giving up their citizenship compared to 2008. Of course, the figures do not take into account those people who simply drop off the map. In other words, they may keep their US passport but cease to fill in a US tax form and travel everywhere on another, second, passport. Why are so many leaving? It isn't to do, oddly enough, with politics. It is believed that the vast majority are willing to make what is, after all, a very serious step because they are fed up with FATCA (see above). By the way, America charges $2,350 to hand in your passport and they expect Americans to be up to date with their tax affairs.their main residence, CGT relief against the gain will be available in exactly the same way as it is for an owner-occupier.

Putting US citizenship to work

Attendees at a recent conference in Berlin on the subject of international tax planning were interested to hear the case history of someone living in the UK who was actually a US citizen and as a consequence taxable in the US even though he wasn't resident there. In other words, he was being taxed in the UK on a remittance basis. By holding his US assets in a partnership, it is possible for him to avoid all tax – both in the US and the UK – on dividends. This is because if his partnership is taxed as a corporation in the US there is no tax liability, so far as the IRS is concerned, while, so far as the UK is concerned, he receives no income, providing he doesn't bring the money back to the UK. What is interesting, of course, is that the partnership could invest the money it receives in the form of a dividend into the UK without a tax charge. Moreover, should the taxpayer pass his money to his wife, assuming she is a UK resident and UK domiciled, she should have no tax liability either because it is her husband's unremitted income and not her income. The news is not all bad for US citizens living abroad!

Law Society defies HMRC

The Law Society has advised HMRC that it will "vigorously defend and protect legal privilege by all possible means, including litigation as necessary". Essentially, HMRC has plans to write to all professional firms involved in the establishment and running of trusts and companies. They are to be served, apparently, with formal notices requiring them to hand over details about the offshore entities and their owners, including names and addresses. HMRC claims that this data is not protected by legal professional privilege as it is not a communication between the lawyer and their clients. But the Law Society does not share HMRC's view and says that legal privilege was very likely to be engaged when a client sought advice on matters such as establishing an offshore company or trust. As hardly any UK residents are able to benefit from offshore tax planning, HMRC's fishing expedition is most likely to affect non-doms.

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News

Re-mortgage woes

Buy-to-let landlords are experiencing increasing problems attempting to re-mortgage their properties. Aware of the problem, lenders have slightly reduced their interest rates. For example, Barclays is offering a five-year fixed-rate loan at 2.99% on a 75% loan to value. New Street, Virgin Money and Precise have all followed suit with similar deals.

Under rules introduced by the Bank of England, landlords must generate sufficient income from their property to pay at least 125% of their mortgage interest costs. Moreover, they should still be able to meet all their costs using a hypothetical stress test interest rate of 5.5%. Most lenders, concerned about breaking Bank of England rules, have already insisted that landlords have an interest coverage ratio of 145%.

There is one, possible, silver lining. Landlords who are re-mortgaging may do so, providing they are not borrowing any more money. However, although the Bank of England will allow this, few lenders are willing to provide cash on this basis.

It must also be remembered that with base rates at a record low of 0.25% even landlords who are forced to move to a lender's standard variable rate probably won't run into financial problems. However, if the variable rate rises many landlords may begin to feel the pinch.

Other problems facing landlords include the fact that higher-rate relief on mortgage interest payments begins to reduce this year and higher-rate relief will disappear completely by 2020.

Once you are in, you are in

Last month, I wrote about passive versus active investment. This month, I just want to point out that if you had been out of the FTSE All Share Index for 10 of the best-performing days over the last 20 years you would have lost 170% of your returns! In fact, if you had missed the 30 best-performing days then your investments would have lost money over the period (as opposed to almost tripling in value). The moral of the story is not to let short-term falls panic you. Also, if you wish to optimise your returns, remember what Baron Rothschild said in the C18th: "The time to buy is when there is blood in the streets."

When will UK interest rates rise?

As usual, economists can't decide what is going to happen to interest rates. For example, Kristin Forbes, who sits on the Bank of England's Monetary Policy Committee, believes that surging levels of inflation are likely to lead to a rise in interest rates. On the other hand, Neil Woodford, the famous investment fund manager, believes that interest rates will remain static until 2019 or beyond. Woodford believes that inflation will peak at around 3% and his greater fear is deflation.

Meanwhile, the pound is worth less and less against the dollar. At the time of going to press, you can get between $1.20 and

$1.25 compared to between $1.40 and a $1.45 prior to the EU referendum. Many now believe it is the Bank of England's decision to cut the base rate from 0.5 to 0.25%, rather than the leave vote itself, that has caused the pound's continued struggle.

One thing most experts agree on: whatever happens to interest rates, the value of sterling is likely to remain low until the markets can see a positive outlook for the British economy. This will depend on the Brexit negotiations more than anything else.

Housing supply down

The National Association of Estate Agents (NAEA) monthly housing report has found that the number of prospective buyers signing up with their members has increased by over 10% since last December. At the same time the number of properties available has fallen. Reflecting this increase in demand, more than 1 in 20 properties have sold for more than the original asking price and there are 11 buyers chasing every property for sale.

Pension age could rise to over seventy

One of the pension changes introduced by the Conservative–Liberal Democrat coalition was a guarantee that the state pension will rise each year by at least 2.5% or the rate of inflation or growth in earnings – whichever is the highest. In its 2015 election manifesto, the Tories stated that they would extend this 'triple lock' until 2020. However, will they be able to afford it after 2020? Most commentators feel they won't.

The Work and Pensions Committee has produced a report that suggests the state pension age will need to increase to over 70 years by 2060. This is higher than the current average male life expectancy rate in 162 areas in Scotland and 26 areas in England. The report states: "with the triple lock in place, the only way state pension expenditure can be made sustainable is to keep raising the state pension age. This has the effect of excluding ever more people from the state pension altogether. Such people will disproportionately be from more deprived areas and manual occupations, while those benefitting most will be the relatively prosperous."

The Foundation Stones Of Good Investing

When investing money, it is often tempting to spend most of your time considering what to invest in rather than how to invest. If investors spent more time thinking about the latter, their investment experience would in all likelihood be a more fruitful one. Although investing is not easy, the following simple steps provide the foundations for success.

The challenge of investing

Investing is the process of delaying consumption from today to sometime in the future and in the meantime employing that money in the markets to grow at a rate at least in line with inflation but preferably more. Not scaring oneself to death along the way is also a key goal. As the old saying goes, investing is simple but not easy.

This article summarises what we believe to be a sensible and highly effective way to invest your money. Investing may never be easy, but it can be far less daunting if you adopt a systematic approach, such as the one detailed below.

Start by building your investment compass

Investing money well requires a logical and robust framework on which to build a lifelong investment programme. It needs to be grounded in investment theory, supported by empirical evidence and enhanced with an insight into the behavioural traps and pitfalls which all investors face that can and do cost them dear.

Successful investors operate with a coherent investment philosophy that they apply consistently to all aspects of the portfolio management process. Philosophical principles represent time-tested insights into investment matters that rise to a level of enduring professional convictions.
David Swensen, CIO, Yale University Endowment

Six lifelong principles

We start by looking at six guiding principles that provide the backbone for how we should think about investing, rather than in what we should invest.

1. Have faith in capitalism and confidence in the markets

Capitalism is an adaptive and robust economic system which has delivered incredible developments for the benefit of mankind. For example, the wealth creation of capitalism has meant that over the last 25 years around 2,000,000,000 (two billion) people are no longer trapped in crushing poverty and child mortality rates have fallen by over 50%. Despite the apparent doom and gloom in the news, the world's economy continues to grow year on year, which creates wealth and return opportunities for investors.

As investors, we need to keep faith in capitalism as a robust and resilient economic system and to recognise that free markets are an efficient mechanism for rewarding those who provide capital to those engaged in the pursuit of wealth creation. Despite current market challenges, the future looks bright from where we are sitting.

2. Accept that risk and return go hand in hand

One of the inescapable truths of investing is that to achieve higher returns you have to take on more risk. That seems logical enough but you might be surprised at just how many investors seem to think that it is possible to get high returns with low risk. Yet risk should not be feared, because when appropriate risks are taken they are the source of returns that investors seek.

The one thing we know for sure about risk is that if an investment looks too good to be true it probably is. If you ever see such an opportunity and the risk is not obvious, you need to establish what the hidden risk is, as risk and reward are *always* related.

3. Let the markets do the heavy lifting

In investing, there are two main sources of potential returns. The first is the return that comes from the markets themselves and the second is the return generated through an investor's skill in exploiting that return.

At its simplest, there are two main ways in which an investor – using their skill – can try to deliver a better return than the market: one is to time when to be in or out of the markets (market timing); the other is to pick (or find someone to pick for you) great individual stocks or sectors (stock picking).

Empirical evidence suggests that trying to beat the market, through either market timing or stock picking, is a tough game, with very few long-term winners. Our view, in line with both academia and many major institutional investors, is that it is a game not worth playing, particularly when costs are taken into account. Letting the markets do the heavy lifting on generating returns takes a great weight off your shoulders; you no longer need to worry about picking the right stock, the right manager or deciding whether you should be in or out of the markets. As one cannot control the returns of the markets, the structure of your portfolio becomes key.

Human Development Report (2015) *Work for Human Development*, United Nations Development Programme, New York.
Sharpe, W. F. (1964) Capital asset prices: A theory of market equilibrium under conditions of risk, *Journal of Finance*, 19(3), 425–442.

4. Be patient – think long-term

One of the great challenges that all investors face is that there is no easy or quick way to investment success. Aesop's fable of the tortoise and the hare is a useful metaphor. You have to use the time on your side – which could be over multiple decades – to capture the returns of the markets effectively but often slowly. In the short-term, market returns can be disappointing. The longer the period for which you can hold an investment, the more likely it is that the returns you will receive will be at worst survivable and hopefully far more palatable. It is time that allows small returns to compound into large differences in outcome for the patient investor. The reality is that markets go up and down with regular monotony but not to such an extent that those movements can be reliably predicted.

If you want to be a good investor, you have to be patient. On your investing journey, you will spend a lot of time going backwards, recovering from a setback and then surging forward again, often in short, sharp bursts of upward market movement. You just have to stick with it. Remember that you have to be in the markets to capture their returns. Impatient investors tend to lose faith in their investments too quickly, with often painful consequences.

5. Be disciplined

Patience and discipline are close bedfellows. Once you realise that generating good long-term returns takes time, patience and belief in the markets, it is essential to put in place the discipline to stop yourself succumbing to impatience and ill discipline. Discipline comes in many forms: sticking to the principles above, constructing well-researched and tested portfolios that should weather all investment seasons relatively well, not chasing investments that have gone up dramatically but sticking with the logical reasons for not owning them in the first place and the discipline not to become despondent about unimportant short-term market noise and to focus on your long-term strategy.

We know from research in the field of behavioural finance that we tend to feel at least twice the pain from losses compared to the pleasure from gains of a similar magnitude. Consequently, every time their portfolio falls, investors feel glum. The key to this discipline is to understand the very ordinariness of these market falls and not to look at your portfolio too often. If you look at your portfolio every day you have about a 50/50 chance of seeing a loss, yet if you only do so once every five years that drops to around a 1-in-10 chance, falling further to around a 1-in-20 chance over 10 years. Time is your friend.

6. Don't let the tax tail wag the investment dog

While it makes sense to take advantage of simple tax breaks such as utilising your ISA subscriptions each year, investing spare capital in tax-free National Savings certificates, when they are available, and utilising pensions to benefit from the tax relief available on contributions, tax should never be the primary motivation for your investment decisions.

People are often reluctant to crystallise gains that would result in a tax bill, and will unconsciously rank their reluctance to pay tax ahead of maintaining a disciplined asset allocation strategy (see point 5 below), and an exposure to risk with which they are comfortable.

The truth is that the most tax-efficient portfolios are those which always make losses and no one wants to be invested in a portfolio like that. Of course, make use of your annual CGT exemptions each year wherever possible and use the tax-efficient wrappers mentioned above to their full but also accept that paying some CGT is the result of having a successful investment experience and therefore a price worth paying from time to time.

Five effective investment practices

Having established a sensible set of investing principles, let's turn our attention to five key investment practices on which the evidence and theory suggest we should focus.

Albion Strategic Consulting – internal research 2016.

1. Build a well-structured portfolio

Once you accept that returns come from markets and are rarely enhanced by the judgmental approaches of individual investors or professional managers of market timing and stock picking, it is evident that structuring a well-thought-out mix of different types of investment (referred to as asset classes) should sit at the heart of your investment programme. Your long-term portfolio structure will dominate the investment returns obtained during your investment lifetime.

Successful investing is all about taking on well-understood risks that deliver a positive return expectation – these are carefully selected market risks associated with ownership and lending. It avoids taking on risks that add little (or worse) to the portfolio, such as illiquidity, small numbers of holdings, poor predictive portfolio manager performance and opaque, expensive and complex product structures.

2. Use diversification to manage an uncertain future

Not putting all of your eggs in one basket is an intuitive and valuable concept. No one knows what the future holds and owning a highly diversified portfolio spread widely across asset classes (bonds, equities and commercial property, for example) and across global markets, industry sectors and companies helps to make sure that we are prepared for whatever the markets throw at us over time; a portfolio for all seasons, if you will. Diversification is the key tool that we have against the uncertainty of the future and the future is, by definition, always uncertain.

Owning a diversified portfolio brings its own challenges. Inevitably, there will usually be one or two parts of the portfolio that are doing well but one or two that are not. The patient and disciplined investor knows that there is little point in knee-jerk responses and that this is simply the way markets are. The impatient and ill-disciplined will seek to change their strategy. More fool them.

3. Avoid cost leakage from your portfolio

Costs eat away at the market returns that you should be gathering for yourself. Small differences in costs will compound into large differences over extended periods. Investment industry costs are high, particularly those related to predictive (active) managers. The costs of investing are more than simply the explicit annual management charge (AMC) charged by the fund or portfolio manager. Other fund-related costs (marketing, accounting, registrar fees, etc.) can also be offset against the fund's performance and these combine with the AMC into the ongoing charges figure (OCF). Yet that is not all. When a manager buys and sells equities or bonds they incur transaction costs, which eat further into returns. The more transactions take place and the more expensive it is to trade those assets, the harder the portfolio has to work to overcome the drag effect of them.

If one takes two portfolios with the same gross (pre-costs) returns – one with a cost of 0.25% a year and the other with a cost of 1.5% a year – the low-cost strategy will, on average, end up with a staggering 65% more money in the pot over 40 years.

Brinson, G. P., Hood, L. R. and Beebower, G. L. (1986) Determinants of portfolio performance, *Financial Analysts Journal*, 42(4), 40–48.
Fama, E. F. and French, K. R. (1993) Common risk factors in the returns on stocks and bonds, *Journal of Financial Economics*, 33, 3–56.

4. Control your emotions, using a systematic, disciplined approach

Unfortunately, evolution has hard-wired the human brain to be particularly poor at making investment decisions. A deep-seated subconscious battle is constantly being waged between greed and the desire for reward against the fear of uncertainty and loss, which creates ongoing anxiety and irrational decision making in many investors. Investing is certainly not emotionally easy. Evidence of wealth-destroying, emotion-driven decision making is plentiful, as impatient and ill-disciplined investors have a propensity to chase fund managers, and markets, which have previously performed relatively well and sell those which have performed relatively poorly. 'Buy high, sell low' is not a good investment strategy. Research reveals that this bad behaviour may cost investors around 2.5% per annum, on average. Given that equities have only delivered an average long-term return of around 5% above inflation, that is a material erosion of potential wealth.

Recognising that both investors and advisers suffer from a range of behavioural biases that are more likely than not to result in the erosion of wealth, we believe that the design of a disciplined, systematic and understandable investment process, and its ongoing implementation, is central to your success as an investor, reducing this 'behaviour gap', as the industry calls it.

Sharpe, W. F. (2013) The arithmetic of investment expenses, *Financial Analysts Journal*, 69(2), CFA Institute.
Kinnel, R. (2014) Mind the gap, *Morningstar*, http://news.morningstar.com/articlenet/arti-cle.aspx?id=637022.
Barclays Equity Gilt Study 2016, data from 1900 to 2015.

5. Manage risks carefully across time

Our approach to investing positions us as risk managers, rather than performance managers as advisers have traditionally been. We have identified three key areas of risk management which we believe everyone should employ.

The first is rebalancing a portfolio. Having spent considerable effort ensuring that a client's portfolio is both suitable for them and robustly structured, it is important to keep it that way. Rebalancing involves selling out of better-performing assets and buying less-well-performing assets (i.e. selling, rather than buying, 'hot' asset classes). This enforces a systematic, rather than a market valuation-based, defence against possible market bubbles. Rebalancing is simple in concept, but in practice it is hard to do; it requires considerable discipline and fortitude, particularly at times of market turmoil when our emotions, particularly fear or greed, are heightened. If you choose to manage your portfolio yourself, maintaining this disciplined approach is likely to be your biggest challenge.

The second is fund selection. Choosing which funds to invest in requires a reasonably detailed and insightful due diligence process. The focus should always be on risk management that starts with eliminating fraud, explores operational risks, then focuses on product structure risks and finally looks at the ability of the fund firm to deliver market returns effectively.

The third is ongoing governance of the investment programme you are employing. It is entirely possible, and indeed likely, that your portfolio will look much the same between one period and the next, with little activity except for rebalancing. That most definitely does not mean your job is done. You should make a point of keeping an open mind and reviewing any new evidence (whether it supports or challenges your approach), the latest research on asset classes and additional due diligence aimed at ensuring that your chosen 'best-in-class' funds remain just that.

In conclusion

Employing a systematic investment approach (as detailed above) provides the discipline and objectivity that is required to avoid the pitfalls that all investors inevitably face. It certainly makes investing far simpler and easier, but never easy.

You can find out more about an evidence-based investment approach from our Guide to Investing, which is available to download from our website here: http://www.bloomsburywealth.co.uk/category/guides/.

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Alternative Investment Opportunities

Profit ahoy!

I was interested to read in *The Economist* that BlackRock, the world's biggest asset manager, has started buying and managing marinas. For example, it owns Premier Marinas, which operates seven marinas dotted along the south coast. Altogether, the group controls 5,170 berths believed to generate something in the order of £20 million a year. Each marina also has shops, offices and in many cases residential units.

BlackRock's marina investment is part of a trend by investment managers to move outside the conventional property classes (commercial, office, retail and industrial), and into more alternative sectors such as student housing, data centres and casinos. *The Economist*, for example, reported that BlackRock operates over 150 doctors' surgeries. Apparently, AXA Real Estate, part of the giant French insurance group, has over €2 billion worth of alternative properties, including hotels, police stations, care homes and petrol stations. What sort of returns do marinas and other alternative properties offer? Excellent. Indeed, there is a school of thought that alternative properties are more recession-proof because whatever else happens people have to visit doctors, buy petrol and so forth. Average returns are believed to be in the region of 10% a year in the US.

Perhaps one of the most interesting things about this asset class is that it is difficult to invest a really substantial amount of money. This, on the whole, deters the big players such as the pension funds. It leaves much more opportunity for small to medium-sized investors.

Gold: Buy, sell, hold?

What's happening to gold? Since 2011 – when it went, if memory serves, well over $1,800 an ounce – it has fluttered up and down, but mostly down. At the time of writing, it is standing at more or less $1,200 an ounce. Given that in 2007 it was more or less half this price, you may feel that it has got a lot further to fall. Indeed, if you have a long memory you may remember when it fell to less than $300 an ounce (this was back at around the turn of the millennium).

I'd still hold and I think I might still buy. I certainly wouldn't sell.

Why? The developed world has insane amounts of debt. For example, in the UK the debt-to-GDP ratio is a staggering 85%. In general, the only way that economies can deal with unsustainable debt is through inflation. What is the best hedge against inflation? Gold.

My own view would be to hold on to it until such time as government finances are properly managed and debt has fallen to below 50% of GDP. In other words, probably never.

Score!

Every year, Deloitte produces an annual review of football finances. Interestingly, the English Premier League's (EPL) revenues rose by nearly 30% last year from £2.5 billion to £3.3 billion. Against this, wages increased by just 6%, which was a much lower figure than anybody had anticipated. In February 2015, the EPL sold television rights to its games for a staggering £5 billion, which was over 71% of the previous deal. It is projected that from this year onwards, even the bottom club in the league can expect around £100 million in central prize money each season and the highest earning club will receive around £156 million. Football clubs have many other sources of revenue, of course: ticket sales, merchandising deals, advertising, sponsorship, stadium naming rights and a dozen other lucrative, moneymaking opportunities.

It is impossible to know what any particular football club in the different leagues is actually worth. It has been suggested, for instance, that Chelsea is worth in excess of £8 billion, Manchester United is worth more than £4 billion while Tottenham Hotspurs could be worth well north of £5 billion. The trouble is that unless a football team is sold – and the figure is made public – it is impossible to know.

One does not, necessarily, have to be a billionaire in order to afford even a League 2 club. Many clubs lower down the league are believed to be worth well under £10 million. Moreover, the real bargains may be found outside the league or abroad. For example, a European club can be purchased for a few hundred thousand pounds and may serve as an excellent way to get into the buying and selling of young players (often highly lucrative as the deal may include rights to future earnings). It is by no means impossible that a small group of private investors with a love of the game and a determination to build up a small club could see real and serious returns on their money. Brighton and Hove Albion, for example, never did very well until well into the 1970s (it was founded in 1901). In the last 40 years, the club has moved from a tiny primitive stadium to no stadium at all to a state-of-the-art stadium with a capacity of 30,750. It can be done.

The garage and the cellar

In February the *Financial Times* ran a headline: "The garage and the cellar: the best place for your money". The article that followed basically pointed out that assets other than property were delivering superior returns for the super-rich. In particular, it quoted the Knight Frank Luxury Investment Index (KFLII) which rose by 7% in 2015. This compared with a 5% drop in the value of the FTSE equities index, a rise of only 1% for the top end of the London residential market. Moving to 2016 several asset classes outperformed property. The fine wine market managed a reported growth of nearly 25% and classic cars continue to perform well up by 9%. Incidentally, Knight Frank's Prime International Residential Index for 2016 was up 1.4% and the estimated total return for global commercial property for 2016 was 6.7%. The best performers were Indonesia (15.3%), Ireland (14.7%) and the US (12%). Only one sector did not do as well as expected: the art market had a relatively bad year dropping by some 14% in 2016.

Property

Short-Term Rental Planning

Whether you are involved in the rent-to-rent or buy-to-rent property business, short-term rental can prove one of the most profitable residential property businesses possible. Indeed, despite recent setbacks (such as a decision that London hosts using Airbnb may not rent their properties out for more than 90 days a year without council permission), the market is thriving. A thriving market means, of course, profits – and profits usually mean tax.

How can short-term landlords best reduce their tax bills?

Landlords based outside the UK/non-doms may opt to receive any income into their overseas bank accounts. Whether in doing so they evade British tax will depend on their circumstances. It has to be said, however, that if they are renting out their personal home the chances of HMRC ever catching up with them are slight.

Either way, for those renting out their own homes (i.e. their main residence) rent-a-room relief exempts the first £7,500 a year from income tax. If the gross rentals are, therefore, less than £7,500 they will be fully exempt. If they exceed this sum, the landlord will be subject to tax on profits calculated in the same way as for any other letting business.

Another, often better, option is to take advantage of the rules as they apply to furnished holiday lets (FHL). We have covered this subject extensively in *The Schmidt Tax Report* so I won't repeat all the details again. The important thing is that the property must be available to the public as FHL accommodation for at least 210 days during the year and it must be commercially let to the public for at least 105 days during the year.

The beauty of the FHL regime is that you can offset any losses against other FHL profits and if you sell the business you should be able to reduce your capital gains tax (CGT) bill to just 10%. Incidentally, you will also be entitled to plant and machinery capital allowances for such items as furniture, equipment and fixtures, and the profits will count as earnings for pension purposes.

In the future, incidentally, under the proposed changes to loss relief (see editorial) you may also be able to make better uses of any FHL losses.

Finally, a piece of general advice: as it currently stands, it is very difficult for HMRC to ever trace cash payments received. It may, therefore, be tempting to accept some or all of the rent (or extra charges such as cleaning or utilities) in cash and not to declare it. The best thing is, of course, to keep accurate records of every cash sum received. As a worst-case scenario you should keep a running monthly total. If you keep a monthly record, should you ever happen to host a tax inspector at your property who initiates inquiries later you can, at least, take comfort from the fact that you have accounted for the cash received.

Property Tax Tips

Dealers' choice

The huge shortage of building land means that a growing number of entrepreneurs are likely to move into the area of property development. For those doing so, the first question must be to decide what the most tax-effective business structure is. Some involved in this area may be operating trading companies, where others will be running companies 'dealing in land' for tax purposes. One of the biggest issues arising from this is whether the ordinary shares in the company dealing in land can possibly be eligible for inheritance tax (IHT) business property relief.

Let me give you a very basic example. If you own farmland that is being actively farmed and you stop this farming business and sell the land as a trading asset, you ought to be able to qualify for the lower 10% rate of CGT under entrepreneurs' relief. On the other hand, if you simply deal in land, this is a trading activity and therefore will be excluded from the scope of business property relief.

If we look at HMRC's IHT manual, we discover that:

- A company that buys land with a view to selling it on after it has increased in value (possibly by obtaining planning permission) will be in the business of land dealership and therefore will be excluded from business property relief.
- A company that develops property, on the other hand, will qualify for business property relief.

Incidentally, many landowners may sell land for a combination of shares and cash or just as likely shares and a loan note. In this way, they are financially involved in the development activity but not physically involved. HMRC generally seems to agree that company shares will still be eligible for business property relief even if the shareholder is not directly involved in the development/construction activity.

Nevertheless, it has to be said that there is a certain amount of risk attached to shares in the development company as they *may* be excluded from business property relief.

A direct sale of land for development, from a tax perspective, is always going to be much cleaner than selling it for a combination of shares and/or cash. Even if entrepreneurs' relief is not deemed available, the CGT rate should still only be 20%.

Business rates update

Any UK-based business owner with commercial premises will be aware of the first re-evaluation of business rates in seven years. It has provoked considerable anger and calls for an overhaul of the system. The newspaper headlines over the last few weeks tell the story:

- Businesses face astronomical rise in rates bills.
- May reviews business rates relief to appease angry Tory MPs.
- Chancellor under pressure to ease tax burden for businesses.
- What changes are happening to UK business rates?

Property tax in the UK is levied at a much higher rate on businesses than on residences. For residences, property taxes are still based on house prices from 26 years ago. However, for businesses, they are updated on a much more regular basis. This April the first business rate re-evaluation since 2010 will take effect. Some businesses in central London are facing increases of up to 400%.

Why are businesses paying so much more than residents?

Professor Tony Travers, from the London School of Economics, has suggested: "The sum total of the property tax system is far more draconian for businesses than for households. It is hard not to conclude that this is because householders vote, whereas businesses are seen as able to cope."

It also has to be said that business rates are a major source of revenue for the British government. During the current tax year, they should raise some £28 billion, which is only £15 billion less than is raised through corporation tax.

Interestingly, it is not the objective of the current re-evaluation to increase the amount of income. Rather, the idea has been to redistribute the burden so that it better reflects the changing property market.

By the way, the redistribution is supposed to occur every five years, but this would have meant that the last review took place just one month before the general election. Draw whatever conclusion you want from this!

In theory, there should be appropriate relief for small companies hardest hit by the changes. However, for many small businesses the increases will seem terribly unfair. Lots of businesses are likely to close.

It also has to be said that online/virtual businesses really benefit from being able to locate themselves in low-cost, lowly rated areas of the country. Incidentally, no large building can see a rise of more than 42% next year even if they are liable for a much bigger increase.

We have now reached a point where business rates are likely to not only be higher than rent but even a multiple of rent. Moreover, the only effective way to reduce the cost is to relocate. We would urge readers who own or rent UK property to write to their MPs about this important subject.

Property Notes

Business as usual for buy-to-let

For the last few years, the government has been doing its best, partly through new regulations (such as affordability constraints on loans) and partly through increased tax, to take the heat out of the private, buy-to-let market. One of the ways in which the government has sought to reduce the amount of investment property being bought for rental purposes is to introduce a 3% tax surcharge on such transactions. Interestingly, after the surcharge had been introduced there was no sign of any reduction in activity. Indeed, it raised a staggering £1 billion for the Treasury between June and December of last year. As the number of loans issued for buy-to-let purchases fell over the same period by as much as a third, it is assumed that it is now cash buyers who are adding to their buy-to-let portfolio. This makes sense since the advantages of being leveraged are greatly reduced, owing to the reduced availability of tax relief on mortgage interest payments.

Good news for property developers

One of the biggest costs that all property developers face is that of business rates while they are refurbishing or redeveloping a building or buildings. In some cases this can, of course, run to millions of pounds. Unfortunately, a 2015 Court of Appeal decision (*Newbigin v. Monk*) came to the conclusion that business rates were, indeed, applicable even if a property was unusable. However, earlier this year the UK Supreme Court reversed this and stated that a Sunderland property should not have been charged business rates as if it were fully usable during the period when it was undergoing refurbishment. The court stated that instead it should have been valued at the nominal sum of £1, resulting in an enormously reduced rates bill. It is believed that there are thousands of rating appeals in the system waiting for settlement in anticipation of this particular ruling.

Equity Release And Taxation

For those unfamiliar with the concept of equity release, this is the situation where a person cashes in on the capital value of their home by going to a specialist provider of finance and entering into a contract under which the financial institution pays them a lump sum in return for a share of the property's value.

Fundamentally, there are two types of equity release: one is where the finance provider lends money on a sort of mortgage. The interest rolls up on this mortgage and the homeowner doesn't have to pay it. On the owner's death, however, the mortgage provider takes the appropriate proportion of the eventual sale proceeds.

The other type is where the finance provider takes a share in the property and, of course, the big difference is that this sort of equity release arrangement gives the finance provider a right to share in the future capital growth of the house or flat.

Equity release as inheritance-tax planning

We're writing about equity release in a tax magazine because it actually has significant advantages as a component of inheritance tax (IHT) planning, or can do. Very often a person's only substantial asset, or one of their most substantial assets, is their home; and there are all kinds of barriers to tax planning using your home as the subject matter.

Forget about the simple idea of giving away your home, or a share in it, to the children. All the time you continue to live in the property, and they don't live in the property, this gift will be effectively ignored for IHT-planning purposes. This is under the 'gifts with reservation of benefit' anti-avoidance rules.

The same doesn't apply if you take a lump sum by way of equity release, and then make a gift of the cash to the beneficiaries. You aren't reserving a benefit in the cash given away, and, providing you survive for seven years after you make the gift, this will result in a permanent reduction in your taxable estate for IHT.

A word of warning

Until very recently, there was another, rather neat, variant of this idea making use of business property relief. The way the arrangements worked was like this.

A person took out an equity release loan secured on his house, and used the money to invest in a family company or partnership. The investment in this trading business was eligible for 100% relief, so that the taxable value of the person's estate has reduced by this amount, even though the total value of their estate hasn't (because the liability against the house is matched by the asset in the form of the interest in the business).

If the equity release is in the form of a loan, this doesn't work any more, because new rules introduced recently require you to deduct the loan from the business property, thus wiping out the availability of the relief.

It does seem to work, though, where the equity release is in the form of the finance house taking a share of the property: because these new anti-avoidance rules only apply to loans and other liabilities.

'Do it yourself' equity release?

How about this as an idea, though? We've all heard of the Bank of Mum and Dad. Young people today are facing an immense challenge in being able to afford to live, let alone buy a property, and it's becoming more and more popular for the middle-aged generation to provide substantial funds, either by way of gift or by way of loan, to their struggling children.

But you probably only need to move up one generation to see this idea actually turned on its head. A number of people in their 40s, 50s and early 60s still have parents living who are actually nothing like so well off as they are.

You see this in the not infrequent phenomenon of children buying their parents council property for them, and allowing the old people to live there. But you could also imagine a situation, easily, where your equity release is provided not by some large insurance company but by another family member: DIY equity release.

Inevitably, there are important tax points to watch out for here. (That's why we're writing about it.) So here goes.

First, remember that the tax consequences of doing the loan type of equity release are very different from those of acquiring a share of the property, looking at it from the finance provider's point of view. If you go down the loan route, where interest rolls up unpaid on the 'mortgage' you have provided, there could be a very substantial amount of rolled up interest when you finally come to cash in your chips – all of which would be chargeable on you as income in the year in which this happens.

By contrast, buying a share of the property gives you a capital gain if it is sold after the death of the property's occupier.

In the absence of planning, this capital gain would be taxable, in all probability, at 28% subject to a fairly minor deduction for any available annual exemption you have. But if, instead of simply buying the property on your own account, you buy it in a trust in which the occupiers are beneficiaries, you will be able to claim exemption from this gain under the trust equivalent of the 'main residence' capital gains tax exemption – at least if this exemption survives until that time.

We're mostly talking, here, about equity release not for IHT-planning purposes, but simply to provide your aged parents, for example, with a little bit of money to relieve financial stress.

There are immense complications if the money you pay them for a share in their house is then given away, especially if that is to you and/or your siblings. Any such 'tricky' tax planning definitely would need the seal of approval of a properly qualified specialist tax adviser!

Saving VAT On Buying And Doing Up Property

For most people, VAT on property is a horrid mystery. We don't plan to write an encyclopaedia on the subject here but instead will pick out those points that are likely to cause problems, and give our preferred solutions to those problems.

The VAT situation differs widely, depending on whether the property you're buying is residential or commercial in nature. We'll look at residential properties first.

Buying residential property

To start with, the one thing you don't need to worry about when buying residential property is VAT. If the property is new-build, it will be technically zero-rated, and if it is a property being sold other than by the person constructing the new dwelling, it is exempt from VAT. This technical distinction makes little or no difference to you as the buyer, because either way there is no VAT on the purchase price, and therefore no question of being able to reclaim any, of course.

Improving residential property

Unlike the position with buying a dwelling, there is certainly likely to be VAT on costs incurred in refurbishing or improving one that you've bought. If you use a VAT-registered contractor, that is one whose turnover is more than £83,000 (£85,000 from 1st April 2017), he will obviously charge VAT on his services, as well as on the materials he provides as part of his work.

Even if you are in the position of being able to use non-VAT-registered traders – which is obviously excellent planning – you will still be incurring VAT at least on the materials that are used in the refurbishment/improvement work.

With one exception, VAT incurred in this way can't be reclaimed. The exception is where the property concerned is let as holiday accommodation, and the business is either compulsorily registered (because its turnover is over the threshold) or has been voluntarily registered.

This is where you have a tax-planning choice. If the work on the property is so extensive that the VAT is a major figure in the overall equation, you may decide to register your holiday accommodation business even if its turnover is less than £85,000. So long as you are making, or intending to make, taxable supplies, you can register on this voluntary basis and the effect is that all the VAT you are incurring can be reclaimed.

Do think twice or three times before doing this, all the same. The impact of putting VAT on the charges you make to the holidaymakers will be a significant one, as very few, if any, of them will be able to reclaim the VAT you charge. And you are likely to be stuck with charging VAT for the indefinite future.

In general terms, we think it's likely that most people will elect simply to swallow the VAT which is part of their cost of work on the property rather than letting themselves in for the horrors and expense of registration.

VAT-favoured residential conversions

Given that, for the reasons we've set out, you're unlikely to be able to reclaim VAT on work done to residential property, is that the end of the story? Have you simply got to put up with the 20% tax?

The answer is that you don't need to, and shouldn't put up with this full rate of VAT where you are doing any one of a range of favoured types of property conversion.

These favoured types of conversion, which entitle you to a reduced rate of VAT of 5%, are as follows:

- A 'changed number of dwellings conversion'. This includes not just turning a house into flats, and turning flats back into a house, but also turning a commercial property into a property made up of one or more residences. The relief does what it says on the tin.
- Conversion of a property to an HMO (house in multiple occupation).
- Conversion to various kinds of residential institution, including nursing homes, children's homes, accommodation for schoolchildren and certain others.
- Conversion or refurbishment of a property which is a dwelling after the work has been done but has not been lived in for at least two years prior to the work.

In practice, the most common of these is likely to be the changed number of dwellings conversion, and there are two important practical points to bear in mind with regard to this.

First, there's nothing stopping you changing your plans in order to get the improved VAT treatment. If the *commercial* case for turning two flats into a house (or alternatively a property which is three flats) is equivalent to retaining two flats, the work which involves changing the number of dwellings could be preferable simply because the lower rate of VAT tips the economic scale in favour of doing this.

Second, bear in mind that the 5% rate depends on your builder or contractor charging you the lower rate on his invoices. In our experience, builders are slow to do this, because they have no downside risk in charging you 20%, whereas if they charged you 5%, and for some reason HMRC disagreed with the decision to do so, it is the builder's head that is on the block.

Because of this reluctance to charge the lower rate of VAT, or perhaps, in some cases, because of sheer ignorance on the part of the builder concerned, it's sometimes necessary to be very assertive in claiming your right to the 5% tax rate.

Buying commercial property

When you're talking about commercial property, the VAT-planning issues get arguably more acute. And they're made worse by the tendency of all concerned to forget about VAT until an advance stage of the purchase negotiations. Even now, 28 years after the concept of VAT on commercial properties was first introduced into the legislation, there's often a degree of vagueness about the question of whether VAT will be added to the sale price by the vendor. Sometimes this question doesn't come up until as late as the day before contracts are due to be exchanged.

If the property is more than three years old when you buy it, there won't be any VAT on the purchase price unless the vendor has 'opted to tax' it. If he has opted to tax the property, though, it is compulsory to put VAT on the sale price.

If there's no VAT, that's the end of the story as far as our article here is concerned. If you have VAT to pay as the purchaser, though, you have some thinking to do, perhaps in conjunction with your accountant or tax adviser.

The first point to make in this connection is that you can reclaim the VAT if you are going to use the commercial property for the purpose of a business, carried on by the purchasing entity, which is a VATable business, that is which has turnover of a VATable type and is registered for VAT in respect of that turnover. You don't need to opt to tax if you are in this position: the VAT can be reclaimed, even though there may be serious cash flow issues in between you having to shell out the VAT-inclusive purchase price and getting that back from HMRC.

If you're buying a VATable commercial property and you're not going to be using it directly for the purpose of a trade, you need to decide whether to opt to tax the property. In almost all cases, this decision is one which the purchaser is effectively forced into, because having to pay an extra 20% isn't a viable economic option. But you have to bear in mind the upsides and the downsides.

The upside of opting to tax is that you can reclaim the VAT that has been charged. The downside is that you need to charge VAT when you rent out the property, on top of those rents, and if your tenant is not a VAT-registered business this will simply make the rent that much more expensive for them. Moreover, if you sell the property, you will have to put VAT on the sale price; and, again, this makes the property more expensive for the purchaser. In practice, you may even find yourself getting less than the market value of the property because your ideal purchaser needs to discount what he is paying you to take account of the irrecoverable VAT from his point of view.

Buying a VATable commercial property: A planning 'angle'

Adding insult to injury, if the vendor charges you VAT on selling you the property, the stamp duty land tax (SDLT) that you pay on top of the purchase price is based on the VAT-inclusive amount: a 'tax on tax'. So it would be really good, wouldn't it, if it were possible to arrange things such that the vendor didn't increase the sale consideration by the 20% VAT?

As it happens, this is exactly what you can do. If you opt to tax the property before you buy it, and before you even exchange contracts, then the vendor, assuming that he, like you, is a landlord letting the property to a tenant, can treat the sale of the building as the transfer of a business as a going concern. Where a business is sold as a going concern, the supply is outside the scope of VAT and therefore not only do you not have to find the extra cash flow of paying the 20% on top of the purchase price you had agreed but also the SDLT is reduced because it is based on a lower stated purchase consideration.

You can even deliberately engineer this situation in a case where you were actually looking to buy the property to occupy yourself for a VATable business. The normal rule here would be that you have to pay the VAT and then claim it back, as we've explained. But what is stopping you, say, acquiring the property in different ownership from your trading company, partnership or whatever and deliberately setting up a landlord/tenant relationship between this property-holding entity and the trading entity? Because your property-holding entity is a landlord and not a VATable trader, they are within the scope of the 'option to tax' and the 'transfer of going concern' rules: so no VAT to find, and less SDLT.

It's important to remember that your option to tax, in this situation, needs to be in and acknowledged before not just completion but also exchange. If you've exchanged contracts before you have opted, there will be VAT on the deposit you pay on exchange – even if you opt before completion and the main payment is VAT-free.

Refurbishments and improvements to commercial property

Apart from the wrinkle to do with buying the property in the form of a transfer as a going concern, the general principles relating to work on a property which you already own are basically the same.

Since there's sure to be standard rated VAT on any such work to your property in practice, remember that you can reclaim this VAT, without opting to tax the property, if you are occupying the property for the purposes of a VATable business. There is no need to opt the property, and you could regret doing so in these circumstances.

On the other hand, if you are a landlord and you have already opted to tax the property, the situation is once again quite straightforward. You can reclaim any VAT you incur, on the basis that it is attributed to the onward supply of VATable rent.

There is a third possibility, though, which is that the property is not opted, perhaps because you acquired it from a previous owner who also hadn't opted to tax, and therefore there was no need for you to enter into the option in order to get any VAT back.

The question of whether you should opt to tax in order to get VAT back on the refurbishment or improvement work can be a finely balanced one. Remember that we're talking, here, about a landlord who is letting the property out rather than a business which is occupying it for its trade. It's a finely balanced question because the upside of being able to claim VAT back on your expenditure is balanced by the downside of having to charge VAT, for the first time, to your tenant.

Once again, if the tenant is himself VAT-registered and can reclaim the VAT you add on top, there's probably no problem – although, even in this situation, you have to bear in mind that an opted property has to have VAT applied to its sale proceeds if you ever do sell (there is a revocation period of 20 years). If your tenant can't reclaim VAT, though, you first of all need to check very carefully whether the lease forbids you to opt to tax. There is sometimes a clause put into a lease when the tenant is not a VAT-registered sort of business.

If you are allowed to opt to tax under the lease, you still have to bear in mind the commercial side of things. Does this make your property uneconomic for the tenant, because his rent has just suffered a 20% hike? Or, in extreme cases, does the increase in rent actually threaten the very viability of your tenant?

Property Opportunities

Berlin

It is expected that quite a few financial service companies will decide to go to Berlin when Britain leaves the EU. To begin with, the average price of residential property in Germany's capital is around a third of equivalent property in London and well under half that of equivalent property in Paris. Moreover, the cost of living in Berlin is about 25% cheaper than that of London. It already has a sizeable financial sector, a booming tech and start-up sector and English is extremely widely spoken.

The trendiest area to live in is Kreuzberg, which is Berlin's answer to Shoreditch and Old Street. Another area that is becoming very popular is the Tiergarten, which has the added benefits of its huge public park, a wide ethnic mix and low rents. The smartest area is probably Mitte. Charlottenburg, which is West Berlin's answer to Bond Street, is another popular location.

Between 2013 and 2016, property prices in Berlin grew at around 9–10% a year. In other words, there are fewer bargains to be had compared to after the financial crash in 2008. Still, prices are still low compared to other capital cities in Europe and demand is definitely growing. At the moment, roughly 40,000 people a year decide to move to Berlin and it is also a huge tourist destination. As a result, it could prove a very sound investment.

Property Partner

Property Partner is a technology-driven property investment platform and marketplace, enabling investors to acquire, own and trade shares in high-quality UK residential property at the click of a button, without the hassle of mortgages, solicitors or maintenance. Shareholders receive rental income each month in the form of dividends, and can realise capital gains if the property rises in value. The letting and management are carried out by professional agents on behalf of investors – so there are no late-night calls about dripping taps to deal with.

To date, Property Partner has funded over 346 UK properties, making it easy for investors to spread their risk by diversifying their portfolio. The company was founded in 2014 and is regulated by the FCA. It claims to be producing a current estimated return of approximately 7% per year, after fees.

This performance has attracted over 9,700 individual investors, who have invested more than £46 million of equity across primary listings and secondary market trades. There is also reassurance in the way the assets are owned. Each property investment is held in a limited company called a special purpose vehicle (SPV). This means it is totally ring-fenced from the assets and liabilities of Property Partner, and other investments on the platform. Property Partner claims that it has created the world's first, and biggest, property exchange. It states that this marketplace gives investors the opportunity to exit the market at any time and price of their choosing. Investors can realise capital returns by selling their shares on the platform and pocket 100% of the proceeds as there are no exit fees to pay. Over £11.3 million worth of shares have already been traded on the marketplace, bringing liquidity to an illiquid asset class.

Property Partner claims that tenants are just as important as investors. It states that it sets fair rents, fixes problems quickly and invests in upgrading its estate because happy tenants stay longer and good landlords make good returns.

Interestingly, many of the directors have come from other relatively high-risk financial businesses. For example Ed Wray, the cofounder of Betfair, is on the board, as is Neil Rimer, who helped found the global venture capital firm Index Ventures.

Property Partner plans to expand, incidentally, throughout Europe and even beyond. Its dream is to create a global stock exchange for residential property.

All of which sounds absolutely great. But, what margin are you paying to have the whole thing handled for you and what are the risks? The first risk has nothing to do with the company itself.

In London, the price-to-income ratio for a property is nearly 16 times. The ratio is also 16 in Oxford and over 10 in Cambridge, Brighton and Reading. Across the country as a whole it is generally above 5.

Investors will tell you that the fact that consumers have to use so much of their income to buy property isn't really important because there is such a shortage of supply that prices will always be high. But maybe there are just as many good arguments to suggest that the property market is overheated and that it isn't really a supply issue but more a location and space usage issue, for example it is believed that some 50% of owner occupiers are not using all the space in their properties.

Property Partner and other property crowdfunding sites such as Property Moose and The House Crowd all operate on broadly the same principles. You go online, you sign up to purchase a property with a group of other people you have never met through an SPV and, Bob's your uncle, you have become a buy-to-let landlord.

The downside? Well, obviously, you have no control over what happens. You can't choose the tenants. You can't decide how the property is going to be managed. You can't really decide which costs are and aren't acceptable.

Fees are also quite high. As far as I can make out from its prospectus, House Crowd is charging 5% up front, and a profit share for its management company. Property Moose also seems to be charging 5% up front as a finder's fee and then 15% of the yield as well as 15% of any capital gain.

I actually think that property crowdfunding is an extremely sensible way to buy into the British housing market – if this is what you want to do. It is particularly attractive if you don't have the time, energy or interest in handling individual investments yourself. However, the charges are high and you will have no control. Still, it does offer an interesting property opportunity.

Kenya

It is the cradle of humankind, one of the most beautiful and unspoiled countries in the world and has a rich and diverse culture. There are massive, as yet untapped, natural resources. Tourists love it. Communications are, for Africa, good. Property is cheap.

What is not to like about Kenya?

Well, the key thing putting off investors are the attacks by the Islamist militant al-Shabaab movement, which previously confined itself to waging war in Somalia. These attacks include the 2013 West Gate Shopping Mall atrocity and the 2015 attack on Garissa University College in the north-west of the country.

Also, of course, as anyone who has visited the country will be aware, like much of Africa there is high unemployment, crime and poverty. The country often suffers from drought conditions. Corruption, as you might well imagine, is rampant.

Yet for all of this, if you are interested in buying a piece of one of the world's last wildernesses and in establishing a nature conservation area capable of being self-funding – if not profitable – then Kenya is a very promising location.

To give you an example of the sort of money that can be made, take a look at Il Ngwesi, a Maasai-owned and -run eco-lodge that costs around $345 a night to stay in. And eco-tourism is just one of the ways you could see a return on your investment. There is the very real potential for capital gain. Not to mention the possibility of other income from crops and manufacturing.

If you want to buy in Kenya, you really need to be concerned with and sensitive to the requirements of wildlife, other landowners and local communities. Otherwise, you will find it very difficult to enjoy your investment. On the other hand, land is cheap and it is also possible to divide it up and parcel it off. For example, take a look at the Naretoi estate which abuts the Enonkishu Conservancy. Naretoi has some 34 five-acre house sites with 99-year leases at between £250,000 and £400,000 each. That is a lot to pay for a site in, bluntly, the middle of nowhere. But, perhaps, a small price to pay for being in an area where you can see leopards, tigers and elephants.

Become a convert

In 2014, a barely reported change to planning rules meant that a much wider range of agricultural structures could be developed for residential purposes without full planning permission. Rather, all that is needed is prior approval from the local council. Suddenly, as one expert put it, post-war cowsheds and dairies with portal steel and precast concrete frames, previously off limits, became available for conversion. The legislation, incidentally, also allows for change of use. Between 2010 and 2012, some 25,000 non-residential buildings in England were converted to domestic use. Between 2014 (when the new legislation came into force) and 2016, the number doubled to over 50,000. All over the UK there are what may look like hideously ugly, relatively modern farm buildings begging for a development.

Kensington and Chelsea... or Shetland?

An article in *The Economist* pointed out that house prices in Shetland have doubled in real terms since 2003. Indeed, in recent years, they have grown at a similar rate to those in London's most expensive area: Kensington and Chelsea. Why? It isn't an influx of second homeowners or of properties being let out on a short-term basis to tourists and holidaymakers. After all, as beautiful as Shetland is, it takes 13 hours by ferry from Aberdeen to get there or, if you prefer, a very expensive (and often rather uncomfortable) plane ride. No, what seems to have caused the boom is the Sullom Voe oil terminal. Since 2012, this has employed a growing number of construction workers with the result that over the last 10 years wages in Shetland grew 300% faster than in the UK as a whole. Will the boom last? You might think that as oil prices have crashed so would property prices in Shetland. In fact, thanks to the Shetland Gas Plant, a relatively stable local economy is expected over the next few years. Moreover, in the slightly longer term, Shetland hopes to cash in on the decommissioning of old oilrigs, which will, over the next two decades, require billions of pounds of investment.

Warsaw

For around £75,000, you can buy a one-bedroom studio in the city centre with a balcony or shared courtyard. For around £400,000 you can buy a three-bedroom penthouse with terraces and marble floors in an upmarket suburb. Although most of the city was rebuilt in the years after the Second World War, inhabitants love the cobbled streets, coffee shops, cocktail bars, boutiques and bespoke furniture shops to be found remarkably close to the centre of town. You can find a pre-war apartment with wooden floors, high ceilings and big windows. You will be amazed at how little it costs. What else should you know about Warsaw? Public transport is excellent. There is a large and growing middle class. Polish food is remarkably good. The city is remarkably sophisticated and something of a cultural hub.

What about the overall position in Poland? If the UK does indeed leave the EU, Poland could be one of the biggest losers. That is because it is the largest receiver of EU funds in Eastern Europe. Obviously, with less money to hand out it is likely to suffer from scaled-back financial support. The country is also suffering from the fact that between 2006 and 2008 many mortgages were issued in Swiss francs rather than in the zloty. As readers of this newsletter will be aware, the Swiss franc has increased enormously in value over the last couple of years and it is now worth nearly twice what it was worth six years ago. This means that many mortgage owners have not been able to enjoy the increase in property value over this period.

However, government plans are afoot to convert Swiss mortgages back to zlotys with the government and the banks covering the total costs.

At any rate the whole Swiss franc mortgage problem, together with the question of whether EU support will be reduced, has had the effect of restraining property prices. It is interesting to note that Warsaw property has not performed as well as the other major Polish cities (Krakow, Wroclaw, Poznan, Lodz, Gdansk and Gdynia) over the last decade. Whereas Warsaw has seen roughly 3%-a-year growth, the other locations have seen something closer to a 4% growth. Put another way, Warsaw is only about a quarter more expensive than the average of the other big Polish urban centres, while London is more like 140% more expensive than the UK average.

How about investing with a view to renting? The latest figures suggest that the typical gross yield should be around 9% a year. One possibly big area of opportunity is that of student housing.

Warsaw, indeed all of Poland, could prove to be an excellent long-term property investment. It has none of the volatility of many European cities, it is cheap to enter the market, it is well regulated and, perhaps most important of all, it is actually a very nice place to visit.

The Schmidt Tax Report

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