The Schmidt Tax Report

Tax, Money & Property

May 2017

You must pay taxes. But there's no law that says you gotta leave a tip - *Morgan Stanley Advertisement*

The Schmidt Tax Report

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The password is all lower case: str

Tax

News

Businesses liable for tax evaders

Legislation set to be introduced under the Criminal Finances Act 2017 will make businesses liable for criminal acts committed by employees who encourage or assist tax evasion by other individuals (e.g. customers or suppliers). Under the new legislation, businesses will be liable even in cases where senior management were either uninvolved or unaware of the acts. These measures, expected to be implemented in September 2017, apply to UK and non-UK tax. Ensuring oversight will likely represent an added compliance burden for businesses.

Patent success

In 2016/17 the Patent Box scheme saved businesses £875m in corporation tax, up 17% from the previous year's £750m. The scheme means UK businesses pay just 10% corporation tax on profits derived from any UK or certain EU patents. It was introduced in 2013 in order to encourage businesses to invest in research and development (R & D). Some EU member states objected to the scheme, claiming that it did not comply with state aid rules and, in 2016, it became harder to implement. However, it is anticipated that after Brexit the UK government will remove EU red tape and make the tax break even more effective.

UK still popular

Every year, KPMG surveys UK and international business decision makers on a wide range of topics from ease of doing business to tax competitiveness. This year, although the UK has retained its overall position as the second most competitive tax regime for businesses, after Ireland, the gap between the two has widened from 1% in 2015 to 9% in 2016. Amongst non-UK companies, the UK has dropped quite significantly from first to fifth place. The UK has also lost ground as the most attractive destination for foreign investment. The findings demonstrate a notable difference of opinion between UK companies and non-UK companies, leading KPMG to ask: "Are UK respondents being too bullish with misplaced optimism, or are non-UK respondents too bearish and too quick to discount the UK?" Factors previously cited as reasons behind the UK being an appealing destination for business – such as political stability, availability and cost of skilled labour and access to a single market – are now the greatest sources of concern for companies post Brexit. Despite concerns, the report shows that there is no real shift yet towards companies looking to move business out of Britain. However, in contrast to the 2015 report, businesses looking to move business functions *to* the UK has dropped considerably in 2016 – which is a crucial source of foreign direct investment.

Insolvencies up

During the first quarter of 2017, the number of insolvencies rose by about 5%. Personal insolvencies are 15.7% higher than this time

last year and have risen by 6.7% from Q4 2016 to Q1 2017. Corporate insolvencies are up by 5% in the same period.

Accelerated gains

HMRC's Business Directorate collected £943m from large businesses through accelerated payment notices (APNs) last year. Many observers have been surprised at how little tax has been collected as a result of APNs, which are issued to individuals and businesses who are suspected of having engaged in tax avoidance, and require full payment of the disputed tax within 90 days. APNs have been subject to controversy as they are issued without the right of appeal, and HMRC has previously had to withdraw several APNs following a number of legal challenges, including judicial review.

£3.3bn unpaid tax

An extra £3.3bn of unpaid tax has been collected from SMEs following VAT inquiries during 2016/17. Two newly created teams at HMRC, the Individuals and Small Business Compliance Unit, and the Wealthy and Mid-sized Business Compliance Unit – are believed to have taken responsibility for much of the extra tax collected.

Google pays up

Google has settled its long-running tax argument with the Italian government by agreeing to pay €306m (£259m). In exchange, the Italian government will not press criminal charges. The payment covers disputes dating between 2002 and 2015. The payment is significantly higher than the £130m that Google agreed to pay the UK Treasury last year for a decade of underpaid taxes. The Italian authority reportedly started proceedings against Amazon last week, which it estimates could owe €130m for passing its earnings through Luxembourg.

HMRC overcharging taxpayers

The *Daily Telegraph* believes that UK taxpayers are facing demands for up to £1,000 of tax that they do not owe thanks to outdated software being used by HMRC's calculators. The problem, confirmed by accountants and admitted by HMRC itself, applies to distinct groups of people who have certain combinations of savings and other income. It arises because HMRC's online tax calculators, which are used by online taxpayers, have not been updated to cope with recent changes to tax allowances.

Digital tax break disappears

EBay sellers and Airbnb hosts will not be entitled to a £1,000 annual tax allowance as promised in last year's Budget. The tax breaks were designed to help micro-entrepreneurs who sell goods and services online on platforms, such as eBay, Etsy and Airbnb, and those who take on occasional jobs such as providing lift shares or let out their homes or garages. One allowance applied to digital trading and the other to property. Both were supposed to be introduced in April 2017 but were left out of the Finance Bill.

Editor's Notes

New rules on hold

Over half of the Finance Bill was dropped in order that it could be rushed through Parliament prior to the next election. As a result, what would have been the longest Finance Act in British history has become one of the shortest in recent memory. Some 72 of the proposed 135 clauses were removed, including the planned raid on dividend incomes, the overhaul of the non-dom rules and plans to force small businesses to keep digital tax records. Measures that have been widely anticipated are now likely to be included in a special post-election Finance Bill that may be put before Parliament after the election and before the summer recess (21st July), although it is more likely to be postponed to the autumn. Leaving aside the plans to make digital record keeping mandatory for businesses, the delay is unlikely to affect the starting dates for any measures that do eventually get introduced. Indeed, some had already been put into force from the start of the financial year, in anticipation of the legislation being passed. Recent governments have developed a habit of instigating new rules before legislation has actually been passed. On one hand, there is now a period of uncertainty. On the other hand, for those who were disadvantaged by the rules, the delay offers extra time to alter their tax affairs. *Please note* that government proposals regarding a sharp rise in probate fees — charges paid when someone dies and the executor of their estate distributes their assets — from £155 or £215, to a sliding scale based on estate values have been dropped for the time being. Fees would have risen to £1,000 for estates worth between £300,000 and £500,000, and to £20,000 for estates worth £2m or more, equivalent to a 9,000% increase. There would have been no fees on estates valued up to £50,000.

£93,200 tax-free!

How much could you earn every year, tax-free? Believe it or not, the figure is now as high as £46,600 for an individual (or £93,200 for a couple). How can this be? It is all to do with what form your income (or gains) take. To arrive at this sum you would have to do a fair amount of organisation (and have a fair amount of luck) – still, it could be done. This is how.

From 2015, the starting rate of tax for savings income was cut from 10 to 0%. At the same time, the starting rate band was increased from £2,880 to £5,000. However, the 2015 changes were not as generous as they sound: the personal savings allowance and a person's entitlement to it depend on the level of non-savings income (i.e. income from employment, self-employment, pension and rents) and is subject to income tax before savings and dividend income. Ever since April 2016, a personal savings allowance has been available. Since then, bank and building societies have no longer been required to deduct 20% tax at source on interest. These measures, coupled with the £5,000 starting rate of savings, have resulted in many savers no longer paying any income tax on their savings income, especially given the low interest rates. The personal savings allowance is available only to basic- and higher-rate taxpayers – not those on the additional rate. A basic-rate taxpayer is entitled to receive up to £1,000 and one on the higher rate up to £500 of interest tax-free. All of which means, in plain English, that a taxpayer could earn up to £17,000 of income tax-free in 2016/17 (£11,000 personal allowance + £1,000 personal savings allowance + £5,000 savings starting rate). It does not allow, incidentally, for any gains shielded by a tax-free wrapper such as an ISA or even a VCT.

Supposing one also has dividends? These are treated separately thanks to a dividend allowance. As with the personal savings allowance, the dividend allowance is not a deduction; instead, a zero rate of tax applies to the relevant income. Above this amount, dividends in the basic rate band are subject to income tax at 7.5%, 32.5% at the higher rate and 38.1% at the additional rate. When added to the savings allowances, a taxpayer in 2016/17 could earn up to £22,000 tax-free (£11,000 personal allowance + £1,000 personal savings allowance + £5,000 savings starting rate + £5,000 dividend allowance).

If you can contrive to make a capital gain, you can take advantage of your capital gains tax (CGT) allowance of £11,100 and, if you rent a room in your house, you can also take advantage of the rent-a-room relief of £7,500. This takes the total of tax-free income (and gains) up to £40,600. The first £6,000 gain from the sale of personal possessions is also tax-free, taking the grand total to £46,600. Of course, if you could contrive to make yourself redundant then you could increase this sum to £76,600 tax-free. That's £153,200 for a couple.

Handling HMRC

I was interested to read a report of a talk given by Keith Gordon, a barrister who works out of Temple Tax Chambers at the Chartered Institute of Taxation Spring Conference. Mr Gordon's lecture was on dealing with HMRC inquiries and he made two, very helpful, comments. First, it is vital to ascertain that an inquiry has been correctly raised before giving any information to HMRC. To open an inquiry under TMA 1970, s 9A, the taxman must have a reason to suspect an underpayment of tax. On receipt of the s 9A notice, the first thing to do is to check that it arrived within the inquiry time limits. Second, the APN legislation had given the taxman much greater powers, but nearly every notice Keith Gordon has seen has suffered from defective drafting. Judicial review is an expensive way to challenge a notice, but it is the safest.

Penalty warning

In the good old days, corporate tax avoidance schemes were all upside. If the scheme succeeded, the business would save substantial sums of tax. If the scheme failed, the interest and penalties, though annoying, were not onerous. Moreover, it was possible to cover the business against the highest level of penalty, by making a full disclosure on the company's tax return. Full disclosure made it difficult for HMRC inspectors to accuse the company of trying to slip something past them. As a result, it was by no means unusual for companies to become involved in tax-planning schemes. Things have, however, changed dramatically. Penalties are much higher and if an offshore structure is involved could be as much as 200% of the original tax. And, as if this was not bad enough, there is another downside: unresolved tax liabilities can have a major effect on other aspects of the business. Try, for example, selling a company that has a potential but unquantified tax liability. Next time your tax advisers suggest something clever in the tax-saving line consider what the effect will be if it is challenged. Could it have an effect on your ability to merge or sell your business?

The customs of the country

If and when the UK leaves Europe, one of the major changes is likely to be the introduction of a new customs duty scheme. As it currently stands customs duties (aka import duties) are imposed on all imports from outside the EU. They are collected on behalf of the European Commission by the member state in which they arrive. VAT, on the other hand, has different rates in each EU country and is collected by each state but retained for its own use. Unlike import VAT, customs duties are not recoverable by traders unless the goods in question are exported out of the EU. They are therefore usually an absolute cost for the importer, subject to duty reliefs, and (indirectly) the final customer. What will happen after Brexit? The UK government says it will negotiate with each country on a country-by-country basis. If this is not forthcoming – and it seems unlikely – the rules under the World Trade Organization (WTO) will apply. This will result in UK goods exported into the EU being subject to the bloc's external tariffs under the most favoured nation (MFN) category until (assuming it happens) a free trade agreement between the EU and the UK is in place. The UK will be able to set its own tariffs on imports into the UK up to ceilings allowed by the WTO, which could be as high as 8.4%. After Brexit, the UK will have to negotiate free trade agreements with the major economies, the largest four being China, the EU, the US and Japan, but this will obviously take time. The government has not yet announced the recruitment of free trade negotiating experts to be in place by 2019, and there is a concern that it could lead to a very tricky time for UK businesses involved in import or export.

UK property register

The UK government appears to be set on creating a new register of beneficial owners of overseas companies that own UK property. This would be the first register of its kind in the world. It follows a British decision in 2016 to force people with significant control (PSC) to be included in a central, publically accessible register of those who control UK companies and limited-liability partnerships.

The new register would apply to existing property ownership as well as to future property acquisitions. At the moment the Department for Business, Energy & Industrial Strategy (BEIS) has simply published a call for evidence on the proposals. However, assuming that the current Conservative government is re-elected, it is almost certain that such a register will proceed.

A new register is expected to work as follows:

- It will be held by Companies House.
- Overseas entities will not be able to buy or sell property in the UK unless they

have provided full information about their beneficial owners to the registrar.

- It will be available free of charge online via Companies House.
- Any legal entity that can hold a property will be included in its scope.
- The requirements will apply in respect of freehold property and any leasehold of more than 21 years.
- The definition of beneficial ownership will be the same as it is for the PSC register.
- Overseas entities that already own property will be given a year to disclose the required information or sell their property.
- It is likely to be a criminal offence to fail to provide information for the new register or fail to keep information up to date.
- The level of information required about beneficial owners will probably be the same as that required for the PSC register. It will include an individual's name, nationality and country of usual residence, nature of their control over the entity and the date on which they acquired control. It will also include their date of birth and residential address, but these will not be publically accessible.
- Overseas entities will be required to take reasonable steps to find out the identity of the persons who control them and to check the information with their beneficial owners before disclosing it for the new register.

There will be a protection regime allowing information about an individual to be kept off the public register if that individual would be at risk of violence or intimidation as a result of the information being made public.

Ask The Experts

Q. My aunt wants to part gift a buy-to-let property to me she bought for £100k and now has a market value of £200k. I will pay her £150k, and then sell it to clear some of my debts. Please let me know how much:

1. SDLT there is to pay, and
2. Whether there will be any CGT payable (and on what amount of gain) by her or by me if I sell it.

M. G.-P., via email

A. Provided there is no mortgage in the property there will be no SDLT charge. However, for CGT purposes your aunt will be taxed as if she had sold the property for its open market value of £200k (i.e. she will be taxed on the deemed £100k gain). This is because as you are relatives the transaction is taxed as if it took place at market value.

Q. I have noticed over the last few issues advice to use one's £1000 interest allowance by charging interest on directors' loans, which seems like an excellent idea. I have a £130k director's loan so £1000 would only be reasonable percentage would you say? However in the Dec/Jan issue, in the 'Editor's Notes' about the Autumn Statement, it mentions that deductibility of interest for CT will be restricted. Does this affect this advice?

Also in a previous issue it mentioned in passing that from 2020 the £3000 employment allowance (the employers' NI refund, I assume) will not be available to sole employee shareholders. I am 100% shareholder but there are 2 other directors: my sons, who take £11k wages each to use their allowance. Will this still catch us?

J. W., via email

A. We think a 10% interest rate could easily be justified. Some commentators can justify higher rates and some say lower. The rate should be commercial. So if the company were borrowing at arm's length what rate of interest would it be charged?

If it could get a bank loan or a Funding Circle loan the interest rate would probably be between 6 and 11%, but interest rates on credit cards and finance deals are higher.

So you could easily charge the company much more than £1,000. Do bear in mind that when the interest is paid the company needs to fill in a CT61 and deduct basic-rate tax from the interest it pays you. To the extent that you personally are not liable to tax on the interest, you would then claim a tax refund from HMRC through your personal tax return.

The Autumn Statement interest deductibility restrictions are only for large groups of companies paying interest of more than £2m.

The £3,000 employers' allowance has not been available to single employee companies since April 2016. However, the restrictions will not affect you since there are three employees in your company.

Q. I have a client who bought a large house approx. 30 years ago for himself, his wife and their 5 children, owned by the taxpayer and his wife. The house sits in 2.52 acres and has over 20 living rooms.

Three years ago the owners built a separate house some distance away from the original house but within its acreage, there not having previously been any form of barrier between the original house and the area on which the new house was built. The new house has grounds of 1.46 acres, within what was originally part of the grounds of the original house. Thus, the original area of the main house appears to have been nearly 4 acres.

As the children had all moved away from the parents the latter had the smaller house built, albeit significantly larger than the conventional 3-bed house, as the main house had become too large for just the two of them.

The original house was only ever used as the PPR of the family, the latter having no other residence except for a holiday home in Portugal, which the family used very occasionally. The family did not use the main house grounds for any leisure activities such as may be related to horses, for example.

The main house was sold in 2014/2015 approx two years after the husband died and the wife moved into the new house which had been completed a little before that sale. She lived there for approx. 8 months before selling it, this house having become her PPR throughout that 8 months.

Would you kindly let me have your view of the potential capital gains liability for either or both of these houses?

S. D., via email

A. The larger house was the PPR until a few months before its sale when, as a matter of fact, it ceased to be the PPR. The period of non-occupation prior to sale was less than 18 months so will be covered by the 'last 18 months of ownership' rule. Therefore, the whole of the gain on the larger house itself will be covered by PPR. The question is therefore whether all of the grounds qualify as permitted area and are therefore covered by PPR as well. Historically, the grounds for the larger house were four acres and presumably the four acres were bought at the same time as the original house. The standard permitted area is 1.25 acres but grounds of a greater area can qualify for PPR if they are appropriate to the nature and character of the property. It does not seem to us that grounds of 2.52 acres are inappropriately excessive for a 20-bedroom property, particularly as for most of its history it has had grounds of 4 acres. We would therefore claim PPR relief on the whole of the house and garden of the larger property.

The smaller property's base cost will be the appropriate proportion of the land value of the initial purchase plus the building costs. Again, the gain on the house itself should be covered by PPR, provided the house was genuinely lived in as the widow's main residence. The apparently short period of occupation seems a little contrived but if there is a good and genuine reason for this (e.g. the widow had to move into a care home or moved closer to the children) then this should not be an issue. The question is therefore whether 1.46 acres is an appropriately sized garden for the new property. At only just over the permitted 1.25 acres, it does not seem excessive. We would suggest a review of similarly sized houses in the area and their gardens to establish whether 1.46 acres is normal for similarly sized houses.

You And The Revenue

The trigger happy taxman

There's one area where HMRC has unquestionably got much more aggressive very recently, and that's in its attitude to charging penalties.

It's actually about 10 years ago, now, that HMRC rolled out a 'modernised' penalty regime for those whose tax returns are shown to be incorrect. For 'modernised', of course, read 'increased'.

In place of the old, admittedly rather vague, system, we've now got a fairly specific regime (although even this involves the exercise of judgement by the taxman) under which you can pretty much predict what sort of level of penalty you are likely to incur if HMRC amends your tax return.

Penalties are completely different in principle from interest for late-paid tax. If it turns out that your tax return for last year, or several years ago, understated your tax bill, there will of course be interest to pay when you put this right. But interest isn't any kind of punishment, or so the Revenue insists. It's merely commercial restitution for the fact that the government had to wait for your money. So interest, unlike penalties, is an additional charge that HMRC says it has no discretion to mitigate (except in cases where the delay was its fault).

Let's start with the really bad news: the maximum penalty is 100% of the tax. That is, you can end up paying twice as much as you would have paid originally if your return had been right.

But, in practice, of course, this level of penalty is very rarely actually charged. If the error is deliberate and efforts are made to conceal it from HMRC when it inquires, you could in theory be up for the full 100% sting. If you don't conceal it, though, such that HMRC can find out about it on inquiry, your penalty can reduce to 70%, or to 30% if the error wasn't deliberate but simply the result of carelessness.

But these only apply where you don't make any disclosure in cooperation with the HMRC inquirer. If you do disclose, albeit that that disclosure has been prompted by HMRC's queries, the above rates of penalty can be reduced by as much as half.

The best position of all, of course, from this point of view, is where you make the disclosure yourself and HMRC has not started inquiring, and the disclosure has therefore not been prompted by it in any way. In that case, you can get away with a complete lack of penalties if your error was merely careless, with minimum penalties of 20% for deliberate but not concealed errors, and 30% for deliberate and concealed errors.

The table summarises the above regime.

	Careless (%)	Deliberate but not concealed (%)	Deliberate and concealed (%)
No disclosure	30	70	100
Prompted disclosure	15	35	50
Unprompted disclosure	Nil	20	30

You should note that the figures in the second and third rows represent the minimum penalties, because of course the extent to which you disclose can be regarded as a sliding scale.

The good news is that, if you find a careless error in your return and make full unprompted disclosure of this, the chances are you won't pay any penalties at all (although you will still pay interest if the tax is late). This is a good reason for making this disclosure, of course, rather than waiting for the taxman to, possibly, find it out. (Leaving aside the fact that you have a duty to do so, of course!)

These rates of penalty are pretty stiff, it has to be said, but apart from the actual level of penalties, you might say that nothing could be fairer than the regime as set out in the table. The more assiduous you are in correcting anything that's wrong in your tax affairs, the less the penalty you will pay, including going right down to nil.

It would be nice if we could end the story there. Unfortunately, the aggressive attitude of HMRC, that we started off by highlighting, finds its outlet in a frankly trigger happy standard procedure of threatening taxpayers with penalties – even before HMRC has found any solid indication that any tax is due. Clients of accountants are currently receiving distinctly threatening letters going on at great length about the possibility of penalties being imposed on them even where the inquiry into

the taxpayer's affairs is at an early stage and there is no rational ground for concluding, as yet, that there are any irregularities.

This is extremely objectionable, especially since a reasonably high proportion of inquiries are closed without any adjustment.

We suggest that taxpayers who receive such letters direct from HMRC (bypassing their accountants) simply throw them in the bin.

Inheritance Tax: Some Fallacies

Inevitably, a lot of mythology has built up around tax, because it's a complicated subject that affects a great many people who don't have the time or the ability to get their heads round the detailed rules. Inheritance tax (IHT) is by no means immune from this, and I thought it might be useful to list out what are the commonest errors in my experience, on the principle that forewarned is forearmed.

Hopefully, this won't be a too depressing read. In many cases, the mythology pictures IHT as more of a monster than it really is. But unless you know, of course, you can't plan properly.

1. Gifts are taxable

I wish I had £100 for every time a conscientious and worried client, or prospective client, has come to me asking where they should disclose a large gift or bequest they have received on their tax return. Come to think of it, I probably have had!

The truth of the matter is that we have no donee based tax, as far as gifts are concerned, in this country, unlike, perhaps, some other jurisdictions. Instead, the decision was made by Mr Healy, when he introduced capital transfer tax (the forerunner of IHT) in 1974, to make IHT a donor based tax; in other words, the IHT on a gift is the responsibility of the giver and not the recipient; and if the gift in question is a bequest on death, the liability rests with the executors of the deceased person's estate.

A gift, putting it another way, is 'capital' in nature as far as the recipient is concerned. It therefore doesn't fit within any of the categories of the Income Tax Acts as taxable income and does *not* need to be entered on your tax return.

2. You can only give away £3,000 a year

This may just about be the commonest misapprehension in my experience of talking to clients. As with a number of falsehoods, it is stronger because there is a small grain of truth hidden inside it.

Let's talk about PETs. Not dogs and cats, but potentially exempt transfers. Most gifts made by an individual during their lifetime are categorised as PETs, with the only real exception being gifts into most sorts of trust. A gift to another individual is not taken into account for any IHT purpose, providing the donor lives for at least seven years after making the gift. In consequence, you can give away £10 million, or £100 million, if you like, but you have to take the simple precaution of living for another seven years after doing so. Then there will be no tax – either on the giver or on the receiver.

Where the idea that you can only give away £3,000 came from is the fact that this is the annual exempt amount for IHT. This is only relevant, though, if a person makes a gift and then fails to survive it by the seven-year period. In this case, £3,000 is deducted from the taxable amount of the gift; and if the exemption doesn't apply to any gifts in the previous tax year (ended 5th April), that previous year's exempt £3,000 can be used as well.

It obviously makes sense, in planning terms, to use your £3,000 exemption: for example, a married couple who have made no gifts in this or the previous tax year have a total of £12,000 that they can give away completely tax-free even in the event of their premature demise. If you don't use your £3,000 annual exemption, at least within this and the following year, you lose it. So those who fear for their life expectancy but want to make gifts would do well to remember the availability of the £3,000 exempt amount. For everyone else, though, frankly it's of fairly limited relevance.

The positive side of this mythology, or rather the exploding of this mythology, is that there is actually no limit at all on how much you can give away and thereby save IHT.

3. Giving your house to the children

A lot of people don't realise that giving away their home, even more than seven years before death, is of not benefit in terms of saving IHT at all – if they continue to live in it.

This is because of the 'gifts with reservation of benefit' rule that was specifically designed to circumvent attempts by individuals to reduce their taxable estate for death duty purposes, whilst not really disadvantaging themselves at all in any real or practical sense. Unless the property given away is enjoyed to the exclusion, or virtually the entire exclusion, of any benefit to the donor, these rules treat the asset concerned as if it were still owned by the donor, and it becomes fully taxable on death if the benefit is still reserved at that time.

Some advisers, I know, advocate doing this and neutralising the 'reservation of benefit' rules by paying the children a full market rent for their continued occupation of the house. In principle this works, but there are a number of drawbacks which make it something I personally very rarely advocate:

- The rent received by the children is taxable income for them, whereas the parents, of course, get no relief against their tax for making the payment. You can't claim rent of your home as an expense in most circumstances. So you are creating an income tax charge at the expense of the family.

- It is an 'all or nothing' remedy. If you pay even slightly less than a full market rent for the occupation of the house, you don't lose some of the relief you lose all of it. And remember that HMRC could come up with a very different idea of what a market rent is, after the person's death when it is too late to do anything about it.

- Giving the house to the children, unless they live in it themselves, is converting an asset that is eligible for CGT main residence relief into one which is not so eligible. Although the deemed 'gain' on the gift itself to the children will be covered by main residence relief from CGT provided the donor parents have lived in it throughout their period of ownership, any subsequent sale by the children will not be sheltered from tax. So, in the likely event of the property increasing in value between the gift (which, remember, must be more than seven years before death) and the sale of that property, there is likely to be an otherwise avoidable CGT charge.

- The plan may be self-defeating if the parents have assets from which they derive an income, rather than their lifestyle being funded entirely, for example, from pensions. Often, if you take out of account the asset which is producing the income (perhaps an investment property), because you now need to use its income to pay the rent for the occupation of your home, it can work out that you might as well have given away that income-producing asset instead, with none of the complications listed above.

So, while I'm not saying that this device of giving away your home and paying rent on it is never an appropriate one, it comes with so many drawbacks that I am reluctant to advise it.

Apart from simply selling the house, downsizing and giving the difference to the children (which is a perfectly valid IHT-planning strategy) is there any planning, then, that actually does work in relation to one's own home?

I can think of two off the top of my head.

First, if at all possible make use of the specific exception to the gifts with reservation of benefit rule. This is where the recipient actually lives in the property, and the expenses are shared between the donor and the recipient after the gift in an appropriate manner. If these requirements are met, there's a specific rule which says that it is not treated as a gift with reservation of benefit.

I have seen this used in cases where a daughter moves in to look after her aged mother, just to take one example. The mother's main asset might be her home, in these circumstances, and a gift to the daughter of, say, a half interest in the property, while halving or nearly halving the taxable estate of mother, is nevertheless treated as wholly allowable planning for IHT purposes, even though the mother continues to live in the whole property rent free.

The other idea, which is dependent on its merits as financial planning, is that of taking out an equity release arrangement secured on the house, and giving away the money thus released. Equity release arrangements are not just for situations where an old person has nowhere to turn to for the necessary income, therefore: they can also be used as a method of IHT planning.

4. Investing in a company makes your investment IHT-free

The response to this statement is: not necessarily. What those who think this have in mind is the availability of IHT business property relief (BPR). An investment in a business, or a limited company carrying on a business, is eligible for 100% relief, providing it has been held for at least two years on the date of death.

So I've seen it suggested, for example, that a person should introduce his buy-to-let property portfolio into a limited company in order to make the value of that portfolio eligible for BPR.

What this suggestion overlooks is the fact that only trading businesses, or at least businesses which are 50% trading, are eligible for the relief. A business which consists of investing in assets and receiving income from those assets will not become relievable just by being put into a limited company.

But there is one way you can turn an investment business into a relievable trading business, if the facts are right. This is by changing the whole basis of the business to a trading one, either by getting rid of the investment assets and ploughing the proceeds into a trade or by changing the nature of the assets that you hold without necessarily disposing of them straight away. Let's take an example.

Gerald has two adjacent properties, forming the two halves of a semi-detached house, which he has let out to tenants for years. This is clearly an investment business and won't qualify for BPR. But supposing Gerald goes into a joint venture arrangement with Mega Homes plc, and they secure permission to demolish the semi-detached house and build a lot of smaller houses on its grounds. This looks very like converting a non-relievable investment business into a relievable trading (property development) business. Assuming (which shouldn't be taken lightly) that you can satisfy the demands for evidence of this change in intention, this has the pleasant effect of wiping out a large amount of the taxable value of Gerald's estate, in our example, overnight. The rules don't say that your business needs to have been a trading business for two years prior to death; they merely say that you must have held the business for two years, and that it must be a trading business at the date of your death – a subtle but very well marked difference.

5. PETs save IHT after three years, not seven

As stated, the above isn't completely false. It's just necessary to point out that it isn't always the case. The best way to explain this is by giving another example. Mrs Grundy's estate is worth £2.325 million, made up of £1 million for her home, £325,000 for an investment property and £1 million in cash or other liquid investments.

Unfortunately, Mrs Grundy's health isn't too good, and she's realistic enough to assume that she may well not make the seven-year survival period necessary for PETs to become completely exempt.

She discusses this problem with her son, who suggests that it may be worth making a gift nevertheless, because 'taper relief' applies to gifts which become 'failed PETs', with more and more tax relief becoming available the longer the donor survives a three-year period. After three years from the gift, the tax on that gift goes down by 20%, and then goes down by another 20% on each anniversary, reaching a 100% relief, therefore, after seven years. So he suggests that Mrs Grundy gives him the investment property, worth £325,000, since that, out of all her assets, is the one which causes

hassle. Even though her estate is still taxable, and to a fairly substantial extent, every little helps, and for each year after the second that Mrs Grundy survives, her son works out that the IHT bill goes down by £325,000 × 20% × 40% (the IHT rate), that is the fairly respectable annual saving of £26,000 IHT should be saved for each year that Mum manages to struggle on.

Needless to say, Mrs Grundy loves her son and thinks he is the cleverest man ever born (except for her late husband). Nevertheless, a vain of common sense in her leads her to check the position with an accountant.

The accountant breaks the bad news that there is actually no saving at all on the £325,000 gift unless Mrs Grundy breasts the seven-year tape. It's the *tax* on the lifetime gift that is tapered by 20% a year from the fourth year onwards, not the amount of the gift; and the way the rules work is that failed PETs are treated as the bottom layer of the person's estate, so to speak. So, because the value of the gift is within Mrs Grundy's available nil band for IHT (which by an amazing coincidence is currently £325,000), there is no tax on that gift as such. It merely means that there is tax on another £325,000 of her estate at death, which is not available for any taper relief.

Following the accountant's advice, Mrs Grundy decides to bite the bullet and give away twice as much as she was going to, that is she gives away both the investment property and £325,000 cash. In that way, at least, her son's hopeful predictions of the IHT savings after three years will be fulfilled.

6. Non-UK domiciliaries don't pay IHT

An oil sheik who has rarely if ever visited the UK's death in Arabia is surely no reason for the UK taxman to rub his hands in glee?

Unfortunately (for the sheik), it is: if he has any assets which are situated in the UK.

This is because the rule doesn't actually say that non-UK domiciliaries don't pay UK IHT. What it actually says is that property which is situated outside the UK, and is owned by non-UK domiciliaries, is outside IHT. Ergo, UK-sited property owned by non-UK domiciliaries is very firmly within the IHT net, at least in principle.

As we pointed out in an article last month, radical changes have been proposed, which, assuming the law goes through as intended, apply from 6th April 2017.

Where the asset concerned is UK residential property (which, in practice, it most often is), this tax grab on foreigners' assets will apply even if they are held through various kinds of offshore corporate 'envelopes'. Before that date, it was pretty simple to avoid IHT if you were non-UK domiciled: you put your UK-based assets into the ownership of an offshore company (usually) which meant that, instead of owning a UK asset, you owned the shares in an offshore company that derived their value from a UK asset. As a non-UK company, incorporated and managed outside this country, it was a non-UK-sited asset and free from IHT.

We suspect strongly that this simple loophole was deliberately allowed to remain by successive governments, since they actually thought it was a good idea for foreigners to invest in the UK, and not be put off by the prospect of a swingeing 40% tax charge. The current Conservative government doesn't seem to hold this view.

Note particularly, though, that this only applies to UK-sited residential property. Any other type of UK-based asset, such as commercial property, or a trading company or trading assets generally, can escape the IHT treatment if they are held through offshore vehicles: even under the new regime.

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This Is A Self Assessment Alert!

A huge number of people are going to get into big trouble, we predict, with HMRC shortly. This is the class of people who have been brought, unwittingly in many cases, into the Self Assessment system by a recent law change.

As everyone knows, the tax system is run not for the sake of the people, or to fund the government, but for the convenience of HM Revenue & Customs. This recent change is a good example of this, and may also yield the government some useful extra revenue in the form of substantial penalties levied against those who haven't kept up with the swirling, hurricane-like pace of tax change.

To explain, we probably need to set out what the position was in the good old days (before 6th April 2016) and compare it with the situation now.

The good old days

What we're going on about here is the way dividends from companies, and interest from bank deposits, are taxed. Pre-6th April 2016, dividends were taxable on the recipients effectively, and only if those recipients were higher-rate taxpayers (i.e. paid tax at rates of 40% or higher). If you were a basic-rate taxpayer, you had no additional liability to pay, and no need, therefore, unless you were in the system for other reasons, to complete a Self Assessment tax return.

That changed on 6th April 2016, with a new dividend tax of 7.5% being introduced, which applied to basic-rate taxpayers (with higher rates for those in higher income tax brackets). The reason for the non-taxability of dividends, basically, is that they are paid out of company profits, which are presumed to have already borne corporation tax, so that it would be wrong to effectively double tax these amounts when paid out as dividends, if those dividends paid the full rates of income tax when received.

Amongst all the furore caused by Mr Hammond's attempted increase in National Insurance contributions (NIC) rates, nobody seems to have noticed that the imposition of this dividend tax, the previous year, was a flagrant breach of the Tories' election promises not to raise income tax. They seem to have avoided this, Sir Humphrey Appleby like, by calling the increase something else: that is the 'withdrawal of tax credits'.

Nevertheless, they have certainly got away with this even if they failed subsequently to get away with the NI hike, and the practical effect, of course, is that basic-rate taxpayers who receive dividends will now have to do something about paying the tax on them.

In order to save HMRC trouble – sorry, we mean in order to shelter lower-income families – a £5,000 tax-free band was introduced (subsequently reduced with effect from next year, to £2,000). So anyone, for example the old lady with a small share portfolio, who only receives a comparatively small amount of dividend income will not need to do anything. But anyone who received more than £5,000 in dividends in the tax year just ended, that is the year ended 5th April 2017, must register for Self Assessment in order to pay their tax bill on the excess (if on nothing else).

There is a parallel change for bank interest, which most people will be aware ceased to be paid under deduction of basic rate income tax from 6th April 2016. In the case of interest a more modest exempt band of £1,000 was introduced, so anyone receiving interest over this amount in 2016/17 must similarly register for Self Assessment in order to pay over the tax on it – because it's no longer being deducted at source.

The rules say that anyone who is chargeable to tax, whose tax bill is not being met by deduction (e.g. under PAYE) and who has not received a tax return to complete needs to inform HMRC of this fact, and register for Self Assessment, prior to the 5th October following the tax year-end.

One class of individual that this is likely to affect is the 'wives' of individuals who are on Self Assessment. (I put 'wives' in quotation marks because, of course, the same applies to husbands, civil partners, same sex partners, etc., etc.) It is fairly common practice, when doing planning, for the main earner in the household to bring about the position whereby his or her partner's personal allowances and basic rate bands are utilised by paying them dividends on a shareholding in the family company. If these partners have hitherto not needed to complete Self Assessment returns, because their income hasn't taken them into the higher rate bracket, they will need to do so now.

Feature: Pensions: Still Worth It?

The former Pensions Minister, Ros Altmann, wrote an interesting piece in *The Daily Telegraph* a few weeks ago detailing how the continued reductions in the lifetime allowance (LTA) – now at £1m – are resulting in more and more long-serving and middle-ranking workers being affected. What was once seen as a curb on the wealthy building up 'excessive' pension funds is now starting to bite, and bite hard, many who are earning relatively modest amounts.

The calculation for determining whether the LTA has been breached is a fairly crude one for final salary schemes as the accrued annual pension is simply multiplied by a factor of 20. This means that anyone on course to receive a pension of £50,000 or more from their final salary pension scheme at their normal retirement age will – if they have no form of protection in place – be hit by an LTA tax charge. So that's pretty much all long-serving doctors, dentists, head teachers, consultants and senior civil servants in the public sector and an awful lot of middle management in the private sector.

It could be argued that those in defined contribution (investment-related) pension schemes are even worse off, since while a member of a final salary scheme can receive a pension of £50,000 before being deemed to have breached the LTA, just try to buy a £50,000 annual pension with a pension fund valued at £1m. No chance. At best, at current annuity rates, you're looking at that sort of fund value buying you an inflation-linked annual pension, with 50% spouse's pension of about £20,000 at age 60. So under this scenario not only are you penalised for saving hard during your working life but if you save to the maximum, in order to avoid a tax charge, you're limiting yourself to a very modest pension income in retirement.

As well as there being limits on the total value that you can build up in pension entitlement, there are of course also limits on how much you can contribute (or accrue for defined benefits schemes). Again, thanks to constant tinkering, we now have four different annual allowances in place:

- annual allowance of £40,000;
- money purchase annual allowance (MPAA) of £10,000 (proposed to be reduced to £4,000 in 2017/18 but the reduction has been deferred until after the June 2017 general election);
- tapered annual allowance (TAA) of between £10,000 and £40,000 depending on income (which is assessed according to two different tests);
- alternative annual allowance (AAA) of £30,000 or less (may be reduced by the taper).

Confused? You should be. Determining which one (or more) of these annual allowances applies can be a minefield.

The introduction of the TAA and the expected reduction of the MPAA mean that more and more people will now find themselves breaching the limit and having to pay an annual allowance tax charge. While those contributing to personal pensions can of course control the level of contributions made each year, members of final salary pension schemes have

no control over the amount of annual allowance deemed to have been used. For such defined benefit schemes, the increase is calculated using a formula based on the amount by which the individual's accrued benefits have increased by more than inflation during the relevant tax year.

In situations where the increase in benefits in the scheme results in a breach of the annual allowance, and the tax charge is more than £2,000, the member can request that the 'scheme pays', in which case the scheme administrator will pay the tax due to HMRC and there will be a resultant reduction in the pension benefits accrued in the scheme. In order to be able to utilise this option it is only the annual allowance which must be exceeded. If it is only the TAA or MPAA which has been breached then 'scheme pays' cannot be used. In these instances, it is necessary to make use of 'voluntary scheme pays'.

Under this route the pension scheme administrator can pay the tax charge as detailed above (although they do not have to offer to do so). However, an additional option exists, whereby the member can choose to have the tax charge paid from an alternative scheme if they so wish. For example, a high earner in a final salary pension scheme could breach the TAA within that scheme. Rather than choosing to have the tax charge paid by that scheme – with the resultant reduction in accrued benefits – they can, instead, choose to pay the tax charge on a voluntary basis from a personal pension that they also hold. This may well be worth considering if the final salary scheme is generous in terms of increases to pensions in payment, especially given the high cost of purchasing an increasing pension via an annuity.

It is undoubtedly the case that as the regulations become more and more complex, and the restrictions on both contribution levels and benefits accrued increase, many people are being put off using pensions at all as a means of saving for retirement. It is not unusual for us to meet with new clients who have done little or no pension planning in recent years for that very reason. However, in my opinion, pensions should not be dismissed so easily. In spite of the complications and restrictions, with the flexibility in terms of how benefits can be drawn and the tax reliefs still available they should remain the cornerstone of everyone's retirement planning.

As a simple example, we have recently been engaged by a lawyer couple, one a partner in a large firm and one operating via her own limited company. Neither had contributed the maximum to pensions in recent years. When we calculated what it was now possible for them to do legitimately in 2016/17, without any tax charges, and taking into account unused annual allowances from previous years, they were able to contribute more than £160,000 between them (at a net cost of considerably less, as much of that qualified for tax relief at 45%).

Complicated? Yes, definitely. Nevertheless, pensions should not be ignored and with the help of a financial planner who understands them, there is still much value to be had from including them within your lifetime planning.

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Feature: To Travel Hopefully...

If you don't think you have a firm grasp of what you can claim in the way of travelling expenses against tax, this article is for you. If you do think you have such a grasp, the chances are you are delusional!

The truth is that the tax rules relating to deduction of travel and subsistence expenses are of that typically English 'make it up as you go along' variety. Under the English doctrine of legal precedent, the law effectively doesn't exist until someone goes to court to dispute it, and the statutory rules (i.e. those which are actually written down) are scanty to say the least, particularly for self-employed people. Making sense of the rules is very often a case of applying the simple principle 'Don't take the mickey out of HMRC.'

Employed or self-employed?

That is the question. For reasons that aren't always perfectly clear, our tax system makes a big distinction between the taxation, and computation, of income from employment on the one hand and income from self-employment on the other. So it's necessary to be very clear about which of these categories you fall into.

Without wishing to write a book on the subject (which you could do), the essential difference is that an employee is subject to control over how he does his job, whereas the self-employed person isn't. Normally speaking, to be fair, the distinction is pretty clear in practice. If you are an employee, your employer will be applying PAYE and NI deductions to your salary. And this includes the situation where your 'employer' is your own company of which you are a director.

In most ways, the tax system tends to favour the self-employed over the employed, and for this reason a lot of questionable or even outright bogus self-employment situations are set up in practice. The deduction for travelling expenses, though, is a rare example of where it is arguably the other way around.

The situation for employees

The pages and pages of legislation on travelling and subsistence for employees are all based on one very simple principle: travelling for the purposes of your job is tax allowable, providing it isn't an expense of 'ordinary commuting'.

How do you decide whether you are commuting or travelling allowably on business, where you go to the same place several times? Actually, for once the rules are quite sensible and well thought out!

The question is all about whether you are travelling to a permanent workplace, or a temporary workplace. If your destination is a permanent workplace, the costs of getting there are ordinary commuting and can't be claimed against tax. If, on the other hand, your destination is a temporary workplace, travelling costs to get there, and subsistence expenses while you are there, are tax deductible.

You distinguish between the two types of workplace by considering how long your attendance there will be, and what proportion of your overall employment contract period that workplace takes up. If you work in the same place (or closely defined area) for more than two years, or if your time there comprises the whole of your period of employment, this will be a permanent workplace.

RIP tax planning

The reason we need to keep updating our articles regularly is because nothing stays the same in tax, and the rules relating to one particular tax wheeze have changed recently. So we no longer put forward the suggestion of a person who has a number of short-term work assignments for different employers putting his income through a personal service (or one-man) company. The idea was that, although your period working for each different company was the whole of the time you spent working for them, if you were an employee of your own company instead, this meant that you had an overarching employment contract where you were required to work at all kinds of different premises. Therefore what would otherwise have been permanent workplaces became temporary workplaces, and the expenditure magically became allowable.

Unfortunately, HMRC seems to disapprove of this one, and is introducing rules to reverse this advantage. So beware!

Of course, that doesn't mean that no tax planning to avail oneself of these fairly generous tax deduction rules is possible. From now on, we think employees of the mobile variety will, or should, be concentrating on two main areas:

- where there is flexibility on the point, ensuring that an employment contract requires attendance at more than one location, and no one location takes up more than a two-year period;

- making sure that the reliefs available are fully exploited, by making a careful note of every penny that is spent, and not forgetting the 'subsistence' element (of which more below).

The dark side

The rules relating to tax deduction for travelling etc. by employees are actually quite clear: because these rules have been written recently by someone (if we may say so) who had some kind of notion of reality.

Now, welcome to the dark side! The rules for self-employed travelling expenses give all the appearance of never having been thought out at all, by anyone, in the slightest detail. Instead, we have one basic rule which applies to all expenses, not just travelling, and a mass of fairly indigestible case law precedent which establishes no very clear principles. As we say, that's the way the law is made here.

If you're interested in these things, or are an insomniac, you could try going through the Revenue's own summary of the rules in its internal manuals. Distilling these, though, the essential point, which seems to come up frequently, is to decide where the 'base' of a person's self-employment is.

Sometimes, of course, there's no real room for doubt or controversy. Bert is a plumber and in a sufficiently large way of business to have his own workshop in the middle of town, to which he travels, most mornings, to start the day's work. The day's work largely consists, naturally, in going out to customers' premises, mending those leaking taps, re-lighting the boilers, etc., etc. In this instance, hopefully no one would dispute that Bert's travel to the workshop in the morning is not allowable, but all his journeys out from that workshop to customers' premises are.

But what about the situation where he has an emergency call out, and goes straight to the customer's place? Will you believe us if we say that the rules are by no means clear on this situation?

In other instances, the position is even muddier. Take the example of the doctor who receives a phone call at home where he has to deal with a medical emergency by giving initial instructions over the phone before going to attend to the patient. Is his home his 'base' in this instance, because he's certainly on duty all the time he's travelling from home to where the patient is? We think that a claim for deduction of this cost would be thrown out, though, because (if there is a firm rationale at all) his home would not be regarded as the base of his self-employment. It would be different if his home were also his surgery, that is he 'lived over the job', but many don't do this these days.

Absurd though it no doubt is, we can only suggest, looking at things purely from the point of view of tax efficiency, that journeys to carry out work as a self-employed person should start whenever possible from premises that are clearly the 'base' of the self-employed business.

'Wholly and exclusively'

And there's the wholly and exclusively rule. Whoever thought this one up really didn't like taxpayers, and obviously wasn't self-employed himself! Expanding the rule a bit, it is to the effect that no expenses can be claimed against self-employed income unless they are incurred wholly and exclusively for the purposes of the business. So if there is any non-business element in the intention behind incurring the expenditure, you don't get the expenditure apportioned between the business and the non-business purpose; instead, the whole expense claim is thrown out, root and branch.

So if you leave your office in which your business is based, to go and see a client or customer and take Auntie's birthday card to post at the same time, in principle your whole travelling expenses (even if they are to the other end of the world) become disallowable.

Absurd? Yes! This rule has only survived as long as it has because HMRC doesn't rigorously enforce it.

It seems that the rule doesn't stop you enjoying yourself when you get to wherever it is you're travelling on business. In the famous (or notorious) case on this point, which is *Mallalieu* vs. *Drummond*, a judge gave an example of how to distinguish between allowable and non-allowable in the context of travel. The example he chose was a doctor who went to attend a friend of his who was ill in the south of France. Whilst there, he no doubt enjoyed what was effectively a holiday, after he had finished treating the friend. But because the enjoyment of the time in the south of France was not the purpose of the visit, the expenditure would, in the judge's opinion, be allowable.

Once again, though, you have to attend

very carefully to the sacred principle, part of our unwritten constitution, which states in letters of gold: "Don't take the mickey." One suspects that a doctor actually claiming his expenses in the case mentioned by the judge would face a barrage of cynical questions and attack from a real-life tax inspector.

You get the idea. Rightly or wrongly (and we think wrongly), large and unusual items of expenditure are going to be subject to attack in any HMRC inquiry, as are situations that are in any way 'unusual'. Avoid these if you want certainty on your tax treatment.

The nitty-gritty

On the other hand, don't do what so many people do, both employed and self-employed, and actually end up under-claiming. Let's ask one simple question: if you travel by cab in the course of your employment, who (a) always makes sure they get a properly completed and dated receipt, and writes the purpose of the journey down somewhere, and (b) remembers to give these receipts to whoever formulates the expenses claim?

We suspect that very few hands will have gone up at that question. But think of it this way. Top-rate taxpayers are subject to 45% income tax and, very often, 2% employees' NI, plus 13.8% employers' NI, on their top slice of income. That is, the effective overall tax rate between the employee and the employer could be expressed as something over 60%.

So keeping that cab receipt for £17 actually can be seen as saving payments to HMRC of £10, whereas failing to get the receipt, or keep it, is effectively like throwing away a £10 note in the street.

Think of it this way, we suggest, and you're more likely to adopt a scrupulous approach to keeping records.

What is 'subsistence'?

We've talked about subsistence, as a companion type of expenditure to travelling costs, a number of times in what we've said so far. But what, precisely, is 'subsistence'?

If you go away for work and have to stay overnight, your accommodation in the hotel, which may well include the cost of your breakfast the next morning, will obviously go down as a claimable expense. In practice, subsistence of this type will be allowed by HMRC, even though technically it breaches the 'wholly and exclusively' rule. You eat breakfast not just in order to do your job, after all, but also to stay alive. This is another example of HMRC making an absurd and unworkable system workable by simply not enforcing it where it would be uncomfortable or embarrassing to do so.

What if we take an extreme example, and assume that you stay in a luxury hotel, and have the most expensive possible dinner, with champagne and brandy at £160 a shot afterwards. Is this dinner 'subsistence'? In principle, it shouldn't make any difference, you'd have thought, how expensive or otherwise your food and accommodation is. However, the non-mickey-taking principle should, in our advice, be taken seriously here. Don't make HMRC's bending of the rules too embarrassing for it!

The word 'subsistence' itself does have overtones of maintaining existence at the minimum possible cost, as in the phrase 'a subsistence wage'. This overtone may well have rubbed off on tax inspectors who examine travel and subsistence claims.

Oddly, though, we feel that the cost of the accommodation itself, so long as the journey is wholly and exclusively for business, should not be a sticking point for HMRC. In a famous case on a similar issue it was ruled that HMRC was not entitled to require business people to choose the cheapest method of attending to their businesses' needs.

You may wonder what the rational basis is for feeling that an expensive hotel is more likely to be claimable than an expensive dinner. Keep wondering! As far as we can see, there is no such rational basis, as 'subsistence', strictly speaking, no doubt shouldn't be claimable at all in any circumstances.

Again, this is a case where the employed individual is arguably better off than the self-employed individual, particularly at lunchtime, when the meal taken at a restaurant, or from the local supermarket, whilst away on business is very unlikely to be questioned, in contrast to lunch expenses for a self-employed person.

Perhaps, one day, someone could actually make up some rules? In the meantime, to repeat yet again, our motto has to be that expressed in Latin: *Noli Michaelum extrahere.*

Running cars tax efficiently

Last month, we set out some principles for tax-efficient motoring, and so it's not our aim to repeat these here. Nevertheless, it is pertinent, in the context of talking about tax-allowable business travel, to consider more closely two particular questions:

- Should employees be provided with a 'company car'?
- Should a company provide 'pool cars' for the use of its employees?

Company cars are treated generally very harshly by the tax system. There are winners and losers, but probably more losers than winners. If you're provided with a company car, you have tax to pay based on an imaginary 'benefit' figure which is calculated based on a given percentage of the list price of your car when new, with percentages going up to 38%. So if you run a car which cost £100,000 when new, you could end up being taxed on an imaginary 'income' of £38,000. This is regardless of the actual cost of running the car, whether you drive the car privately to any extent or how much of its use is unimpeachably business related. In an extreme case, an individual could end up being taxed effectively several thousand pounds for each private mile he drives – an absolutely absurd result.

On the other hand, you have the person who drives the very environmentally friendly car (with, therefore, a very low percentage), but drives this car a lot on private mileage and very little, if any, on business mileage. Counterintuitively, the person who drives their company car predominantly privately, rather than on business, is favoured by our loopy tax system.

Because the answer can genuinely come out differently in different circumstances, and there are a huge number of variables including the CO_2 emission figure, the cost of the car, the proportion of business and private mileage and the absolute figures for both of these, there's actually no substitute for doing the sums, even if only on the back of a fag packet. You could find that the company car idea works in many circumstances, and you can't therefore rule it out as potentially the most tax-efficient way of travelling on the roads.

And what about owning and running pool cars? Well, if you've struggled to the end of this fairly long article and are losing the will to live, the best and most succinct advice to you is: don't!

The idea of a pool car is that it doesn't get treated as a taxable benefit in kind for any employee, because it's generally available to all employees. The situation the legal rules clearly have in mind is the car whose keys are kept in the top drawer of the front office reception that can be taken out on journeys at a moment's notice by a wide range of employees (not necessarily all). What happens more often in practice, though, we suspect, is that the so-called pool car is actually used predominantly by one member of staff, who may even take it home at night. If this is a common practice, it will rule out the car being treated as a pool car, and the individual who takes it home will end up with a benefit-in-kind charge. So the planning point (if you can call it that) is to steer well clear of pool cars unless you can say, with Shakespeare, something like "'Tis mine, 'twas his, it has been a slave to thousands."

Offshore News

Australia shows the way

If higher-tax countries wish to stop multinationals from switching profits to lower-tax countries, they will, in many cases, need to introduce new legislation. One of the first countries to have done so is Australia. In March this year it passed a new diverted profits tax (DPT), which is designed to "encourage greater compliance by large multinational enterprises with their tax obligations in Australia, including with Australia's transfer pricing rules". Companies trading in Australia that fall foul of the DPT will suffer a penalty tax rate of 40%. The legislation only applies, however, to significant global entities – a member of a group whose annual global income is at least A$1 billion – operating in Australia where, based on information available to the Commissioner, it is reasonable to conclude that profits have been artificially diverted from Australia.

New blacklist in July

The G20 (the world's 20 largest economies) reiterated their commitment to "a timely, consistent and widespread implementation of the Base Erosion and Profit Shifting (BEPS) package" when they met in Baden-Baden, Germany in March. As part of the official communiqué after the meeting, the G20 said that they were looking forward to "the OECD's preparation of a list by the Leaders Summit in July 2017 of those jurisdictions that have not yet sufficiently progressed towards a satisfactory level of implementation of the agreed international standards on tax transparency". The G20 threatened defensive measures against listed jurisdictions.

BVI courts uphold objection

A court decision in the British Virgin Islands means that: "Statutory requests and notices issued for the mutual exchange of information should be subject to the same principles of fairness as any other decision or act made by a functionary of a public body, which cannot be eclipsed by a duty of confidentiality." The case arose because two BVI companies objected to a demand by the BVI International Tax Authority (ITA) to produce information for the purpose of the BVI complying with a request from another state under a tax information exchange agreement (TIEA). The companies said that they should be given more information, namely details of the requesting state, the nature of the underlying investigation, the taxpayer involved, the tax period concerned or the applicable foreign tax laws. They argued that this denied them the basic right of procedural fairness and was unfair and unconstitutional. In March, the BVI Administrative Court agreed. Time will tell as to whether the ITA decides to appeal.

Gibraltar launches foundations

The Gibraltarian parliament has passed legislation that will allow for foundations to be established in the jurisdiction. These foundations will have a separate legal personality with its own charter and rules that set out its purposes and rules for its administration and provide details of the beneficiaries and guardian. Details of each foundation will be filed at Companies House in Gibraltar, which is to maintain a Register of Foundations. The founder provides the initial assets, as an irrevocable endowment, and may reserve certain powers such as to appoint or remove the guardian or councillors, or to amend the constitution of the foundation. The foundation council manages the foundation and makes distributions to the beneficiaries. It must include a Gibraltarian resident company that is licensed as a professional trustee in Gibraltar. Beneficiaries may be either enfranchised or disenfranchised. Enfranchised beneficiaries are entitled to copies of the accounts and other documents relating to a foundation. A guardian may be appointed to provide protection for the beneficiaries. In certain cases, for example, if there are no designated beneficiaries, or more than 50 beneficiaries, a guardian is required to be appointed. An annual report must be filed. In terms of tax, a rate of 10% will be charged on profits or gains accrued or derived in Gibraltar from any trade, profession or vocation. The beneficiaries of a foundation who are ordinarily resident in Gibraltar will be taxed in Gibraltar on distributions received from the foundation, the use of assets owned, used or leased by the foundation or any loan received from it.

Results of Indonesian tax amnesty

Most governments wildly overestimate the amount of revenue they will receive from the pursuit of offshore funds held by their own citizens (wishful thinking?), and it has been no different in Indonesia. Between July 2016 and March 2017, there was an extremely generous amnesty programme. It attracted a total of 965,983 taxpayers who declared a combined total of $366 billion, which yielded a little short of $7 billion against a target of $12.5 billion.

Wife exposes corruption

Jersey has returned £3 million of stolen assets to Kenya. The assets were held by a Jersey-registered company, Windward Trading, whose beneficial owner was Samuel Gichuru, the former chief executive of Kenya Power and Lighting Company (KPLC), the Kenyan government's electricity utility company. Windward Trading benefited from commissions paid by companies doing business with KPLC. The

corruption came to light when Gichuru's wife filed court papers during proceedings for divorce.

Panama update

Panama has ratified the Convention on Mutual Administrative Assistance in Tax Matters, which allows for the exchange of tax information multilaterally on request with the 107 jurisdictions that are signatories and provides a common legal basis for cooperation on tax matters. It is an important condition for delivering on Panama's commitment to start exchanging Common Reporting Standard (CRS) information in 2018.

Meanwhile, Joseph Muscat, the Maltese prime minister, has called a snap general election over the fact that his wife, as well as his energy minister, Konrad Mizzi, and his chief of staff, Keith Schembri, all had Panamanian companies. The Maltese economy is in reasonable good shape with the first national budget surplus in 35 years, record low unemployment and steady economic growth. It is, therefore, widely believed that Mr Muscat will be re-elected.

QROPS update

HMRC has announced a 25% overseas transfer charge on certain transfers from a UK-registered pension scheme to a qualifying recognised overseas pension scheme (QROPS) and transfers of UK tax-relieved funds to a QROPS made on or after 9th March of this year. The charge will not apply where the member is resident in the same country as the country in which the QROPS receiving the transfer payment is established or the member is resident within the European Economic Area (EEA) and the QROPS is established in a country within the EEA.

Caterpillar search

In 2014, the US Senate permanent subcommittee on investigations found that Caterpillar, the heavy machine manufacturer, had adopted "a tax strategy that shifted billions of dollars in profits away from the United States and into Switzerland, where Caterpillar had negotiated an effective corporate tax rate of 4 to 6%." In March this year US law enforcement agents searched the company's headquarters. It has been suggested that Caterpillar deferred or avoided paying $2.4 billion in US taxes between 2000 and 2012 by shifting more than $8 billion of parts sales to Switzerland. Caterpillar said, in its 2016 annual report, that it was "vigorously contesting" the IRS demand.

LuxLeakers get off more lightly

The Luxembourg-based whistle-blowers who leaked documents showing how PwC helped multinational companies evade tax in Luxembourg have had their sentences reduced on appeal. Antoine Deltour was given a six-month suspended sentence and fined €1,500. He originally received a 12-month jail term. His colleague Raphael Halet received a €1,000 fine in place of a nine-month prison sentence.

Offshore Comment

On the 7th of April, John Dizard, writing in the *Financial Times*, reported that: "For the past year or so, members of the political class around the world have been sticking nationalist badges onto the lapels of their dark suits. The international rich and their money, though, are ever more actively looking for an additional country they can call home, or at least residence. The search for second passports and offshore havens is beginning to take on a last-helicopter-out-of-Saigon urgency as capital controls, tax reporting and visa procedures tighten up around the world."

The article goes on to point out that for the international rich the new wider exchange of information about taxable assets and income among the world's governments is bad news. Around 100 different jurisdictions have now signed up to the Common Reporting Standard (CRS) introduced by the OECD. This means that detailed information about foreigners' holdings will be automatically sent to their home country's tax agencies. Early adopters of the CRS, which includes all EU members have already begun to exchange information with each other. In 2008, the next wave of adopters, such as Switzerland and other offshore centres, will start the process. Indeed, the only big economy that is refusing to sign up to CRS is the United States.

As discussed in previous issues of *The Schmidt Tax Report*, while the US government insists that overseas financial institutions provide full details about Americans' offshore assets, it does not provide information the other way. As a result of this, money is flowing from Switzerland, Luxembourg, the Channel Islands, Singapore and other offshore centres into newly established trust companies in the four states of America that offer the greatest level of confidentiality: Nevada, Wyoming, South Dakota and Delaware.

The *FT* was unable to find any reliable figures relating to the amount of flight capital entering the US thanks to the CRS, but it reported that: "portfolio managers and fiduciaries put it in the hundreds of billions of dollars".

The *FT* also reported that many private client advisers feel that those with offshore investments simply haven't yet grasped the effect that the CRS is going to have on their future financial confidentiality. For decades wealthy individuals have been used to being able to hide assets in certain countries of the world and they haven't yet realised that this will no longer be possible.

Is it possible to stay out of the CRS net?

Interestingly, Switzerland has announced that it will not exchange information with countries that do not allow for reasonable regularisation, by which it means an amnesty for newly reported money.

Another option is to obtain a second, legal residence and to use this for all your offshore transactions. For example, supposing you are a German citizen with offshore assets. You could apply for residence in, say, Cyprus or Uruguay, and use this as your legal identity. The fact that you have two residences need not come to the tax authority's attention providing you are careful with your paper trail.

A third option is, of course, to move all your assets to the US.

Intriguingly, the offshore industry itself seems to feel that although there will be winners and losers the idea of keeping money away from one's main country of residence will never lose its appeal – and even more so in these times of political turbulence.

Money

Editorial

Which asset class produces the highest average returns over the medium to long term? Equities. What has this resulted in? The creation of vehicles designed to mirror or track the various stock market indices, such as exchange traded funds (ETFs). The *FT* recently summed it up thus:

Exchange traded funds are eating the US stock market… and passive investing vehicles now dominate trading activity on American exchanges. Mounting disappointment with the ability of stockpickers to pick stocks that consistently beat the broader market has spurred a momentous shift towards passive investing strategies such as index-tracking funds and, increasingly, ETFs.

In fact, global inflows into ETFs averaged more than $12,000 a second last year, but because of tax and cost advantages, this trend is particularly advanced in the US – and especially in equities, where it is easier to structure cheap ETFs that accurately track the market. ETFs now account for about 30% of all US trading by value, and 23% by share volume.

However, suppose overall market conditions change? What if we are in for a long period of relative stagnation or – worse – market decline? It is possible that a long era of extraordinary interest rate policy by central banks which boosted the value of both equities and bonds for the last decade may have reached the end of the line.

Under these circumstances, stockpicking may enjoy a renaissance. Either way, investors would be well advised to follow a rarely discussed, but highly effective, strategy: that of investing in companies that offer what might be called 'the compounding effect'. This requires investors to look for businesses that retain some or all of the profits for re-investment rather than paying them out as dividends. An excellent example of this is Warren Buffett's Berkshire Hathaway, which hasn't paid a dividend in over half a century.

We are not suggesting a sudden rush to active investment. But, if you are considering active investment, almost certainly some of the greatest gains will be made by investing in companies that are re-investing some or all of their own profits rather than distributing them.

The election result and tax

Although many see the UK general election as being about Brexit, it is probably more about the economy. Following on from many years of fiscal prudence and in line with the economies of many other developed nations, Britain has actually been doing quite well. However, since the beginning of the year – partly because of Brexit and partly for other reasons – it looks as though it may be about to take a dip. If things are declining – as falling consumer spending would suggest – it is an astute move for Mrs May to go to the country now.

Interestingly, tax would appear to be a central election issue.

The Labour Party has said openly that it will target rich people earning more than

£70,000 to £80,000 with higher taxes and it is proposing the most left-wing prospectus of recent years.

The Liberal Democrats say that they believe in clamping down on tax dodging and ensuring that unearned wealth is taxed more aggressively than earned income.

The Conservatives, who seem most likely to win, have so far said nothing meaningful on the subject of tax. Philip Hammond, the chancellor, has complained of being extremely constrained by the previous manifesto pledges.

He would like to scrap the five-year tax lock, which was a pledge not to raise rates of income tax, national insurance (NI) or VAT made in 2015. He would also like to reduce tax relief on pensions. Conservative backbenchers know that any tax rises will be extremely unpopular with their supporters. If there is a larger Conservative majority, Philip Hammond is likely to get his way. If there is a smaller Conservative majority, the backbenchers will have more sway.

Inflation ahoy

According to the latest government data, living standards in the UK are falling. Average earnings, which were rising faster than the Consumer Prices Index, are no longer doing so. No one is forecasting what will happen to wages (currently growing at *c*.2% a year), but when it comes to consumer prices, the Bank of England is expected to revise its current 2.75% forecast upwards to 3.3%, or even more. Given that the current base interest rate is 0.25%, this is going to have a major effect on many consumers' spending power. Investors could be well advised to start planning for inflation.

Alternative Investment Opportunities

Seed capital

Samuel Johnson said: "There is a frightful interval between the seed and the timber." Forestry investment was not, apparently, for him. However, as we mentioned in last month's issue of *The Schmidt Tax Report*, woodland has become one of the top performing asset classes in the UK in recent years with total returns currently running at, more or less, 15% per year.

We touched on the tax benefits last month but we have had several emails asking for detailed clarification. Here is what you need to know about woodland as a tax-saving vehicle.

Most accountants will divide forestry into three different types of investment: (i) commercial woodlands, (ii) forestry that forms part of a farm and (iii) forest land that is used for some other trade.

Commercial woodland is the most tax-efficient. All the timber – and this includes 'thinnings' – may be sold tax-free. That is to say, there will be no income tax (ITTOIA 2005, s 11) or capital gains tax (TCGA 1992, s 250) to pay. Forestry is not generally considered 'agriculture' and, therefore, does not qualify for agricultural property relief. However, it may qualify for business property relief. Moreover, because HMRC accepts that timber can take, literally, generations to mature, inheritance tax (IHT) may be deferred until such time as all the timber has been sold, in order to avoid double taxation.

There are situations where a forest does qualify as agricultural land. This is where it can be described as: "shelter belts, game covets, fox covets, coppices grown for fencing materials on the farm, amenity trees or spinnies and where it occupied together with agricultural land or pasture and be ancillary to that land or pasture". Incidentally, any woodland which is regularly harvested at ground level at intervals of less than 10 years will be regarded as farming, not forestry. Tree nurseries also, generally, qualify for agricultural property relief.

Supposing you use your woodland as the basis for some other business – such as camping, glamping, forest schools, off-road driving or paintballing? Under these circumstances you should be able to achieve capital gains tax (CGT) rollover relief, holdover relief and entrepreneurs' relief. You may also be able to take advantage of IHT business property relief.

Woodlands that are owned and occupied simply for recreational purposes do not qualify for any reliefs.

Incidentally, any plantation of Christmas trees is not considered woodland for the purposes of income tax but will be considered agricultural land.

Commercial woodland offers, then, significant tax advantages and should certainly be considered by investors building a diversified portfolio. It offers the possibility of tax-free income, tax-free or reduced CGT and the possibility of 100% relief from IHT.

On the wings of angels

Have you ever considered becoming a theatre angel (opinions differ as to whether the name refers to the fact that they are creative saviours or whether they are likely to be dead before they see any return on their money) and investing in a stage production?

Successful plays, musicals, operas and other performances that prove popular can prove popular for, literally, generations. Think *The Rocky Horror Show* or *The Mousetrap* if you are in any doubt.

It is also true that the West End has proved itself pretty much recession proof. Over the last 20 years, gross box office receipts have more than doubled to nearly £650 million, there are more productions every year than ever before and ticket prices have more than kept pace with the cost of living. Of course, costs have also risen. Twenty years ago it would have been possible to put a play on in the West End for £200,000 to £250,000. Nowadays, the minimum cost is considered to be around £500,000. A musical could cost millions.

Between a third and a half of all theatre productions breakeven or produce a profit with between one in 10 and one in five offering really decent returns. The secret, therefore, is to diversify so that the successes more than cover the cost of the failures.

What about the tax breaks? In 2014, the then government introduced theatre tax relief (TTR) and all productions that began after the 1st September that year were eligible to qualify. TTR is, basically, a simplified version of film tax relief. It allows theatre companies and producers to make claims with a minimum of expense or red tape and works like this:

- It is available to production companies that are responsible for the production, running and closing of a theatrical production.
- The production company can be a commercial company – but it could also be some other sort of organisation such as a charity or a partnership.
- The production of plays, operas, musicals and potentially even circuses can qualify for TTR.
- There are few conditions. Only professional theatrical productions qualify and at least 25% of the core expenditure on the production must be incurred within the European Economic Area.
- Productions that qualify obtain relief on 80% of the lower of qualifying expenditure and overall available loss and there are two rates of relief: 20% for non-touring productions and 25% for touring productions.

TTR is probably best explained by an example. Imagine that you have a non-touring theatrical production. The total amount of income produced has been £1.5 million but the total expenditure has been £2.5 million. The qualifying expenditure is £2 million. Relief is obtained on 80% of the qualifying expenditure, meaning relief at 20% of £320,000 (£2 million × 80% × 20%). This relief can come as a credit or a cash payment.

Unfortunately, however, a very popular tax concession for theatre angels is about to be withdrawn. Private investors were always able to offset losses against profits made on other theatrical investments. This concession was withdrawn last April and it means that the only relief available for theatrical losses will be against capital gains. However, by investing through a limited company, obviously, all losses can be used.

Incidentally, you may have wondered why we haven't mentioned enterprise investment schemes (EISs) as a possibility for theatre production. The reason is that these demand a minimum three-year timeframe, which, for anything but a successful theatre production, is obviously too short.

What about the actual returns? After the preproduction costs have been paid off the profits are split 60/40 between the investors and the producers. It isn't easy for would-be investors who have no contacts to get involved. The best option is to search online for theatre producers and theatre production companies and draw up a short list of those you like the look of. You can then contact them and ask them to bear you in mind when opportunities come along. It is best to work with producers who have lots of experience and, as explained above, to invest in a basket of productions.

(It is a natural jump from theatre investment to think of film investment. The film tax relief introduced in 2007 gives a generous cash rebate to the company making the film. In addition, many film production companies have in recent years taken advantage of the EIS, which offers investors 30% income tax relief. Some companies have even managed to use the Seed Enterprise Investment Scheme (SEIS) which offers further tax breaks. However, as a result of a string of high-profile film tax deals that went wrong, it is important to ensure that one only invests where there is genuine risk.)

Gold report

On the day that Theresa May called for a general election, the price of gold shot up to $1,286 an ounce – an 11% increase since the start of the year. It now looks very much as though gold is going to make up the ground it lost after Donald Trump's election last November. This is why the experts expect gold to carry on rising in price:

- General global tension, especially over North Korea but also elsewhere, including the Middle East.
- Concerns about what is happening in Europe – especially the possible break-up of the EU.
- Increased demand for gold in Asia – especially China, where sales had been falling in recent years.
- Growing inflation – gold is generally a good hedge against inflation.
- A falling dollar – gold usually rises as the dollar falls.

We cover gold a great deal in this column, if only because it is a good indicator of investment sentiment in general. Obviously, it provides neither a dividend nor an income, so there is an opportunity cost in holding it. Still, with interest rates so low, maybe the lack of income makes no difference!

Property

However, switching to a corporate structure comes at a price. As one expert pointed out: "While this reduces the tax on the interest to 19%, it increases that on distributed profits from 40% to an effective rate of 45.325% for a 40% taxpayer and significantly more if the money is taken out as salary, so attracting National Insurance."

There is also the fact that incorporation increases the tax on property disposals from 28% to an effective 35.4%, and to get the rate locks the gain inside the company until it is liquidated.

We have discussed alternative strategies in previous issues of *The Schmidt Tax Report*. Perhaps the most effective is to reduce the interest charge either by repaying part of the loan or refinancing it. The interest rate on home loans is normally less than on buy-to-let loans, so increasing the mortgage on your own home and using the extra borrowing to repay your buy-to-let loan could make sense. Note that HMRC does not mind how a loan is secured but how the money is being used.

What else could you do? One option could be to divert part of the rent to adult children who may have little or no income, and so will pay tax at only 20%. This can be done by gifting an interest in the property. There is no stamp duty on a gift to another individual unless they take over part of the liability under the mortgage. Alternatively, one could gift only a right to income. However, there are catches to this as may trigger a potential CGT bill. Professional advice, therefore, is definitely recommended.

Property Tax Tips

Trading up

One of the best ways for property investors to make capital gains tax (CGT) free profits is to buy a home, live in it, renovate or improve it in some other way and then sell it for (hopefully) a substantial gain. It was called 'trading up' and many a family fortune was built this way. This is because under the terms of the main residence exemption (aka private residents' relief), you don't pay CGT when you sell or dispose of your home, providing the following apply:

- You have one home and you have lived in it as your main home for all the time you have owned it.
- You haven't let part of it out – this doesn't include having a single lodger.
- You haven't used part of it for business only.
- The grounds, including all buildings, are less than 5,000 square metres or just over an acre in total.
- *You didn't buy it just to make a gain.*

In the past, the taxman paid very little attention to homeowners who were trading up. Recently, however, there are an increasing number of reports in the accountancy media about HMRC pursuing homeowners who, in its belief, were buying property just to make a gain. If this could possibly describe your own activities, what can you do to avoid falling within the CGT net? Here are three tips:

- Don't move too often. If you stay in a property for at least three years it is difficult for HMRC to argue that you are simply flipping properties.
- Make sure it is your only home and there is nowhere else where you could be residing at the same time.
- Ensure you have plenty of evidence that you have actually been residing there. Utility bills are a great help. Believe it or not, photographs of family events held in the property could also make a big difference.

Avoid bad company

A recent newspaper headline read: "Tax Changes Prompt Landlords To Set Up Companies". The story went on to point out that a record one in five rented homes was owned within a corporate structure in the first quarter of 2017, after tax changes prompted thousands of landlords to set themselves up as limited companies. In London, the percentage was even higher with as many as one in three properties let out in the first three months of the year being company owned.

The predominant reason for this was that corporate structures are eligible for relief on mortgage interest, whereas private buy-to-let landlords have been suffering since April, when the government began to phase out the long-standing and generous tax relief on mortgage interest payments.

Moreover, landlords can no longer simply subtract the interest on their home loans when figuring out their tax bill. Instead, they will have to pay tax on their total income – including rent – and then ask HMRC for a tax credit of 20%.

Inheritance Tax 'Hiroshima'

Yes, we have no *mañanas*

Following the 2008 property crash in Spain, many UK investors were left stranded by bankrupt developers. However, a landmark ruling by the Spanish supreme court has declared that the banks, which were meant to safeguard the buyers' money, are now obliged to repay deposits put down on off-plan developments in Spain, if the developer went bankrupt. Reports suggest that a staggering £5.3 billion pot of cash is available for compensation.

Figures gathered by the specialist legal service Spanish Legal Reclaims indicate that Spanish banks still owe money to a staggering 130,000 British property buyers and that the pay-outs could be worth anything from £10,000 to £500,000 per investor.

In general, investors have 15 years after a developer has failed to deliver the property to make a claim. However, the longer you leave it, the harder it will be to get a favourable result.

Consider the demographics

Generally speaking, property investors tend to think short to medium term. However, those seeking to build long-term wealth (for their own retirement or for the next generation) would be well advised to consider local and national demographics. Moreover, they should not be swayed by irrelevant statistics. For example, the total size of the British population is expected to grow steadily, so that it passes 70 million people in 2026 and rises to 77 million by 2050. Yet, it is the age and location of those people that will determine property opportunities, not its sheer size. For example, the population is ageing and it is more the fact that people are living longer rather than the fact that new people are being born (or moving to the UK) that is causing the total population to increase.

Perhaps the best illustration of how demographics ought to influence one's investment strategy is to look at the student market. There were far more children aged under 10 in 2015 than there were in 2005. However, there were far fewer 10- to 18-year-olds in 2015 than there were in 2005. The number of students turning 18 over the next 10 years will be down by 20,000 to 100,000 every year until the numbers soar for the following decade. In plain English, student landlords may have to survive some lean years before they can feast again!

By the way, there are more people in their twenties now than there were 10 years ago, which explains why the demand for small, buy-to-let property in major conurbations has been going up. Also, the massive drop in home ownership in recent years has been because the number of people aged 30 to 45 has been falling since 2005.

Incidentally, the pensioner crisis will peak from 2025 onwards.

By the way, migration seems to have very little effect on total property demand. This is because if we look at the last 20 years then, although some 1.516 million EU member citizens have moved to the UK, some 1.325 million British citizens have moved elsewhere within the EU during the same period.

Anyway, to develop an effective long-term property investment strategy it is well worth looking at the figures.

Digging down

It costs between £150 and £450 per foot to dig down under a residential building to create extra rooms or – if ambitious – extra floors. It is, therefore, simply a matter of mathematics to work out whether it is worth doing. If space is worth more than the cost in a particular area then it is worth considering. It is in almost any area of London and – increasingly – in many other parts of the UK. Yet, although many private homeowners dig down, few investors – largely because of the time it requires to arrange – seem to have it on their radar. One investor who has some experience in this area is John Stainton, and we asked him to offer a few tips based on his own experience.

A recent High Court ruling means that homeowners who wish to expand their basements may now be forced to apply for planning permission. Prior to the case, homeowners have been able to go ahead with dig-downs with relative ease. Only those who wish to put in a particularly large underground extension (where, for example, more than one storey is planned or the new basement will extend more than three metres away from the property) have faced planning problems. The High Court case involved a Victorian terraced house in Kentish Town. The plan was to put in a single-storey structure under the property. However, there were 15 objections from adjoining occupiers, including a petition with 32 signatories, and the residents were supported by their local councillor. The residents' concerns included disruption, dirt and noise caused by the construction work, lack of road access, loss of parking and the risk of instability given the sensitive nature of the period property itself.

It is likely that local councils all over the UK will start to see 'dig downs' as a lucrative money spinner. Westminster Council has been the first to seize the opportunity and planning fees in the borough now average £8,000 a property.

The reason why most people are digging down, of course, is because it is cheaper than moving house. Incidentally, although lots of people talk about the so-called iceberg homes of tycoons and oligarchs (enormous houses under which three- and four-storey basements have been dug to house swimming pools and car collections) most dig-downs are simply to provide an extra room or two for ordinary families. As a developer, I see a dig-down as a way of increasing my return on an investment.

Most obstacles can be overcome, but high water tables and particularly where there are main services running beneath the property may make costs prohibitive. Modern properties that are built on raft foundations generally can't be underpinned and so can't have basements.

Until 10 to 15 years ago, basements simply relied on being dug out and finished with cement, with no extra waterproofing. The result was that after several years leaks would inevitably occur, perpetuating the reputation that basements have always had for damp and susceptibility to flooding. Today, basements are excavated and their foundations underpinned with waterproof concrete, but in addition the whole area is tanked on the inside with a heavy waterproof membrane covered in studs. This cavity membrane system ensures that any water that may build up is directed down the studs into a gulley that runs all round, and thence into a chamber where a pump (or more than one if it's a large area) drains it away.

The advantages of a dig-down include:

- There is extra internal space without loss of external space.
- The new space is often closer to the living space than, say, an attic conversion or extra top floor.
- Underpinning may also serve to stabilise an old building.
- Waterproofing generally makes the whole house drier and healthier and increased insulation makes it more energy efficient.
- Soundproofing can make the room quieter for you and your neighbours and the rest of the house.
- Basements free up space in other parts of the house.
- It creates adaptable space that can change depending on a family's needs.

The disadvantages of a dig-down include:

- There will possibly be disruption, noise and mess – especially if you are enlarging or creating more headroom and so need to underpin.
- The requirement by the future owner to arrange an annual inspection of the pump and drainage.
- The neighbours tend not to like the dust and disruption!
- Unforeseen problems, especially if there is a party wall.
- Extra cost of another access route.

Property Opportunities

Don't fall for fixed income promises

The following is a quote from a brochure we recently received entitled the *Emerging Property Q Studios Investor Report*.

Q Studios is a quality new build student property, ideally situated opposite an upcoming student village development and within walking distance of two popular university campuses. It also sits directly adjacent to the brand new £282 million UniQ university campus development. With only 7% access to purpose built student en suites citywide, demand is assured for these highly sought after studio apartments – of which there are 153 in phase one of the development. Indeed, only 21% of the city's growing student population currently have access to any form of purpose built student accommodation – including university halls. Professional onsite management and a range of excellent facilities, including a gym, cinema and study centre further enhance the attraction of Q Studios to tenants and property investors alike. Buyers receive an effortless 10% net income fixed for 10 years, with zero costs during this period.

For as little as £69,950 you can buy one of these studios and earn the promised 10% return a year. You are free at any time to sell your studio on. At the end of the 10 years, you will simply switch to whatever a competitive rent is for your property. Q Studios, incidentally, is located in Stoke-on-Trent and the developers have already completed 16 other student properties as well as other developments including four blocks of luxury serviced holiday apartments in Devon.

Reading the Emerging Property prospectus, you could be forgiven for thinking that the company was a charitable organisation keen to help investors unable to get a decent return on their money. The truth is that it is promoting an unexpectedly high-risk investment. The only way that it can possibly be guaranteeing a 10% net return is if it is making its profit from the development itself. In plain English, the £69,950 studios it is selling are probably costing the company much, much less to build. Developers normally work on a 20–25% gross profit. Imagine Emerging Property is working on, say, a 40% profit (which is by no means impossible). This gives the company, more or less, £28,000 to play with. It can afford to pay some of this to the management company to guarantee the 10% return. If it had to subside the return to the tune of 2% a year that would cost it £13,800 over the 10 years. As it happens, assuming that the college manages to fill the rooms for all the university term and some of the holidays, a 12% gross rental yield is not impossible – maybe a bit more. But after setting aside money for maintenance and future maintenance, it is hard to imagine that there will be 10% left over. So, investors are, in my opinion, likely to be substantially overpaying for the property in the first place. There are other risks. Supposing the company goes bust – as has happened with other student property developers – bang goes the guarantee. Supposing, in 10 years' time, the student property market is flooded and there is no demand – the value of the studio and the rental income would plummet.

If you want to go into student property there are, without doubt, better ways of doing it.

Land price explosion

Savills, the estate agents, has issued a report on the price of residential land. In Glasgow, Birmingham and Manchester fierce competition has pushed the value of land up faster than the price of homes in the same areas. For example, in Glasgow land is up by 15%, whereas house prices are only up by 6.3%. Developers are looking to build in these regional hotspots because property prices there have been climbing much faster than in London and other southern cities. To put this into perspective, across the UK urban land values have increased by slightly over 4% in the last 12 months.

Demand for residential land in these northern cities has been going up due to a shortfall in available housing. There has also been a great deal of urban regeneration and infrastructure improvements. Savills said that many international investors were partnering with local developers in order to take advantage of the weak sterling.

Interestingly, property prices across the Midlands have been growing faster than the rest of the country. Right to Move reported that in the first quarter the East Midlands saw annualised price rises of 5.7%, whereas the West Midlands prices climbed to 4.2%. This compares with a 2.3% year-on-year increase across the UK.

Tenanted properties

Have you ever considered buying a residential property with tenants in place? Such properties are occasionally advertised and also come up at auction. Generally speaking, most investors avoid them. The reason is twofold. To begin with, the research required to purchase such a property is much greater. Then there is the fact that some tenancies favour the tenant much more than they do the landlord.

On the other hand, tenanted properties can offer two extraordinary benefits. First of all, they come with an inbuilt income stream (though not always a very large one). Second, some residential tenants are responsible for the maintenance and upkeep of the property, thus substantially reducing the investor's expenses.

The starting point for anybody wishing to purchase a property with a tenant in place is to ascertain the exact nature of the tenancy. The greatest property discounts are to be had by purchasing a property with something called a lifetime tenant. These tenants are obliged to maintain and insure the property but they will pay little, if any, rent. In most cases such tenants are retired and have sold all or part of their property to a home reversion company at a fraction of the market price. The money raised is invariably used to supplement a pension and the terms of the agreement mean the occupants can remain in their home rent free for the rest of their days. It is only when both have died – or gone into a nursing home – that the new owner can rent, sell or move into the property. Such investments have to be seen as very long term. Moreover, if you can only afford to buy one or two such properties, there is always the risk that your lifetime tenants will live a very long time! This is a better investment if you can afford to buy half a dozen properties or more. Such properties, incidentally, usually sell for as little as 30 or 40% of their market value.

Another type of property that sometimes comes up at auction is one with a sitting tenant. By sitting I really mean one that has a protected or regulated tenancy agreement. These long-term lets had strict rules on rent rises. In some instances, they gave tenants lifetime security and could on occasion be passed to their children. The sitting tenant system was abolished in 1989 and replaced with assured shorthold tenancies. It is estimated that there are still a 100,000 or more such tenancies in the UK and from time to time the properties definitely come up for auction. Again, properties with these sorts of tenants in situ generally cost as little as 30 or 40% of their market price.

Finally, we come to the most usual situation. This is a buy-to-let property or house in multiple occupation that has rent-paying tenants in situ. These can represent extraordinary value as, in general, many investors are put off by the thought of having to deal with an unknown tenant. Here is how to avoid the pitfalls when purchasing this type of property:

- Begin by making sure that the tenancy is genuine. Ask for a copy of the tenancy agreement, check the utility bills and council tax and the rent quoted. Check the rent receipts. If you can try to talk to the tenants themselves in order to make sure that they are (a) real residents and (b) good tenants.
- Carry out all the other normal checks that you would make when purchasing a property. In other words, consider the location of the property, its condition and so forth.
- Set the return figure you want on your investment. This has to take into account the income you wish to receive versus what sort of capital gain you want/expect to make long term. You also have to allow for repairs and other expenses. For my own part I look for an 8% minimum rental yield. In my experience this is the smallest amount required to meet all the costs and come out ahead on the whole deal. However, I usually look for much higher yields and, generally, achieve them.

Overall, tenanted properties are well worth the extra time that has to be spent on evaluation and research. That is why they sell at a discount!

Portuguese opportunities

We believe that the time has come to invest in Portugal. In last month's *Schmidt Tax Report*, we looked at the possibilities offered by going to the 'wrong' end of the Algarve. In this issue, we are looking at Lisbon.

To give you a bit of background, Portugal has been going through a long period of population and economic decline. The total population of around 10.3 million (divided into 9.8 million living on mainland Portugal and the rest on the Portuguese islands of Madeira and Azores) has been falling. It has dropped by a quarter of a million since 2010 and, because the birth rate is lower than the death rate, it is losing around another 25,000 people per year. Portugal had 45,000 fewer people living in it in 2016 and it is expected that 45,000 fewer people will be living there by next year. At the same time the number of people receiving welfare is over half of the total population (this is made up of children under 15 and pensioners).

So, where is the opportunity?

Unlike almost any other capital city in Europe the population of Lisbon has been falling consistently for over three decades. In 1980, for example, there were 800,000 people living in the city centre, whereas today the number is closer to 500,000. The total size of the population of the Lisbon metropolitan area, for example, is 2.8 million.

Contractor accommodation

Workers in all sorts of sectors – everything from building to engineering and from IT to agriculture – now have to be much more mobile. As a result, there is a growing demand both in the UK and elsewhere for something that is now referred to as 'contractor accommodation'. These are, essentially, short-term rental properties designed to meet the needs of mobile, non-permanent workers.

Why would you want to get into such a sector? Well, the yields can be staggering. If a large employer or project is bringing a substantial number of people into an area and accommodation is tight then prices, not surprisingly, shoot up. Moreover, many contract workers have their rents paid for them by their employers. They make good

tenants, too. They are generally well paid and tend not to have any sort of antisocial behaviour issues.

Incidentally, demand is much higher than you may imagine. The British government believes that there are around 1.2 million people working for private contractors in the construction industry alone. Infrastructure projects account for nearly 60% of all total construction work.

What's the major disadvantage? Voids! Moreover, many tenants will only require accommodation during certain days of the week as they will go home at the weekends or when they have time off. Medium- to lower-paid workers will not wish to pay for accommodation they aren't using.

How do you get into the contractor accommodation market? One of the most sensible ways in is to offer serviced accommodation. This could include cleaning, laundry services and even meals. Many employers and employees prefer this type of arrangement as it leaves the worker free to focus on their work.

There are, believe it or not, managers who specialise in providing contractor accommodation. There is a company called Intelligent Housing Group that provides accommodation to a portfolio of both national and multinational clients throughout the UK and you could talk to them. Another option would be to look at some of the specialist online accommodation sites such as Spare Room, Easy Room Mate or even Airbnb.

If you don't already own suitable contractor accommodation property then one of the things you could definitely do is start looking for location, where future major construction projects are planned. The biggest clients in the UK are the Department for Transport, Department of Health, Network Rail and the Ministry of Defence. And the country's five largest construction companies are Morgan Sindall, Kia, Royal BAM, Laing O'Rourke and Galliford Try. You could do worse than looking to see what projects have been planned by those clients and those construction companies.

This is a niche market. It requires a higher service level, more work and consistent marketing. Tenants are harder to acquire. On the other hand, it offers increased rental income, lower levels of wear and tear and better tenants.

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