



Taxcafe Tax Guides

Tax-Free Property Investments

How to Earn 140% More Income and Retire Rich
with a Property Pension

By Nick Braun PhD

Important Legal Notices:

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Tax Guide - "Tax-Free Property Investments"

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Introduction

If you want to invest in property and do not want to pay any tax on your income and capital gains, you have come to the right place! This guide explains how to invest in property without paying a single penny of income tax or capital gains tax.

It also contains a wealth of information about property funds, many of which have risen in value by over 70% since the property market recovery started in 2009.

Property funds include real estate investment trusts (REITs), property vulture funds (which snap up bargain properties), property unit trusts and other exciting property investments.

Some of these funds invest in prime UK property, some invest all over Europe and some invest in high-growth emerging markets including Eastern Europe, Africa and Asia.

One of the big benefits of property funds, apart from the potential to earn tax-free returns, is the small initial investment required. A few hundred pounds is all that's needed to invest in most of them, so you don't have to put down a hefty deposit or take out a buy-to-let mortgage.

In recent years there have been some extremely important developments both in the property world and the tax-free investment world:

- In 2006 ISA investors were allowed to invest tax-free in bricks and mortar property unit trusts for the first time.
- Also in 2006, the 'A-Day' pension changes came into operation, making self-invested personal pensions (SIPPs) much more attractive and flexible for the average investor.
- In 2007 the UK's first tax-free real estate investment trusts (REITs) were launched.
- But in the same year the UK commercial property market started to collapse. Some parts of the market fell by more

than 50% and shares in many real estate investment trusts and other property funds fell in value by over 80%.

- Residential property prices also started falling in 2007. Between August 2007 and June 2009 the Halifax House Price Index registered a 21% fall.
- Throughout 2008 almost every property unit trust started levying hefty exit penalties or placing a freeze on investor withdrawals to avoid being forced to sell properties on the cheap to raise cash. Despite these desperate actions their unit prices plummeted. Investors in Aviva Investors Property Trust, the biggest and best-known fund, saw 45% of the value of their investment wiped out.
- While most of the big property fund managers failed miserably to protect investors from the collapse in the property market, more entrepreneurial property experts started setting up 'vulture funds' to purchase bargain properties. Some of these funds are open to the public and can be invested in tax free via an ISA or SIPP.
- In 2009 the property market started to recover. Since then the average UK house has risen in value from around £159,000 to £166,000 – an increase of just over 4%.
- Real estate investment trusts, which invest in commercial property, have rebounded dramatically, rising by over 70% since reaching their March 2009 lows.
- Many property unit trusts have also rebounded and risen in value by 20% or more since the middle of 2009.
- There has also been some good news for those using ISAs to invest in property. The annual ISA investment limit has been increased from £7,200 to £10,200 (£5,100 for cash ISAs). The increase applies from 6th April 2010. In the March 2010 Budget it was also announced that the annual ISA limit will be increased with inflation every year.

This guide examines all of these developments and explains how you can use them to make profitable tax-free property investments.

We kick off in Part 1 with property ISAs, one of the simplest and most tax-efficient ways to invest in property. First of all I'll explain what types of property you can shelter inside an ISA. We'll then move on to a fascinating example that shows how an ISA investor can earn 80% more money than someone who wastes this valuable tax break.

Part 2 is all about property funds. These powerful investments not only help you save tax, they also reduce many of the risks and problems faced by buy-to-let investors.

We start off with a detailed look at all the pros and cons of property funds before taking a closer look at the three types of fund available to both ISA and SIPP investors. These include real estate investment trusts, property unit trusts and property investment companies.

Part 3 looks at the fascinating world of property SIPPs. We kick off with a detailed example showing exactly how powerful the pension tax breaks are and how you could end up with twice as much money as someone who invests outside a pension.

We then move on to a brief overview of the most interesting of the 'A-Day' pension rules, which came into operation on April 6th 2006. After this comes a detailed look at what types of property qualify for inclusion in a self-invested pension.

You may recall Gordon Brown's famous U-turn in December 2005, banning residential property from pensions. As it turns out, the legislation is not so bad after all and there are lots of property investments that still qualify.

Part 4 contains examples comparing bricks and mortar property investments with property ISAs and SIPPs. We also conduct a detailed comparison of ISAs and SIPPs to see which of these tax shelters is likely to leave you with most money at the end of the day.

Finally, Part 5 contains a few extra titbits, including a detailed look at the benefits and drawbacks of paying off a mortgage versus investing in property ISAs, and how you can save an extra £3,636 in tax every year by using your ISA allowance in conjunction with your annual capital gains tax exemption.

Part 1

Property ISAs

A Simple and Tax-efficient Way to Invest

Chapter 1

Introduction to Property ISAs

The Individual Savings Account, or ISA, is one of very few tax shelters available to private investors in the UK. Others include pension funds, venture capital trusts and enterprise investment schemes.

ISAs don't enjoy as many tax breaks as other tax shelters – in particular, they don't give you an income tax refund when you put your money in.

What makes ISAs more attractive than other tax shelters is their *flexibility*:

- **No minimum investment period.** Your investment returns are completely tax free whether you invest for one day or one decade.
- **Easy access to your money.** You can leave your capital invested and withdraw income tax free at any time, or sell your investments and take a tax-free lump sum. Your ISAs are therefore both a tax-free savings vehicle and a tax-free income generator.

A few years ago there were fears ISAs would be scrapped altogether but in December 2006 the Government announced that these wonderful tax shelters will be around indefinitely.

Furthermore, from 6th April 2010 the annual investment limit has been raised from £7,200 to £10,200.

In the March 2010 Budget it was announced that the ISA allowance will be increased annually to compensate for inflation. Even without annual increases the investment limit is generous enough to help you build up a substantial tax-free nest egg. For example, over five years a couple can shelter over £100,000 from the taxman plus all their investment income and profits.

Stock Market Turmoil

ISAs generally fell out of favour following the stock market collapse of 2000 to 2003. Sheltering profits from the taxman became the least of investors' worries... just making a profit in the first place seemed to take a miracle!

From April 2003 the stock market started rising strongly and ISAs came back into vogue.

And then it all started to unravel again. Between July 2007 and February 2009 the FTSE-100 fell from around 6,700 to 3,800 – a collapse of 43%.

It's hardly surprising that so many people became completely disillusioned with stock market investing. If you invested in early 1996, you would not have made a single penny of profit by 2009 – some 13 years later!

The two massive stock market meltdowns which have taken place in the first decade of this century have completely debunked the conventional wisdom that shares always perform well in the long run.

Investing in Property

But ISAs aren't just for share investors. They can also be used to invest in certain types of property.

Property ISAs have been available for quite a few years now but did not receive much attention from the mainstream financial media in the early days. As a result, most investors were unaware of their existence.

In 2006 ISA investors were given the green light to invest in property unit trusts for the first time and a wall of money poured into the most popular funds.

January 2007 saw the much anticipated introduction in the UK of real estate investment trusts (REITs). These property investments can also be sheltered inside an ISA.

Of course, REITS and other property funds have not been immune

from the wealth destruction which accompanied the credit crunch and the recession that resulted. Far from it.

Apart from banks, probably the worst performing stock market companies were those in the real estate sector, in particular real estate investment trusts.

The share prices of many REITs – which are some of the UK's biggest landlords – performed even worse than many of the internet companies whose share prices were decimated when the infamous Dot Com Bubble burst.

Nevertheless investing in property is still extremely popular and many shrewd investors are starting to see opportunities despite the general gloom and doom. That is why we have published this guide.

In this part I'm going to explain exactly how you go about investing in a property ISA, weigh up all their benefits and drawbacks and then take a detailed look at some of the investments available. I'm also going to explore other important issues that will be of interest to anyone investing in ISAs, not just property investors.

Every year some of the leading investment magazines publish ISA supplements. Most contain a list of expert share and unit trust tips and background information on how ISAs work. The better guides also contain detailed performance tables to help you choose the best investment funds for your ISA wrapper.

However, over the years I have found that none of the articles published in newspapers, magazines or specialist ISA supplements answer the *really* important questions. For example, instead of an ISA are you better off using your savings to invest somewhere else or to pay off your mortgage? Should you use an ISA to save for future expenses such as a child's education, or is it better to leave your savings intact to provide tax-free retirement income?

These are some of the questions to which I *personally* wanted concrete answers and hence I decided to do the research myself.

What you will not find here, however, are any specific investment recommendations.

The Property Market in 2010

Market timing is a fool's game and nobody can predict whether property prices will keep rising or fall in the months ahead.

Sentiment has certainly improved significantly since the last edition of this guide was published and a lot of cash has been flowing into UK property, especially London property.

A lot of this money came initially from overseas investors looking to snap up cheap sterling assets. Now UK institutions have joined the party and many are looking to increase their bricks and mortar exposure.

Whereas 12 months ago you could perhaps pick up a property for 50% less than its peak value, now the same property would possibly cost 20% less than at the peak.

Although the 'easy money' was made in 2009, because there is still so much cash available for investment there is no shortage of property experts predicting double-digit returns (10% or more) in 2010.

It is the prime end of the commercial property market that has fared best and rental yields have come down sharply in the last year as prices have risen. Prices for secondary property have been much slower off the mark and many experts believe we will have to wait until 2011 for a recovery in this part of the market.

(A prime property is generally a modern or recently refurbished property in the best geographical location and with good tenants. Secondary property is property that lacks one or two of these features.)

Although investor demand for the best properties is strong, the occupier market is still weak. Or, as the cynics would argue, lots of people want to buy property but nobody wants to use them!

Actually this sort of trend is not uncommon. In the property downturn of the early 1990s rental values continued to fall for almost two years after capital values began to recover. The \$64,000 question is whether rental values will fall for a shorter or longer period this time.

Falling rental income caused by weak occupier demand seem to be the biggest fear of property fund managers. In most towns and cities hundreds of shops are empty and there is a glut of office space. Tenants are using their bargaining power to force landlords to cut rents. In other cases they are simply going bust.

As a result, many property funds now have vacancy rates (voids) of over 10%.

Looking at the performance of property funds themselves, many still have quite high income yields but these have fallen significantly since the last edition of this guide was published, as property prices have risen.

In 2009 many of the REITs and stock exchange quoted property funds were sitting on income yields of 10% or more because their share prices had taken such a beating. (Remember the income yield is calculated by dividing a fund's income distribution by its share price, so the lower the share price the higher the income yield).

A fund that was yielding 10% in 2009 may now only be yielding 6% or 7%. So clearly the bargains that existed in 2009 are no longer available. Real estate investment trusts whose share prices were trading at a large discount to the underlying property assets, are now trading at a significant premium to net asset value.

Of course income yields, whether high or low, can be misleading because they are not always sustainable. You have to look for funds with a long average lease length and high dividend cover (the rental income should comfortably cover the income paid to investors).

For example, a fund with just 110% dividend cover could be forced to cut its income distribution if some of its tenants go bankrupt or if expiring leases cannot be renewed.

Chapter 2

Brand New Property Tax Shelters

Property ISAs are available from some of the UK's most reputable investment companies, such as Aviva, Axa, and Standard Life.

They're ideal for anyone wanting to invest in commercial property without the hassle of personally managing a portfolio of properties. They're also suitable for anyone who wants to maximize investment income.

The benefits are potentially huge. You get to invest in what is unquestionably the country's most popular type of asset – property – using what is arguably the cheapest and most flexible type of tax shelter.

So What Exactly is a Property ISA?

Let me start by explaining what I do NOT mean when I use the phrase 'property ISA'.

First of all, I do not mean buying actual bricks and mortar and sheltering them inside an ISA. Revenue & Customs regulations prevent you from investing in 'real' or 'actual' property.

As you'll see later on, however, property ISAs have a number of advantages over traditional bricks-and-mortar investments and are therefore a useful addition to most well-balanced investment portfolios.

Secondly, when I use the phrase property ISA I am not talking about *residential* property. At present most property ISAs are *commercial* property investments. This is both a benefit and a drawback. The commercial and residential property markets are quite separate – one can be rising when the other is falling.

Thirdly, property ISAs are not investments in general property companies such as stock-market-listed estate agents, construction companies, home builders and other organisations providing

property services. Examples include the likes of Savills and Persimmon.

It's possible to put all of those property companies in an ISA and protect yourself from income tax and capital gains tax.

However, it's not these investments I'm referring to when I talk about property ISAs.

Property Funds

When I use the term property ISA I am referring specifically to **property funds**. A property fund is simply a pot of money used to buy a spread of buildings which are rented out.

Property funds are referred to as *indirect* property investments – the investor does not own the property itself. Instead he or she owns units or shares in a fund that owns property.

Property funds are the closest you will get to putting bricks and mortar in an ISA. The fund takes your money and sticks it directly into shopping centres, retail parks, offices and warehouses.

If everything goes to plan you will enjoy capital growth and a steady flow of rental income.

There are three types of property fund you can stick in an ISA:

- Property unit trusts
- Real estate investment trusts (REITs)
- Property investment companies

We'll take a closer look at each type of fund in Part 2. For now we'll just cover the basics.

Property Unit Trusts

Property unit trusts have been around for many years and some, such as Aviva Property Trust, have over £1 billion of property under management.

Property unit trusts take money from investors and use it to buy a

spread of offices, high street shops, shopping centres, warehouses and factories.

For a small initial investment of usually no more than £1,000 the investor ends up owning a little piece of dozens of properties.

In return the fund management company charges a small annual fee.

You'll find property unit trust prices quoted in the *Financial Times* or on certain investment websites such as Trustnet.com.

Real Estate Investment Trusts (REITs)

REITs do pretty much the same job as property unit trusts: they own a big portfolio of properties, collect the rent and pay it out to shareholders.

There are, however, two important differences between REITs and property unit trusts:

- REITs are listed on the stock market (this has both benefits and drawbacks).
- REITs are allowed to borrow money, unit trusts cannot.

There are currently 21 REITs in the UK, the biggest being British Land and Land Securities. You'll find them quoted in the *Financial Times* on the 'London Share Service' pages under 'Real Estate'.

Another excellent source of REIT information is www.reita.org.

In Part 2, I'll take a more detailed look at the pros and cons of REITs and property unit trusts.

Property Investment Companies

Before 2006 the only way to invest in property through an ISA was to invest in a 'property investment company'. Like REITs, property investment companies are stock market listed and normally borrow to invest.

They're usually based offshore in the Channel Islands which brings certain benefits.

Although they don't market themselves aggressively or attract much press coverage they're managed by very reputable financial institutions such as Standard Life and Axa.

You'll find 'Investment Companies' at the end of the 'London Share Service' pages in the *Financial Times*.

An Example Fund

Let's take a very quick look at just one of the funds on offer so you have some idea what a property ISA actually looks like.

Take, for example, the Property Income Trust, a property investment company managed by life insurance giant Standard Life.

This fund has a portfolio of approximately 30 properties worth £168 million dotted around the UK, with 39% in offices and office parks, 14% in retail, 6% in leisure properties and 23% in distribution warehouses, industrial parks and standard industrial properties. 18% of the portfolio is currently held in cash.

The fund is structured as a closed-ended Guernsey registered investment company. You'll find the share price online if you go to Yahoo Finance (uk.finance.yahoo.com) and type 'SLI' in the share price lookup box.

The shares fell from 140p back in 2006 to 27p at the depths of the financial crisis and were trading at 60p at the time of writing.

The fund manager, a chap called Jason Baggaley, spends his days looking for new properties to invest in and selling properties that he thinks will fall in value or produce unattractive rental income.

A recent acquisition was the purchase of a £10 million office building in Docklands with a rental yield of 8.6%.

When the fund manager is not buying new properties he will be managing the existing portfolio: finding new tenants and negotiating new leases with existing ones.

For these services Standard Life receives an annual fee – 0.75% of assets under management.

Rents are collected and then paid out to investors as dividends. At present this fund pays an income of 4p per share. When you consider that shares in the fund cost 60 pence each, the 'rental yield' is 6.7%.

If you invest in the fund through an ISA that 6.7% income will, of course, be completely tax free. Because many property investors pay 40% income tax on their rental profits, that 6.7% is equivalent to earning 11% from a 'bricks and mortar' or direct property investment!

In other words, if you invest in commercial property outside an ISA you will have to earn an 11% rental yield to beat a fund like this held inside an ISA.

It's also critical to point out that 11% is *net of all costs*: interest on borrowings, management fees and so on.

A net rental yield of this magnitude is almost unheard of in the world of buy-to-let flats.

However, the income is by no means guaranteed and could fall if voids in the underlying properties increase significantly.

Every few months the portfolio is revalued and when these figures are published this will usually cause the shares to move up or down.

Like all quoted property funds the performance in recent years has been dismal. However, the shares have risen by 120% from the rock-bottom lows reached in March 2009.

At the time of writing the shares were trading at a premium of around 6% to their net asset value. We'll discuss the importance of discounts and premiums later on.

The Standard Life fund's main focus is to hold a diversified UK commercial property portfolio but it can also undertake property development up to 10% of its assets.

Many REITs are also involved in some property development but

property unit trusts are usually not.

The Standard Life fund is allowed to borrow money to buy extra property and boost its rental income and capital growth. Most property investment companies and REITs do this which boosts their performance when property prices are going up but punishes returns when prices are falling.

Property unit trusts do not have any borrowings and as a result their prices fell less heavily during the recent property market collapse. Conversely, as the recovery got underway, they have not delivered as high returns as funds which have borrowings.

At present the Standard Life fund has a modest loan to value ratio of 39% which means that for every £1 of property, 39p is debt and 61p is owned outright (like the equity in a buy-to-let property).

If you want to buy shares in a fund like this all you have to do is phone up a stockbroker and you'll own them in minutes. However, to get the tax relief you have to buy them through an ISA, typically a self-select ISA. A self-select ISA is essentially a 'do-it-yourself' ISA, available from most major stockbrokers and other investment companies. They allow you to invest your money pretty much as you please (see Chapter 22 for more information on self-select ISAs).

Summary

- Property ISAs are not investments in 'direct property' or bricks and mortar.
- Property ISAs are investments in property unit trusts, REITs and property investment companies.
- These funds invest directly in commercial property. The properties earn rental income that is paid out to investors.
- A typical property ISA will invest in a spread of commercial properties dotted all over the UK (some funds are also starting to look further afield).

- A typical spread consists of shops, offices and industrial property. Some funds focus more on a specific sector, such as London offices or industrial properties.
- Some of these funds deliver a high income – up to 6.7% per year or more. Because ISA income is tax free this is equivalent to earning 11% outside an ISA, net of all property costs. Very few bricks and mortar properties have *net* rental yields of 11%.
- All capital gains are completely tax free.

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