

AF4 2020/2021

Asset Classes

Property, Commodities and Alternative Assets

The milestones for this part are to understand:

- The main risks and rewards of investing in property as an asset class.
- The main risks and rewards of investing in buy to let property.
- The qualifications and benefits of Furnished Holiday Lettings
- The qualifications and benefits of rent a room relief
- The £1,000 property exemption.
- The risks and rewards of investing directly into commodities.
- The risks and rewards of using alternative investments.

Property as an asset class

Individual investors are unlikely to invest directly into property but shares in a property business could be considered as having the characteristics of a property asset.

The basic business model is:

- Borrow money from the banks or other financial institutions.
- Use the money to build a shopping mall, office block or business park
- Rent the property out.
- If they can attract good quality tenants there would be a steady flow of income.
- Moreover, the leases would usually include a clause stating that rents had to be reviewed every five years and they could only increase.
- This in turn would lead to an increase in the value of the property

This model has come under stress following the covid epidemic. Retailers have had to close their shops so they lost their income but must still pay the rent. As a result they are threatening to withhold rents unless the owner renegotiates a reduction.

Some leading retailers have gone into liquidation meaning that those sites are empty and the owners are likely to find it difficult to attract new tenants.

This can lead to a downward spiral where rental income is falling making it more difficult to pay the interest on their borrowings. In turn the value of their property will fall and it may be impossible to sell the property as a new owner would have the same difficulty in finding tenants willing to pay the rent.

Commercial property is positively correlated to the economy in general and in particular the health of retailers. Office property might also come under stress as tenants start to question whether they need expensive city centre property when a lot of work can be done remotely.

Buy to let property

The main method used by individuals to invest directly into property is by purchasing and letting out residential property.

As with shares property investment offers a potentially rising income through increased rents together with capital appreciation in the property itself. Covid has hit this model as renters who lost their jobs can't pay the rent.

A unique advantage to direct property investment was that the interest paid on any loan to buy the property could be offset against the rental income. From 20/21 this is no longer allowed but 100% of the mortgage interest can be offset as a tax reducer at 20%.

Gwen has a salary of £35,000 and has invested in two properties bringing in gross rents of £72,000. She pays £30,000 in mortgage interest and £12,000 on other allowable expenses.

Salary		£35,000
Rental income	£72,000	
Less expenses	<u>(£12,000)</u>	
	£60,000	<u>£60,000</u>
Total Income		£95,000
Less PA		<u>£12,500</u>
		£82,500
	£37,500 @ 20%	£7,500
	£45,000 @ 40%	<u>£18,000</u>
		£25,500
Less £30,000 @ 20%		<u>£6,000</u>
Tax liability		£19,500

Mortgage interest can still be offset if the property is owned by a company rather than an individual. The advantages and disadvantages are:

Advantages

- Mortgage interest can be offset against rental income.
- Corporation tax at 19% would be taxed on profits and capital gains.
- Capital gain can be reduced through indexation but restricted to gains made up to 31 December 2017.
- Any dividends paid would benefit from the Dividend Allowance.

Disadvantages

- Switching from private holding would be a disposal for CGT.
- Dividends come from taxed profits.

- Greater costs for accountancy fees.
- May be more difficult for a company to raise a mortgage

Mortgage interest can still be offset if the investor owns commercial property.

There are other significant disadvantages to direct property investment.

- There are high start-up costs when property is purchased such as legal fees and stamp duty. The latter is paid at 3% in excess of the standard rate for owner occupied property.
- There are continuing costs of managing the property and whilst these can be done by managing agents they will charge a fee.
- Property is illiquid.
- There could be void periods when there is no tenant.
- Disposing of the property incurs costs.
- CGT will be charged at the higher rates of 18% and 28%.

One formula that you may be asked to calculate is the **Gross Rental Yield**. This is:

Gross rent less expenses/Property purchase cost plus costs of acquisition.

Note that mortgage interest is not deducted from the gross rent.

Bill purchased a property for £600,000 and the acquisition costs were £60,000
 The gross rent was £60,000 and ongoing expenses were £10,000
 The gross rental yield is $\frac{£60,000 \text{ less } £10,000}{£600,000 \text{ plus } £60,000} = 9.26\%$

Exposure to property can also be achieved by investing in the shares of property companies. This eliminates the liquidity problem and CGT will be charged at standard rates. A disadvantage is that the company pays tax on its rental income. This becomes part of the companies' overall profits and paid as dividend. This will be looked at further in the section on investment products.

Furnished Holiday Lettings (FHL)

A furnished holiday lettings property is let for a series of short-term periods. Whilst it doesn't need to be in a holiday resort the lettings mimic the typical holiday pattern in that there is a high turnover of tenants. The principle benefit is that the profit is treated as trading income rather than property income.

To qualify the property:

- Must be in the European Economic Area
- Must be furnished and let on a commercial basis
- It must be available for 210 days a year

- It should be let for 105 days a year (if more than one property this can be averaged)
- It should not normally be let for more than 31 days at a time. Letting for longer than 31 days does not disqualify its holiday lettings status but any such let will not count towards the 105 day requirement

The tax benefits are:

- It is treated as a trade for the purposes of loss relief. Any losses can be offset against future profits from the same holiday lettings business or the investor's other income.
- Mortgage interest can be offset against rental income.
- Capital Allowances can be used.
- It is considered as relevant earnings for pension contributions.
- If a property is sold and reinvested in another one, holdover relief on CGT applies.
- Entrepreneur relief is available

It is also possible that it may qualify for Business Property Relief. To get this the owner must be offering some additional services such as providing meals or arranging local excursions. There are no hard or fast rules so each case will be considered individually by HMRC.

Rent a room scheme

Rent a room can only be used by a resident landlord. It can also be used by a bed and breakfast or guest house owner. It cannot be used for homes converted into separate flats.

This relief lets individuals let out a room or rooms in their house. The scheme allows a tax free income of £7,500 per house per year. If the ownership is in joint names the allowance is split equally between the couple. The income can also include any amounts received for meals and services such as cleaning and laundry.

The tax exemption is automatic if the total income is less than £7,500. If the income is more the owner must complete a tax return and then opt into the scheme and claim the allowance. Any income over £7,500 will be taxed as the owner's non-savings income.

If the scheme is used the landlord cannot offset any expenses against the rental income.

Theresa takes in paying guests into her home and in 2020/21 she earns £12,500. She calculates her expenses are £4,000. Opting into rent a room means that £5,000 of her income will be taxable (£12,500 less £7,500). If she keeps to the "normal" basis £8,500 of her income will be taxable (£12,500 less £4,000)

To qualify the property:

- Must be part of the resident landlord's main home.
- must be in the UK

- must be let as a residence. A part that is let out as an office would not qualify. However, the scheme can be used if the lodger works at home in the evening or at the weekend or is a student who is provided with study facilities.
- The area let out cannot be a self-contained. It could not be claimed if there was a flat with its own separate entrance within the house.
- must be furnished.

Rent a room relief is designed to give tax relief by taking in a lodger. Prior to 20/21 there was a loophole that enabled the property to be let whilst the owners were absent.

This was typically used by residents who lived in a house near a sports venue. For example owners of property near Wimbledon would let it out during the championships and go away on holiday. The rent paid for the holiday and using rent a room relief the income was tax free.

From 20/21 the owner must live in the property whilst it is let to benefit from rent a room relief.

The £1,000 property exemption

- If property **income** is less than £1,000 this is exempt from tax and does not need to be declared.
- This could include letting out a driveway for parking.
- If the income is higher than £1,000 an individual can offset £1,000 but cannot claim any other expenses.
- The election to take the £1,000 exemption can be taken on a year by year basis
- It cannot be combined with Rent a Room relief.

Commodities

Commodities fluctuate in price according to supply and demand. Rather like shares they are correlated to the world economy, if this is buoyant prices will rise and vice versa. Exposure to commodities can be achieved by investing in mining and extraction companies. Part of their profits will come from the rise in the price of the commodity so if the oil price increases then shares in BP will tend to rise. In addition they will make money from other sources such as refining and offering other specialist services. Alternatively there are specialist commodity funds.

The most common form of direct investment is to buy gold. This is a fairly liquid market and relatively small amounts can be invested.

The characteristics of gold as an investment are:

- It produces no income
- Return is purely on capital growth.
- Investors will incur costs of storage and insurance.

- There can be wide spreads between buying and selling prices particularly for smaller purchases

Gold is seen as a refuge in uncertain times and the price has rose to almost \$2,000 per Troy ounce in July 2020 the wake of the Covid crisis. Just as with other commodities, investors can get exposure to gold and other precious metals by buying shares in mining companies. Two of the biggest risers in the first six months of the crisis were Fresnillo (a Mexican silver and mining company) and Polymetal (a Russian mining company)

The former share price fell to 527p on March 16 and rose to 1,189p on July 23. On the same dates Polymetal fell to 103.95p and rose to 181.15p

Alternative Investments

These include any tangible object such as art and antiques which have the potential to grow in value. Promoters of these often quote spectacular gains that have been made but there are a number of disadvantages.

- They produce no income, the only return is the potential capital gain.
- Being a physical object they have to be stored, maintained and insured, all of which incurs costs for the investor
- Spreads between buying and selling are high.
- If bought and sold at auction there are high costs on both transactions
- The value of any object is subject to fashion and changing tastes.
- They are unregulated so the investor has no protection under the FSCS nor can claim compensation from the FOS for bad advice.

That concludes this part so you should now understand:

- The main risks and rewards of investing in buy to let property.
- The qualifications and benefits of Furnished Holiday Lettings
- The qualifications and benefits of rent a room relief
- The £1,000 property exemption.
- The risks and rewards of investing directly into commodities.
- The risks and rewards of using alternative investments.