

LAWPACK



Getting the most out of
your buy-to-let investment

The Seven Pillars of **Buy-to-Let** Wisdom



Ajay Ahuja

This is an excerpt from Lawpack's book *The Seven Pillars of Buy-to-Let Wisdom*.

To find out more about how to build a profitable property investment portfolio, [click here](#).

The Seven Pillars of Buy-to-Let Wisdom
by Ajay Ahuja

Published by
Lawpack Publishing Limited
76–89 Alscot Road
London SE1 3AW
www.lawpack.co.uk

1st edition 2004
Reprinted 2005
Reprinted 2006
Reprinted 2007

© 2007 Lawpack Publishing

ISBN: 978-1-904053-42-2

All rights reserved.

Crown copyright material is reproduced with the permission of the Controller of HMSO and the Queen's Printer for Scotland.

Exclusion of Liability and Disclaimer

While every effort has been made to ensure that this Lawpack publication provides accurate and expert guidance, it is impossible to predict all the circumstances in which it may be used. Accordingly, neither the publisher, author, retailer, nor any other suppliers shall be liable to any person or entity with respect to any loss or damage caused or alleged to be caused by the information contained in or omitted from this Lawpack publication.

For convenience (and for no other reason) 'him', 'he' and 'his' have been used throughout and should be read to include 'her', 'she' and 'her'.

Contents

<i>About the author</i>	vii
<i>Introduction</i>	ix
1 Yield	1
What you get out	1
What you put in	6
My policy	14
2 Management	17
You	18
The bank	20
The tenant	21
The letting agent	23
Choosing the right agent	23
Managing your chosen agent	25
Your employees	26
The contractors	28
Builders	28
Plumbers	29
Electricians	30
Your solicitor	31
The mortgage broker	32
The local authority	33
What is Housing Benefit?	34
How is a claim made?	34
What tenancy information is needed?	34
How much Housing Benefit will be paid?	35
Pre-tenancy determination	36

How is Housing Benefit paid?	36
How long is Housing Benefit paid for?	37
What does the council need from the landlord?	37
Council Tax	38
The freeholder and managing agent	38
Definitions	39
Your accountant	41
The law	42
Regulatory	42
All-encompassing	44
3 Gearing	47
The correlation between yield, ROCE and the interest rate	48
ROCE based on yield and the interest rate (85 per cent gearing)	48
ROCE based on yield and the interest rate (50 per cent gearing)	49
Achieving 100 per cent LTV financing	51
Achieving the 15 per cent deposit	52
Vendor incentives	52
100 per cent plus mortgages	54
Loans	54
Get a partner	58
The cost of holding money	61
The opportunity cost of money	62
4 Awareness	65
Pactual: The current market value of the property	65
Preal: The real price of a property based on fundamental principles	66
The price willing to be paid by an investor	66
The price willing to be paid by a first-time buyer	67
Pbubble: The surplus or deficit of the actual price over the real price	68
Why the bubble element exists	68
Assumptions	69
Awareness table	71
Are we heading for a crash?	74

The lender	74
The investor	75
The first-time buyer	75
Outside the property market	75
5 Appreciation	77
Identifying properties without foresight	77
Why do negative bubbles exist?	79
Using lenders to your advantage	79
Identifying properties with foresight	81
Identifying properties with potential	82
Refurbish it	83
Extend the property	85
Convert the loft	86
6 Risk	89
Understanding risk	89
Eliminating risk	90
Systematic risk	90
Leverage risk	93
Managing risk	94
Leverage risk	94
Specific risk	96
Overall risk	97
7 Exit	99
The property quadrant	99
Selling the portfolio in one hit	102
Capital Gains Tax	103
How to reduce your capital gain	103
And finally...	109
<i>Appendix</i>	111
<i>Index</i>	115

CHAPTER 7

Exit

It's all about going out on a high! They always say to leave on a high note and this also includes property investment – except you leave on a high price!

To know when to sell you have to understand, what I call, the property quadrant.

The property quadrant

Look at this quadrant:

4 + YIELD & – GROWTH (WARMSPOT)	+ YIELD & + GROWTH (HOTSPOT) 1
3 – YIELD & – GROWTH (COLDSPOT)	– YIELD & + GROWTH (COOLING SPOT) 2

Negative and positive yield growths can be defined as:

Term	Definition
+/-yield	A positive yield means that, as a result of your investment, cash is put into your pocket. ALL expenses are taken into account, which includes interest payments, void periods, repairs, management fees and tax.

Term	Definition
	A negative yield means that, as a result of your investment, cash is taken out of your pocket. This is due to increased interest payments (caused by an increase in interest rates or overborrowing), higher voids (caused by over-supply of the rental market) and large repair bills.
+/-growth	<p>A positive growth means that the property's value is on an upward trend.</p> <p>A negative growth means that the property's value is on a downward trend.</p>

The definitions of a hotspot, cooling spot, coldspot and warmspot and the type of buyers for properties located in these areas are:

1. + YIELD & + GROWTH (HOTSPOT)
<p>Description</p> <p>Since we are in a rising property price market overall, you should only ever invest in this place. This investment puts money in your pocket and it also enables you to grow quickly because you can access the capital growth by remortgaging. As prices rise (due to the professional investors competing for the same properties) the yields fall until they go negative. Then the hotspot goes to a cooling spot – see below.</p>
<p>Typical Region: The North</p>
<p>Buyers: Professional investors, owner-occupiers</p>

2. – YIELD & + GROWTH (COOLING SPOT)
<p>Description</p> <p>This is where even though the investment takes cash out of your pocket, investors are banking on capital gain to give them a return. This situation can only last until their money runs out. At some point they have to sell, which causes the market to become a buyer's market rather than a seller's market and prices fall, creating negative growth. It then becomes a coldspot – see below.</p>
<p>Typical Region: London</p>
<p>Buyers: Bandwagon investors, amateur investors, owner-occupiers</p>

3. – YIELD & – GROWTH (COLDSPOT)

Description

No-one wants these properties as investments! These investments are bad for your wealth. The only buyers are owner-occupiers who want to live in the property rather than rent it out. When owner-occupiers are unable to buy due to unaffordability a rapid decline occurs. Certain areas will become warmspots – see below.

Typical Region: Posh areas (e.g. Kensington, Cambridge and Oxford)

Buyers: No investors as it is negative yield AND negative growth.
Owner-occupiers only.

4. + YIELD & – GROWTH (WARMSPOT)

Description

While rapidly declining, certain areas will still put cash in your pocket, even though they continue to decline. Considering the market is only heading downwards, only professional investors will take the chance as the investment is cash positive. Owner-occupiers will wait for the market to bottom out. Property prices will recover due to rental price increases, falling interest rates and properties becoming affordable. Hence a warmspot becomes a hotspot – see above.

Typical Region: None currently

Buyers: Professional investors in a falling market. The professionals see that these investments are better than leaving their cash in the bank. No owner-occupiers.

There's no point in selling your property when it's in a hotspot (unless you want to sell your portfolio in one hit – see below). This is because there's still room for the price to grow and it's currently profitable so it's not costing you to own it. It only becomes worth selling when the property becomes unprofitable, but the price is still growing. The highest point in the market can only ever exist within a cooling spot. This is because the property price has risen to the point that it's unprofitable, but it's still on an upward trend. The professional investor drops out of buying in this market and only owner-occupiers and novice investors remain.

You will be able to sell within this market as there are owner-occupiers who are not concerned about the profitability of a property as they wish

to live in it rather than rent it out. There are also speculative investors out there who are banking on the continuing increase of property prices and the novice investor not doing his sums right. The reasons why these buyers are able to buy your property at an inflated price above the real price are outlined in the table on pages 68–9.

It's these type of buyers who cause the bubble in the property market – so use them to your advantage!

Selling the portfolio in one hit

If you want to sell your portfolio as one job lot, you have no choice but to sell to the dreaded 'professional investor'! He will look beyond whether the tenant pays the rent on time, a tenancy exists or the décor is up to date. Instead, he wants to know the core fundamentals.

A professional investor will only ever invest in warm- or hotspots. Since various hotspots exist, he will only invest in a warmspot for non-financial reasons. This may be due to the fact that he lives near the warmspot, has knowledge of the area or has a preference not to invest in a hotspot due to the type of tenant.

You should preferably position your property portfolio for sale when it is in a hotspot. At least the property portfolio value is growing and the professional investor may over-speculate and give you that little bit more, banking on further rises, which are probably likely. You should avoid selling in a warmspot as the value of the property portfolio is falling and the professional investor will use this to his advantage and over-discount his offer to you.

One thing to learn in all this is never, never, never sell in a coldspot. This is where the general property market loses but the professional investor survives as he never realises his losses. Selling in a falling market can cost you dearly.

The professional investor will want to know the following:

- The individual price wanted for each property
- The individual yield information on each property

- The overall yield on the whole portfolio
- The Profit & Loss Account for the portfolio
- The types of tenancies existing on all the properties
- Anything unique to any of the properties, such as flying freeholds (properties that sit above land that isn't owned, e.g. a flat on a bridge), etc.

Capital Gains Tax

This tax only arises when you sell the property. The capital gain is worked out as:

Sale price minus purchase price = capital gain

The sale price is deemed to be the price achieved after deducting estate agent's costs, solicitor's fees and any other expenses that were incurred wholly, necessarily and exclusively in the sale of the property.

The purchase price is the cost of the property plus all survey and legal costs.

How to reduce your capital gain

The calculation

The way to reduce your capital gain is to understand the capital gain calculation. If you dispose of a property, the following calculation will be made to work out your capital gain:

	Sale price	£125,000
minus	Allowable costs	£100,000
	Purchase price	£80,000
	Incidental costs of purchase	£2,000
	Home improvements	£15,000

	Costs of establishing or defending title	£1,000
	Selling costs	£2,000
=	Chargeable gain	£25,000

The sale price and the purchase price are fixed. You cannot change what you sold the property for or what you paid for it.

Allowable costs

To reduce your capital gain, you have to maximise the other allowable costs. Let's look at these and what you can include. This part is paraphrased from the Inland Revenue themselves:

Allowable Costs	What You Can Include
Incidental costs of purchase	<ul style="list-style-type: none"> • Fees, commission or remuneration paid for professional advice. • The costs of transferring the property. • Stamp duty. • The costs of advertising to find a seller. • The costs of any valuations needed to work out your chargeable gain (but not the costs of resolving any disagreement with the Inland Revenue about your valuations).
Home improvements	<p>These are costs which:</p> <ul style="list-style-type: none"> • you incurred for the purpose of enhancing the value of the property; and • are still reflected in the state or nature of the property at the date of its disposal. <p>You may not claim for the cost of normal maintenance and repairs.</p>
Costs of establishing or defending the title	<ul style="list-style-type: none"> • Fees, commission or remuneration paid for professional advice.

Allowable Costs	What You Can Include
Selling costs	<ul style="list-style-type: none"> • Fees, commission or remuneration paid for professional advice. • The costs of transferring the property. • The costs of advertising to find a buyer. • The costs of any valuations needed to work out your chargeable gain (but not the costs of resolving any disagreement with the Inland Revenue about your valuations).

Source: Inland Revenue

So in a nutshell you can include:

- Solicitor's costs
- Accountant's fees
- Mortgage broker's fees
- Redemption penalties on cleared mortgages
- Stamp duty
- Advertising
- Estate agent's fees
- Valuations needed to calculate your gain
- Any improvements that still remain in the property
- Legal costs in defending your title to the property

So the first part of reducing your capital gain is to include **all** costs involved with the purchase, ownership period and sale of the property that fall within the definitions stated by the Inland Revenue. Yet it doesn't stop here! You can obtain further relief on the gain:

Taper relief

You can reduce your calculated gain by up to 40 per cent. Take a look at this table:

Number of Whole Years the Property Has Been Owned	Gain Remaining Chargeable (%)
Less than 1	100
1	100
2	100
3	95
4	90
5	85
6	80
7	75
8	70
9	65
10 or more	60

The longer you have owned the property, the less gain you have to pay. In reference to the above table, after three complete years of ownership you start to attract taper relief. After ten years or more, you attract the maximum amount of relief where only 60 per cent of the gain is chargeable or, in other words, a 40 per cent discount on the gain is chargeable.

Please note that it has to be complete years. Another way to reduce your capital gain is to stall your purchase, if possible, to capture another year. Look at this example:

Harry has found a buyer for his investment property that he has owned for five years, 11 months. The capital gain on the sale is £100,000. If he sells straight away, 85 per cent of the gain is chargeable as he is deemed to have owned the asset for five complete years, equating to £85,000. However, if he stalls the sale one month later then he is deemed to have owned the asset for six complete years so only 80 per cent of the gain

is chargeable, equating to £80,000. This method only works for the sale of assets that have been owned for two to nine years. Otherwise, it makes no difference.

Personal allowance

You can reduce your gain even further. Everybody gets a Capital Gains Tax allowance of £9,200 (2007–8) per tax year rising year on year with inflation. So if you have a gain of £10,000, it is reduced by £9,200 to £800.

If you are selling a couple of properties, the best plan is to sell one before 5 April and one after so, for example, you can use the capital gains allowance for the tax year 2006–7 as well as the one for 2007–8. This then makes full use of your yearly allowances.

There is one final trick – your principal place of residence:

Principal Place of Residence (PPR)

You do not have to pay any Capital Gains Tax on your personal residence. If you move out of home and let it out, and then sell your original residence within three years of leaving, there is no tax to pay! If you sell after the three years, say five years later, you still get relief for three years out of the total five, even if you have purchased another property. Let's look at this example:

Jamie lives in a house that has been his personal residence for eight years when he bought it, but he decides to move out and rent it out. If he sells the property two years after he rented it out, there is no tax to pay. If he sells it five years later then only:

$$\frac{(5 \text{ minus } 3)}{13} \text{ of the gain is chargeable.}$$

The equation being:

$$\frac{(\text{Amount of years rented minus three years})}{\text{Period of ownership}}$$

SIPP and FURBS

You may have heard these terms flying about in connection with properties and pensions. Let me explain their relevance to this subject.

SIPP

This stands for Self-Invested Personal Pension. The reason why it is mentioned is that you can buy commercial property within this pension and enjoy all the tax breaks a normal pension has. The reason why a SIPP is not applicable in this situation is because we are investing in residential property. Residential property is not allowed under the SIPP scheme.

Commercial property is not as attractive as residential property, the reasons being that:

- the yields are lower;
- borrowing is restricted to 70 per cent LTV;
- the business risk is doubled as you are reliant on your tenant's business to trade well out of your property, plus there are the normal risks associated with owning the commercial property itself.

This is my own personal opinion. You may think that commercial property is for you. If you do get into this game, I would seriously consider investing in commercial property under the umbrella of a SIPP as the shelter to tax is quite significant.

FURBS

This stands for a Funded Unapproved Retirement Benefit Scheme. Its main beneficiaries are the higher-rate taxpayers only, so if you're not a higher-rate taxpayer and don't expect to be one, ignore this bit.

If you buy a residential property under this umbrella, then:

- profits from the scheme are taxed at 22 per cent rather than 40 per cent if you are a higher-rate taxpayer;
- Capital Gains Tax is 34 per cent in comparison to 40 per cent. A FURBS also attracts the normal taper relief explained above;

- you can pass a FURBS down to your family. There is no Inheritance Tax to pay when it is passed on after death, as opposed to the normal Inheritance Tax limits (currently £300,000 – 2007–8). Also, a traditional pension fund cannot be passed down;
- there is no limit on the contributions to a FURBS, but you don't get any tax relief on your contributions;
- the whole of the fund can be withdrawn tax free compared to a traditional pension fund, which is restricted to 25 per cent;
- you can retire after the age of 75. Traditional pension funds are restricted to an age limit of 75.

The two key things you need to consider when deciding on whether to invest in property using a FURBS are as follows:

1. You can only access the money at retirement, so you can only use the money to make further investments but no money can be taken out to be spent personally. If you want to retire prior to normal retirement age, then it's not possible under this scheme. FURBS restricts your freedom.
2. There are administrative costs involved. You have to use an accountant and the accounting for such a scheme has to be spot on.

Personally, I like the freedom that I have. Maybe when I'm over 45 and FURBS are still about, then I'll consider one. I think that if your target earning is more than £50,000pa profit from property, you presently don't require more than £50,000pa to live on and you're aged over 45, then a FURBS may be for you. Do seek professional advice.

And finally...

Once you've sold up you can buy that yacht that you've always wanted and retire to the South of France, but I suspect you'll be back in a year looking to buy and build up a portfolio again...