



profile

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SELF INVESTED PERSONAL PENSIONS (SIPPs)

CONTENTS

	<u>Page</u>
Introduction	2
Pre/post A-Day rules	2
Brief history	4
The mechanics of a SIPP	5
Who can invest in a SIPP?	5
Charges	5
Transfers	6
Contracting-out	6
Ways of taking retirement income	7
Tax advantages of SIPPs	8
Property investment	9
- Overseas Property	
- Joint Ownership	
Pension investments after April 2006	11
Government U-turn on investments	12
Restrictions on whom the member can transact with	14
Borrowing	14
Loans	16
Summary	16
Appendix 1 - SIPP permissible investments (up to April 2006)	17
Appendix 2 - Pre A-Day property investment rules	18
Appendix 3 - Definition of 'Connected Persons'	19
Appendix 4 - Pre A-Day prohibited investments	20

Any questions?

If you have any questions or comments in relation to this article please email pensions.technical@landg.com



Introduction

It is important to remember that Self Invested Personal Pension Plans are, in essence, just Personal Pension Plans. The fundamental difference is that through a SIPP, individuals can literally become their own fund managers and have the facility to invest outside insured contracts within a pension wrapper. In the new simplified world of pensions from A-Day (6 April 2006), investment choice and flexibility are likely to be even more appealing. One thing is certain, SIPPs are being thrown into the spotlight and the growth of the popularity of these contracts over the coming years is widely anticipated. This Profile is a ‘back to basics’ guide to SIPPs, providing a short historical background, and detailing the current rules and changes from A-Day.

	PRE A-DAY SIPP RULES	POST A-DAY SIPP RULES														
MAXIMUM ANNUAL CONTRIBUTIONS	<p>The higher of £3,600 gross a year or the following age based limits: (NB £3,600 is the maximum for concurrent members)</p> <table border="0"> <tr> <td>Age at start of tax year</td> <td>% of capped NRE*</td> </tr> <tr> <td>35 or less</td> <td>17.5</td> </tr> <tr> <td>36 - 45</td> <td>20</td> </tr> <tr> <td>46 - 50</td> <td>25</td> </tr> <tr> <td>51 - 55</td> <td>30</td> </tr> <tr> <td>56 - 60</td> <td>35</td> </tr> <tr> <td>61 - 74</td> <td>40</td> </tr> </table> <p>*Earnings cap is £105,600 for 2005/2006</p>	Age at start of tax year	% of capped NRE*	35 or less	17.5	36 - 45	20	46 - 50	25	51 - 55	30	56 - 60	35	61 - 74	40	<p>Tax relief will be available for members' contributions based on the higher of £3,600 a year or 100% of relevant UK earnings.</p> <p>Annual Allowance for 2006/2007 is £215,000 (does not apply in final year provided that all benefits are taken).</p> <p>No limit to employer's contribution.</p> <p>Contributions made in excess of the Annual Allowance will be liable to a tax charge of 40% on the member.</p>
Age at start of tax year	% of capped NRE*															
35 or less	17.5															
36 - 45	20															
46 - 50	25															
51 - 55	30															
56 - 60	35															
61 - 74	40															
CONTINUING CONTRIBUTIONS AFTER EARNINGS CEASE	<p>Contributions over £3,600 a year can continue for 5 years after earnings cease.</p>	<p>Tax relief will be restricted to maximum of £3,600 a year. Can still contribute more but tax relief is not available on any contributions over £3,600 a year.</p>														
BASIS YEAR RULES/ EVIDENCE OF EARNINGS	<p>When contributions are greater than £3,600 a year, a basis year must be nominated to set the earnings used to calculate the member's maximum contribution. The basis year may be any of the 5 previous tax years.</p>	<p>Basis year rules no longer applicable. No requirement for evidence of earnings.</p>														
RETIREMENT AGES	<p>50-75 It may be possible to take benefits below the age of 50 if specialist occupation or on ill-health grounds.</p>	<p>50* - 75 *Increases to 55 for those who do not reach age 50 before 2010. Exceptions for those with SIPPs effected prior to 6 April 2006 in special occupations provided that the member is tested against a reduced lifetime allowance (2.5% a year from age 55 (50 prior to 2010)) and that the full pension must be vested.</p>														

TAX-FREE LUMP SUM	25% of SIPP fund. No maximum monetary amount. Where the fund includes a transfer from an occupational pension scheme, the tax-free cash arising from the transferred fund may be restricted to less than 25%.	25% of fund subject to Lifetime Allowance (£1.5m for 2006/2007).
PENSION	No maximum pension restriction.	Benefits tested against Lifetime Allowance with any excess having Lifetime Allowance Charge applied. This excess could be taken as a lump sum.
MAKING CONTRIBUTIONS FOR PREVIOUS TAX YEARS	Carry back was available for contributions paid in 2005/2006 to be treated for tax purposes as paid in 2004/2005. Final opportunity to effect this carry back exercise was 31 January 2006.	Not available.
PROPERTY PURCHASE AND BORROWING RULES	Can invest in commercial property (not connected to member) and borrow 75% of cost.	Can invest in commercial property. Can borrow up to 50% of a member's net pension assets. Connected party transactions will be permitted.
INVESTMENTS	Investments restricted.	Investments unrestricted – but holding prohibited investments will incur punitive tax charges.
LOANS TO MEMBERS	Not permitted.	Not permitted, any loan to a member will always be treated as an unauthorised payment.
PROTECTED RIGHTS	Not permitted.	Permitted, but investment choice will be restricted.

Brief history

From 1 July 1988, the first personal pension plans were wholly insured and planholders were restricted to choosing from the list of funds offered by an individual product provider. As part of the Government's aims to widen the flexibility and appeal of personal pensions provision, the SIPP was given the 'green light' in Nigel Lawson's budget speech of 15 March 1989:

'I propose to make it easier for people in personal pension schemes to manage their own investments'.

Joint Office Memorandum (JOM) no. 99 was issued shortly after the Chancellor's budget. It contained a list of acceptable investments in which personal pensions could invest and clarified a number of restrictions. JOM 101 followed in October 1989. This set out the Inland Revenue's definitive list of SIPP permitted investments and restrictions, to which was added commercial property.

JOM 101 remained the official ruling on permitted investments until 24 January 2001 when the Inland Revenue issued the Personal Pension Schemes (Restriction on Discretion to Approve) (Permitted Investments) Regulations 2001. The main aim of these regulations is to list both the permitted and prohibited investments for SIPPs and set out a formal legal framework for fund management activities such as lending and transactions with scheme members. These regulations came into force on 6 April 2001.

Most of the permitted investments fall into the traditional asset management classes that are generally used by investment managers, with the exception of commercial property that adds a specialist area of investment. The list of permissible investment options encompasses thousands of different equities/unit trusts etc and advisers have abundant opportunities to construct a portfolio under one roof that meets their clients' specific needs, and which can subsequently be altered to take into account their clients' changing circumstances.

The permitted SIPP investments specified in the Regulations, which are relevant up to 6 April 2006 are listed in Appendix 1.

SIPPs were not covered by the majority of the Pensions Act 1995 provisions and as a result have been far less complex to administer than occupational pension schemes (e.g. SSAS). SIPPs have become increasingly popular since the government introduced 'income drawdown' in the Finance Act 1995. This means that income can be paid directly from the SIPP on retirement, rather than having to buy an annuity. According to the December 2005 edition of Money Management, it is estimated that over 100,000 individuals have a SIPP accounting for collective assets in excess of £20 billion. The SIPP sector has grown at about 20% a year in the recent past, a rate which looks set to increase substantially when the new pension regime comes into effect.

The Finance Act 2004 will be introducing fundamental changes to all pension schemes from A-Day under the Government's tax simplification programme. After A-Day, SIPPs will simply become a registered pension scheme and even though the SIPP acronym may eventually disappear, the concept will still remain.

Late U-turn on the provisions of the Finance Act 2004 relating to self-directed investments – the Chancellor's pre budget report in December 2005

In the pre budget report, the Government stated that it will be removing the tax advantages of investing in residential property and most forms of tangible moveable property, that had been permitted by the provisions of the Finance Act 2004. This is effectively tantamount to a ban on such investments. This is to prevent people benefiting from tax relief in relation to contributions for the purpose of funding

purchases of holiday or second homes and other prohibited assets for their or their family's personal use. The adverse tax implications of this U-turn will be examined later on.

The mechanics of a SIPP

Quite simply, a SIPP works in much the same manner as a personal pension plan. Contributions are paid in the form of regular contributions and/or single contributions or other pension benefits can be transferred in. The SIPP will enjoy the same tax reliefs and tax advantages as any other registered personal pension plan. The key difference is that contributions are invested in accordance with the individual's specific instructions into the allowable investments. Prior to the investment instruction being received and executed, contributions will be held in a trustee bank account where they will usually earn a competitive rate of daily interest.

A provider may stipulate that a minimum amount must be retained in its insured pension funds which cannot be used for self-investment purposes.

Who can invest in a SIPP?

Under the pre A-Day rules, in order to be eligible for a SIPP, the individual must have UK net relevant earnings, or a transfer value from a tax approved pension plan. Also eligibility extends to those under 75 and either resident and ordinarily resident in the UK at some time in the tax year when they apply, or a Crown Servant or a spouse of a Crown Servant. Members of occupational pension schemes who are eligible for concurrency may contribute up to £3,600 a year (gross) into a SIPP.

After A-Day, many individuals who were not eligible to contribute towards a SIPP will be able to do so. All members of occupational pension schemes will be able to simultaneously contribute to a SIPP.

Charges

The SIPP provider will levy charges to cover the costs of setting up and running the SIPP and these are often fixed monetary amounts not related to the size of the fund, so there is economy of scale. Some providers will make an all-inclusive charge while others charge on an itemised basis, so clients may pay for services they do not use, or get a better deal on an inclusive rate if they actively change investments, for example. Some investment companies or insurance companies offer reduced charges provided a minimum amount is invested in their insured pension funds. These insured pension funds may have charges such as a bid-offer spread, an annual management charge and/or a plan charge.

Additional fees will be incurred from the stockbroker used for investment transactions; from the custodian bank and from the use of an investment manager. Charges/fees may or may not be subject to VAT at the prevailing rate. For purchasing property, there are a number of acquisition costs for an individual to consider. Many of them could be quite substantial and therefore, it is important for the individual to work out a budget at the outset. There will be solicitor and surveyor fees plus legal disbursements. Certain pension providers will insist on their panel solicitors and surveyors being used and others will allow members to use the solicitor/surveyor of their choice. Legal disbursements will include Land Registry fees, search fees and importantly will include stamp duty. Other costs will include finance fees such as bank arrangement fees and valuation fees. The planholder may have a choice of going to a lender of his preference depending on the practice of the SIPP provider. There will also be ongoing property management charges for services such as checking and reviewing insurance requirements, inspecting property, reviewing rents etc. Because the pension scheme and not the individual will own the property, all property related bills would have to be paid from the pension fund e.g. buildings insurance.

Transfers

SIPPs can accept transfers from most other types of pension schemes (although transfers arising from protected rights benefits are only allowed post A-Day if the SIPP is contracted out (see below)) and this can be a good way to consolidate savings in order to purchase, for example, commercial property. Furthermore, after A-Day, some individuals may wish to consolidate accrued pension entitlements in order to facilitate the checking of benefits against the new Lifetime Allowance.

'In specie' transfers

As an alternative to the traditional cash transfer basis, an in-specie transfer of assets can be made directly from one pension arrangement to a SIPP (as long as the SIPP provider agrees to accept the asset). With the legal ownership of assets themselves being transferred, the need to sell investments and purchase new ones will be removed and this therefore reduces transaction costs. 'In specie' transfers can be appealing when:

- There is a particular requirement to retain ownership of a specific asset e.g. an existing equity portfolio.
- It is not in the member's best interests to realise an investment at the time of transfer (e.g. equity based investments during a period of market depression).
- It is problematic to realise a specific asset to finance a cash transfer payment in the desired timescale (e.g. property investment).

All transactions involving the acquisition of land or property must be reported to HMRC.

The principle of 'in specie' transfers will not be affected by the new simplification pensions legislation.

Contracting-out

Under the pre A-Day rules, the Department for Work and Pensions had disallowed self-investment for 'protected rights' funds originating from contracting out of the State Second Pension. Although it was initially proposed that SIPPs would be prohibited from holding protected rights, in the DWP's response to its consultation - Pensions: Contracted-out Benefits and Miscellaneous Amendments - it stated: 'Sipps are no longer necessarily high charge and high risk investment vehicles and there should be no restrictions on Sipps holding protected rights'.

Although protected rights can in future be held within a SIPP, the investment options in respect of such benefits will be restricted. The Government will amend the pre A-Day rules so that from A-Day 'an arrangement such as a SIPP plan can be held within the 'wrapper' of an 'appropriate scheme' without invalidating that scheme's contracting-out certificate'. However, the protected rights benefits within the appropriate scheme must be kept separate and comply with the specific rules relating to protected rights (i.e. there will effectively be no self-investment).

The DWP has stated that the issue of SIPPs holding protected rights will be reviewed again in due course, in the light of possible changes to the regulatory provisions for various types of pension products which may take effect from 2007.

Ways of taking retirement income – alternatives to annuity purchase

Pre A-Day

Taking income withdrawal is a means for those individuals who are reaching retirement to delay annuity purchase until the maximum age of 75. SIPP's are a useful vehicle to manage individuals' investments while they move into retirement and need access to their income and tax-free cash. An individual can take a tax-free lump sum of up to 25% (it may be less if transferred from a company scheme). The balance must be taken as regular income by means of withdrawals from the fund within upper and lower limits (known as the 'GAD' limits from the Government Actuary's Department). The maximum withdrawal limit is 100% of the benefit that could be purchased on GAD rates. The minimum amount that must be taken out each year is 35% of the maximum amount. These limits are recalculated every three years until age 75, based on an individual's age, fund size and current interest rates. If individuals have a commercial property within their SIPP, they will need to make sure that they have sufficient additional assets to pay the income, or they will be forced into selling the property.

Post A-Day

The above option will still apply although there will be no need to take a minimum income and the maximum income will be 120% (rather than 100% as at present) of the GAD annuity reviewed at least every five years.

In addition, under the new Alternatively Secured Pension (ASP) rules, there will no longer be the requirement to purchase an annuity at age 75. ASP means annuity purchase can be deferred so individuals are not compelled to liquidate any property investment by age 75 in order to buy an annuity, unless of course they want to. There will be no requirement to draw a minimum income, and maximum income is 70% of the GAD annuity for a 75 year old, reviewed annually. Like unsecured income, the member would have to ensure that they have sufficient alternative liquid assets in the pension scheme to pay the required income.

On death, while any remaining unsecured pension fund can be paid to dependants (less a 35% tax charge), remaining ASP funds must first be passed to a spouse or dependant in the form of an income. This inherited fund is subsequently used to: buy a lifetime annuity; scheme pension; provide unsecured income (if under age 75) or provide ASP (if over 75). In the absence of a spouse or dependant on death while drawing an ASP, any residual fund can be transferred to other scheme members or to a charity. If those other scheme members happen to be the deceased member's children or grandchildren, the fund remaining on death (transfer lump sum death benefit) could be passed down the generations. The concept of a 'family SIPP' has been born, although 21 July 2005 saw the publication of the long-awaited 'Discussion paper on Inheritance Tax (IHT) and Pension Simplification' where HMRC has admitted that IHT will be charged when the transfer lump sum death benefit is passed on. The industry is currently waiting for the definitive outcome of consultation on this issue (the consultation period ended 30 September 2005). HMRC will bring forward legislation in the Finance Bill 2006 to clarify how IHT will apply to choices under the new pensions tax regime. Further details are shortly anticipated.

Tax advantages of SIPPs

SIPPs like all other types of registered pension schemes enjoy tax advantages of various kinds:

- Contributions to SIPPs by individuals are made net of basic rate income tax and higher rate relief is available under self-assessment.
- Under pre A-Day rules, tax relief is available on age-related percentages of an individual's net relevant earnings (which is subject to the earnings cap) or £3,600 a year if greater. A basis year can be nominated to justify a higher contribution, earnings from the current year or any of the previous five can be used. However, this requirement will be relaxed from 6 April 2006 where tax relief will be available on the greater of: 100% of an individual's UK relevant earnings or £3,600. Any contribution in excess of the Annual Allowance (£215,000 for 2006/2007) will be subject to a tax charge of 40%. Note that this Annual Allowance restriction does not apply in the tax year that benefits are wholly crystallised from the arrangement.
- The fund itself is tax-privileged (apart from tax on dividends from UK equities which is irrecoverable).
- Rental income from a property is received tax-free.
- Up to 25% of the fund may be taken tax free from the age of 50 (55 from 2010). Thereafter, any pension paid will be subject to income tax at the individual's marginal rates.
- No NICs are payable on contributions made to SIPPs or on pension income.
- Company contributions made into SIPPs reduce the company's profits assessable to corporation tax relief. From A-Day there will no limit to the levels of employer contributions that may be paid for each individual per annum (although if total contributions exceed the Annual Allowance (starting at £215,000 in 2006/2007) the excess will be subject to a tax charge of 40% on the employee). It is important to note that although in theory, contributions are unlimited, employers claiming tax relief on contributions could face problems when the new tax rules come into force in April 2006. From that date, tax inspectors will have the final say on whether a business can deduct pension contributions in calculating taxable profits. All employer contributions to pension schemes will be subject to the 'wholly and exclusively' test defined in Section 74 of the Income and Corporation Taxes Act 1988.
- Gains made on investments held by SIPPs are exempt from capital gains tax. However, with the Lifetime Allowance of (initially) £1.5m from April 2006, care should be taken that capital gains and income accrual do not take the fund over this limit as the planholder may face a tax charge of up to 55% of the excess.
- In the event of death before the individual's selected retirement date, lump sum death benefits normally escape IHT if paid by discretion exercised by trustees.

Property Investment

The pre A-Day rules for property investment within a SIPP are outlined in Appendix 2.

Key points (applicable pre A-Day)

- Only designated commercial property is normally acceptable. The general rule is that the property must be designated 'commercial' with the local rating authority.
- The property cannot be purchased from a connected party or if it was owned by a connected party in the preceding 3 years, this means that the member cannot buy it from his/her company or business.
- Borrowing must not exceed 75% of the purchase price/costs of development.
- The SIPP cannot purchase fixtures or fittings or business goodwill, only the fabric and structure of the property may be purchased.
- The property is part of a pension fund and therefore as with all other pension schemes, the age 75 compulsory annuity rule also applies, the property must be liquidated at retirement or upon death (this may be possible by selling to the SIPP's held by other individuals).

Key points (applicable both before and after A-Day)

- The scheme trustee buys and owns the property bought by a SIPP, and not the SIPP planholder. The trustee is legally responsible for maintenance of the property. Any development/refurbishment/renovation requires the scheme trustees' agreement and must only be undertaken under their strict control. The trustee can insist that a property is returned to its original condition if work is undertaken without prior consent.
- Any lending requirements are made to the trustees and therefore no personal guarantee may be offered.
- The mortgage and any legal costs must be met from the pension fund.
- In theory, a SIPP can purchase part of a property but as this could lead to problems when, for example a death claim or a divorce arises. Therefore, many SIPP providers will be unwilling to permit this.
- Joint property purchase is possible with SIPP's held by other individuals.
- Property is relatively illiquid, so care should be taken if individuals need to draw income from the fund.
- Sufficient liquid funds will need to be available in order to maintain rental payments.

Key points (applicable after A-Day)

- Pension funds can borrow up to 50 per cent of their net asset value to purchase property.
- Residential property, although classed as a prohibited investment, will be allowable as an investment but will incur tax penalties (see page 13). Therefore only designated commercial property is a viable option.
- Connected party transactions will be permitted, but there will be a potential tax charge if the transaction is not on an arm's length basis.

Property Investment – things to consider

It is important to remember that commercial property is an investment like any other and it can rise or fall in value – ultimately affecting the benefit payable at retirement. If a property is bought when the market is high, then if there is a future slump in property prices, an individual's pension fund could potentially be in negative equity.

In addition, if there is an instance when a commercial property is empty for a long period of time, then there may be problems with meeting the repayments on any borrowing the SIPP has secured to finance the property purchase. The SIPP may potentially have to enforce the sale of the property in order to clear the debt and such a situation would therefore create conflict between the provider and the investor. As commercial leases are generally secured over a long period (5 to 25 years), these problems are not commonplace.

Finally, it takes time to sell a property and so contingency plans such as diversifying assets into a number of different asset classes should be considered to cover the event of death, divorce or retirement of the member.

In spite of the above drawbacks, there are a number of attractions of putting a commercial property into a pension scheme:

- All legal costs and expenses are payable from the SIPP
- The rent paid by the tenant is tax deductible as a business expense (if it is a business that pays the rent)
- No CGT is payable on gains on the disposal of the property held in the SIPP
- There is no limit on the number of properties which can be purchased (provided borrowing limits are not exceeded)
- The rent received by the pension scheme helps to increase the retirement benefits.

Overseas Property

Under pre and post A-Day rules, it is and will be permissible to invest in overseas commercial property. However, some providers may not offer this facility due to complexity of administration such as overseas legal processes, overseeing letting agents and difficulty in finding specialist lenders who are able and willing to provide funds for purchase in various countries. Furthermore, many European countries such as France and Spain do not recognise UK trust laws. This situation will still remain after A-Day and will obviously generate problems for those individuals who want to use their pension fund to purchase a commercial property overseas. Finally, when buying overseas, individuals will need to consider local income tax on rental income and capital gains tax which cannot be reclaimed by the UK pension arrangement as well as the application of any double taxation treaty.

Joint Ownership

Depending on what the pensions provider allows, planholders can join together in order to purchase an investment. In theory, there is no limit on the number of planholders who may do this. The SIPP provider may ask the planholder to sign a co-ownership agreement so that if a co-owner wishes to dispose of his share, or in the event of a co-owner's death, the remaining partners have a right of first refusal at fair value. There is no requirement for joint owners to have equal shares; they can have unequal shares and

borrowings so long as each co-owner individually respects the allowable borrowing limit (see page 15). By sharing ownership, the initial cost of entry to direct property investments is reduced and after A-Day this will enable smaller SIPP funds to club together to acquire property investments which would otherwise be unavailable to them on account of the new borrowing restrictions.

Creating liquid funds to buy out a member

A valuation will need to be performed if one of the co-owners wishes to disinvest from the property or dies. Various steps can be taken to make the necessary funds available:

- Use existing assets within the SIPP.
- Borrow more money (subject to HMRC borrowing limits) – if the property has increased in value or some of the original loan has been paid off.
- Make further contributions or transfers – this could be added to the remaining members' arrangements and then invested in the property.
- A new member with a SIPP in the same scheme investing in the property.
- A combination of any of the above.

Property funds

An alternative way of receiving some property exposure without the risks of direct ownership is to invest in a property fund. In the past, these investments have typically been restricted to commercial properties. However, post A-Day, although residential property investment has had its tax relief stripped away after the Government's pre budget report and is now a deeply unattractive investment (see pages 12/13 for further details), the Government will be allowing self-directed pension schemes 'to invest in genuinely diverse commercial vehicles that hold residential property or other prohibited assets' (e.g. the proposed Real Estate Investment Trust). Draft legislation has recently been published by the Government for consultation to enable the creation of UK-REITS. However, the Government will also include rules to prevent the use of such vehicles to facilitate investment in prohibited assets with continued scope for the personal use of those assets. HMRC has indicated it will not hesitate to act if it transpires that people are trying to use collectives or other forms of pooled investment to circumvent the rules on investment in prohibited assets.

Pension investments

A number of investments are prohibited up to A-Day and for reference purposes; a list of such investments is shown in Appendix 4.

After A-Day, SIPP planholders will have the ability to invest in up to 100% of the scheme assets in shares of the 'sponsoring employers' which will provide planning opportunities for small businesses. These rules are in stark contrast to SSASs/other employer sponsored pension schemes where there will be a limit on holdings of shares in the sponsoring employer of up to 5% of a scheme's assets or up to 20% of the scheme assets where they relate to more than one sponsoring employer. According to HMRC, it will be down to the SIPP provider to limit (or not) the amount that can be invested in employer's shares. Any shares must be bought at an open market value to make sure tax charges do not apply.

There will be two different ways of putting assets into a SIPP. Firstly, there will be the advance funding method, and secondly (and less commonly) there is the 'in specie' method.

1) The advance funding method

This is where sufficient funds must be built up within the pension scheme before an asset is purchased. A combination of contributions, tax relief, transfers from other pension schemes and pension scheme borrowing is utilised to build the fund up. By using the new tax rules, and paying contributions up to 100% of the individual's earnings over a three or four year period, a large pension fund can be amassed in a short space of time. The advantage of this is that if an individual sells an investment to the pension fund, cash is received in return which can be used to repay any existing borrowing and pay any capital gains tax bill that is outstanding.

2) Contributions made 'in specie'

Certain shares acquired under approved employee share schemes can be transferred by an individual to a SIPP and be treated as a member contribution. In fact this form of contribution via shares has been permitted pre A-Day. There are tax advantages in doing this. For example, if a client decided to pay in a gross contribution of £10,000 but actually paid in shares valued at £7,800 (subject of course to the scheme agreeing to purchase these shares), the pension scheme would be able to claim tax relief from HMRC and receive an extra £2,200. The scheme would therefore be worth £10,000, of which £7,800 would be the shares and £2,200 would represent the tax relief. It is important to note that the client must relinquish his ownership of the shares – instead this would be owned and retained by the scheme trustees. The contribution would be treated as a disposal by the member and may trigger capital gains tax, although in practice transfers from share incentive plans would be expected to be CGT free.

Following on from this, provided a monetary value can be ascribed to an asset, it will be possible to use that asset as an in specie contribution by the individual. So long as the scheme trustees are willing to accept the investment class, the individual making the payment can state how much the contribution is in cash terms and then can subsequently pay in an asset of equivalent value in lieu of this monetary contribution. For example, if an individual wishes to make a contribution of £100K, he cannot effect this by merely stating 'take this asset and whatever it is worth, is the £100K contribution'. What that individual must instead do is say that the contribution is £100K and this may be paid through a transfer of the asset.

Despite there being enthusiasm for this new flexibility of putting assets into a SIPP, scheme trustees will obviously need to consider whether they will permit this method and at what cost.

Government U-Turn on Investments – December 2005

For many individuals, one of the major attractions of the new pensions tax regime was the ability to invest in residential property and other esoteric investments. However, the Chancellor's pre budget report has effectively put a stop to this. Although these types of investments will still be allowed post A-Day, draconian tax penalties will make them completely unattractive.

The changes will apply to any direct investment in 'prohibited' assets, which are defined as:

- Residential property
- Most forms of tangible moveable property (which are very similar to personal chattels as defined in the Personal Pension Schemes (Restriction on Discretion to Approve)(Permitted Investments) Regulations 2001 - SI 2001/117.

Any indirect investment in 'prohibited assets that are a close proxy for direct investment and to other forms of indirect investment that could be used to get around the new rules for prohibited assets'. An

example is given of this, where residential property is owned by a company in which a SIPP held 100% of the shares.

Future legislation will define 'residential property' and how it will apply to property used for more than one purpose.

Tax treatment

The legislation will remove all the tax advantages from holding 'prohibited assets'.

- An unauthorised member payments charge will be levied in respect of any such investment
- A scheme sanction charge will apply
- An unauthorised payments surcharge could apply, and
- It could result in the potential de-registration of the scheme

The below example illustrates the severity of the tax charges:

If a SIPP was to use its fund to purchase residential property (as defined in future legislation) valued at £100,000 post A-Day, the following tax charges would apply:

- An unauthorised member payment charge of £40,000 (40% of £100,000)
- An unauthorised payment surcharge of £15,000 payable by the member (this 15% surcharge applies as the amount of the unauthorised payment is greater than 25% of the fund).
- A scheme sanction charge of £40,000 (40% of £100,000) – however this would be reduced to £15,000 (15%) as the member has also had to pay 40% on the unauthorised member payment.

Therefore the total tax charge is 70%.

Furthermore, the scheme could be deregistered in cases where the total amount of the unauthorised payments by the scheme in a 12 month period exceeds more than 25% of the market value of the scheme's assets, resulting in a further charge of 40% of the total value of the scheme assets.

Also, any income and gains derived from prohibited assets will not benefit from the normal tax exemptions and will be subject to a scheme sanction charge.

Last but by no means least, where benefits are eventually taken, the normal tax charges on benefits will apply e.g. pension benefits will be taxable as earned income and the crystallised benefits will still need to be tested against the member's Lifetime Allowance.

In view of the penal tax charges, in practice it is highly unlikely that SIPP providers will offer member-directed residential property investment post A-Day. It is also unlikely that scheme trustees will feel comfortable in sanctioning such investments.

Transitional protection

Although a measure of transitional protection has been granted to off plan purchases of property that have been bought prior to 6 December 2005 (the date of the pre budget report), this is unlikely to count for much as this protection will be lost if the property becomes residential property at a later date.

Restrictions on whom the member can transact with

Pre A-Day

Investment transactions are not permitted between the scheme and members or connected persons (see Appendix 3 for definition of connected persons). This includes both the acquisition of commercial property from the member and the disposal of assets to the member.

Although it is not possible to acquire commercial property from a member, once property had been acquired by a scheme, it may be leased to a member for the purposes of his or her trade or profession, or to a business or partnership connected with the member. The lease, including the rent payable, must be on commercial terms determined by an independent professional valuation.

Although it is not possible to transact directly with a member or connected person, it is possible for a SIPP to purchase an asset that was previously owned by a member or connected person, provided at least three years have elapsed since ownership ceased. Similarly, a member or connected person may purchase an asset previously owned by a SIPP provided the SIPP disposed of the asset to an unconnected person at least three years ago.

The ban on the purchase of assets from a member does not prevent the transfer of eligible shares into a SIPP from an approved employee share scheme. This is an acceptable form of contribution introduced in April 2001 (although the SIPP provider may not offer this).

Post A-Day

The above connected party rules will be removed and investment transactions will be permitted between the scheme and members or connected parties.

Borrowing

If there are insufficient funds to buy a property outright, a commercial mortgage may be taken out by the trustees of the SIPP. The purchase price of property can include associated legal and incidental costs; and development can include the erection of, or extensions to, buildings, or the refurbishment or renovation of, or any improvements to, buildings. Repayments are made from contributions to the pension plan and rental income. Care needs to be taken to ensure that repayments may be afforded in light of the scope for future contributions. The loan may only be secured by a first legal charge on the property. No other guarantee or security is allowed. In theory, the purpose of borrowing is not restricted to property purchase, but this is certainly the main purpose. When considering borrowing, the SIPP provider will always bear in mind the 'sole purpose' test, namely that the SIPP is set up to solely to provide pension benefits. The SIPP provider may accept loans from lenders introduced by the scheme member or adviser, provided that the lender's terms are acceptable. The typical high street banks are still the main beneficiaries of SIPP lending, as an existing banking relationship is usually in place and will tend to be the client's automatic choice. However, this choice can be fraught with difficulties, especially where the bank does not have knowledge of the pension trust. As a result there is an increasing move towards some other less mainstream specialist lenders.

Maximum borrowing rules pre A-Day

Until the introduction of the Permitted Investments regulations referred to earlier, there was no restriction on the amount of borrowing that could be undertaken by a SIPP. However it had to be on a commercial basis and in practice the maximum amount that could be borrowed tended to be about 70-75% of the value of the property to be purchased. The 2001 regulations stated that borrowing by SIPP trustees must

only be in relation to the purchase of a freehold or leaseholder interest in commercial property or towards the development of such property. The amount borrowed:

- Must not exceed 75% of the purchase price of the property concerned or 75% of the costs of development;
- Must be secured only on that property or any other asset of the scheme, and
- Where the property is subsequently sold, must be repaid on completion of the sale of the property.

An existing loan may be replaced by a new loan provided the amount of the new loan does not exceed the amount outstanding under the previous loan.

A short-term loan may be taken in addition to cover VAT if necessary.

No borrowing may take place after the pension date, that is after income withdrawal has commenced or an annuity has been purchased. Where a phased approach has been adopted, borrowing would still be possible for any non-vested arrangements. Once a planholder has gone into drawdown, he can buy a commercial property if under 65, but is not entitled to borrow to gear up the purchase.

Maximum borrowing rules post A-Day

A SIPP may be able to borrow for any purpose. Borrowing may be from any individual, company or financial institution whether or not they are connected with the scheme, but any borrowing from a connected party which is not made on commercial terms will be subject to a tax charge.

From A-Day, the borrowing limits will be amended and it will only be possible to borrow 50% of the scheme assets. Where a scheme borrows an amount in excess of the 50% limit, the scheme will be treated as making a scheme chargeable payment and will be subject to a scheme sanction charge of 40% of the excess amount of the borrowing above the 50% limit. It may, therefore be possible to borrow a larger amount of money prior to A-Day depending on the value of the assets held. However, the following important factors must be considered:

- Any borrowing must actually be drawn down prior to A-Day to qualify for the pre A-Day rules.
- Borrowing which is agreed, but not drawn down prior to A-Day, will be subject to the post A-Day rules with any excess borrowing above the 50% limit being subject to a 40% scheme sanction charge (as this will be deemed unauthorised borrowing).
- Any refinancing of SIPP borrowing post A-Day will be deemed as new borrowing and will bring the whole of the borrowing within the post A-Day rules. Likewise, any 'in specie' transfer of assets between SIPP schemes after A-Day, where borrowing is involved, will also trigger a test against the post A-Day 50% borrowing limit. This will mean that SIPP planholders will not be able to refinance any pre A-Day SIPP loan unless the new borrowing is within the post A-Day 50% limit. SIPPs could therefore be stuck with uncompetitive interest rates.

Example of borrowing calculations pre A-Day

Paul has a SIPP and has seen a commercial property that his SIPP can purchase and then lease back to Paul to run his business from. Paul has £50,000 in his SIPP; the property is valued at £200,000.

Under the pre A-Day rules it is possible for Paul to use his SIPP to borrow 75% of the value of the property - his SIPP can borrow £150,000. The SIPP will use the £50,000 held in the fund as the balance needed to meet the purchase price of £200,000.

If Paul were to leave the purchase until after A-Day the maximum amount his SIPP could borrow would be 50% of the asset value of his SIPP - £25,000. This sum together with the value held in the SIPP will limit the purchasing power to just £75,000.

The value of any borrowing should be based on the net asset value of the arrangement. It is also important to note that there is no separate limit to fund a liability for VAT, for example.

Example post A-Day:

William has a pension fund of £200,000 and wishes to purchase a commercial property for £150,000. He wishes to retain £125,000 invested in shares so uses £75,000 from his pension and borrows £75,000. The gross asset value of Williams's pension is £275,000. Should he wish to borrow more money to purchase another property, the borrowing requirements will be based on his net asset value as illustrated below:

Gross asset value:	£275,000
Net asset value:	£200,000
Borrowing limit 50%:	£100,000
Existing borrowing:	£ 75,000
Potential borrowing:	£ 25,000 (borrowing limit less existing borrowing)

Loans

The sole purpose of an approved personal pension scheme must be the provision of retirement benefits. Accordingly, HMRC insists that scheme funds must not be used to provide loans.

Importantly, even after A-Day, loans will continue to be expressly prohibited. The investment rules encompassing loans for SIPP's will be very different to those of occupational pension schemes (e.g. SSAS). According to legislation within the Finance Act 2004, if a pension scheme makes a loan to a connected party, it is an unauthorised payment unless the connected party is a sponsoring employer of the occupational pension scheme and the loan meets certain criteria. This means that SIPP's cannot lend money to any connected party, as obviously SIPP's do not have sponsoring employers.

Summary

Looking to the future beyond A-Day, there are four key reasons that will increase the popularity of SIPP's:

- The removal of the ban on transactions between connected parties.
- The new and for most individuals, significantly higher contribution limits.
- Full concurrency, which will allow individuals to be able to contribute simultaneously to more than one pension.
- The relaxation of the rule requiring an annuity to be purchased at age 75 with the potential (IHT permitting) to cascade assets down the generations.

APPENDIX 1

SIPP permissible investments (up to April 2006)

1. Stocks and shares listed or dealt in on any HMRC recognised stock exchange (including the AIM), including equities and warrants, fixed interest securities, debentures and other loan stock, permanent interest-bearing shares and convertible securities.
2. Futures and options, relating to currency, stocks and shares and options, traded on a recognised futures exchange.
3. Depositary interests.
4. Units in an authorised unit trust scheme.
5. Units in a unit trust scheme which -
 - (a) is an unauthorised unit trust whose gains are not chargeable gains by virtue of section 100(2) of the Taxation of Chargeable Gains Act 1992, and
 - (b) does not hold any freehold or leasehold interest in residential property (*for exceptions, see Appendix 2*).
6. Stocks and shares in investment trusts purchased and held through investment trust savings schemes or investment plans operated by persons resident in the UK and authorised for that purpose under the FSA, or by persons resident outside the UK but subject to regulation for that purpose in terms of the FSA.
7. Shares in a UK-based open-ended investment company (OEIC) or FSA-recognised EEA member state equivalent.
8. Undertaking for Collective Investment in Transferable Securities (UCITS), that is either a recognised scheme or a designated scheme within the meaning of section 86 or 87 of the Financial Services Act 1986.
9. Contracts or policies of insurance linked to insurance company managed funds, unit-linked funds or investment funds of an insurance company resident in the United Kingdom or authorised in accordance with Article 6 of Council Directive 79/267 (First Council Directive on Direct Life Assurance).
10. Traded endowment policies transacted with a person regulated by the Financial Services Authority.
11. Deposits in any currency held in deposit accounts with any UK-based deposit-taker.
12. Shares received by a SIPP as a contribution to the scheme via a savings-related share option scheme, an approved profit-sharing scheme, or a share incentive plan.
13. Individual Pension Accounts (IPAs).
14. Commercial property (*see Appendix 2 for details*).

APPENDIX 2

Pre A-Day property investment rules

A SIPP may invest in:

1. A freehold or leasehold interest in commercial property (including land) where the interest is acquired from any person other than a member of the scheme or a person connected with him, or the interest is acquired from a member of the scheme or a person connected with him.
2. A freehold or leasehold interest in any residential element of commercial property which is:
 - (a) property which is, or is to be, occupied by an employee, whether or not a member of the self-invested personal pension scheme or connected with a member of the scheme (see below for definition of connected persons), who is not connected with his employer and is required as a condition of his employment to occupy the property, and
 - (b) property which is, or is to be, occupied by a person who is neither a member of the self-invested personal pension scheme nor connected with a member of the scheme, in connection with the occupation by that person of business premises held as an investment by the scheme.
3. Ground rents, rent charges, ground annuals, feu duties or other annual payments reserved in respect of, or charged on or issuing out of, property, except where the property concerned is occupied by a member of the scheme or a person connected with him.

Examples of residential property which are allowable (provided it is an integral or associated part of a commercial property held by the SIPP):

1. A caretaker's flat – the caretaker must be required to occupy the flat as part of his contract of employment and must not be connected to the employer.
2. A residential part of the property occupied by an employee who is required as a condition of his/her employment to occupy the property. The employee can be a member of the SIPP or connected with the member, but must not be connected with the employer otherwise than by employment.
3. A flat owned on a long-term leasehold by a person who is neither a member of the SIPP nor connected with the member. The person does not necessarily have to occupy the business part of the premises. (The SIPP could invest in the ground rent.)

HMRC has also agreed that hotels, motels, nursing homes and public houses can be included but there must not be any benefit for the member or a connected person in the form of residing within the property. A resident manager is acceptable provided that he or she is not connected with the employer and the terms of employment require residence on the premises.

Investments in riding stables, golf courses, forestry, woodlands and agricultural land are usually acceptable. Care has to be taken that any residential element is agreed by HMRC (see section above on residential property). There must be no potential for members of the scheme or their relatives, including spouses and their relatives, to enjoy the benefits of the land. Forestry, woodlands and agricultural land may have attached amenity rights such as shooting or fishing. These amenities must not be made available to members of the scheme, scheme trustees or any of their relatives even if they pay a commercial rate for them.

APPENDIX 3

Definition of 'Connected Persons'

Properties/assets can not be bought from or sold to a connected party: A connected person is a:

- Spouse
- Brother or brother-in-law
- Sister or sister-in-law
- Parent or parent-in-law
- Grandparent or grandparent-in-law
- Son or son-in-law
- Daughter or daughter in-law
- Grandson or grandson-in-law
- Granddaughter or granddaughter-in-law

of the member.

Also:

- A trustee of a settlement is connected with a settler, or with a company connected with a settlement under ICTA 1988 s681.
- A partner is connected with his other partners and their spouses or relatives.
- Companies are connected if under common control.
- Two or more persons acting together to exercise control of a company are connected with each other (and with it). In this contract, 'control' means that together they have 51% or more of the share capital.
- In the case of a sub-sale, the previous vendor must not be a connected party.
- Even if the vendor is not a connected person, the scheme cannot acquire property which has belonged to a connected party within the last three years.
- Tenants may be connected persons, but they must be dealt with on commercial terms. This includes the level of rent, treatment of rent arrears, and the terms of the lease and their enforcement. The relationship with a member in their capacity as tenant should be kept separate from that with them in their capacity as member.

A widow/er can purchase a property from a deceased spouse's SIPP, as they cease to be connected after death. However, this does not apply to other members of the family.

This is a summary of the connected party rules, the definition is set out in Section 839a of the Income Corporation and Taxes Act 1988.

APPENDIX 4

Pre A-Day prohibited investments include:

- a)** Loans of any sort (these will still be prohibited post April 2006 – see page 16)
- b)** Residential property and land connected with such property except as stated in Appendix 2
- c)** Unquoted stocks and shares
- d)** Milk quotas
- e)** Fishing quotas
- f)** Personal chattels (e.g. classic cars, jewellery, paintings, fine wine)
- g)** Gold bullion and coins
- h)** Premium bonds

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