

Government u-turn spells end for residential property investment

For many individuals one of the key attractions of the new pension tax regime was seen to be the ability to invest in residential property. Despite some initial scepticism that the HMRC would permit such an investment, their continual reassurance that residential property would be an acceptable investment for a registered scheme encouraged advisers and clients to make arrangements for the inclusion of such property from A-Day. It is therefore somewhat surprising and disappointing that the HMRC has left it as late as this month's Pre-Budget Report to announce that, after all, it will remove the tax advantages of a registered scheme investing in residential property. This Talking Point considers the position on investment in residential property following the Pre-Budget Report.

Schemes and investments involved

The tax advantages of investing in prohibited assets (ie residential property and certain other assets including fine wines, classic cars, art and antiques) will be removed from self-directed registered schemes (ie schemes "where the member can direct which investments the scheme makes").

The definition of prohibited assets will include direct investment in such assets and also any indirect investments "that are a close proxy for direct investment and other forms of indirect investment that could be used to get around the new rules for prohibited assets".

An example of an indirect investment is given where residential property is owned by a company in which a SIPP held 100% of the shares. However, certain products offering indirect investment in prohibited assets will not be subject to the loss of tax advantages. The Government is minded to allow self-directed pension schemes "to invest in genuinely diverse commercial vehicles that hold residential property or other prohibited assets". The proposed Real Estate Investment Trust is given as an example of such an investment.

The Government also issued a warning that it will include rules to prevent the use of such vehicles to facilitate investment in prohibited assets with continued scope for the personal use of the assets. It has indicated it will not hesitate to act if it becomes clear that people are using collectives or other forms of pooled investment to get around the rules on investment in prohibited assets.

Tax Treatment

Where an investment is made in a prohibited asset this will be treated as an unauthorised member payment resulting in a 40% tax charge (based on the purchase cost) on the scheme member and in most cases further tax charges in respect of an unauthorised member payment surcharge (15%) and a scheme sanction charge (15%).

It could also result in the scheme being de-registered with a further 40% tax charge on the remaining scheme assets. An example will help to demonstrate this. If a SIPP were to use its whole accumulated fund to buy a residential property valued at £200,000 post A-Day, this would trigger the following tax charges:

- an unauthorised member payment charge of £80,000 (ie 40% x £200,000)
- an unauthorised payment surcharge of £30,000 payable by the member (ie this 15% surcharge applies as the unauthorised member payment is more than 25% of the value of the SIPP fund)



Tax treatment (cont.)

- a scheme sanction charge of £30,000 (15%) payable by the SIPP

The scheme could also be de-registered (ie where the total amount of unauthorised payments by the scheme in a 12 month period exceed 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 fund immediately before it ceased to be registered.

In addition, irrespective of whether the scheme is de-registered, the income and gains arising from prohibited assets will not benefit from the normal tax exemptions, and will be subject to a scheme sanction charge. Where these assets produce no, or low levels of, income the scheme sanction charge will be levied on an amount of deemed income.

Finally where benefits are drawn from funds derived from prohibited assets the normal tax charges applying to benefits will apply (eg any pension will be taxable under PAYE and the crystallised benefits will be tested against the member's Lifetime Allowance).

The effect of these tax charges is to make investment in prohibited assets completely unattractive

Transitional protection

HMRC are prepared to grant some transitional protection to residential property purchased in accordance with the table below.

<p>SIPP/SSAS The purchase of residential property</p>	<p>Where this is allowed (in limited circumstances) under the current rules (eg includes investments in ground rents, feu duties and property related to an employment for an employee unconnected with the scheme):</p> <p>This will be protected from the new rules where the property was purchased prior to A-Day, provided it was not enhanced or developed after that date.</p>
<p>SIPP/SSAS Off plan purchases (or property that is not fit for use as residential property)</p>	<p>If the investment was made before midnight on 5/12/2005 and the off plan investment does not become residential property thereafter, it will be protected from the new rules.</p>
<p>SIPP/SSAS Indirect investment in residential property or where property is purchased directly under the pre 1991 rules for SSAS</p>	<p>Where the indirect investment was made before midnight on 5/12/2005, and that investment was not specifically prohibited under the current regime, the investment will be protected from the new rules. This is provided the investment is not enhanced or developed on or after 6/12/2005.</p> <p>Where property was purchased prior to 5 August 1991 by a SSAS, it will be protected from the new rules, provided it is not enhanced or developed on or after A-Day.</p>
<p>Personal Pension Scheme</p>	<p>As for SIPP/SSAS - where appropriate</p>
<p>S.226 Direct and indirect investment in residential property</p>	<p>All purchases of residential property made before 6/4/2006 will be protected from the new rules, provided they are not enhanced or developed on or after A-Day.</p>
<p>S.590 Approved Schemes</p>	<p>The purchase of a residential property pre A-Day by a section 590 scheme set up and approved before midnight on 5/12/2005 will be protected from the new rules, provided it is not enhanced or developed on or after A-Day.</p>





Transitional protection (cont.)

Although it is good to see the transitional protection in respect of off plan purchases of property made prior to 6 December 2005, this protection is unlikely to count for much as it will be lost if the property subsequently becomes residential property.

What is also disappointing is that the new regime will apparently be even more restrictive than the current rules, which permit certain limited types of residential property.

The changes made by the government to the rules on residential property investment beg the question as to what other changes HMRC will seek to make to the provisions of the new regime. With the legislation for the new regime still far from being finalised it makes it difficult, and potentially dangerous, to advise clients on how to structure their pension arrangements in light of the new regime. For example, the position is still unclear on the IHT provisions to apply in respect of the new regime while the relievability of employer contributions is also unclear. Both of these areas need to be clarified now as they directly impinge on advice given to clients now.

In light of the above, it is unlikely that we will permit any direct investment in residential property. However, we will be interested to see how residential property is defined to establish what investment opportunities remain and how these could be accommodated in our SIPP. With regard to indirect residential property investment and the possible vehicles to facilitate this, we are again waiting for clarification of what will be allowable. Again this will enable us to determine what opportunities exist and what to accommodate.

This bulletin is based on our current interpretation of the changes under Pensions Simplification.