

Briefing Note - SIPPs investing in UK residential property

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The ability for pension schemes to invest in residential property after 6th April 2006 has undoubtedly been one of the main headline grabbers of the new pension legislation.

I thought therefore that it would be useful to scratch beneath the surface and explore some of the issues involved.

The purpose of this document therefore is twofold. The first is to formally announce that our two main low cost online SIPP offerings, namely SIPPcentre (www.sippcentre.co.uk) and Sippdeal (www.sippdeal.co.uk), will allow investment in UK residential property post 6th April 2006. Whilst final details will not be released until later in the year, I can promise you that we will continue to adopt a very aggressive pricing strategy, this backed up by an innovative online delivery including a number of unique features relating to investment in residential property.

The second purpose of this document is to consider, in a little more detail, some of the relevant issues applicable to SIPPs purchasing UK residential property. A separate Briefing Note covers [Spanish property](#).

A recent survey we carried out suggested that almost two thirds of existing SIPP customers are considering buying residential property through their SIPP. Whilst I suspect that the percentage who actually convert this into reality will be significantly smaller, the results are testimony to the interest in this area. Survey results can be found at [survey results](#).

Legal ownership

As you would expect, the legal ownership of the residential property will rest with the SIPP. For practical purposes this will either be in the name of the trustee(s) of the SIPP or in some cases the SIPP Provider. The structure of the SIPP, be it master trust, sub-trust or private fund will therefore dictate the owner. Similar issues arise for UK residential property as have long been relevant to UK commercial property.

We have always favoured the sub-trust approach in connection with commercial property, whereby property is owned by the sub-trust representing that member's SIPP. This approach is likely to continue post A-day for residential property in all of our SIPP products, this giving the member additional peace of mind, security and control as a legal owner of the property.

Health and safety

The legal owner of any buy to let property has quite onerous health and safety obligations. Failure to comply with these regulations can lead to criminal sanctions on the owner. These regulations extend to gas safety, electricity safety and even the furniture and furnishings contained in the house. It would be dangerous to assume that these responsibilities could be fully absolved by delegation to a third party. Indeed many property managers will insist that the landlord retains responsibility in these areas.

Any SIPP administrator accepting residential property as an investment into their SIPP must be fully conversant with these regulations. Further, the SIPP administrator must have systems and controls in place to ensure full compliance. The prospect of criminal sanctions will, I am sure, rest heavy with many SIPP administrators who, in one form or another, will be the effective landlord and owner of the residential property.

This issue is likely to surface as one of the key issues for SIPP administrators considering allowing buy to let properties in their SIPP.

Benefit in kind rules

Section 173 of Finance Act 2004 sets out the benefit in kind rules.

Basically, if a scheme member, or a member of their family or household utilises a pension scheme property without paying the full market rent then the pension scheme is deemed to have provided a taxable benefit to the member.

The taxable value of the benefit is equal to the sum of :

- (a) The commercial rent and;
- (b) The cost of the property in excess of £75,000, multiplied by the HM Revenue & Customs (HMRC) official rate of interest, which for 2004/05 is 5%.

Any rent paid to the pension scheme is deducted from the taxable value of the benefit.

Example

Assume Fred's SIPP buys a residential property for £200,000 in Nottingham. Fred allows his son, who is at Nottingham University, to use it rent free.

The commercial rent, as determined by a local surveyor and property agent, is £8,000 per annum.

The cost of providing the accommodation is (£200,000 - £75,000) @ 5% = £6,250.

Total unauthorised payment i.e. the taxable benefit is £14,250.

Irrespective of Fred's personal tax rate, he will have to pay a 40% tax charge on the unauthorised payment i.e. £5,700.

As long as the property is owned freehold, or leasehold with an unexpired term of greater than 50 years, then the asset is not deemed to be a wasting asset. Hence there is no scheme sanction charge (this is the additional 15% tax payable by the scheme on most unauthorised payments).

It is important to appreciate that the benefit in kind rules have not been created specifically for pension schemes, but rather Finance Act 2004 points to Income Tax (Earnings and Pensions) Act 2003 in such circumstances.

It is hopefully also clear to see that the tax charge is probably more penal than many will have first anticipated. This, as daft as it sounds, is probably good news. Paying a market rent is therefore likely to be the norm. In the above example, Fred can choose to pay £8,000 p.a. into his SIPP or to pay £5,700 p.a. in tax. I know which I would do!

There is of course still the issue of determining the market rent. It is probably not too difficult to determine this where the member, or their family/household, occupy the property all year round, but clearly it is going to be far more problematical in holiday let scenarios. There are no pension specific requirements for determining the market rent. Instead one needs to rely on the accepted principles of general taxation law. Negotiation with HMRC is likely to be commonplace in establishing the basis of taxation in individual circumstances, particularly where there is a potential dispute over whether the benefit is taxed on an availability or usage basis.

Benefit in kind complications

Understanding the operation of the benefit in kind rules is fundamental to making reasoned investment decisions post A-day. Let us assume, in the example above, that Fred decides to pay the market rent of £8,000 p.a., but this rent is successfully challenged by his local inspector as being £500 p.a. too low.

Had the £8,000 p.a. been accepted as a market rent then there would be no benefit in kind. As it is, the £500 shortfall triggers an unauthorised payment and hence a benefit in kind. This would lead to an unauthorised tax charge at 40%, payable by Fred, on the full value of the taxable benefit less any payments made i.e. £6,750 (£8,500 + £6,250 - £8,000). So an innocent underpayment of £500 in rent would lead to a tax bill of £2,700. Ouch!

Whilst on the subject of the benefit in kind rules, it is worth noting that the taxable value of any benefit in relation to works of art etc. is calculated as 20% of the cost, or the market value when the asset is first made available to the member. So a £100,000 painting, if made available to the member at no cost, would generate a tax bill of £8,000 p.a. (40% x 20% x £100,000). Effectively, for such assets, the market "rent" is deemed to be the taxable value. Any "rent" paid by the member less than this will trigger a benefit in kind.

Borrowing

We have made representations to the powers that be that the borrowing rules to be introduced from 6th April 2006 are grossly unfair. It does however seem as though there is little likelihood of change.

Assuming that these borrowing rules are introduced and can't be legitimately circumvented, pension schemes will only be able to borrow 50% of their net asset value.

Whilst most people have got to grips with this formula, for the avoidance of doubt, in a situation where a SIPP's only asset is a property of £500,000 with an outstanding mortgage of £100,000, only a further £100,000 of borrowing is allowed.

In-specie contributions

Since we first clarified with HMRC that in-specie contributions will be allowed under the new pension regime, there has been much enthusiasm for this new found flexibility (for SIPPs anyway; the option has always been available for SSAS). I would, however, point out that the benefits of this are arguably more cosmetic than many are suggesting but, nevertheless, I am sure there will be some people who will buy into this concept. The only real advantage of an in-specie contribution is that the member doesn't have to take out short term borrowings to finance the pension contribution to purchase the property only then to repay the borrowings!

It mustn't be forgotten that the transfer of a property owned personally by the member into their SIPP, be it as a sale or in-specie contribution, will trigger a disposal for personal capital gains tax purposes.

Excluded properties

As SIPP administrators take stock of the residential property market, there will I am sure be a consensus to exclude certain types of properties. Short leasehold, multi-tenanted properties and those with financially supported tenants or protected tenancies could be problematical. We are currently compiling our "properties to avoid" list.

Tax

Again, hopefully it goes without saying that rental income will be received tax free by the SIPP and of course all capital gains will be tax free.

Coupled with tax relief on contributions, it is not difficult to see that many buy-to-let investors, who have previously shunned pensions, may now start re-thinking their position.

Until we see the outcome of the recently announced consultation on the IHT treatment of transfer lump sum death benefits i.e. the re-allocation of funds under alternatively secured pension (ASP) on death after 75, and pension death benefits more generally, then a true analysis of the tax position re SIPP and residential property will not be possible.

It should also be noted that any profit from property developments, that are deemed to be a trade, will not be exempt from tax.

Property management

How SIPP administrators deal with this issue, bearing in mind my comments re health and safety above, is likely to dictate the shape of SIPP products operating in the residential property arena post A-day. Those SIPP administrators that force an external property management company onto their SIPP clients are likely to make their product unattractive and expensive, with possibly only a perceived and false sense of security re health and safety.

Those that choose to ignore property management as an issue are likely to expose themselves to criminal sanctions for non-compliance with the various health and safety regulations.

Other issues such as dealing with general repairs, refurbishments, tenancy agreements, contents inventories, schedules of condition, buildings insurance, frequent turnover of tenants and sporadic methods and frequencies of rental payments are all new challenges facing SIPP administrators.

Issues for SIPP members

Many of the issues raised above are practical in nature and do not address the more subjective issues as to whether or not individuals would be wise to invest into residential property within their pension fund.

Some individuals want to save for retirement, but neither trust nor understand the stock market. They may take some comfort in investing in residential property in their pension fund, seeing this as an asset class they can touch, feel and understand.

Arguments against residential property have been put forward based on liquidity to provide benefits. Well, for individuals who anticipate taking advantage of unsecured and then alternatively secured pension (USP and ASP respectively), a tenanted residential property could prove an excellent means of underpinning income withdrawal. Clearly an empty residential property will not! It must not be forgotten that there is no minimum income under the USP or ASP rules, so tenancy voids may not be as problematical from a regulatory perspective as they can be under the current income withdrawal regime.

Over exposure to one asset class is an issue, but again once a client has decided to buy a residential property, the financial advice required will often reduce to whether to buy it personally or buy it through the individual's pension fund.

There is no doubt that the residential property market is slowing down. I do not expect to see a massive influx of new SIPP customers who are buying residential property for the first time. It is far more likely that this market is of most interest to seasoned buy to let investors and those who already own a second property of some form.

Different issues arise when considering pure buy to let, second home/holiday home and principal primary residence (PPR). These have been set out in some detail in my previous Finance Act 2004 documents.

I would hope that the benefit in kind treatment will lead us to a situation similar to the way commercial property operates in SIPPs currently, i.e. a market rent is paid in all circumstances where the tenant is connected. This will hopefully ease the Treasury's concerns over abuse, particularly in the PPR area.

Cost to the Treasury

I suggested in my first detailed summary of Finance Act 2004 that there would be many people who will sell residential properties they currently own to their pension fund. Some will achieve this by way of an in-specie contribution, but I believe the vast majority of these transactions will be funded by way of transfers into SIPPs from existing funds accumulated in traditional insurance company based pension policies.

I must admit to being absolutely staggered by the recent claims of one insurer that the cost to the Treasury in the first tax year alone of the new pension regime would be approx £4bn. For what it is worth, this estimate is arrived at by assuming that £10bn of residential properties will be purchased by SIPPs in 2006/07 (equating to an arbitrary estimate of 10% of the supposed £100bn UK residential property market). They then bizarrely assume that all of this £10bn is funded by way of relievable contributions in 2006/07, hence the £4bn cost equating to 40% tax relief! As an aside, there is no inclusion in the estimates of the capital gains tax raised by these transactions!

I only include comment here as this estimate seems to have both rejuvenated the campaign against SIPPs being allowed to own residential property and also angered Government officials who are having to defend against politically sensitive accusations which they believe to be fundamentally flawed. I don't think Gordon Brown needs to lie awake worrying about this!

Everyone has their agenda on SIPPs at the moment and maybe it is time that the high level lobbying and criticising stopped, allowing energies to be diverted into ensuring a smooth and timely implementation of the new pension regime.

Summary

I have been quoted regularly in the financial press expressing what may appear to be very negative views on residential property in SIPPs. I make no apology for the fact that I have serious concerns over this issue and am still concerned as to the possibility of a knee jerk reaction from the Government in the light of any perceived abuse in this area. I would have probably preferred that we keep the existing SIPP borrowing rules along with the ability only to buy commercial property, broadly as is the current position.

Having said all of the above, I am actually quite excited about the potential of this market and we have been working flat out on developing an extremely low cost and innovative residential property solution for our various SIPP products that should enable us to become market leaders in this area. For those who are seeking to aggregate pension assets before A-day, to facilitate the purchase of residential property post A-day, you need look no further.

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