

Commercial Property Buying Property in Your Pension Fund

The aim of these notes is to assist in purchasing, letting or selling properties, to ensure the transaction is handled correctly and any pitfalls are avoided. Please read these notes, ensure you understand them and ask us if you have any queries.

We do not advise specifically on any individual tax position and you should obtain this advice where necessary from your accountant, tax adviser or pension adviser as appropriate. However, this guide should give a useful overview. The details are correct at the time of preparing this guide, but should be checked in the context of any changes in legislation or regulation according to your individual circumstances before making any decisions.

From 6 April 2006 (entitled A Day by the HM Revenue & Customs), UK pension schemes were permitted to purchase and invest in an extended range of property types both in the UK and overseas.

The type of pension vehicle that can be used for direct property purchase is the self-administered scheme. There have traditionally been two types, the Self Invested Personal Pension (SIPP) for individuals, and the Small Self-Administered Scheme (SSAS) for companies. From April 2006 the rules for these types of scheme merged, effectively creating one type of arrangement known as "Investment Regulated Pension Schemes".

Advantages of Using A Pension Scheme

The advantage of investing in property via a pension scheme is the tax relief available:

- Contributions made to pension schemes attract tax relief at the individual's or company's (whichever pays the contributions) highest rate. For example, a high rate tax payer can make a contribution to a pension scheme, and receive 40% tax relief on the amount paid. From April 2006, the maximum annual contributions payable is 100% of earnings with a ceiling per person which increases each year.
- Rental income received by a pension scheme attracts no UK income tax.
- Capital appreciation of a property held by a pension scheme attracts no UK capital gains tax (overseas properties may attract local tax).
- On retirement, 25% of the pension fund can be paid as a tax free lump sum.
- On death before retirement, the whole pension fund may be paid as a tax free lump sum (i.e. no inheritance tax).
- Hotels, including ownership of part or all the hotel, provided no part is occupied by a member or connected person (see below), or they have a right to occupy a part.
- Student accommodation (e.g. a hall of residence but not flats or houses).
- Care homes or prisons.
- Purchase of land and development of residential property, or conversion of a building to residential, provided the pension scheme disposes of the property before the development or conversion is complete (e.g. in the UK when the certificate of habitation is issued). This means the property must be sold before it becomes habitable. In these cases there is a risk that the transaction will be classified as trading, and have their profit taxed accordingly.
- The residential element of a commercial property, provided it is not occupied by a pension scheme member or a connected person. For example a shop with flat above, where the shop and flat are let to the shopkeeper. The implication is that the shopkeeper must be in residence at the point of purchase, and if they leave and are not replaced simultaneously by another, then the property becomes taxable immediately.

Permitted Property, and Types of Property To Avoid

Although HMRC do not specifically ban any type of property, they have introduced regulations which impose very severe tax charges on pension schemes which invest in certain types of property. This has effectively created a permitted and non-permitted list:

What Is Permitted?

- Commercial Property – As with Pre A Day regulations, there is no change with commercial property.

- Residential elements of a commercial property which are occupied by an employee as a condition of his or her employment (provided the employee is not a member of the pension scheme or a connected person). If the occupant changes and is no

Commercial Property Buying Property in Your Pension Fund

longer resident as a condition of employment, the property automatically becomes a taxable property.

Investments That Will Incur Tax Charges

- Direct purchases of residential property (and grounds) – defined as a building or structure used or suitable for use as a dwelling.
 - Beach huts.
 - Time shares.
 - A lease of a hotel room with the right to stay there at a reduced or free rate.
 - Shops with flats above (unless the flat has been sold on a long lease and has a separate entrance, or is let to the shopkeeper – see point 6 above).
 - Development or conversion costs to convert property to residential (except see point 5 above).
 - Ground rents relating to residential property, unless the lease is of no value (e.g. peppercorn rent).
 - Property Limited Liability Partnerships. Where a pension scheme with more than one member invests in taxable property, the tax charge applies to each member according to the percentage of his or her fund share which participates in the investment.
- Tax Charges will apply where a pension scheme either deliberately or inadvertently invests in a property which is subject to tax and specific advice should be taken relevant to your circumstances if this issue arises.

Connected Persons

These are defined in Section 839 of the Taxes Act, and can be summarised as:

- A wife, husband or relative
- A wife or husband of a relative
- A trustee is connected with a settler and vice versa
- A business partner, wife, husband or relative of a business partner
- One company controlling another, or two companies being controlled by the same person (either with or without other connected persons)

Other Types of Property To Avoid

As the property will be an investment of your pension scheme, which is ultimately intended to provide benefits on your retirement (or death), consideration should be given to whether the property is appropriate for a pension scheme investment.

Examples of properties to avoid are:

- Specialist properties which might be difficult to sell on retirement.
- Properties which are not saleable in their own right (e.g. a factory extension).
- Joint purchase with a member or a person connected with a member or joint purchase where the trustees cannot force the sale of the whole property.
- The property to be used as security for partnership or personal borrowings.

- Any fixtures, fittings or business goodwill.
- Frequent purchase, development and sale of property, where this may be deemed as trading by the Inland Revenue, meaning the “profit” will be taxed as a trading receipt.

In any “grey areas” the Inland Revenue would form an opinion based on whether the pension scheme has been set up genuinely to provide retirement benefits or simply to buy the property in question.

Basic Principles

The basic principles behind a pension scheme property purchase are the same for the UK and overseas. The pension scheme is established and funds are paid to it, either by contributions or transfers from other pension arrangements. To establish a UK pension scheme, you must be UK resident at the time, or transferring from one UK pension scheme to another.

The pension scheme then purchases the property with a mortgage if necessary. It is let either on the open market or can be occupied by your business or the business of a family member, and the rent can service the mortgage until it is repaid. The rental income then builds up additional funds in your scheme, while (hopefully) the value of the property continues to grow.

You can then draw retirement benefits from the fund in the form of a tax free lump sum, and a pension which is subject to income tax (with no National Insurance). If enough cash has accumulated in your fund to pay the tax free cash, and the rental income is sufficient to pay your

Commercial Property Buying Property in Your Pension Fund

pension, there is no requirement to sell the property, and this can potentially stay in your pension scheme until you die, at which point the regulations should allow the pension fund to be passed to a surviving spouse or children (a tax charge may be levied at this point).

Pension Scheme Borrowing

The pension scheme will be permitted to borrow up to half its value to purchase the property. For example, someone with a pension fund of £200,000 can borrow a further £100,000 to purchase a property for £300,000.

- Borrowing must be from a commercial lending source of the member's choice, who will take a first legal charge on the property
- The borrowing must be repaid when the property is sold and any re-mortgaging cannot increase the amount of the outstanding borrowing beyond the Inland Revenue's limit of 50% of the net fund value.
- It is important to consider whether the loan can be serviced by rent or other investment income, so that arrears do not build up if pension contributions cease.
- The lender must incorporate in their documentation a clause, which states that the liability of the Trustee company is limited to the extent of the assets of the pension scheme. Any borrowing in excess of 50% of the net fund value is treated as an "Unauthorised Payment" which is reportable to the Revenue and on which tax charges are payable of at least 55% of the excess amount.

Property Syndicates

A group of people, such as family members or business partners, can club together to make a joint property purchase. This could be particularly popular for those whose pension funds are not large enough to purchase a property outright themselves. In these cases, for a group of SIPP's a Declaration of Trust is completed by the parties involved, to record the split of the ownership. For a SSAS arrangement, the property forms part of the pooled fund and is split in accordance with the overall percentage split of the fund. The rental income is then split in the same proportions (usually being paid to a central account). We can provide a Declaration of Trust to deal with this.

Legal Ownership

Pension schemes can purchase property on the open market or from connected parties (e.g. from your business, yourself or a member of your family or their business). Where the purchase is from a connected party, the purchase price must be evidenced as being an open market value by providing an open market valuation from a qualified valuer (FRICS or ARICS).

The purchase, sale or letting of a property must be handled by a solicitor. Pension Scheme Trustee Companies should not impose any restrictions on the use of solicitors and the pension scheme member(s) are free to use their own solicitor to act on the pension scheme's behalf. The Pension Scheme Trustee Company will require sight of all documentation in draft form for approval before being asked to sign the final version.

For UK property purchases, properties should be purchased in the names of the pension scheme trustees:

For a SIPP: "members name(s) and 'X' Trustees Ltd as trustees of the 'X' SIPP for 'X' member's name(s) "

For a SSAS: "members names and 'X' Trustees Ltd as trustees of the ('X' pension scheme name)"

For overseas properties, the legal ownership depends on the law in the country of purchase. For example, some countries may require the purchase to be made in the name of the professional Trustee only (i.e. "'X' Trustees Ltd"), or some may require the purchase to be made in the pension scheme name only (i.e. "'X' SIPP")

Some countries will only permit property purchases by a company established in their country. Whilst pension schemes are permitted to purchase shares in unquoted companies (implying that one or a number of pension investors can establish a property investment company which is effectively owned by their pension scheme), the potential pitfalls of this approach – such as foreign company law and taxation may make this option unfeasible.

We do not deal directly with purchases outside England and Wales but can suggest names of lawyers who may be able to assist you. The lawyer dealing with the purchase/sale must ensure that all documentation includes a clause to limit the liability of PAL Trustees Ltd to the extent of the assets of the pension scheme e.g. "Provided always that the liability herein of 'X'

Commercial Property Buying Property in Your Pension Fund

TRUSTEES LIMITED shall not be personal but shall be limited to the extent of the assets of the 'X' SIPP for J Smith / XYZ Executive Pension Scheme but without prejudice to the full personal joint and several liability of the other person or persons herein”.

In-Specie Contributions

Another method of achieving property investment via a pension scheme would be to transfer an existing permitted property into the pension scheme as an “in-specie” contribution, either in one go, or in stages. HM Revenue & Customs have confirmed this is permitted provided the amount of the contribution is based on the open market value of the property.

For example, if you are self-employed and your business owns an office worth £200,000, and your income is £51,282 p.a. you can contribute £40,000 worth of the property (78% of earnings) to a pension scheme each year for five years, and also obtain a tax refund each year of £11,282 (22% of earnings) which generates cash in your pension scheme. A further amount may also be reclaimed as a personal tax refund, depending on how much of your earnings exceed the higher rate tax threshold that year. There may be a capital gains tax charge, but this could be avoided by only transferring a proportion of the property which carries a capital gains tax liability of less than the annual allowance. Stamp Duty will apply on the transfer of ownership to the pension scheme.

Each time you did this, you would have to have the property valued, and a solicitor transfer ownership

of the relevant percentage of the property to the pension scheme. A lease/tenancy would also need to be amended each time, to show the correct split of rental income between yourself and your pension scheme.

Letting and Rental

A formal lease must be entered into at the time of the purchase, unless the property is subject to an existing lease. The property can either be let to an unconnected party via an open market lease, or let to your business or the business of a connected party.

A proper lease must be drawn up between the trustees as landlords and the tenant of the property. This will normally be a full repairing and insuring lease on terms suitable for the type of property involved and a solicitor should be able to draft a suitable lease. A few special points need to be considered, however:

- If the tenant is connected, e.g. a business or partnership connected with the member(s), the rent payable will need to be independently assessed by a valuer (FRICS or ARICS). A letter from the valuer indicating the open market rent is required, and the Pension Trustee Company will need a copy of this on its file.
- The lease should avoid creating a controlled tenancy which will make the property potentially difficult to sell when the member reaches retirement. A solicitor will be able to advise you on this, but please refer to your Pension Trustee Company if further guidance is required.
- The SIPP member(s), as Trustees, will be responsible for collection of

rent/rent reviews/maintenance etc. In some cases a property manager may be appointed to carry out these functions.

- If the property is occupied by your or a connected business without a commercial lease, the open market rate of rent is treated as an unauthorised payment to the company, and the tax charges outlined above will therefore apply.
- Similarly, should rent arrears build-up, it is the pension scheme trustees' duty to ensure these are paid as they would if the lease was to an unconnected tenant, even if this involves the liquidation of the company. Should this not be done and arrears remain outstanding, it is the Pension Trustee Company's duty to report this to the Revenue, with the likely outcome that the arrears will be treated as an unauthorised payment with the consequent tax charges.

Environmental Considerations

Recent legislation has serious implications for pension scheme trustees who own property:

The Control of Asbestos at Work Regulations 2002

Regulation 4 came into effect on 21st May 2004 by when all commercial properties must have had specific asbestos management plans in place. The Health and Safety Executive are entitled to inspect the plan and criminal prosecution could result from non-compliance. The regulations state that the responsibility for the management of asbestos, including the management plan, falls on the “duty holder”, defined as:

Commercial Property Buying Property in Your Pension Fund

'every person who has an obligation under a contract or tenancy to repair or maintain property or where there is no such contract/tenancy every person who has control of the premises'.

A suitable assessment as to the presence of asbestos on the premises must be carried out, the results recorded and, if asbestos is present or is likely to be present, a management plan must be prepared.

In normal circumstances, the tenant is responsible for the maintenance of the property and will, therefore, be the "duty holder".

Environmental Protection Act 1990

The legislation covers the identification and remediation of contaminated land. The regulatory regime has been in force since 1st April 2000 following implication under the Contaminated Land (England) Regulations 2000 (SI2000/227). Please note that these regulations apply throughout the UK.

Responsibility for remediation of contaminated land falls upon either the original polluter (Class A appropriate person) or, failing him, the current owner / occupier (Class B appropriate person). It is clear that pension scheme trustees, including the professional trustee, can be included in the definition of 'owner'. However, it is the trustees who stand to benefit personally from the trust who will be directly liable (i.e. the pension scheme members).

Contaminated Land

In accordance with Law Society practice, solicitors are required to advise their clients regarding

the consequences of purchasing contaminated land. The advice should include making enquiries of the vendor and statutory and regulatory bodies, obtaining a site report and advising that a full site investigation be undertaken if necessary. Please note that surveyors are under no obligation to make enquiries about contamination unless specifically instructed to do so.

Prior to completion, Pension Trustees will usually need:

- A copy of the site report and any further surveys undertaken.
- A copy of the Asbestos Management Plan.
- Confirmation that the lease will be on a full repairing and insuring basis, noting the tenant as the Duty holder for the purposes of the Act.
- Confirmation from the solicitor acting for the trustees that the issue of contaminated land has been addressed.
- A completed and signed property questionnaire and Resolution noting responsibility to comply with the regulations and limiting the liability of the professional trustee to the assets of the pension scheme.

VAT

Many properties are subject to VAT, meaning this must be added to the purchase price when calculating the funding for a pension scheme property purchase. It is therefore essential to establish whether a property is subject to VAT before deciding whether to proceed.

At the point of completion, the solicitor will arrange for payment of the VAT, and will request sufficient funds to cover this when providing the completion statement.

It is permitted for the pension scheme to register for VAT, and to reclaim the VAT paid at the point of purchase from HM Revenue & Customs. From then-on VAT must be charged on the rent paid to the pension scheme, and quarterly VAT returns submitted to account for this (less VAT charged on property repairs and expenses).

VAT registration and VAT returns are not services provided by PAL and PAL reserves the right to charge additional time cost fees to cover any work carried out in connection with this. These functions can be carried out by the pension scheme member(s), or a property manager.

It is possible to register for VAT online via the HMRC website. VAT returns can then also be submitted online, and VAT liability paid by direct debit on the pension scheme's bank account. In the case of SIPP's, it is therefore necessary to have a separate property rental account from which the direct debits are taken (where pension scheme borrowing is arranged, a rental account is usually required by the lender to service the mortgage).

The Pension Trustee Company must countersign the direct debit for the VAT registration, but all other documentation can be completed and submitted by the scheme member(s) or the property manager.

Commercial Property Buying Property in Your Pension Fund

Stamp Duty

Stamp Duty Land Tax (SDLT) was introduced on 1 December 2003. This imposes a SDLT charge on both purchases and leases of commercial property.

SDLT is normally handled by us acting on behalf of the SIPP Trustees, who must submit Revenue form SDLT1 with payment.

Purchases

(liability is on the purchaser):

Property purchase price	% SDLT
£150,000 or less	0%
£150,000 -£250,000	1%
£250,001 -£500,000	3%
£500,001 or more	4%

Transfers between pension schemes £5

Leases

(liability is on the tenant):

Leases with a term of 7 years or less	0%
Leases with a "Net Present Value" of £150,000 or less	0%
Leases with a Net Present Value over £150,000	1%

Net Present Value is calculated according to a formula set out by the Inland Revenue.

It is essential that Stamp Duty is included in the purchase price when calculating the required funding of a pension scheme property purchase.

Additional Features

There are a number of additional practical points to note before deciding to embark on a pension scheme property investment:

- Overseas purchases require detailed consideration on numerous points which are outside the ambit of this guide.
- Pension Trustee Companies usually delegates the responsibility for arranging property insurance to the member trustee(s), and will require a copy of the property insurance schedule before completion. Where the pension fund is to pay the premium (as opposed to the tenant), the Trustee Company should be sent a copy of the insurers premium request to arrange payment.
- For those investing in residential developments who are planning to sell these before completion, there is a risk that a buyer cannot be found and the pension scheme will be required to complete. This could be potentially disastrous for the pension scheme investor due to the tax charges involved.
- Development of property for sale can in some cases be deemed as using a pension fund for trading, and the "profits" can be taxed by HMRC as trading receipts. To determine whether trading has occurred, the Revenue will apply their principles known as "badges of trade", where they consider aspects such as the frequency and number of transactions, whether the pension scheme member's business is property development, the extent of the development carried out, the way the sale

occurred (e.g. was a surprise offer made, was the sale made urgently to raise funds to pay death benefits or was it intentional), the extent that borrowing was raised to finance development and the time interval between purchase and sale.

- In must also not be forgotten that the investment is being made with the use of a pension plan offered by a UK pension provider, whose role is merely to facilitate the purchase and ensure the operation of the scheme complies with UK pension regulations. The investor must therefore be prepared to indemnify the Trustee Company against any legal or tax issues which may arise, and must undertake responsibility for the insurance, letting, legal, mortgage, health, safety, environmental and valuation aspects.

Fees

Our costs will be estimated at the outset of the transaction and may be by reference to a fixed fee and/or on a time cost basis factoring in such elements as:

- A complicated and time consuming purchase
- Multiple leases
- Property development
- Transfer of a property from/to another pension arrangement.
- Aborted transactions

Commercial Property Buying Property in Your Pension Fund

Checklist for the Process

- Check the purchase is allowable
- Check finance arrangements, including VAT, stamp duty and borrowing
- Complete and return property purchase questionnaire and Resolution
- Appoint solicitor
- Forward copy site report / environmental survey
- Solicitor's written confirmation that the issue of contaminated land has been addressed
- Provide details of proposed / existing lease
- Arrange insurance – send copy policy to the Trustee Company.
- Provide copy purchase / rental valuation if applicable
- Provide development quotes / specification if applicable
- Solicitor provides the Trustee Company with draft documentation for the purchase, borrowing and lease for approval before signing

Summary

In practice, the direct property option for UK pensions is likely to continue to be popular, although the final warning to make is the old adage about putting all your eggs into one basket!

Note: this guideline is based on our interpretation and understanding of the regulations at time of writing and may be subject to change.