R04 2020/2021
Accumulation Phase
Part 3 Further accumulation rules

This part will cover some of the practical issues in the accumulation phase.

The milestones for this section are to understand

- The taxation of pension funds
- The main individual pension products
- Property Investment
- Restrictions on self-investment
- Recycling of tax free cash

Taxation of Investment Funds

The basic principles are:

- No income tax on interest, rental income or dividends
- All gains free from CGT

Personal Pensions (PP) & Self Invested Personal Pensions (SIPP)

The main individual product is the Personal Pension. This is mainly offered by insurance companies and the member can choose from a selection of the company's investment funds which are usually unit linked.

A SIPP is a Personal Pension that allows investors to select their own investments rather than just using the funds offered by a single Personal Pension provider. A SIPP manager will offer the legal structure and the member can then select their own investments

In theory, there are no restrictions on what a fund can invest in but private property and tangible objects such as antiques or fine wines carry heavy tax penalties and are therefore avoided.

A SIPP was originally viewed as a specialist product that would only be appropriate for "sophisticated" investors. However, the development of fund supermarkets and other platform services have made it available to a wider market. A platform such as Fidelity's will allow a wide range of funds from different providers to be placed in a range of tax wrappers including a SIPP.

The investor pays cash into the platform net of basic rate tax and the administrator will reclaim the additional amount. This is then used to buy funds of their choice. The SIPP can also buy assets owned by the member. Let's take the example of someone who has £10,000

of shares and wishes to put them into a SIPP. The SIPP would sell sufficient assets to raise the £10,000 needed to buy the shares.

Property Investment

One of the main attractions of a SIPP is that it can invest directly in commercial property
The SIPP owns the property so the tenant pays rent and of course no tax is payable. When the property is sold it is free of capital gains tax. The property can be let to a third party but can also be let to the member.

Mel owns the property he occupies for his business. He arranges that the property is transferred to his SIPP. The business must pay rent to the SIPP. This would not be counted as a contribution so has no impact on his annual allowance.

The SIPP would not pay tax on the rent but the business could claim tax relief as a business expense.

When the property is sold there is no CGT

To prevent abuse, if the property is not bought on the open market HMRC will insist that the property is independently valued otherwise Mel could arrange for the SIPP to buy it at an artificially low price. HMRC will also require that a market rent is paid and will want to see evidence confirming this.

Whilst property can be a good investment there are several potential drawbacks.

- It is probable that the property will be the sole or main asset so there would be a lack of diversification.
- Property is illiquid and this could be a serious problem when the member wants to retire.
- If it is let to a third party, then if the tenant is lost there is no income.
- If it is let to the member and the business fails, it would have massive impact on the pension fund as no further rent will be paid.
- As the SIPP rather than the business owns the property it cannot be used as security against any loan taken out by the business.

Borrowing powers of a SIPP

If the SIPP has insufficient funds to purchase the property (or any asset) it is allowed to borrow. HMRC restricts this to 50% of its net assets. This is defined as the value of the assets in the fund less any existing loans.

Jack has a SIPP with a fund value of £400,000 and an existing loan of £100,000
The net assets are £300,000
50% of this is £150,000

However it cannot borrow this since there would then be £250,000 of loans against a net asset value of £300,000 (£400K + £150K less £250K)

The value of the existing loan must be deducted so it can borrow a further £50,000. (£150,000 less £100,000)
Assets £450K less £150K = net assets £300K. Total loans £150K which is 50%

An **occupational scheme** can borrow and is subject to the same restrictions. An occupational scheme can also **lend money to its sponsoring employer**. Since a SIPP has no sponsoring employer it is not allowed to lend.

This can be useful if, for example, two directors of a small private company set up a scheme and are the only members. Money invested in the pension wouldn't be totally lost to the business as it could borrow from the scheme. The rules are:

- the scheme can lend 50% of its **net** assets
- It must be secured as a first charge on assets
- Charge an interest rate of at least 1% higher than the average base rate of the main clearing banks rounded up to the next 0.25%
- Must not exceed a 5 year term but can be rolled over once for a further 5 years
- Be repaid in equal instalments which must be paid at least annually.
- All members must be in agreement.

Self-Investment (Investment in the sponsoring employer)

An **occupational scheme** is restricted to holding no more than 5% of the scheme assets in the shares of the sponsoring employer. Where the shareholdings relate to more than one sponsoring employer this is increased to a maximum of 20% of the scheme assets.

A **SIPP** is not an occupational scheme under the definition of the Finance Act 2004 so could invest 100% of the fund in the shares of the member's employer.

Recycling tax free cash

In part 1 we said that HMRC were not concerned with the source of a contribution to a pension but there was one exception to this. This is when someone recycles cash from a crystallised pension. Consider this situation.

Jude invests £8,000 net into a Personal Pension
This equates to a gross contribution of £10,000
He crystallises this immediately and takes £2,500 tax free cash
He reinvests this into another PP and it is grossed up to £3,125
Again it's crystallised and takes £781 cash
This is recycled and grossed up to £976
£244 cash is taken

The end result is a pension fund of £11,015 at a cost of £8,000. If she had been a higher rate tax payer the cost would be £6,000.

HMRC view this as a potential abuse and may treat it as an unauthorised payment. In practice it's not too onerous and a recycled lump sum would only be treated as unauthorised if the following conditions were met:

- The lump sum that was taken in the previous 12 months together with the current lump sum was greater than £7,500
- The cumulative amount of additional contributions exceeded 30% of the cash sum taken in the two tax years before or after receipt of the cash sum
- The additional contribution must exceed 30% of the original "normal" pattern contributions.
- The recycling of the cash sum was pre planned

That concludes part 3 so you should now know:

- The taxation of pension funds
- Self-Invested Personal Pensions
- Property Investment
- Restrictions on self -investment
- Recycling of tax free cash