

CLIENT MEMORANDUM

HOW TO SAVE TAX WITH A SIPP IN 2009

Once again, the rules on pensions are changing! The purpose of this Memorandum is to explain the advantages and disadvantages of operating a self-invested personal pension scheme (SIPPS)

SIPPS

A SIPP is a money purchase personal pension scheme from which may be paid the usual personal pension scheme benefits of a tax free lump sum of 25% of the fund and pensions and death benefits. Membership is generally open to anyone with taxable earnings in the UK who is self employed or employed including directors. Because of the administration costs and investment returns, most SIPP providers set a minimum limit to the funds invested so they are best suited to high net worth taxpayers. The self employed are usually ineligible to join an occupational scheme anyway, so if they have substantial earnings, a SIPP is most likely to be the ideal vehicle for them.

SIPPS are mostly funded by personal contributions from the members in the absence of an employer's contribution for self employed taxpayers, although there is a growing tendency for employers to make contributions. Where an employer makes a contribution on behalf of an employee it may be more cost efficient to pay all contributions to reduce any National Insurance liability. Members' personal contributions qualify for tax relief, but in some instances from basic rate only from 6 April 2010 (see below). SIPPS do not have to complete self assessment tax returns and the Pensions Act 2004 requirements generally do not apply to them.

RESTRICTIONS ON TAX RELIEFS

The Finance Act 2009 contains legislation to restrict tax relief for 2011/12 et seq for individuals with income of £150,000pa or more. Relief will be tapered so that for those earning over £180,000pa relief will be worth 20% as for basic rate taxpayers. It is not yet known exactly how the tapering will work, but it is expected that an individual with income of more than £150,000 in 2011/12 and paying personal contributions to a pension scheme in that year which would qualify for higher rate tax relief will only be able to obtain tax relief at the basic rate on those contributions. Tax relief at the basic rate of tax will continue to be given on contributions either via relief at source or the net pay arrangement.

The Finance Act 2009 also contains legislation that will apply from 22 April 2009 restricting higher rate tax relief on personal pension contributions. The restrictions will apply to individuals with income of £150,000pa or more in 2009/10 and 2010/11 or in either of the two preceding tax years who change their ongoing regular pension savings and whose total pension savings exceed £20,000, or in some cases up to £30,000 (see below). These latter provisions are intended to forestall individuals from increasing their pension contributions in excess of their normal pattern. A new

special annual allowance tax charge of 20% may apply where pension savings exceed £20,000 and will be collectible via self-assessment.

For high income individuals only, if your total pension savings are greater than £20,000, any new pension savings may be subject to the special allowance charge.

Example 1 Annual income £200,000 and normal regular pension savings £15,000pa. After 22 April 2009 additional contributions of £10,000 are made. There have been no other irregular contributions in the tax years 2007/08 to 2009/10. The special annual allowance tax charge would apply to £5,000, ie total savings of £25,000 less £20,000.

Example 2 Annual income of £175,000 and normal regular pension savings of £25,000. After 22 April 2009 additional contributions of £10,000 are made. There have been no other irregular contributions in the tax years 2007/08 to 2009/10. As the normal contributions at 22 April 2009 are greater than £20,000 the special annual allowance charge applies to £10,000, ie all the increase in savings.

The special allowance and related tax charge can arise unexpectedly in 2009/10. Example 3 An individual earns £149,500 in 2009/10 and decides to contribute £25,000 to his SIPP. If his savings earn £499 interest, he can obtain tax relief on the full £25,000, but if the savings earn him just £1 more, he may be denied higher rate tax relief on the amount over £20,000, ie £5,000 @ 20% = £1,000 special allowance tax charge.

Regular pension savings are not caught by the legislation, eg contributions at the same level, by percentage or amount, as before 22 April 2009, nor are contributions to new pension arrangements for schemes of 20 or more members. Irregular contributions and one off lump sum contributions may be caught however. To allow for individuals who make annual contributions or who contribute to money purchase pension schemes as their circumstances permit where irregular contributions have been made over the past three years, the special annual allowance charge is increased to the average of those contributions if it is more than £20,000 with an upper limit of £30,000.

Example 4 An individual earns £165,000 in 2008/09. In the years 2006/07 to 2008/09 they make no regular contributions to their SIPP, but due to financial circumstances are able to pay contributions to the SIPP in these years of £12,500 on 1 August 2006 and £17,000 on 31 March 2007 (both in 2006/07), £40,000 on 30 June 2007 (in 2007/08) and £4,000 on 24 April 2009 and £22,000 on 31 December 2009 (both in 2008/09). The average of the irregular contributions for those years is £28,500 and as this is more than the special annual allowance and less than £30,000, the individual's special annual allowance is increased to £28,500 with the result that they are not liable to the special allowance charge..

The special annual allowance and related tax charge apply to total contributions regardless of whether they are paid by the individual, employer or a third party. Any salary sacrifice arrangement entered into on or after 22 April 2009 in return for pension contributions or additional pension benefits will be included as a "benefit in

kind” in calculating an individual’s total income for 2009/10 or 2010/11 to see if it exceeds £150,000.

It is most important that clients with income of £150,000 or more in 2009/10 or in either of 2007/08 or 2008/09, who are either contemplating paying contributions in 2009/10 that exceed regular contributions by £20,000, or irregular contributions, or who are contemplating making a salary sacrifice, should seek advice well in advance of 6 April 2010 before making such contributions to ensure they are not caught by the forestalling provisions.

INVESTMENTS

SIPPS may invest in a wide range of investments which the trustees administer themselves. In a SIPP where the member is not a trustee, the member may nonetheless decide on the investments. This means a full range of investments, eg commercial property, equities, gilts, life policies, managed funds, etc are permitted. Income accruing to a SIPP from investments and capital gains realised on disposals of investments are exempt from tax. There are though certain HM Revenue & Customs (HMRC) restrictions on some investments. Loans to the member, his employer or his business are banned.

Unquoted Shares

SIPPS may invest in unquoted shares, and there is no restriction on the size and value of an unquoted shareholding held by a SIPPS. However, it would be most advisable to obtain a clearance in advance from HMRC under the transactions in securities legislation, even if the shares are being transferred from a SAYE or share incentive plan, if a SIPP is acquiring unquoted shares other than a small minority holding.

Quoted Shares

An individual holding quoted shares may wish to consider selling them and paying the proceeds to his or her SIPP as a contribution or transferring them in specie (see below). The disposal occurs at deemed market value, but any capital gains may be covered by the individual’s annual exemption (currently £10,100) or by existing capital losses.

Property

SIPPS may invest freely in commercial and industrial property whether situated in the UK or abroad. However, legislation was introduced in the Finance Act 2006 imposing severe restrictions on investments in residential property and personal chattels (see below) from 6 April 2006. Commercial property of any kind can be a useful planning tool when leased to the family company or the member’s business or partnership. The company or business obtains tax relief on the rent it pays and the rent received by the SIPP is tax free. The facility to purchase, say offices, for a partnership can be very useful. The purchase may be funded additionally from borrowings or a transfer from another pension scheme or retirement annuity contract. Because a SIPP is free of Income Tax it is more efficient when using a loan to

purchase a property as the rental stream can be used directly to reduce a debt. An individual would have to pay Income Tax before reducing the debt.

The ownership of the property by the trustees protects it from any predator or liquidator of the company or member's/partner's business. If commercial property is leased to the company or the member's business, it must be on fully commercial terms, otherwise a tax charge will arise on the member on the value of the "benefit" so enjoyed.

The legislation in the Finance Act 2006 is intended to make certain investments of "investment-regulated pension schemes", ie where the members have control of investments, no more advantageous in a pension scheme than if they were held personally. The legislation covers direct investment in residential property and tangible moveable property. Tangible moveable property is taken to mean personal chattels, including works of art, antiques, fine wines, jewellery, yachts, commodities, etc. The legislation also extends to indirect investment in residential and tangible moveable property which includes, subject to a few exemptions, shares in an unquoted company that owns such property. If a SIPP acquires such an asset it will be subject to a tax charge of 40%, in effect recovering all tax relief given on the amount used to acquire the asset. In addition, any income received from the asset or capital gain made on its disposal will be subject to income tax and capital gains tax respectively.

Despite the taxation implications for SIPPS investing in residential and tangible moveable property, there are still some very useful advantages to be gained in relation to other property in their ownership from the lifting of the ban from 6 April 2006 on transactions between connected persons. As a result, SIPPS can buy property from and sell it to members; lease property to members and to partnerships of which the members are partners; and own property jointly with members and partnerships of which the members are partners. These transactions must take place on fully commercial terms, but there is the opportunity for partners to own property jointly via their own SIPPS and to sell a share of a jointly owned property to another partner's SIPPS, a useful facility on the unexpected death of a member where investments have to be realised to pay benefits.

Borrowings

SIPPS may borrow up to 50% of the net value of the fund. This limit includes any borrowings outstanding at the date of borrowing. The value of any member's funds supporting a pension already in payment (drawdown) must be deducted from the fund before making the 50% calculation. There are no conditions attaching to the use to which the borrowing may be put. It may be used to purchase a property or to fund drawdown payments, but in the latter case care is needed to avoid breaching the 50% limit. Borrowings made by SIPPS prior to 6 April 2006 on terms which were then acceptable to HMRC may continue under the current pensions regime.

Contributions in Specie

Assets such as shares or property may be transferred as an employer or personal contribution in specie into a SIPP. The employer qualifies for Corporation Tax relief and the individual qualifies for Income Tax relief in the normal way for pension contributions. The transfer of shares in this manner may include a personal contribution of shares from a SAYE option scheme or a share incentive plan. The value of the shares is treated as a contribution for the purposes of tax relief. The transfer of a property as a contribution in specie to a SIPP should be carefully structured to obtain tax relief. An individual has to agree to pay a monetary amount so that the debt thus created can be settled by a transfer of the property. It is important that clients contemplating making contributions in specie to their SIPP obtain advice thereon before taking any action, not only on the structure of the transaction but also to avoid the provisions of the Finance Act 2009 regarding the special allowance tax charge (see above) for 2009/10.

FOR GENERAL INFORMATION ONLY

Please note that this Memorandum is not intended to give specific technical advice and it should not be construed as doing so. It is designed merely to alert clients to some of the issues. It is not intended to give exhaustive coverage of the topics.

Professional advice should always be sought before action is either taken or refrained from as a result of information contained herein.