

NOTES FOR GUIDANCE ON PENSION SCHEME

INVESTMENT IN UNQUOTED SHARES

The pension regulations introduced on the 6th April 2006 permit pension schemes to purchase unquoted shares both in UK and overseas companies, although this is subject to various restrictions.

The type of pension vehicle that can be used for this purpose 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 surrounding permissible investments of SSAS and SIPP are broadly the same (apart from one exception) effectively creating one type of arrangement known as “Investment Regulated Pension Schemes”, or “Member Directed Pension Schemes”.

The aim of these notes is to assist Pension Scheme Trustees in buying unquoted shares, and to ensure that any problems are avoided. These investments are not straightforward and it is advisable to discuss plans with us before proceeding and seek advice from a suitably qualified independent financial adviser.

GENERAL PRINCIPLES

An unlisted/unquoted company means a company which is not officially listed on a recognised stock exchange within the meaning of Section 841 ICTA 1988.

It is important to be able to demonstrate that the sole purpose of establishing a pension scheme is not to buy unquoted shares, as this could be deemed as tax avoidance under the Income & Corporation Taxes Act 1988 (s 707) or the regime for disclosure of tax avoidance schemes in the Finance Act 2004 (Part 7). This is easier to demonstrate if (a) the scheme is set up some time before the purchase takes place and (b) the balance of the assets are invested in other asset classes.

If there is any doubt, prior clearance can be sought from Her Majesty’s Revenue & Customs (HMRC). This is a process that you would need to do prior to approaching us to arrange the investment.

There are a number of circumstances whereby the purchase of unquoted shares could involve the pension scheme member(s) or sponsoring employer and pension fund in substantial tax charges. The first step is therefore to establish whether the proposed share purchase is allowable as a pension scheme investment, or whether it will incur tax charges effectively rendering it forbidden. This is a complex area.

TAXABLE PROPERTY AND THE PRINCIPLE OF INDIRECT INVESTMENT

Taxable property consists of residential property and “tangible moveable property”

(e.g. art, antiques, stamps, fine wine, jewellery, cars, office equipment etc). “Indirect investment” in taxable property via unquoted shares of a company that holds taxable property is included in the definition.

Apart from some specific exceptions, UK Pension Schemes are not permitted to invest in “taxable property” (directly or indirectly) without paying substantial tax charges.

Examples of an indirect interest in taxable property are:

1. A pension scheme holds 100% of the share capital of a company which itself owns a residential property. The pension scheme therefore indirectly holds a 100% interest in the residential property.
2. A pension scheme holds 100% of the shares in company A and company A holds 50% of the shares in company B which owns an art collection. The pension scheme indirectly holds an interest in company B of 50% (i.e. 100% x 50%) and therefore a 50% interest in the art collection.
3. A pension scheme holds 20% of the shares in company A, which holds 50% of the shares in company B that holds 40% of the shares in company C that owns residential property. The pension scheme holds an indirect interest in company B, of 10% (i.e. 20% x 50%), and company C, of 4% (i.e. 20% x 50% x 40%), and therefore indirectly holds a 4% interest in the residential property.

The extent of a pension scheme’s interest in a company (and thereby its taxable property) is determined by whichever of the following gives the pension scheme the greatest interest in the company:

- the percentage of the share capital or issued share capital of the company owned by the pension scheme,
- the percentage of the voting rights in the company owned by the pension scheme,
- the percentage of all the income of the company to which the pension scheme has a right,
- the percentage of the amounts distributed on a distribution in relation to the company to which the pension scheme has a right,
- the percentage of the assets of the company to which the pension scheme has a right on a winding up or in any other circumstances,
- where a pension scheme has a right to a percentage of a particular asset of the company, or of the income or gains derived from such an asset, that percentage.

IF A COMPANY HAS ABSOLUTELY NO TAXABLE PROPERTY, FOR EXAMPLE AN INVESTMENT COMPANY WHICH MERELY HOLDS COMMERCIAL PROPERTY, THEN THE PENSION SCHEME CAN OWN UP TO 100% OF ITS SHARES

PURCHASE OF SHARES IN SPONSORING COMPANIES OF AN OCCUPATIONAL SCHEME (SSAS)

There are limits on the total value of shareholdings in its sponsoring employer(s) that an occupational scheme can purchase. The market value of the shares at purchase must be less than:

- 5% of the market value of the scheme's assets in any one sponsoring employer.
- 20% of the market value of the scheme assets where the shareholdings relate to more than one sponsoring employer.

These shareholding limits only apply to schemes that are classed as occupational pension schemes as defined in the Finance Act 2004. This means that a SIPP could be 100% invested in shares of the member's employer on the basis that the SIPP was not defined as an occupational scheme and that the specific circumstances of the member did not deem the investment to be classed as taxable property e.g. if the member was a controlling director of the company.

INVESTMENT IN TAXABLE PROPERTY VIA UNQUOTED SHARES WHICH INCURS NO TAX CHARGES

Indirect investments held through certain kinds of commercial vehicle will not be subject to tax charges when held as a scheme investment by an investment regulated pension scheme. These are called "Genuinely Diverse Commercial Vehicles" of which there are three types:

1. Trading Concerns

These are arm's length trading vehicles. There are four conditions to be met:

1. The vehicle's main activity is the carrying on of a trade, profession or vocation (i.e. it is not an investment company).
2. The pension scheme either alone or together with associated persons does not have control of the vehicle.
3. Neither a pension scheme member nor a person connected to such a member is a controlling director of the vehicle (i.e. owns or controls 20% or more of the share capital) or any other vehicle which holds an interest in the vehicle directly or indirectly.
4. The pension scheme does not directly or indirectly hold an interest in the vehicle for the purposes of enabling a pension scheme member or a connected person of such a member to occupy or use residential or tangible moveable property.

2. Other Kinds Of Vehicle

These are often established as Unit Trusts, Open Ended Investment Companies or other pooled arrangements.

If a vehicle meets certain conditions, where the pension scheme, and associates, directly or indirectly own 10% or less and there is no right to have private use of any taxable property they will not be subject to a tax charge.

The pension scheme together with any connected person (see below for a definition of connected parties but note this includes other members of the same pension scheme e.g. a SSAS but not a SIPP) must not hold directly or indirectly 10% or more of the share capital or issued share capital of the vehicle, or 10% or more of the voting rights in the vehicle, or a right to receive 10% or more of the income of the vehicle, or an interest in the vehicle giving rise to income and gains derived from a specific property of more than 10%.

The vehicle must meet three conditions.

Condition 1

- The total value of the assets held directly by the vehicle is at least £1 million, or
- The vehicle holds at least three assets directly which are residential property, none of which has a value which exceeds 40% of the total value of the assets.

Condition 2

- If the vehicle is a company it is not a close company (i.e. controlled by five or fewer parties), or the equivalent in its country of residence.

Condition 3

- The vehicle does not have as its main purpose, or one of its main purposes, the direct or indirect holding of an animal(s) used for sporting purposes. This is to recognise that many racehorse syndicates have many members and provide them with certain benefits related to the horse ownership such as attendance at race meetings as an owner with access to the owner's enclosure.

The pension scheme's interest in the vehicle must meet the following conditions:

1. There is no right to private use of any taxable property owned by the vehicle.
2. The pension scheme must not directly or indirectly hold an interest in the vehicle for the purposes of enabling a member of the pension scheme or a connected person to occupy or use residential property or tangible moveable property.
3. These limits apply to indirect holdings of a vehicle as well. So if a pension scheme holds 50% of company A which in turn owns 15% of company B then the pension scheme's interest in company B will be 7.5%. The indirect holding in company B will therefore be less than 10%.

3. UK REITS

UK REITS are companies to which Part 4 of Finance Act 2006 (UK Real Estate Investment Trusts) applies or a member of a group to which that part applies.

The pension scheme's interest in the UK REIT must meet the following conditions.

The pension scheme

- Must not directly or indirectly hold an interest in the UK REIT for the purposes of enabling a member of the pension scheme or a connected person of a member to occupy or use the property, and
- The pension scheme together with any connected person must not hold directly or indirectly 10% or more of the share capital or issued share capital of the UK REIT, or 10% or more of the voting rights in the UK REIT, or a right to receive 10% or more of the income of the UK REIT, or an interest in the UK REIT giving rise to income and gains derived from a specific property of more than 10%.

Low Value Holding Of Taxable Property

Where the company concerned is not classed as a genuinely diverse commercial vehicle (for example if the pension scheme member and/or connected persons owns or controls 20% or more of the company), and "low value taxable property" is owned by a company for use in the normal operation of its business, this is only exempt from being treated as taxable property in the following circumstances:

1. Its market value is less than £6,000
2. It is held for the purpose of management or administration of the company
3. No direct ownership is permitted by the pension fund – only indirect via purchase of shares
4. **No member or connected person uses (or has a right to use) the asset**

The fourth point usually means that controlling directors and those who have a direct or indirect control of 20% or more of the company cannot purchase shares with their pension scheme because they have the right to use the equipment (telephones, computers, etc) of the company.

VALUE SHIFTING

It is possible to pass value from a pension scheme without making any payment. For example, an individual is a member of a pension scheme which owns 10% of the class A shares in a company, while the individual personally owns 10% of the class B shares.

Originally both class A and class B shares have similar rights, but if the class A shares then change their rights so they no longer carry the right to dividends, then value has been passed to the class B shares, and therefore to the member without any payment. Such shifting of value is taxable.

WHEN DOES A TAX CHARGE APPLY TO AN INDIRECT HOLDING OF TAXABLE PROPERTY?

Where a pension scheme invests in shares of an unquoted company which holds taxable property, and the company is not classified under one of the exemptions explained above, then it is treated as making an “Unauthorised Payment”. The specific circumstances where an unauthorised payment occurs are the following:

- acquiring the taxable property indirectly
- increasing interest in an indirect holding
- improvement of taxable property held indirectly to increase its value
- the vehicle increases its holding of taxable property
- conversion of non-taxable property into taxable property
- value shifting

In each of these instances, the purchase/conversion cost (or open market value if greater), or increased/decreased value of the taxable property will be the amount subject to a tax charge.

THE TAX CHARGES THAT WILL APPLY

In the circumstances outlined above where an unauthorised payment is deemed to have occurred, the consequent tax charges (and possible allowances) are as follows:

Acquisition

The amount spent on acquiring an indirect interest in taxable property is subject to an “Unauthorised Payment Charge” of 40% on the pension scheme member and a “Scheme Sanction Charge” of 15% on the scheme Administrator – a total charge of 55%.

If more than 25% of the pension fund value is spent on the investment, a further Unauthorised Payment Surcharge of 15% is levied on the member, taking the total tax charge to 70%. If the amount spent on acquiring the investment is not the market value, the market value must be used for this purpose. Some examples are as follows:

- The pension scheme owns 50% of a company and that company acquires a residential property for £100,000. The unauthorised payment will be £50,000.
- The pension scheme holds 100% of company A which in turn holds 50% of company B. Company B acquires a residential property for £100,000. The unauthorised payment will be £50,000
- The pension scheme holds 50% of company A which in turn holds 50% of company B. Company B acquires a residential property for £100,000. The unauthorised payment will be £25,000

Annual Tax Charge

An annual Scheme Sanction Charge of 40% of the income derived from the investment is also payable by the pension scheme Administrator for as long as it continues to be held by the pension scheme. If the income is less than 10% p.a. it is

deemed as being 10% (increased by RPI each year). An example is as follows:

- A pension scheme holds 50% of company A which holds 50% of company B. Company B holds a residential property for the entire tax year. The income is £10,000. The pension scheme is chargeable to a scheme sanction charge on £2,500 (i.e. £10,000 x 50% x 50%).
- In the above example, if Company B pays tax of £2,000 on the income, a credit for tax paid of £500 is allowed to be set against the tax due on the scheme sanction charge (i.e. £2,000 x 50% x 50%).

Disposal

A 40% Capital Gains Scheme Sanction Charge is payable by the pension scheme Administrator on disposal of the asset.

- A pension scheme holds 100% of a company and the company owns a residential property. The unauthorised payment charged on the pension scheme in relation to the acquisition of the asset was £100,000. The pension scheme disposes of 50% of its shares in the company when the market value of the asset is £200,000.
- The cost of the asset for the purposes of the capital gains computation is taken to be 50% of the unauthorised payment - i.e. £50,000. The sale proceeds are deemed to be 50% of the market value of the property i.e. £100,000. The taxable gain is therefore £50,000.
- If the company subsequently disposes of its holding in the property for £250,000. The amount of unauthorised payment charged in relation to the asset was £100,000. However £50,000 was used in the previous capital gain and therefore only £50,000 is available to set against this gain.
- When the company disposes of the property the pension scheme held 50% of that company. Therefore the consideration for the disposal is deemed to be 50% of the actual sale proceeds.
- The capital gain is therefore based on deemed sale proceeds of £125,000 and costs of £50,000, giving a taxable gain of £75,000.
- If any tax is paid on the disposal of the property by the company, this is allowed to be offset against any tax charged on the capital gain as a scheme sanction charge. The amount allowed to be offset is the proportion of the tax paid that relates to the pension scheme's holding in the company. Therefore if the pension scheme holds 50% of the vehicle, 50% of the tax is allowed as a deduction.

In addition, if the unauthorised payment in any scheme year exceeds 25% of the total fund value, HM Revenue & Customs has discretion to withdraw the scheme's tax exempt status, which incurs further tax charges.

Clearly, these tax charges are very high, and make pension scheme investment in taxable property completely unfeasible.

It must also be stressed that it is the responsibility of the pension scheme member(s) to inform us of any occurrences which involve an unauthorised payment, so this can be reported to HM Revenue & Customs in the quarterly "Accounting For Tax" return, and the appropriate tax paid. Failure to make a report in the quarterly return will incur a fine from the Revenue on the pension scheme of up to £3,000. Neither IPS nor the scheme Trustees are liable for

these penalties, and they are therefore payable from the pension fund.

Scheme sanction charges levied on the scheme Administrator must be paid from the pension fund. Neither IPS nor the Trustees are liable. IPS will assess an unquoted investment prior to transaction and it is the responsibility of the pension scheme member(s) to inform IPS of any changes in circumstances that could result in the investment being classed as taxable property.

CIRCUMSTANCES WHERE AN INCREASE IN THE VALUE OF INDIRECTLY HELD TAXABLE PROPERTY DOES NOT INCUR A TAX CHARGE

If the value of a pension scheme's indirect holding of taxable property increases without the pension scheme purchasing further shares in the company, this is not deemed as an unauthorised payment or taken into account for the purposes of the 10% test for genuine commercial vehicles (see above) unless it is part of a scheme or arrangement to enable a lower unauthorised payment to be charged.

For example, if a scheme owns 8% of the shareholding in a company, and this is increased to 15% because others decrease their holdings, this increase will not be taken into account unless it is done as a deliberate device to avoid the unauthorised payments charge.

BUYING THE SHARES

When purchasing the shares, certain requirements must be fulfilled:

1. If the shares are being purchased from or issued by a connected party (see below for a definition of connected parties), a professional valuation of the shares to be acquired by the pension scheme must be provided before the purchase proceeds. The valuation can be supplied by the company's auditor or other suitably qualified person, and must be given in writing.
2. In addition, The Pensions Act 1995 lays down certain requirements for occupational pension schemes (i.e. SSASs) that Trustees must fulfil when making investments. It is our understanding that the Trustees of these schemes who wish to invest in the shares of an unquoted company must take suitable professional advice before doing so. Therefore, in addition to the requirement to obtain a professional valuation, we will require a letter from the company's accountant/auditor, confirming that in their opinion the investment is a suitable one for the Trustees that will not compromise the Trustees' primary duty of safeguarding scheme funds.
3. The shares must be registered in the individual names of the pension scheme trustees with an account designation of the pension scheme's name.
4. It is a requirement that you provide us with a copy of the share certificate for our records.

PAYMENT OF DIVIDENDS

If the shares do not yield an income, or increase in value, the Revenue may regard them as an unsuitable investment for the pension scheme. The company should therefore pay dividends. This can cause problems, especially if there are external shareholders who have not been paid dividends in the past.

When the company declares a dividend, it must pay its shareholders. To pay the dividend to the pension scheme, the company should draw a cheque for the net amount of the dividend (i.e. less 10% advanced Corporation Tax), made payable to the trustees of the pension scheme, and send this to us. The tax cannot be reclaimed by the pension scheme.

VALUING THE SHARES

It will be necessary from time to time to provide us with an up to date valuation of the shares. This is particularly important at the point of commencing or reviewing retirement benefits. It is therefore essential that you provide us with a professional valuation as and when required.

SELLING THE SHARES

Eventually, the shares will be sold at market value to provide retirement or death benefits. However, if there is sufficient income in the fund from other investments to provide benefits, the shares could be retained in the fund for the next "generation".

If the shares are sold to a connected party, a professional valuation must be provided beforehand as evidence that the sale price is the open market value.

TRANSITIONAL PROTECTION

Where, on A-Day (6th April 2006), a SSAS already held shares above the simplified regime limits, it will not be required to reduce the holding to comply with the new rules. Any subsequent purchase or enhancement in value automatically means the whole shareholding must comply with the A Day regulations.

CONNECTED PARTIES

HM Revenue & Customs have a broad definition of a connected party as set out in Section 839 of the 1988 Taxes Act. This basically involves the following:

- A wife, husband or relative
- A wife or husband of a relative
- A trustee is connected with a settlor
- 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)
- Any other member of the pension scheme,

- Any other person connected with such a member,
- Any other pension scheme of which a member or connected person is also a member.
- any associated pension scheme

FEES

The standard fee for the work involved with each investment in unquoted shares is £250 plus VAT. However, if our guidelines are not followed, this usually results in additional administration. We reserve the right to charge an extra fee, on an hourly basis, in respect of any additional work.

For those who wish to proceed with an investment in unquoted shares, the first step is to complete and return the Questionnaire and Resolution with a professional valuation where the transaction is with a connected party.

These guidelines are based on our understanding of current law and HM Revenue & Customs practice, which are subject to alteration.

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