Notes for Guidance on Pension Scheme Investment in Unquoted Shares

(For the James Hay Modular iSIPP, Partnership SIPP, IPS SIPP, IPS (2008) SIPP, IPS Pension Builder SIPP, IPS Family SIPP and SSAS only)

We no longer allow unquoted share investments with the exception of top ups that have been recommended by a regulated financial adviser (subject to policy requirements).

Introduction

Pension regulations permit pension schemes to purchase unquoted shares both in UK and overseas companies, although this is subject to various restrictions. We no longer allow the purchase of new unquoted shares but may allow existing share holdings to be topped up if advice has been provided by a regulated financial adviser, subject to our policy requirements.

The aim of these notes is to assist pension scheme trustees and members in topping up existing holdings in unquoted shares, and to ensure that any problems are avoided. These investments are not straightforward and you must seek advice from a suitably qualified 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 1005(3) Income Tax Act 2007.

If the sole purpose of establishing a pension plan is simply to buy unquoted shares, then this could be deemed as attempting tax avoidance. In order to demonstrate that the above is not the case, a plan should (a) have a balance of assets invested in other asset classes and (b) have been set up some time before any unquoted shares are purchased.
There are a number of circumstances whereby the purchase of unquoted shares in repsect of a top up investment could involve substantial tax charges for the pension scheme member(s) or sponsoring employer and pension fund. The first step is therefore to establish whether the proposed share purchase is allowable as a pension 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:

- A pension plan holds 100% of the share capital of a company which itself owns a residential property. The pension therefore indirectly holds a 100% interest in the residential property.
- A pension plan 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 indirectly holds an interest in company B of 50% (i.e. 100% x 50%) and therefore 50% interest in the art collection.

- A pension plan 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 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 plan's interest in a company (and thereby its taxable property) is determined by whichever of the following gives the pension the greatest interest in the company:

- the percentage of the share capital or issued share capital of the company owned by the pension plan
- the percentage of the voting rights in the company owned by the pension
- the percentage of all the income of the company to which the pension has a right
- the percentage of the amounts distributed on a distribution in relation to the company to which the pension has a right
- the percentage of the assets of the company to which the pension has a right on a winding up or in any other circumstances where a pension 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.

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's assets where the shareholdings relate to more than one sponsoring employer.

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 an investment by a registered pension scheme. These are called 'Genuinely Diverse Commercial Vehicles' of which there are three types:

Trading concerns

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

- The vehicle's main activity is the carrying on of a trade, profession or vocation (i.e. it is not an investment company)
- The pension either alone or together with associated persons does not have control of the vehicle
- 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
- The pension plan does not directly or indirectly hold an interest in the vehicle for the purpose of enabling a pension scheme member or a

connected person of such a member to occupy or use residential or tangible moveable property.

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 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 member 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 numerous 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 member's interest in the vehicle must meet the following conditions:

- There is no right to private use of any taxable property owned by the vehicle
- The pension 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
- These limits apply to indirect holdings of a vehicle as well. So if a pension plan holds 50% of company A, which in turn owns 15% of company B, then the pension's interest in company B will be 7.5%. The indirect holding in company B will therefore be less than 10%.

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 plan's interest in the UK REIT must meet the following conditions:

- The pension plan 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 member 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:

- Its market value is less than £6,000
- It is held for the purpose of management or administration of the company
- No direct ownership is permitted by the pension fund – only indirect via purchase of shares
- 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 plan 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 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 detailed below.

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 plan owns 50% of a company and that company acquires a residential property for £100,000. The unauthorised payment will be £50,000.
- The pension plan 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 plan 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 scheme administrator for as long as it continues to be held by the pension. 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 plan 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 of £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 plan 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 plan 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 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 plan's holding in the company. Therefore, if the pension 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 (HMRC) 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 James Hay of any occurrences which involve an unauthorised payment, so this can be reported to HMRC 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 HMRC on the pension scheme of up to £3,000. Neither James Hay 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 James Hay nor the trustees are liable. James Hay will assess an unquoted investment prior to transaction and it is the responsibility of the pension scheme member(s) to inform James Hay 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 plan indirect holding of taxable property increases without the pension 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 plan 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 payment charge.

Threshold

The maximum percentage of plan value in unquoted shares is limited to 40% under our company policy.

Buying the shares

When purchasing the shares, certain requirements must be fulfilled:

- The member(s) must have received advice in respect of the purchase from a regulated financial adviser.
- 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.
- If the investment involves buying shares from a third party then we will need an independent validation of the share price. This requirement depends on the investment so please contact the Specialist Investment Support Team if you would like further information (see page 9 for contact details).
- 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.
- The shares must be registered in the name(s) of the pension scheme trustee(s) with an account designation of the pension scheme's name.
- The member trustee(s) would normally retain the original share certificate but 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, HMRC 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

We need to value pension scheme assets at least annually. This will mean that the member trustees will need to arrange for an accountant to produce an independent valuation (at the client's cost).

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 at market value.

Transitional protection

Where, on A Day (6th April 2006), a pension plan 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 current regulations.

Connected parties

HMRC has a broad definition of a connected party as set out in Section 993 of the Income Taxes Act 2007. 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.

Charges

Please refer to the relevant Charges Schedule, available on our website at www.jameshay.co.uk, for the associated administration charges. We reserve the right to make an additional charge, on an hourly basis, in respect of any additional work.

It may be that we need to instruct an external solicitor to review documentation. The solicitor will make a charge for this and this will be paid by your pension plan. We will require your agreement to the solicitor's costs before proceeding.

For those who wish to proceed with a top-up investment in unquoted shares, the first step is to complete and return the Unquoted Share Questionnaire, available on our website at www.jameshay.co.uk, together with the appropriate further documentation detailed in this document.

Tax

This guide is based on our understanding of current law and HMRC practice, which is subject to alteration.

How to contact us

Telephone enquiries:

If you have any queries, then please do not hesitate to contact the Specialist Investment Support Team on 03333 206 182.

Lines are open 9am to 5pm Monday to Friday. To help us improve our service we may record or monitor calls.

Visit our website:
www.jameshay.co.uk

Write to us at:
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We are able to provide literature in alternative formats. For a Braille, large print or audio version of this document call us on 03455 212 414 (or via the Typetalk service on 18001 03455 212 414).

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