Unquoted Share Guideline

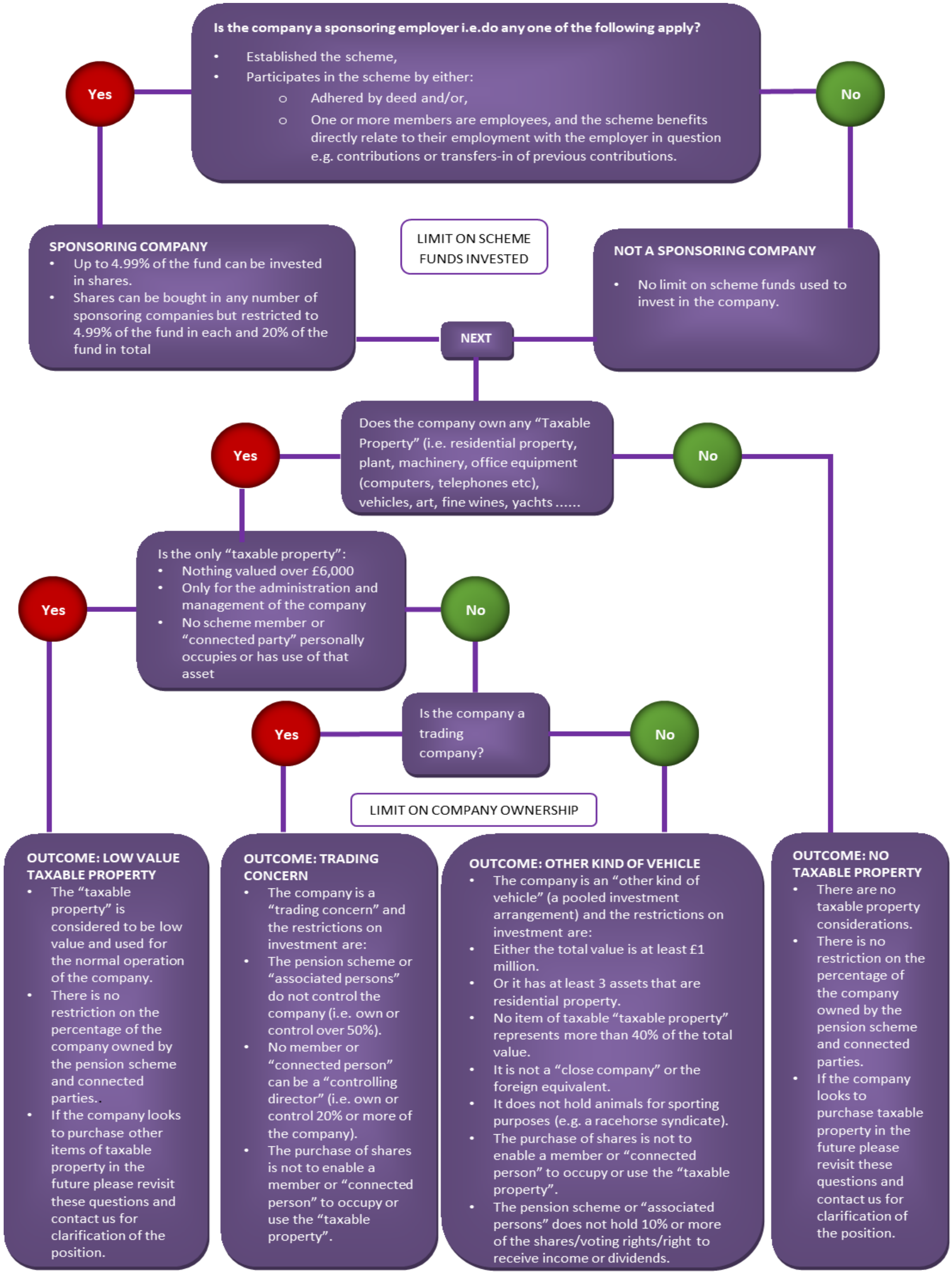
This guideline has been produced to assist scheme Members and their Advisers with purchasing unquoted shares. Please note that we do not give financial advice and this guideline is for information purposes only.

As we do not give financial advice on your investment strategy we strongly recommend that you obtain independent financial advice. If you do not already have an Adviser, information can be obtained from www.unbiased.co.uk or telephone 0800 085 3250.

Contents

1. At a glance

Please follow this diagram to determine any restrictions on the proposed investment.



2. Introduction

These investments are not straightforward and it is advisable to discuss plans with us before proceeding. Unquoted shares are illiquid investments meaning they can be hard to sell and this must be borne in mind when considering whether they are suitable as a pension scheme investment.

An unlisted/unquoted company is a company **not** listed on a recognised stock exchange under Section 841 ICTA 1988. This means that shares quoted on the London Stock Exchange (including Investment Trusts, REITS and Exchange Traded Funds), the UK AIM and PLUS markets and those listed on "Recognised" overseas stock exchanges are all treated as quoted shares and these guidelines do not apply.

We treat a company quoted on an unrecognised overseas stock exchange as unquoted and these guidelines will apply.

HM Revenue & Customs (HMRC) provide a list of recognised stock exchanges on their website at www.hmrc.gov.uk.

3. General principles of Taxable Property

The purchase of unquoted shares is a complex area as some investments could result in the pension scheme or the scheme members or sponsoring employer incurring heavy tax charges. It must therefore be established at outset that the investment is allowable and in our opinion will not involve tax charges.

Taxable Property and Indirect Investment

Pension schemes can purchase shares in companies but cannot invest in "taxable property" except for certain exceptions. HMRC therefore impose restrictions on the purchase of shares in companies that own taxable property.

HMRC define a number of asset classes as "Taxable Property" for the purposes of UK pension schemes. These include residential property, "tangible moveable property" (e.g. computers, vehicles, yachts, antiques and fine wine), commodities and spread betting. Pension schemes that invest in these assets are subject to large tax penalties unless one of the exemptions applies. Investing indirectly in taxable property by purchasing shares in an unquoted company which owns it is deemed as ownership by the pension scheme.

Examples of an indirect interest in taxable property:

- A pension scheme holds 100% of the share capital of a company which owns a residential property. The pension scheme therefore indirectly holds a 100% interest in the residential property.
- A pension scheme holds 100% of the shares in company A and company A holds 50% of the shares in company B which owns a yacht. The pension scheme indirectly holds an interest in company B of 50% (i.e. 100% x 50%) and therefore a 50% interest in the yacht.
- A pension scheme holds 20% of the shares in a company, which holds 50% of the shares in another company that holds 40% of the shares in a third company that owns residential property. The pension scheme holds an indirect interest in the second company of 10% (i.e. 20% x 50%), and the third company 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.
- The percentage of the voting rights in the company owned.
- The percentage of all the income of the company which the pension scheme has a right to receive.
- On a distribution from the company, the percentage the pension scheme has a right a right to receive.
- The percentage of the assets of the company the pension scheme has a right to receive on its winding up.
- The percentage of the income or gains derived from a specific asset that the pension scheme has a right to receive.

Value Shifting

A shift of value from a pension scheme without making any payment is taxable and must be avoided.

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.

Taxable Property with Low Value

Indirect ownership of taxable property owned by companies for the everyday operation of their business is exempt from tax charges where the following conditions are met:

- Its market value is not greater than £6,000.
- It is held solely for the administration or management of the company.
- The taxable property is held indirectly by the pension scheme by the purchase of shares in the company.
- No scheme member or anyone connected to a scheme member personally occupies or has use of the asset.

Trading

Whilst companies can trade, where a pension scheme is deemed as trading, it will be taxed in the same way as a company. Therefore any investment by a pension scheme into the shares of an unquoted company must be for investment purposes only and not be for the indirect purpose of trading. HMRC have six “badges of trade” against which they assess an activity to determine whether it is trading. Each activity is looked at on a case by case basis.

With these general principles in mind, we can now explain what unquoted share investments are permitted. There are four types.

4. Shares purchased in sponsoring employers

Occupational pension schemes (for example a Small Self-Administered Pension Scheme (SSAS)) can purchase shares in its own sponsoring employers but, there are limits on the amount of scheme funds used to invest, as well as the taxable property considerations.

Sponsoring employers include both current and former employers who either established or participate in the scheme. Participation includes employers adhered by deed and any employer where one or more of its employees are members, and scheme benefits for those members are directly related to their employment with the employer in question e.g., contributions made to the scheme or transfers-in of benefits relating to the employment.

- At the time the investment is made the **market value** of the shares purchased in any one sponsoring company must be less than 5% of the total market value of the pension fund.
- The pension scheme can invest in shares of more than one sponsoring employer provided the total amount invested in sponsoring employers is less than 20% of the market value of the scheme assets.

The market value is tested at the time the payment is made for the shares and will not be re- tested at a later date, if for example the scheme assets lose their value, unless new shares in the sponsoring employer are acquired.

There are no restrictions with regard to the percentage of shares which can be held in one company (for example, a pension scheme could potentially own 100% of the share capital of a company) providing that the sums invested are less than 5% of the fund value mentioned above.

For all investments we must consider indirect holdings of taxable property, and there are three permitted types set out in the next sections.

5. Non-trading investment companies owning non-taxable property only

If a company owns absolutely no taxable property, for example an investment company that merely holds commercial property, the pension scheme can own up to 100% of its shares. Investment companies such as this are common vehicles for purchasing property, particularly overseas, but they must not own any related assets such as computers or telephones for their management or furniture, fixtures or fittings of the property.

This is an ongoing test which means, at any time in the future, if the company purchased taxable property, this would trigger an unauthorised payment.

6. Trading Concerns

These are arm's length trading vehicles. As they usually own at least some low value taxable property, there are four conditions to be met to ensure this does not incur tax charges for the pension scheme:

Condition 1

The vehicle’s main activity is the carrying on of a trade, profession or vocation (i.e. it is not an investment company).

Condition 2

The pension scheme either alone or together with “associated persons” does not have control of the vehicle i.e. own 51% or more of the shareholding.

Condition 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.

Condition 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.

This is an ongoing test which means, at any time in the future, if the pension scheme and/or connected parties increased their holding in the company to more than the above conditions, this would trigger an unauthorised payment.

7. Other Kinds of Vehicle: Genuinely Diverse Commercial Vehicles

These are pooled investment arrangements. There is no specific regulation governing the underlying legal structure of these vehicles. They can be unquoted companies, Unit Trusts, Open Ended Investment Companies or other pooled arrangements such as Limited Partnerships (Limited Liability Partnerships (LLPs) are specifically not permitted where investment is in property).

Provided the vehicle meets certain conditions a pension scheme can invest without any taxable property considerations:

Condition 1

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 vehicle.
- 10% or more of the voting rights in the vehicle.
- A right to receive 10% or more of the income of the vehicle.
- An interest in the vehicle giving rise to income and gains derived from a specific property of more than 10%.

Condition 2

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. In either case, no asset which is taxable property has a value which exceeds 40% of the total value of the assets.

Condition 3

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 4

There is no right to occupy or have private use of any taxable property owned by the vehicle or to benefit from any non-pension benefits as a result of the investment. This includes the condition that the vehicle does not have as its main purpose, or one of its main purposes, the direct or indirect holding of 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.

Condition 5

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%.

This is an ongoing test which means, at any time in the future, if the pension scheme and/or connected parties increased their holding in the company, or the company changed the investments to more than the above conditions, this would trigger an unauthorised payment.

8. When a tax charge applies to an indirect holding of taxable property

Any investment in taxable property via unquoted shares which does not fall into one of the above exemptions is an "Unauthorised Payment". Unauthorised Payments are triggered in the following ways:

- Acquiring taxable property indirectly.
- Increasing interest in the indirect holding.
- Improving or enhancing taxable property to increase its value.
- The unquoted company increasing its holding of taxable property.
- Converting non-taxable property into taxable property.
- Shifting value (e.g. by changing the status or rights of the pension scheme's shareholding to increase or decrease their value).
- Receiving income from taxable property
- Receiving a capital gain from the disposal of taxable property

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.

9. The tax charges that 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:

	Taxable Event		
Tax Charge	Acquisition	Annual	Disposal
Unauthorised Payment Charge (payable by the members personally)	40% of the acquisition cost	N/A	N/A
Scheme Sanction Charge (deducted from the pension scheme)	15% of the acquisition cost (rising to 40% if the member charge is not paid)	40% of the annual income on the investment. If income is less than 10% p.a. then 10% p.a. index-linked is used.	40% of the capital gain calculated using prevailing capital gains tax rules
Unauthorised Payment Surcharge (payable by the members personally)	15% of the acquisition cost if it exceeded 25% of the fund value	N/A	N/A

- If the acquisition cost is not the market value, the market value must be used for this purpose.
- Tax charges are payable by the recipient of the Unauthorised Payment and by the pension fund. **We are not responsible or liable for any tax charges. Our liability is limited in the Trust Deed and Rules of the pension scheme.**

- If the unauthorised payment charge has not been paid, the scheme sanction charge on acquisition will be taxed at 40%
- **It is your responsibility as member trustee(s) to inform us of any instance of Unauthorised Payments or any changes to investments which could mean they become taxable property. We must report these to HMRC in the annual event report. The relevant tax charge must be paid by 31st January following the end of the tax year to which the event relates.**
- **If an event report is not made, HMRC will fine the pension scheme up to £3,000.**
- If the Unauthorised Payment in any scheme year exceeds 25% of the total fund value, HMRC has discretion to withdraw the scheme's tax exempt status, which incurs further tax charges.

Examples of Tax Charges:

Example 1: Acquisition

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.

Examples of Tax Charges (continued):

Example 2: Annual

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%).

Example 3: Disposal

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 pension scheme will be deemed to have made a capital gain.

The cost of the asset for the purposes of the capital gains computation is taken to be 50% of the unauthorised payments charged - i.e. £50,000. The sale proceeds are deemed to be 50% of the market value of the property i.e. £100,000.

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

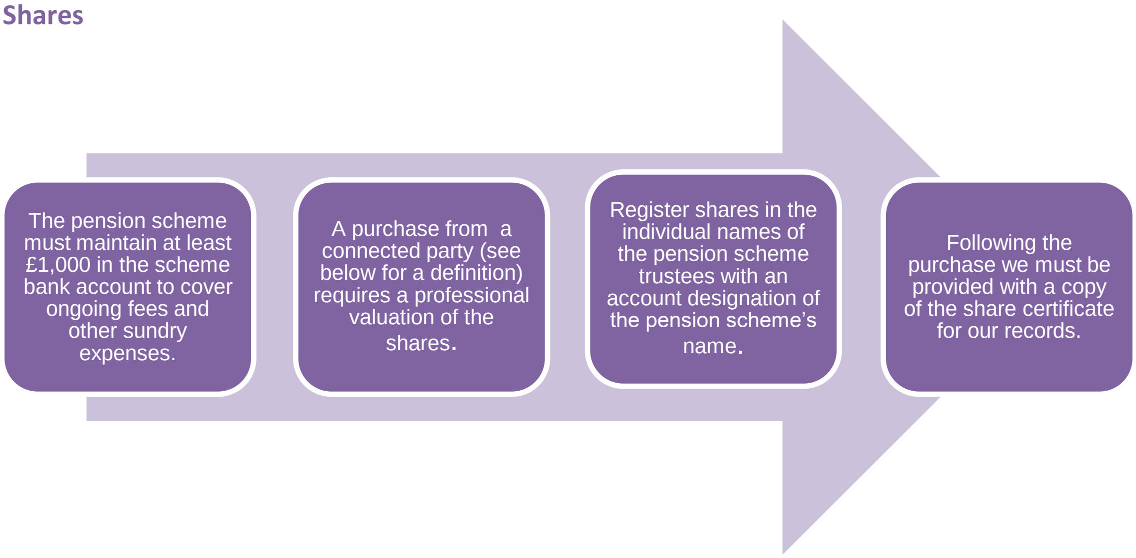
10. Where an increase in the value of indirectly held taxable property does not incur a tax charge

An unauthorised payment charge does not occur where a pension scheme increases the value of its indirect holding of taxable property without making an additional purchase of shares in the company. This is also not accounted for in the 10% test of a Genuinely Diverse Commercial Vehicle. However, if the increase in the holding was a deliberate device to avoid an Unauthorised Payment charge on the original investment then it will be charged.

For example, a scheme has an interest of 8% in a company. Other shareholders reduce their interests which increases the pension scheme's holding to 25%. This does not trigger an unauthorised payment unless it is done to deliberately avoid the Unauthorised Payments charge.

11. The practicalities

Buying the Shares



A professional valuation can be supplied by the company's auditor or other suitably qualified person and must be given in writing addressed to the scheme trustees.

Payment of Dividends

The company should pay dividends on profits. When a dividend is declared, the pension scheme should be paid the net amount less 10% advanced Corporation Tax. The pension scheme cannot reclaim the tax.

Valuing the Shares

Unquoted shares must be independently valued by a suitably qualified expert such as the company's auditor at various times such as when retirement benefits commence or are reviewed. Please ensure we are provided with valuations promptly as and when requested.

Selling the Shares

When the shares are sold to a connected party we require an independent valuation to evidence that the transaction is taking place on an arms-length open-market basis.

Valuation reports

Valuing unquoted company shares is specialist and sometimes difficult to define. We would therefore expect a valuation report to be completed by a suitably qualified independent party. It must be addressed to the trustees and provide full details on how the valuation was reached to be deemed fit for purpose by HMRC. This may be expected to include the calculation basis used, details of historic and future trading of the company, minority/majority shareholding considerations and provide copies of accounts, management reports and cash flows etc. relied upon.

12. Definitions of Associated Persons, Connected Parties, Close Company, Controlling Director

Associated Persons

- Any member of the pension scheme (or another pension scheme they are a member of)
- Any person “connected” with such a member (or another pension scheme they are a member of)

Connected Parties

The HMRC definition of a connected party is given in Section 993 and 994 of the Income Tax Act 2007.

<u>A person connected to another person:</u>

- a spouse or civil partner
- a relative(brother, sister, ancestor or lineal descendant)
- the spouse or civil partner of a relative
- a relative of a spouse or civil partner
- the spouse of a relative’s spouse

<u>A trustee is connected to:</u>

- a trustee is connected with a settlor or a person connected with a settlor
- a trustee is connected with any close company whose participators include the trustees of the settlement

<u>A partner in a partnership is connected to:</u>

- a partner in a partnership is connected with any other partner in the partnership
- a partner in a partnership is connected with the spouse or civil partner of any other partner or a relative of any other partner

<u>A company connected to another company:</u>

- if the same person has control of both companies
- where a person has control of one company and persons connected with them have control of the other company
- where a person has control of one company and they together with persons connected with them have control of the other company
- where a group of two or more people have control of both companies and the groups either consist of the same people or people connected with them

<u>A company connected with a person:</u>

- Who has control of the company
- Who together with connected persons have control of the company

<u>Actions relating to companies</u>

- Any two or more persons acting together to secure or exercise control of a company are connected with one another

Close Company

- Five or fewer participators control the company, or
- Participators who are directors control the company
- Would more than half the assets of the company be ultimately distributed to five or fewer participators, or to participators who are directors, in the event of the company being wound up

Controlling Director

- Someone to whom section 452(2)(b) and (3) of the Corporation Taxes Act 2010 applies.
- a manager of the company or otherwise concerned in the management of the company’s trade or business
- the beneficial owner of, or directly or indirectly able to control at least 20% of the ordinary share capital of the company (this includes shares held through pension schemes)
- they are treated as owning or controlling what any associate owns or controls (an associate is broadly similar to a connected party)
- Therefore you don’t have to be an officer of the company to be a controlling director

To Proceed - Investing in Unquoted Shares

Items Required	✓
Unquoted Share Questionnaire	
Accountant's solvency letter	
Copies of the most recent company accounts and company return	
Copy of the Certificate of Incorporation and Memorandum & Articles of Association	
A copy of the company prospectus/Information Memorandum/Business plan (for a new venture)	
An independent valuation (for a connected transaction)	

We will require these items to assess a proposed investment.

We may also request additional items to carry out due diligence.

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

Please correspond with us

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