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SIPPs and Unquoted Shares

Assessing the market in the wake of the A-Day changes

We are almost six months into the post A-Day pension tax regime and, while much is to be commended about the new rules, many of the concerns that were highlighted before April are now manifesting themselves in real-life situations.

One of the issues that still merits examination is in relation to the holding of unquoted shares in a SIPP, particularly following the taxable property rules introduced in this year's Finance Act.

Andy Bell explores the issues and provides advisers with guidance on how to interpret the rules affecting their pension clients.

The Self-Invested Personal Pension industry has been built around an ethos of "if the Inland Revenue allows it, then we will allow it". Before A-Day, there was always the danger that dealing with fringe asset classes could be risky and unremunerative for providers and advisers alike. In general, however, a strict and tightly defined permitted investment list pre A-Day kept us all on the straight and narrow.

As we now know, HM Revenue & Customs has no desire or intention to maintain a list of permitted investments. Instead it has created an environment whereby investments that aren't consistent with a tax-privileged regime lose those tax privileges, and more! SIPP providers now need to apply a different logic when considering whether or not to allow certain asset classes into a SIPP.

Let's take a step back and look at the taxable property rules. The primary purpose of this legislation was to prohibit investment by registered pension schemes into residential property, works of art, racehorses, vintage cars and the like.

In simple terms, any investment into residential property, or tangible moveable property, either directly or indirectly, will lead to a tax charge of between 40% and 55% (of the amount invested) on the member, a further tax charge of typically 15% on the SIPP and then a tax charge of 40% on any income and/or gains subsequently arising in respect of that asset.

HMRC sensibly concluded that this would be sufficient to drive any sane investor away from such investments. However, introducing legislation without any consultation has a tendency to reinforce the law of unintended consequences. Unquoted shares were, as the politicians call it when referring to the suffering of innocent victims in times of war, unfortunate collateral damage.

Ask a SIPP provider if they will allow unquoted shares into their SIPP and they will either reply "no", or "yes" with caveats. Most of the larger SIPP providers are now firmly in the "no" camp, or if not they are edging there very quickly with the benefit of some real-life experience.

Some of the smaller SIPP providers are, however, playing on their ability to be more flexible and remain in the latter camp.

Who is right and who is wrong? Are the big boys missing out on a great opportunity or are the smaller providers risking all in order to maintain a perceived competitive advantage?

I suppose I had better nail my colours to the mast. It will come as no surprise to those who know me or my firm that I am firmly in the "no" camp. In fact, without being overly dramatic or controversial, I would go so far as to say that there is not a SIPP provider out there who has the administrative capabilities to hold unquoted shares and sleep unaided at night.

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This may be seen as a provocative comment and, in a way, this is as intended. In any event, I guess I had better put my money where my mouth is and explain why I have reached this conclusion.

I think that the SIPP industry is broadly in agreement that certain types of unquoted share investments should be avoided at all costs, for example where the member, connected persons and the SIPP would in aggregate represent a controlling interest in the company. If only it were so simple!

Let's first try and summarise the taxable property rules, as they apply to unquoted shares. As mentioned above, it is generally agreed that unquoted shares were an unintended victim of this legislation. However, one should not underestimate the degree of the last-minute concerns that HMRC were beginning to have about the possibility for abuse in this area.

Hence there was not too much sympathy from HMRC when the full extent of the restrictions to unquoted shares became apparent.

For the purposes of the taxable property rules, taxable property includes all moveable assets that may be purchased by an unquoted company, although there is an exemption for assets costing £6,000 or less (although there is no mention whether this includes or excludes VAT).

Why is that relevant? Well, it is relevant because of the fact that, unless one of three exemptions applies, if a pension scheme holds unquoted shares in a company that buys taxable property (e.g. plant and machinery) then the pension scheme is deemed to have purchased that plant and machinery for the purposes of the taxable property rules (to the extent of the pension scheme's fractional ownership of the company). This would then immediately trigger the aforementioned tax charges.

I would hope that all SIPP providers would agree that this is an untenable situation. As an industry, we neither have the capabilities nor the desire to monitor transaction by transaction, or asset by asset, what an unquoted company invests in.

So, if we can agree that this is a place that we do not want to go to, how can we avoid going there?

Well, first we need to understand what the exemptions are in order that the pension scheme is not subject to these onerous "look through" provisions.

The only one of the three exemptions available that will typically apply to an unquoted company appears in paragraph 21 Schedule 29A Finance Act 2004. This states that the pension scheme investment, i.e. the unquoted company, must satisfy all of the conditions set out below in order for the exemption to apply. If it does then we do not need to look under the bonnet and see what the company is investing in.

If at any subsequent time any of these conditions are not met, then thereafter (or until such time as the conditions are met in the future) any purchase of taxable property by the company will trigger the aforementioned tax charges.

These conditions are:

- The company is carrying on a trade, profession or vocation (i.e. it is a trading company). This will therefore exclude investment companies. If the trading company subsequently converts to an investment company, then this could have serious tax consequences. This could easily happen without the SIPP provider being consulted.

- The company is not controlled by the member, connected persons and/or the SIPP acting either individually or together. Clearly this is easy to establish at outset, but future share transactions could occur without the SIPP provider's knowledge.

- Neither the member, nor a connected person, is a controlling director. This brings the ownership threshold down from 50% (as per the above point) to 20% in conjunction with a directorship. In many unquoted companies, it would be normal for an investor holding 20% or more to be a director or at least have family representation on the board.

There are other conditions to be met, but the above summarises the ones that are most relevant.

So, given the lack of proactive involvement that a SIPP provider is likely to have with the day-to-day running of an unquoted company, including changes to the shareholding and the board, we should be able to agree that any unquoted company investment where, post deal, the member, connected persons and/or the SIPP hold more than, say, 10% in aggregate should be avoided.

Indeed, for larger companies, the exemption set out in paragraphs 23 to 25 of Schedule 29A Finance Act 2004 may be available, but the upshot in these situations is still that the SIPP and connected persons cannot own 10% or more of the shares.

So, that probably just leaves us with those genuine third-party investments into unquoted companies to consider.

The investment in unquoted shares could be by way of a subscription for new share capital, or possibly by buying shares off a shareholder wanting an exit. Assuming the former, this may represent start-up capital or an investment into a more mature company requiring capital to fund the next stage of growth.

It may be that some shares are being bought by the pension scheme and some also personally by the member. Let's assume we can keep this within our arbitrary aggregate 10% limit.

My experiences in the past with SSASs says that these investments very rarely turn in a profit, although in the few cases that they do, this can be disproportionate to the initial investment and, clearly, the impact of the lifetime allowance cannot be forgotten.

As well as the possibility of straying into the danger zone, in the context of the taxable property rules, one also needs to be aware of the wider issues associated with ownership of unquoted shares.

Some of these are covered below:

a) **Legal –** what control does the pension scheme have as a shareholder? Will the pension scheme trustees be required to enter into a shareholders' agreement? If so, then what are the obligations/protections contained in this document? If not, why not and how will the pension scheme be protected?

b) **Minority discounts –** HMRC accepts the principle that minority discounts can be applied to the purchase of unquoted shares. While the valuation of the shares is subjective in itself, the nature of the discount is arguably even more so. These discounts can often be anything up to 90%. The level of any minority discount will be determined by aggregating the shares held in the SIPP and also the shares held by the member and other connected persons.

c) **Valuations –** before we even consider minority discounts, we need to arrive at a share valuation. Anyone who has owned shares in, or been involved with advising, unquoted companies will be fully aware of the number of different ways of arriving at a share valuation and the subjectivity contained therein.

An important decision needs to be made as to whether an independent valuation is required at the point of purchase or subsequent sale. It is inconceivable that this will not be the case if the transaction is connected in nature, but a valuation would be prudent even in unconnected situations.

Who will carry out the valuation? Will the company's auditor be suitable to value the shares or will the SIPP provider/trustee appoint their own valuer?

Costs for share valuations can be very high, particularly when provided by the larger accountancy practices. This reflects the specialist and high-risk nature of such advice. Naturally, excessive fees will dampen down any initial enthusiasm for this sort of transaction.

Finally, the frequency of valuations could cause some issues, particularly depending upon the cost of obtaining these valuations. Finance Act 2004 is prescriptive in determining when a valuation is required.

An updated professional valuation will be required at any benefit crystallisation event and also other circumstances, such as when a fund value is required for unsecured pension reviews and determining loanback or borrowing limits.

This, to my mind, is probably one of the key issues. If the SIPP member is truly not a controlling director then it is unlikely he will wield significant control or influence. Indeed, any request by a SIPP member to instruct accountants to carry out a valuation of the company for HMRC purposes may raise suspicions or concerns with other shareholders/directors, even if the SIPP member is willing to pick up the costs for the valuation.

d) **Legal protection –** I would expect most SIPP providers to conduct such a transaction through their own firm of lawyers. The lawyer's role will, however, go far beyond just processing the transaction and settling stamp duty. The lawyer will need to review the Articles of Association, shareholders' agreement and any other documents pertaining to the share purchase.

There will be an interesting dilemma here. Will the SIPP provider/trustee want to put their own Articles of Association in place? Will they insist on a shareholders' agreement for protection? This may cause difficulties with other shareholders.

Alternatively, if there is already a shareholders' agreement in place, the SIPP provider/trustee will need advice as to whether there are any onerous obligations contained in the agreement or whether the agreement provides sufficient protection for the minority shareholders, which the SIPP will be.

It should be noted that AIM-quoted companies must still pass the same tests to qualify for the exemptions as unquoted companies

e) **Future share transactions –** many companies now have enterprise management incentive schemes (EMIs) which involve staff being granted options for shares in the employing company. Clients need to be aware that selling shares to a SIPP, either in the form of a sale of shares or a new subscription, will create a benchmark valuation against which future share transactions will be considered. This may complicate or compromise future plans.

f) **Future restructures –** in the past, any SSAS investments into unquoted shares I have stumbled across seem to have been fraught with difficulties. I may have just been unlucky but I doubt it.

The problems don't normally arise at outset. The cause of most problems arises from either client or adviser not truly recognising the role of the pension scheme as owner of the shares.

This is often most marked when there are corporate restructures where previously, in our capacity as pensioneer trustee of the SSAS and as co-owner of the unquoted shares, we have on occasion only found out about a company restructure after the event!

g) **Company sales –** while restructures are internally motivated and controlled, trade sales or floats are not. Certainly in trade sales, the purchaser will expect significant indemnities and warranties from the vendors.

It is very difficult to see how a SIPP provider/trustee would be willing to participate in those indemnities/warranties and care needs to be taken not to corrupt any potential exit strategy.

The role of the pension scheme will often be analogous to a venture capitalist taking a stake in a private company. Anyone with experience in this area will be aware of the significant paperwork e.g. investment agreements etc which deal with, inter alia, investor protection and the investor's role on exit.

While I am not suggesting that the paperwork required will be at this level, the SIPP provider/trustee would be advised to adopt the mindset of such an investor.

Interestingly, it should be noted that AIM-quoted companies must still pass the same tests to qualify for the exemptions as unquoted companies. Very few, if any, SIPP providers have placed restrictions in this area, but if a SIPP member chooses to float his company while remaining a 20% director, then the "look-through" provisions may still apply.

h) **Over exposure –** I do have concerns about how much of a SIPP (i.e. what percentage of it), is used to invest in unquoted shares; this to avoid over exposing the pension scheme to such investments.

There are currently no limits, but as the scheme administrator of the SIPP could be exposed to a scheme sanction charge and/or a de-registration charge, they would be wise to retain some other assets to cover this eventuality.

i) **Exercising control and structure of SIPP –** the structure of the SIPP will come into focus when investing in unquoted shares. Where the member is a trustee of his SIPP, e.g. for the A J Bell SIPP, then he would effectively continue to be the legal owner of all assets contained in his SIPP (albeit jointly with our trustee company) and hence will still be able to enjoy a level of control.

Where the SIPP is subject to a master trust, the shares will be owned by the SIPP provider/trustee and clients will be well advised to consider carefully what the SIPP provider/trustee's reaction will be in relation to attending AGMs/voting rights, etc.

The one thing, above all, that clients must realise when going down this route is that they will no longer own these shares in a personal capacity. The SIPP will own them, which is of course a separate legal entity and must be treated as such.

So, in summary, while I acknowledge technically that SIPPs can hold unquoted shares in certain circumstances, I would hope that I have been able to make a convincing argument against such an investment even in the limited circumstances where it is possible.

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