

Exploring Pensions

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LOANBACKS – EXTRA CARE NEEDED

Over the last two years, during and in the wake of the credit crisis, we have seen companies not only struggle for trade but also for cash. With the lack of available liquidity in the banking sector, directors and owners have turned to their pension schemes to generate alternative ways of funding. Typically, this would take the form of a loan, which could be provided from a small self-administered scheme (SSAS). These loans have provided working capital, without which many businesses would not have been able to continue trading. However, HMRC has some specific regulations:

- A loan cannot be over more than five years
- The interest has to be at a commercial rate
- A loan must be to a connected employer
- The value of the loan may not be more than 50% of the assets of the SSAS
- Security is required by way of a first charge on an asset of equal or greater value to the loan, plus the interest over the loan period

Security over the loan has caused the most significant problems for members and trustees. As a result, HMRC has issued 'Pension Scheme Newsletter 39' providing guidance on security and first charges.

Once the charge is applied, the pension scheme automatically has exposure to taxable property, i.e. assets that cannot be held within a pension scheme, typically plant and machinery, residential property, etc. In turn, this is treated as an unauthorised payment where a tax rate of 40% is applied on the value of the asset held in the scheme (the value is nil at this stage as only security is held) and the cost of establishing the loanback. So while the charge will be relatively small, the penalty can be avoided if the costs are paid by the employer.

When the security is over assets that are not allowed to be held by the pension fund under HMRC rules, and if the employer defaults on the loan, calling in the security can result in further tax charges. The pension scheme would incur an automatic unauthorised payment charge of 40% on the value of the asset – now based on the asset's full market value. There is also the possibility of a pension scheme sanction charge of 15% as a penalty on the scheme administrators for allowing the situation to arise.

Loanbacks will continue to provide an invaluable source of business financing. However, great care is needed when deciding on security for a loanback. While it is within the rules to set up the first charge over assets which are not allowed to be held by a pension scheme under HMRC rules, if there is any likelihood of default on the loan, the tax charges of 55% payable by the pension scheme must be taken into consideration on the suitability of the security.

Loanbacks are an excellent alternative when looking to finance working capital, but without specialist advice the tax consequences can be substantial.

*Article by Doug Ryan
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