The purpose of this guide is:

1. To answer some frequently asked questions about a pension scheme making a loan to a third party.
2. To let you know some of our basic requirements before you make your decision to proceed with a loan.
3. To guide you through the process of making a third party loan.

Whilst we can provide generic information please note that Westerby is not authorised to provide financial advice. We cannot therefore comment as to whether a loan is a suitable investment for your particular pension scheme.

Introduction

Current pension legislation allows a registered pension scheme such as a Self Invested Personal Pension (SIPP) or Small Self Administered Scheme (SSAS) to make loans to any genuine third party, a third party being a person or entity who is not connected in any way to the pension scheme member.

Loans to a pension scheme member, or to any other person or entity connected to the member, are not allowed and there are severe tax penalties if such a loan is made.

The one exception to this rule is that an employer sponsored scheme such as a SSAS may make loans to the sponsoring employer but the loan must be on the strictly prescribed terms laid down by HM Revenue & Customs (HMRC). These terms are described in detail in our guidance notes on SSAS loanbacks.

This guide describes only the rules, and our requirements, in relation to third party loans.

Is the proposed loan allowable?

In determining whether we will agree to the making of a third party loan we will look at three main factors:

1. Is the borrower a genuine third party?
2. Is the loan on commercial terms?
3. Is the loan prudent and secure?

What is a genuine third party?

A third party is a person or other entity such as a company or partnership, who is, in law, not connected to you.

What does “connected” mean?

The term “connected” is defined in tax law and the same definitions also apply to pension legislation.

In summary anyone who is your direct relative, or a direct relative of your spouse or civil partner, is connected with you as is a business partner and any company of which you control more than 20% of the shares.

The following table, whilst not exhaustive, gives some examples:

	Connected	Not connected
Relatives	• Spouse or civil partner • Children • Parents/grandparents • Brother/sister • Certain relatives of your spouse or civil partner • Brother in law/sister in law • Father in law/mother in law	• Aunts & uncles • Cousins • Nephews & nieces
Other individuals	• Partners in a partnership • Certain relatives of partners • Co-directors exercising control of a company • Certain relatives of co-directors	• A person with whom you cohabit but who is not your spouse or civil partner • Friends & personal acquaintances • Business acquaintances
Companies	• Company of which you control 20% of more of the shares • Company of which a relative (e.g. brother, sister, parent or in-laws) controls 20% or more of the shares • Company of which a business partner controls 20% or more of the shares	• Any company, including your employer, in which you do not control 20% or more of the shares • A partnership in which neither you or any party connected to you are a partner

N.B. In deciding whether you control 20% or more of the shares in a company any shares owned by a person or entity connected to you must be taken into account. For example if you own 5% of the shares and your brother in law owns 18% you are deemed to control 23% and are therefore a "controlling director" of that company.

What are the consequences of lending to a connected party?

Any loan to a connected party (other than those allowed from a SSAS to the sponsoring employer) will be deemed by HMRC to be an unauthorised member payment and will subject to tax penalties of a minimum of 55% and a maximum of 70% of the loan amount.

The pension scheme member will have personal liability for a minimum of 40% of the tax charge with a further 15% tax charge falling on Westerby as the scheme administrator. In order to proceed with a third party loan we therefore require you to indemnify Westerby against any liability for such tax charges and agree that such tax charges can be met from the pension scheme assets. In the event that the member is unable to discharge their personal tax liability the entire tax charge must be met from the pension scheme.

Due to the seriousness of the tax penalties if you are in any doubt as to whether the potential borrower is connected to you please contact us for further clarification.

What are commercial terms?

Broadly speaking the terms of any loan to a third party should be similar to those that a commercial lender would offer to the same borrower. Amongst other things the pension scheme trustees will need to consider.

- Interest rate
- Term of loan
- Repayment basis
- Restrictions on use of the loan
- Security

Interest rate

If the lender and borrower are genuinely unconnected then both will want to negotiate the best deal and the interest rate will be whatever the two parties eventually agree on.

The interest rate agreed should reflect the risk involved in the loan. For example a loan to a profitable long established company would in general carry a lower rate of interest than a loan to a speculative start up business.

The interest rate will also reflect the security offered in relation to the loan. Good security = lower interest rate, weak security = higher interest rate.

Term of loan

The term of the loan should not generally be for a period of more than 5 years unless the loan is for the purchase of, and is secured on, commercial property.

Repayment basis

Will the loan be:

- Interest only
- Capital and interest
- Monthly/Quarterly/Annual repayments

The most secure basis for the lender is a capital and interest basis with monthly repayments.

Restrictions on use of loan

The loan should be for a specified purpose e.g. purchase of a specific property, not just for general cash flow.

Security

If at all possible loans should be secured. The security can be in the form of:

- A legal charge over an asset
- Debentures
- Personal guarantees

The security must be of sufficient value to allow full recovery of the debt at any time during the term of the loan.

The use of some types of security by a pension scheme can be incompatible with pension legislation. For example if a pension scheme takes a legal charge over an asset that would not itself be an allowable asset of a pension scheme the pension scheme will effectively be unable to enforce the security without incurring the same tax charges as if the pension scheme had directly purchased the asset. The tax charges can amount to 70% of the value of the debt plus costs at the time the security is enforced.

In practice therefore suitable assets for security will normally be restricted to commercial property. In some cases intellectual property such as patents and trademarks may be considered.

Assets that are not suitable as security for third party loans include residential property, plant and machinery, vehicles, stock and any other tangible moveable objects.

What do you mean by prudent and secure?

Trustees of a pension scheme are required by law to act in a prudent and responsible manner and have a statutory duty of care to the beneficiaries, and potential beneficiaries, of the pension scheme. Any third party loan made from the scheme should therefore satisfy the following requirements.

Prudency:

- The pension scheme member/s should take independent financial advice as to the risks associated with the loan and whether it is a suitable asset for their pension scheme and personal circumstances.
- The loan should comprise a sensible proportion of a portfolio of investments. Loans in excess of 50% of the scheme assets will only be allowed in limited circumstances on a case by case basis.
- If the loan is unsecured the amount of the loan should be limited to such amount of money as the member/s can afford to lose if the borrower defaults.
- The member/s and their advisers should undertake sufficient due diligence on the borrower to satisfy themselves as to the borrower's ability to repay the loan capital and interest. Westerby cannot accept any liability for carrying out such due diligence.

Security

- Loans should be secured where at all possible.
- In limited circumstances we may agree to unsecured loans to parties of good financial standing.
- Loans should be utilised for a specified purpose not general cash flow.
- The loan must be documented by a legally enforceable loan agreement and legal charge/personal guarantee where applicable

What will it cost?

Third party loans are not covered by the basic standard annual administration fee.

The fee payable to Westerby for the work involved in establishing the loan is £400 to £600 + VAT, depending on the circumstances; we will confirm the fee to you before you proceed with the loan. There is also an annual loan administration fee of £200 + VAT which covers calculation, invoicing and collection of capital and/or interest payments.

In addition Westerby will appoint a solicitor to draw up a loan agreement and any legal charge or guarantees associated with the loan. We will obtain a quotation on a case by case basis and inform you before proceeding.

These costs can be met from your pension fund. You can request that these fees are reimbursed by the borrower by including them as an "arrangement fee" in the loan agreement.

What happens if the borrower defaults?

The loan agreement will contain various "events of default". If an event of default occurs the pension scheme trustees will have the right to call in the loan and enforce the security if applicable. It will probably be necessary to appoint solicitors to assist in recovering the debt.

As a co-trustee of the scheme you would be required to be party to such action. If the borrower is a friend or business acquaintance this may cause you some personal distress and you should therefore consider this possibility before agreeing to advance a loan to a friend or acquaintance.

For the work involved in the recovery process there will be additional fees payable to Westerby on a time cost basis and to any appointed solicitor. These costs can be met from your pension fund.

The loan process

The first step is to complete and sign our Third Party Loan Questionnaire which is available on request or from our website www.westerby.co.uk

On receipt of the completed questionnaire and supporting documentation we will assess whether the loan is acceptable for inclusion in a pension scheme. If the loan is acceptable we will:

1. Confirm to you and your adviser our acceptance of the loan proposal.
2. Obtain a quotation from our solicitor of the costs of drafting the loan agreement and other legal documents as required.
3. If you agree the legal fees formally appoint the solicitor.

4. Arrange for the loan documentation to be signed by all relevant parties.

5. On confirmation from the solicitor that the loan can be advanced, transfer the funds to the borrower's bank account.

6. Monitor and collect capital and/or interest payments as and when they fall due.

7. Inform you and your adviser if the loan repayments fall into arrears.

We hope you have found this guide useful and that any questions you may have had have been answered.

If however you require any further information please contact us on 0116 326 0183, by e-mail to info@westerby.co.uk, or via the enquiries form on our website www.westerby.co.uk