



Loans from employers to pension schemes

EMPLOYMENT, PENSIONS AND BENEFITS BRIEFING 190

A loan from a sponsoring employer to a defined-benefit pension scheme can sometimes be an attractive way to provide short-term funding for the scheme.

This briefing discusses the UK pension and tax law implications of funding the scheme in this way.

A defined-benefit pension scheme will sometimes need short-term liquidity – for example, to fund a lump sum payment. A loan from a sponsoring employer can be an attractive way of providing this funding.

Trustees and employers may prefer funding the scheme through a loan because the scheme may otherwise need to raise the finance by selling some of its investments (something they may wish to avoid in a weak financial market).

Employers may be using a loan so that their money is not trapped in a pension scheme that may be in surplus in the near future. This is important because section 37 of the Pensions Act 1995 restricts the circumstances in which a pension scheme can return a surplus to a sponsoring employer. On the other hand, if the scheme is paying the employer interest on a loan or repaying the capital this should not be caught by the section 37 restrictions.

This briefing discusses the pensions and tax law issues for trustees and employers to consider before a loan is agreed to be made to the pension scheme's trustees.

When can the trustees accept the loan?

The scheme's trustees must have the power to borrow under the scheme's trust deeds and rules before they can accept the loan.

The trustees will also need to be satisfied that borrowing the money is in the scheme's best interests and that they are not acting in breach of their fiduciary duties.

What types of loans can a pension scheme accept?

Under the Occupational Pensions (Investment) Regulations 2005 a pension scheme can borrow from a sponsoring employer (or anyone else) only if the loan is:

- 'for the purpose of providing liquidity' for the scheme; *and*
- on a 'temporary basis'.

No further guidance is given in the legislation as to what is meant by this provision. In relation to the 'temporary basis' requirement, we think it would be difficult to justify a loan lasting more than one year.

Will the scheme's statement of investment principles need to be revised?

Section 35 of the Pensions Act 1995 requires schemes to put in place a statement of investment principles that governs decisions about the scheme's investments.

The trustees may need to revise this statement to reflect the loan.

Trustees are required to review the principles every three years and, without delay, after any significant change in investment policy.

The loan itself is not an investment, but any changes in other assets will involve investment so the trustees will need to consider this issue.

Are the trustees personally liable to repay the loan?

The trustees will be individually liable to repay the loan to the employer unless the loan agreement expressly sets out otherwise by limiting their liability.

Under section 31 of the Trustee Act 2000 the trustees will benefit from an indemnity from the scheme's assets if the loan was for a proper purpose and there is no other breach of trust.

The scheme rules may also expressly provide for the trustees to be indemnified out of the scheme's assets.

Trustee liability is less of an issue if there is a trustee company because the company will be the contracting party, not the trustee directors. Unless the trustee directors give a personal guarantee, it is the trustee company that will be liable to repay the loan.

of the Pensions Act 1995. Therefore trustees will not generally need to consider section 37 restrictions if they are repaying the loan or capital after 6 April 2009.

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Can the pension scheme pay interest on the loan or repay the loan?

Payments of interest and repayment of the loan would be payments to a sponsoring employer. This raises tax and pensions law implications.

Under the Finance Act 2004 a registered occupational pension scheme will need to ensure that payments made to the sponsoring employer are 'authorised payments', otherwise they risk incurring substantial tax charges.

If the interest rate on the loan is at an 'arm's-length' rate (or less), interest payments or repayment of the loan by the pension scheme are likely to be considered a 'scheme administration payment' and will be authorised under section 175 of the Finance Act 2004.

However, if the interest payments exceed the amount that might be expected to be paid to a person who was at arm's length, the excess amount is likely to be an unauthorised payment. The company may therefore want to consider charging interest below the market rate to ensure that the scheme does not incur tax charges.

Section 37 of the Pensions Act 1995 contains restrictions on when a scheme can make payments to a participating employer. From 6 April 2009 a 'scheme administration payment' is excluded from the requirements of section 37