Interesting inequalities

Employment Tax

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Matt Parfitt reviews the beneficial loan rules

Key Points

What is the issue?

The beneficial loan rules sometimes cause a mismatch between a loan’s economic value and its taxable cash equivalent. In addition, there are some potential inequalities in the rules which can unfairly penalise employees in the financial services industry in particular

What does it mean for me?

As an employee, there can be unforeseen tax consequences of taking out a loan from your employer. For employers, there can administrative consequences of offering loans to employees and it is possible to be caught out by interest rate complications. This is especially relevant for organisations such as banks and building societies

What can I take away?

Only a change in policy and legislation can resolve the issues; therefore, perhaps a review of the rules is warranted. In the meantime, understanding some of the finer points of the rules could be helpful to avoid unexpected consequences, and you may have clients who would benefit from this

The legislation for employment-related loans is contained in ITEPA 2003 Pt 3 Ch 7, and determines when one is a taxable benefit in kind (BIK). Known as the 'beneficial loan' rules, they can prove unfair, particularly for employees of banks and building societies, where loans are regulated by the Consumer Credit Act (CCA 2006).

Background

When an employer provides a loan to an employee, or sometimes one of their relatives, during their employment, this is a BIK. It is calculated as the average loan balance in the tax year (or part of the tax year in which the loan was available) multiplied by the official rate of interest (ORI), though either HMRC or the taxpayer can elect to use the alternative method of the balance on each day multiplied by the ORI. The BIK is then reduced by the amount of interest paid for the same period. Therefore, there is no BIK unless the interest rate of the loan is below the ORI, in which case the employee and employer must rely on one of several exemptions.

The official rate of interest

The Treasury sets the ORI, which HMRC review and make recommendations on future changes to it. There are a couple of issues with this that can cause complications for employers:

- There is little notice given when the rate changes. As a result, it could be difficult for some employers to implement processes quickly enough to be able to report loans to HMRC on an employee's annual form P11D if they unexpectedly find themselves in the situation of offering beneficial loans due to a rise in the ORI.
- There is no legislative methodology for how the rate is determined. Although the ORI moves up and down as the economy and commercial expectations change, there is no obvious direct correlation between this and commercial rates or the Bank of England base rate. For banks and building societies that might offer a staff discount on loans, the uncertainty over the ORI can be a challenge.

To demonstrate the second point, at the start of 2008 before the global financial crisis, the ORI was 6.25% and the base rate 5.5%. However, as the base rate dropped numerous times until the historical low of 0.5% in March 2009, the ORI remained at 6.25%. It was only in March 2009 that it was lowered to 4.75%. In the subsequent years, while the base rate remained stable, the ORI was lowered further until it fell to 3% in April 2015. But this was still significantly higher than the base rate. As a result, new headline loan rates and loans that track the base rate (usually mortgages) have been dropping, but there has been a delay in this being recognised in terms of what loans are taxable and at what rate.

Exemptions

The most widely known beneficial loan exemption is the £10,000 de minimis (ITEPA 2003 s 180), which applies when the total balance of all beneficial loans an employee has from the same employment does not exceed £10,000 at any point in the tax year. This is helpful for interest-free season ticket loans that many businesses offer to employees and was only recently (from 2014/15) increased from £5,000 to meet the soaring cost of some season tickets. Loans made in the normal course of an individual's domestic, family or personal relationships are also exempted, which is generally only useful for small family-run businesses.

Another exemption that a bank or building society may be able to make use of is that in ITEPA 2003 s 176 for loans taken out on ordinary commercial terms. Loans taken out on terms generally available to the public, such that there is no advantage to the borrower of being an employee of the lender, are exempt. This prevents the potentially unjust situation whereby, say, a mortgage holder would have a BIK simply because they happen to be an employee of the lender, even though the loan is not on preferential terms.

On a positive note, these exemptions are helpful and prevent some situations where a loan might otherwise unfairly become a taxable BIK. Moreover, the increase of the *de minimis* to £10,000 is one way in which the rules have moved forward, and helps to prevent discriminating against employees who have costly commutes.

A change in rates

What about the situation where an employee receives a beneficial loan, perhaps due to a staff discount or being able to borrow more than a member of the public would be allowed, but the rate is not below the ORI? This would not be a BIK but the situation changes if the ORI later rises. The result could be frustrating for the employer and employee if the intention was to ensure that the employee did not have a BIK by deliberately setting the rate above the ORI in place at the time the loan was taken out.

ITEPA 2003 s 177 addresses this point by providing an exemption for a loan which would become a BIK purely by reason of an increase in the ORI, so long as both the term and the interest rate of the loan are fixed. This would appear to prevent the loan in the above example becoming a BIK but there is a sting in the tail if the loan is regulated under the CCA, which is particularly relevant to employees of banks and building societies. In this case, the loan must be 'made for a period which cannot be changed'. Loans are normally made for a fixed term but, under the CCA, must be capable of being repaid early if the borrower requests. You would be forgiven for thinking that this alone would not prevent a loan being considered to be for a fixed term; however, HMRC do not accept this and are unequivocal in their interpretation of the rules in their *Employment Income Manual* (EIM26152). This seems at odds with the apparent purpose – to avoid causing financial difficulties – of requiring early repayment under the CCA, since this alone can cause a tax liability to be due.

But it's not all about rates

I referred earlier to the exemption for loans taken out on ordinary commercial terms. This is not limited to the interest rate payable and so there can be other situations when a loan is a BIK and the calculation of this perhaps does not realistically reflect its value. A couple of examples:

- The discounting or waiving of fees (such as early repayment or valuation fees for a mortgage) for employees only would result in a BIK if the interest rate payable is under the ORI. Particularly on a mortgage, where the loan balance could be substantial, this could result in a large annual BIK, even though the value to the employee is limited to the fee discount.
- What about a capped interest rate available to employees only? If a lender offers an upper cap on a mortgage interest rate for staff such that variable rates are guaranteed to never rise above this, it is possible that an employee could be paying the exact same amount in fees and interest for a loan as a member of the public but would be in receipt of a BIK due to the cap, even if the cap never comes into effect. Is it fair to tax the employee in this manner just because of the fact that they may receive something of value in the future?

The future?

It seems reasonable that beneficial loans should be taxed, but perhaps it is time for a rethink in policy to address some of the scenarios discussed. Where the value of a beneficial loan is clear (such as discounted fees, or the difference between the actual interest rate and that available to the public), it seems fairer that the taxable value should match this. Failing that, a statutory framework for the ORI seems sensible such that it is always linked to the Bank of England base rate, or the rate must be justified using a consistent published methodology and subject to a minimum 30 days’ notice for changes.