Guide to the tax treatment of interest- free or low interest loans to employees

Introduction

This Guide explains the tax treatment of interest-free or low interest loans made by an employer to its employees.

See *Public Ruling PR 2024/7 previously PR - 2016/01 – Tax treatment of interest-free or low-interest loans provided to employees under section 5 of the Income Tax Act (Cap 123)*, available on the IRD website, for more details on this topic.

Interest-free or low-interest loans are benefits-in kind, and as such are employment income and subject to tax. Employers are required to include the value of the benefit in the relevant employee's gross employment income, from which they must deduct tax.

What is an interest-free loan?

A loan made by an employer to an employee where the rate of interest payable by the employee is zero.

What is a low interest loan?

A loan made by an employer to an employee where the rate of interest payable by the employee is higher than zero but less than the market rate (that is, the rate if the employee had obtained the loan from a bank).

Why are these loans benefits?

A benefit-in-kind is a benefit given to an employee in a form other than cash. The tax law treats the value of any benefit-in-kind, whether convertible to money or not, as income of the employee. The value of a benefit-in-kind is employment income.

Loans to associates of the employee

If the loan is made to an associate or family member of the employee, and not the employee him or herself, it still meets the definition of a benefit as it was made because of the employment relationship.

How to value the benefit

There are two methods:

1. By comparing the interest rate charged on the loan and the interest rate described for "Personal loans weighted average" published monthly by the Central Bank of Solomon Islands as the market interest rate.

2. Use the market interest rate for loans of a similar character. More detail on this method is covered on the next page.

The value is the difference between the rates calculated by one of the methods above and the rate charged by the employer. For the purposes of determining the value of the benefit for an interest-free loan the loan is treated as having an interest rate of 0%.

Non-recourse loans

A non-recourse loan is one which the employer does not require the employee to repay, no matter what the interest rate is. It is often a payment of income disguised as a loan.

In such cases the entire principal amount of the loan will be treated as income of the employee in the year the loan is made.

Using the market rate method to value the benefit

This method allows employers to determine the market interest rate for loans of a similar character to the loan given to the employee. In doing this consideration must be given the features of the loan provided to the employee, including:

- whether not the loan is secured against any assets, guarantees or other collateral;
- whether the loan has a fixed or adjustable interest rate;
- the class of persons to whom the loans are provided; and
- all risk associated with the loan.

Once these and any other relevant characteristics have been identified the employer providing the loan must then determine the market interest rate for loans of a similar character, provided on an arms-length basis.

The value of the benefit is derived by the employee daily. The employer should calculate the benefit to the employee at the end of each pay period. The actual value of the benefit can be obtained by comparing the actual interest incurred with amount of interest that would have accrued using the market interest rate for that period.

Documentation

Loans from employers to employees should be in the form an agreement between both parties setting out the terms and conditions such as principal, interest rate, term of loan, repayment amount and frequency. Where the loan includes a benefit in the form or low or no interest, the employer must keep records of how they valued the benefit to the employee for tax purposes

Including the value of the benefit in the employee's total income

The employer must add the value of the benefit to the salary or wages (and any other employment income including other benefits) of the employee, and then deduct tax in accordance with the tax tables published on the IRD website.

Example

XYZ Company employs John Smith as its managing director.

The company makes an unsecured loan to Smith of $1,000,000 at 2.4% p.a. interest repayable over 10 years ($2,000 per month interest).

The company uses the second method to value the benefit (market interest rate comparison). It finds that banks will offer 9.6% on average for a similar unsecured loan ($8,000 per month interest.

In the month after the loan is made, the employee is paid $10,000 salary and $4,000 in motor vehicle, housing and other benefits.

The value of the low interest loan benefit is $6,000 per month ($8,000 minus $2,000).

XYZ Company must deduct tax from John's total employment income for the month, being:

Salary...$10,000

Low interest loan benefit.................. $6,000

Other benefits.................................. $4,000

Total...$20,000