PR - 01/2016 – Tax treatment of interest-free or low-interest loans provided to employees under section 5 of the Income Tax Act (Cap 123)

This is a public ruling made under section 107A of the Income Tax Act (Cap 123)

All legislative references are to the Income Tax Act (Cap 123)

Application

This public ruling sets out the Commissioner's interpretation of the application of section 5 to interest-free or low-interest loans provided by employers to their employees.

Interest-free or low-interest loans are benefits-in kind under section 5(1)(b). As such they are "employment income" under the definition of that term in section 2, and are chargeable to tax under section 3(1)(a)(ii).

The value of the benefit is the determined 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. In the alternative, employers may use the market interest rate for loans of a similar character.

The value is the difference between the two rates. 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%.

Under section 36A, employers are required to include the value of the benefit in the relevant employee's gross employment income, from which they must deduct tax as prescribed in the Tax Deduction Rules 2005.

Application period

This public ruling applies from 16 December 2016 for a period of one year. However, this ruling will cease to apply immediately if any of the provisions or rules relied upon in this ruling are amended or repealed.

This ruling is signed by me on 16 December 2016.

Aylton Jamieson
Commissioner of Inland Revenue
Inland Revenue Division

Commentary on Public Ruling PR – 01/2016

This commentary is not a legally binding statement.

All legislative references are to the Income Tax Act (Cap 123) (the Act).

Introduction

Employers are able to provide their employees with a range of benefits, which benefits are being offered because of the employment relationship. One type of benefit is an interest-free or low-interest loan. These loans will be offered at interest rates below the market interest rate, and in some cases, interest-free.

This commentary explains the Commissioner's reasoning that interest-free or low-interest loans are benefits-in-kind under section 5(1)(b) and constitute employment income to the employee receiving the benefit.

Legislation

The relevant provisions of the Act are as follows:

*"**2** (1) In this Act, unless the context otherwise requires—*

...

*"**employee**" means an individual engaged in employment;*

*"**employer**" means a person who engages or remunerates an employee;*

*"**employment**" includes –*

(a) a directorship or other office in the management of a company or body of persons;

(b) a position entitling the holder to a fixed or ascertainable remuneration;

(c) the holding or acting in any public office;

(d) performance under a contract principally for work or services where the Minister provides by Order that the relationship will be regarded as one of employment for the purpose of the tax deduction provision; or

(e) performance under a contract principally for work or services where the parties voluntarily agree with the Commissioner that the relationship will be regarded as one of employment for the purpose of the tax deduction provision;

*"**employment income** " means gains or profits from employment as determined under section 5 of the Act;*

...

***3**(1) Subject to this Act, tax shall be charged for each year upon the income for that year of*

any person in respect of –

(a) gains or profits from –

(i) ……;

(ii) employment; or

(iii) any right granted to any other person for the use or possession of any property;

***5**.(1) For the purposes of section 3(1)(a)(ii) and subject to subsection (2), gains or profits from employment means any amount, whether of a revenue or capital nature, arising from employment, including –*

(a) any wages, salary, leave pay, payment in lieu of leave, overtime pay, bonus, commission, fees, gratuity, or work conditions supplements, and including any remuneration paid to the holder of an office;

(b) the value of any benefit-in-kind, whether convertible to money or not;

…

***36A.**(1) Subject to subsection (2), an employer shall deduct tax from the gross amount of employment income paid to an employee as prescribed in the Tax Deduction Rules 2005.*

(2) This section does not apply to employment income that is exempt from income tax.

(3) The obligation of an employer to deduct tax under subsection (1) –

(a) shall not be reduced or extinguished because the employer has a right, or is otherwise obliged, to deduct any other amount from a payment of employment income; and

(b) shall apply notwithstanding any law that provides that the employment income of an employee is not to be reduced or subject to attachment."

Analysis

Where a person is engaged in employment, they are an employee for the purposes of the Act. The definition of "employment" is extremely broad, and non-exhaustive. Therefore, "employment" as understood in common law and in ordinary concepts and usages, also falls within the purview of the definition to the extent it is not expressly covered.

The use of the phrase "engaged in employment" in the definition of "employee" restricts its meaning so that only taxpayers currently engaged in the relevant employment are "employees" for the purposes of the Act.

"Employment income" is defined as the gains and profits from employment as determined by section 5. Section 5 sets out the various things that are treated as employment income under

the Act. Included in it, is the value of any benefit-in-kind, whether convertible to money or not. Therefore, the value of a benefit-in-kind is employment income. A benefit-in-kind is a benefit provided to an employee provided to an employee by their employer by virtue of their employment relationship.

In an ordinary sense here can be little doubt that an interest-free or low-interest loan is a benefit to the employee. However, it is necessary to determine whether a low-interest loan is a benefit-in-kind for the purposes of the Act.

Historically, determining whether a benefit provided to an employee was assessable income turned on whether the benefit was convertible to money or money's worth. If a benefit is not convertible into money or money's worth, then it is not something that "comes in" and so cannot be regarded as income.

The convertibility principle was initially established in *Tennant v Smith*.[1] The House of Lord's decision in *Tennant v Smith*[2] involved a bank employee who received a benefit in the form of rent-free accommodation. The issue before their Lordships was whether the accommodation was assessable under Schedule E of the UK legislation (by virtue of the words "salaries, fees, wages, perquisites or profits payable"). The Court held that the taxpayer would only be taxable if what he received was convertible into money, i.e. was money or money's worth. Because the taxpayer could not sublet the accommodation or turn it to pecuniary account in any other way, he was not taxed. Summarising the reason for their Lordships decision, Lord Field provided:[3]

> *"For the reasons which have been so fully indicated to your Lordships, it appears to me that the residence of the Appellant upon the bank premises which, although rent free, could not in any way be converted by him into money or money's worth, cannot be held to be either a gain or profit, or perquisite or emolument within the meaning of the statutes."*

The convertibility principle has been discussed and applied by the New Zealand courts on a number of occasions. The leading example of this is the Supreme Court's decision in *Dawson v C of IR*[4] where the Court found that Mr Dawson's the right to use a colour TV set in return for subscribing to a debenture issue, was not income because that benefit was neither money nor capable of conversion into money. In finding for the objector, Mr Dawson, McMullin J concluded that:[5]

> *"In the present case, the benefits received by objector were not in monetary form nor were they capable of being sold, surrendered, assigned or mortgaged for money or money's worth. Indeed, sale, surrender, assignment and mortgaging were expressly forbidden by the agreement. The substantial benefit which objector received from the investment was that he did not have to pay rental for the set. That does not constitute income, not being money or capable of conversion into money."*

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[1] *Tennant v Smith* [1892] 3 T.C. 158
[2] See n1
[3] See n1, at 171
[4] *Dawson v C of IR*[4] (1978) 3 NZTC 61,252 (SC)
[5] See n4

The convertibility principle was also adopted in Australia, as highlighted in the decision of the Full Federal Court in *FC of T v Cooke & Sherden*.[6] In that case, the taxpayers carried on business as "home delivery" soft drink retailers. The manufacturers of the soft drinks operated a free holiday scheme as an incentive to the retailers. Where retailers meet their allotted sales quotas, the manufacturers paid the airfares and accommodation expenses for holidays in Queensland and certain South Pacific islands. The holidays were non-transferable and could not be cashed in. The Commissioner assessed the taxpayers on the value of the holidays. The court found that the benefit of the holidays was not taxable in the hands of the taxpayers. In their judgement Brennan, Deane and Toohey JJ stated:[7]

> *"It is immaterial that the respondents would have had to expend money themselves had they wished to provide the holidays for themselves. If the receipt of an item saves a taxpayer from incurring expenditure, the saving is not income: income is what comes in, it is not what is saved from going out. A non-pecuniary receipt can be income if it can be converted into money; but if it be inconvertible, it does not become income merely because it saves expenditure.*
>
> *The holidays which were enjoyed by the taxpayers in the present case provided them, at a cost to the manufacturers, with a non-convertible benefit."*

Interest-free or low-interest loans are analogous with the holidays considered in *FC of T v Cooke & Sherden*. Like them, interest-free or low-interest loans provide a saving to the borrower, being the difference between the interest charged and that which would have to be paid if the loan were taken out at arms-length.[8] In short, it is a non-convertible benefit to the employee.

Section 5(1)(b), however, overrides the convertibility principle by including benefits-in-kind whether they are convertible to money or not. Thus, the interest saving from an interest-free or low-interest loan provided to an employee because of the employment relationship is a benefit in kind under section 5(1)(b), and is profits or gains from employment.

Next, it is necessary to determine whether the benefit-in-kind is "from employment". This amounts to determining whether, in any particular instance, the provision by an employer of an interest-free or low-interest loan to an employee has a nexus with the employee's employment. The Federal Court of Australia held in *J & G Knowles & Associates v FC of T* [9] that, for a benefit to be "in respect of" employment there required:[10]

> *"some discernible and rational link, between the benefit and employment"*

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[6] *FC of T v Cooke & Sherden* 80 ATC 4140

[7] See n6

[8] The arm's length value is defined to mean the amount that the recipient could reasonably be expected to have been required to pay to obtain the benefit from the provider under a transaction where the parties to the transaction are dealing with each other at arm's length in relation to the transaction.

[9] *J& G Knowles & Associates v FC of T* 2000 ATC 4151

[10] See n9, at 4156

The phrase "in respect of" is sufficiently similar to "from" used in section 5, that the principle cited above can be applied to determine whether a benefit is "from employment" under the Act. This can only be determined on a case by case basis.

Normally, the provision of an interest-free or low-interest loan to employees will represent a benefit-in-kind from employment. However, the potential scenarios in which such loans could be provided are sufficiently varied that we cannot attempt to define the situations where these may occur.

While not the focus of this commentary, it is also worth noting that a benefit provided by an employer to a person associated with the employer, could potentially be a benefit-in-kind under the Act. This is particularly so where the benefit is provided because of the employee's employment.

The value of the benefit is the determined by comparing the interest rate charged on the loan, and the market interest rate for loans of a similar character. The value is the difference between the two rates. Note that when performing this exercise, an interest-free loan has an interest rate of 0%.

For ease of compliance, it is acceptable to use the 'Personal loans weighted average' interest rate, published monthly by the Central Bank of Solomon Islands, as the market interest rate when calculating the value of the benefit. This market interest rate must be compared with the interest rate at which the employer is providing the loan to the employee.

Alternatively employers are able to determine what the market interest rate for loans of a similar character is. In order to do this consideration must be given the characteristics of the loan provided to employees, these include:

- 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,
- All risk associated with the loan.

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

The value of the benefit, thus determined (using either method), is subject to tax. Section 36A obliges an employer to deduct tax from an employee's gross employment income, in accordance with the Tax Deduction Rules 2005.

As the value of the benefit from an interest-free or low-interest loan is a benefit-in-kind under section 5, it is employment income. Thus the employer must add the value of the benefit to the salary or wages (and any other employment income) of the employee, and then deduct tax as prescribed in the Tax Deduction Rules 2005.

The value of the benefit is derived by the employee daily. Therefore, 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.