CHAPTER 18

LOANS TO EMPLOYEES & USE OF ASSETS

18.1 Loans to employees

ITEPA 2003, s.173 – s.191

When a company lends money to an employee, this is likely to give rise to a taxable benefit called a taxable cheap loan. The cash equivalent of the benefit is calculated using HMRC's official rate of interest. If no interest is charged or the interest rate is less than the official rate of interest, the cash equivalent is the difference between the interest that would have been payable at the official rate of interest and any interest which is paid. ITEPA 2003, s.175

If the loan is provided to a lower paid employee who is not a director the benefit is tax free.

There are two ways in which we can calculate the cash equivalent. The first is by using the normal or **average method**, and the second uses the alternative **strict method.** The average method is perhaps more commonly used although either the taxpayer or HMRC can insist that the strict method is used instead. ITEPA 2003, s.182 ITEPA 2003, s.183

The employee will have no taxable benefit if the aggregate of all loans outstanding throughout the tax year is £5,000 or less. Therefore if the employer makes one loan to the employee and throughout the tax year this **loan never exceeds £5,000, the taxable benefit is zero.** ITEPA 2003, s.180

This provision is intended to exempt such things as season ticket loans, so for those of you who travel to work on public transport and have an annual travel card obtained via a loan from your employer, as long as the travel card costs **£5,000 or less** (and you don't have any more loans), you will not have a taxable benefit.

Note here that the **£5,000 rule refers to the aggregate of all loans** in the year – this is to prevent an employer abusing the rules by offering a series of loans to the same employee, each of just under £5,000. ITEPA 2003, s.180(2)

18.2 Average Method

ITEPA 2003, s.182

Under the average method we start by taking the loan outstanding at the **start** of the tax year – i.e. at 6 April – and to this we will add on the loan outstanding as at the **end** of the tax year – i.e. at the following 5 April. Having added these together, we divide by two to give the **average loan outstanding** during the year.

If there is no loan outstanding at the start of the tax year – for example the employer makes the loan to the employee part way through the year – we start by using the amount of the loan **at the point it was made**. Similarly if the loan outstanding at the end of the year is nil – for example if the loan is completely repaid during the year – we add on the amount of the loan **at the point it was repaid**.

Having arrived at the average loan for the year, we multiply this by HMRC's average official rate of interest (ORI) for the year.

$$\frac{\text{Loan at 6 April + Loan at 5 April}}{2} \times \text{average ORI for tax year}$$

If the employee is required to make some sort of contribution – i.e. if the **employee** pays some interest to the employer on the loan – these **contributions reduce the cash equivalent**.

18.3 Strict method

ITEPA 2003, s.183

Under the strict method we **simply calculate interest on a daily or monthly basis** on the exact amounts of the loan outstanding during the tax year.

Either the taxpayer or HMRC has the right to insist that the strict basis be used instead of the average basis. ITEPA 2003, s.183(1)

If the strict basis gives a lower cash equivalent than the average basis, the taxpayer would be advised to elect for this strict basis to apply. Alternatively, if the strict basis gives rise to a higher benefit, you would expect HMRC to insist that we use this strict basis.

However HMRC will only insist on the strict basis if the average basis gives a **significantly distorted result** – if there is only a few pounds difference between the two, HMRC will not insist on the strict basis.

Illustration 1

Paul borrowed £100,000 from his employer in 2005 and uses the money to buy a house. The loan is interest free so Paul is not required to make any employee contributions. Paul repaid £20,000 of the loan on 1 December 2009.

In order to find the cash equivalent we must calculate the benefit using both the average and the strict basis then compare the results. We will assume an official rate of interest of 4%.

Average basis:

$$\frac{100{,}000 + 80{,}000}{2} = 90{,}000 \times 4\% \qquad \underline{£3{,}600}$$

Strict basis:

$100{,}000 \times \frac{8}{12} \times 4\%$	2,667
$80{,}000 \times \frac{4}{12} \times 4\%$	1,067
	£3,734

Either HMRC or the taxpayer can insist on the use of the strict basis. It makes no sense for Paul to make an election here as the strict basis gives a higher benefit. HMRC will only insist on using the strict basis – i.e. on taxing the £3,734 – if they feel that the average basis had significantly distorted the benefit.

Here, HMRC would not bother so the average basis would be used. The taxable cash equivalent would therefore be £3,600.

The employer will prepare the P11D using the average basis. Either the employee or the Inspector can then elect for the strict method of calculating the cash equivalent of a beneficial loan.

18.4 Qualifying loans

ITEPA 2003, s.178

If a cheap loan is made to an employee and the loan is thereafter used for a **qualifying purpose** (i.e. a purpose for which tax relief will be given), there is an interaction between the two sets of rules.

If the **whole of the loan will attract relief** either as a deductible payment under s.383 ITA 2007 onwards or as a trading income or property income deduction, **the loan is ignored**. This means that no benefit arises and no interest relief is given anywhere else. The two entries are effectively "cancelled" as the net income will increase and decrease by the same amount.

Where only **part** of the loan interest qualifies for tax relief, the loan cannot be ignored.

Two adjustments must be made in the income tax computation as we shall see in the illustration below.

Illustration 2

Kelly works part time earning £12,000 per annum. In June 2007 she borrowed £6,000 from her employer. Kelly pays interest at 1% on the loan.

In July 2007 Kelly used the money to buy computer equipment which will be used partly for business (60%) and partly for non-business (40%) purposes.

Assuming an official interest rate of 4%, the position is as follows:

1. Loan interest benefit (2010/11);

	£
£6,000 x 4%	240
Less interest paid (£6,000 x 1%)	(60)
Loan benefit (s. 175)	£180

2. Deduct interest qualifying for tax relief (s.390 ITA 2007);
(£6,000 x 4% x 60%) £144

The deduction is given as a deductible payment in the tax computation.

18.5 Miscellaneous points

A loan interest benefit will arise if the loan is not directly made by the employee's actual employer. S.174 extends the rules to cover situations where an employee receives a loan from:

a) the parent/holding company of a group; or
b) a subsidiary company of the employer company; or
c) a prospective or future employer.

Loans made by **banks** etc to their employees on "**ordinary commercial terms**" will **not** give rise to a taxable benefit even if the commercial rate of interest is below the "official rate". ITEPA 2003, s.176

Loans made by an employer to an employee by way of an **advance** to cover either **necessary expenses** or **incidental overnight expenses will be ignored**, subject to the following conditions: ITEPA 2003, s.179

a) the outstanding advance does not, at any time, exceed £1,000; and
b) the advance is spent by the employee within 6 months of being made; and
c) the employee accounts to the employer at regular intervals for the expenditure of the advance obtained.

If a loan (whether or not a cheap loan) is released or **written off** by the employer, the amount released or written off is **treated as earnings**. This rule will not however, apply if an employee dies and the loan outstanding is subsequently written off or released. In this instance there is no tax charge. ITEPA 2003, s.188 ITEPA 2003, s.190

18.6 Use of employer's assets

ITEPA 2003, s.205

If an **employer lends an asset** to one of his employees, this will give rise to a **taxable benefit**. Note that the employer is allowing the employee to use the asset – ownership of the asset remains with the employer and does not transfer to the employee.

If the asset is provided to a lower paid employee who is not a director the benefit is tax free.

In any other case the benefit is the higher of:

a) the annual value of the use of the asset; or
b) the sums paid by the employer in providing the asset by way of rent or hire charge.

The "annual value" referred to above is **20% of the market value** of the asset at the time it was first made available to an employee.

If the **employee makes a contribution** – i.e. he pays some sort of rent to the employer for the use of the asset – we can **deduct** this to arrive at the taxable cash equivalent.

If the asset is lent to the employee part way through the year, having calculated the basic cash equivalent, we must then **apportion** this for the number of months in the year in which the employee had use of the asset.

This rule will often apply in relation to furniture provided by the employer in living accommodation made available to the employee.

Because the asset remains the property of the employer, at some point the employee will be required to give it back. If the employee doesn't return the asset to the employer – i.e. the employer allows the employee to keep the asset - there will be a taxable benefit on this transfer.

18.7 Transfer of assets

The benefit will be the higher of: ITEPA 2003, s.206

a) The market value of the asset at the date it was transferred to the employee.

b) The market value of the asset at the date it was originally lent to an employee reduced by any amounts which have been charged to tax in respect of an employee's use of the asset.

S.206 ITEPA 2003 contains a "step-by-step" approach in how to compute this benefit.

HMRC will take whichever is the **higher** and will tax this figure. Any payments made by the employee to the employer for the transfer of the asset can be deducted.

Illustration 3

An employer lends a painting to an employee on 1 January 2008. At this date the painting was worth £100,000.

On 30 September 2010, the employer allows the employee to keep the painting. It is worth £40,000 at this point.

Benefit for use of painting:			£
2007/08: £100,000 x 20% x 3/12			5,000
2008/09: £100,000 x 20%			20,000
2009/10: £100,000 x 20%			20,000
2010/11: £100,000 x 20% x 6/12			10,000
			55,000
Benefit on gift is higher of:			
a) MV @ transfer		40,000	
b) Original MV	100,000		
Less: already charged for use	(55,000)		
		45,000	i.e. 45,000

Benefit for use in 2010/11 (from above)	10,000
Benefit on transfer	45,000
Total Benefit in 2010/11	**£55,000**

18.8 Transfers of cars or houses

The rules above on transfers of assets **do not apply** when assets such as **cars** or **houses** are given to employees.

Where an employee has use of a company car and at a later date that car is transferred to the employee, the benefit is the **market value of the car** at the date of the transfer minus any payments made by the employee for the transfer of the car. The rules regarding amounts previously charged to tax do not apply here.

This arrangement commonly applies as part of a termination agreement. If an employee is made redundant, to soften the blow the employer may allow the ex-employee to keep his company car.

The same rule applies to transfers of houses.

18.9 Use of computers – where provided pre 6.4.06

ITEPA 2003, s.320

If "computer equipment" is lent by an employer to an employee and the employee uses that equipment for private purposes, this will give rise to a taxable benefit. The benefit is calculated using the "20% rule" as described above.

"Computer equipment" includes printers, scanners, modems and other similar devices, as well as the right to use computer software. It does not, however, include "access to, or the use of, public electronic communications" (for example, line rental to facilitate use of the Internet).

Blackberries have now been classified as computer equipment (having previously been regarded as mobile phones).

For computer equipment made available on or before 5 April 2006, the **first £500** of the benefit is **exempt** from tax. The **benefit in excess of £500 is taxable**. Therefore if an employer had a computer worth £2,500 and this was lent to an employee to use privately, the benefit was 20% of the £2,500 being £500. This benefit would then have been completely exempt from tax. Charges therefore only arose where the cost of equipment exceeded £2,500.

It is common in practice for an employer to allow an employee to use a desk top or a lap top for some private purposes. The "£500 rule" meant that most employees were unlikely to have a benefit in respect of their incidental private use.

If the computer is subsequently **transferred** to the employee, the benefit is calculated by using the **market value of the computer at the date of transfer**. The original acquisition cost calculation is not used in this case.

18.10 Use of computers – where provided on/after 6.4.06

The £500 exemption has been **removed** in respect of computer equipment provided on or after 6 April 2006.

However, the exemption continues to be available for employees who had been **provided with computer equipment before 6 April 2006**. In effect, the exemption is only removed where computer equipment is **first made available** to the employee on or after 6 April 2006.

If computer equipment is provided to an employee **solely for business use**, there is **no taxable benefit** (hence the £500 exemption is not relevant in this situation).

A more difficult issue arises when an employee uses the computer equipment partly for business and partly for non-business purposes. In this instance, the tax treatment depends on **<u>when</u>** the computer was first made available to the employee.

To calculate the annual benefit, we apply the following steps;

If available **before** 6 April 2006:

1. calculate the benefit using the 20% rule;
2. deduct £500; then
3. deduct the business proportion to calculate the taxable benefit.

If available **after** 5 April 2006:

1. calculate the benefit using the 20% rule; then
2. deduct the business proportion to calculate the taxable benefit.

Illustration 4

Chancery Ltd provides James, an employee, with a desktop computer, with printer, scanner and integrated software. The package cost the company £8,000. James works from home and uses the equipment 70% of the time for business purposes.

(i) Assume equipment provided on 31 March 2006.

The 2010/11 taxable benefit is as follows:

	£
Basic cash equivalent (£8,000 x 20%)	1,600
Less: exemption	(500)
Excess	1,100
Less: business use (70% x £1,100)	(770)
Taxable benefit for private use	£330

(ii) Assume equipment provided on 7 April 2006.

The 2010/11 taxable benefit is as follows:

	£
Basic cash equivalent (£8,000 x 20%)	1,600
Less: exemption	nil
Excess	1,600
Less: business use (70% x £1,600)	(1,120)
Taxable benefit for private use	**£480**

However, no liability to tax will arise where the reason for supplying the equipment is to enable the employee to perform the duties of the employment and the employee's private use "is not significant". There is no statutory definition of what is "significant". ITEPA 2003, s.316(2)

HMRC (in their Employment Manual) will accept that no taxable benefit arises where:

- the employer's policy concerning private use of computers is clearly stated to employees, setting out circumstances where occasional private use can be made; and
- a decision of the employer not to recover the costs of employees' private use is a commercial decision as the administrative costs of so doing would exceeds the amounts involved.

Even with the partial removal of the £500 exemption therefore, employers who have a stated policy permitting incidental private use of computer equipment, should not need to disclose taxable benefits on employees' P11Ds.

Example 1

Ron borrowed £50,000 from his employer to buy a house on 1 May 2010. The loan is interest free. On 1 August 2010 Ron borrowed a further £40,000 to add an extension.

Calculate Ron's taxable benefit assuming an official interest rate of 4% throughout.

Example 2

Lesley borrows a wide screen TV and DVD player from her employer on 30 September 2009. The equipment was worth £800 at that date.

On 1 July 2010, Lesley bought the equipment from her employer for £200. It was worth £450 at that date.

Calculate Lesley's taxable benefit for 2010/11.

Answer 1

Average method:

$$\left[\frac{50{,}000 + 90{,}000}{2}\right] = 70{,}000 \times 4\% \times \frac{11}{12} \qquad \underline{£2{,}567}$$

Strict method:	£
$50{,}000 \times 4\% \times \frac{3}{12}$	500
$90{,}000 \times 4\% \times \frac{8}{12}$	2,400
	£2,900

HMRC may elect for the strict basis as the average basis distorts the benefit.

Answer 2

Benefits for use	£	£
2009/10:		
$800 \times 20\% \times \frac{6}{12}$		80
2010/11:		
$800 \times 20\% \times \frac{3}{12}$		40
		120
Transfer of equipment		
Higher of:		
a) MV at transfer	450	
b) Original MV	800	
Less: charged already for use	(120)	
	680	

2010/11	£
Use of asset	40
Transfer of asset	680
Less: paid by employee	(200)
Total taxable benefit	**£520**