

INCOME TAX (EARNINGS AND PENSIONS) ACT 2003

EXPLANATORY NOTES

COMMENTARY ON SECTIONS

Example 3

£150(Pe) – £50(E) = £100

Chapter 7: Taxable Benefits: Loans

Overview

664. This Chapter deals with the benefits that may arise from loans obtained by reason of an employee's employment. These benefits may be due to a low rate of interest charged on the loan, or the writing off of a loan. The cash equivalent of the benefit of a loan is treated as earnings of the employee's employment.

Section 173: Loans to which this Chapter applies

665. This section describes the loans to which the Chapter applies. It derives from section 160 of ICTA.

666. *Subsection (1)* applies this Chapter to loans if they are employment-related.

667. *Subsection (2)* defines "loan" and sets out what is meant by making a loan.

668. *Subsection (3)* is a reminder that sections 288 and 289 of this Act (limited exemption for certain bridging loans connected with employment moves) may mitigate the charge under these provisions.

Section 174: Employment-related loans

669. This section sets out the basis on which a loan comes within the provisions of this Chapter. It derives from sections 160 and 161 of and paragraphs 1 and 2 of Schedule 7 to ICTA.

670. *Subsection (1)* describes loans which are employment-related. The fact that the loan is made to "an employee or a relative of an employee" indicates that at the time the loan is made there must be an employment.

671. *Subsection (2)* defines "employment-related loans" and the working of this subsection is illustrated by the flow diagram on page 76.

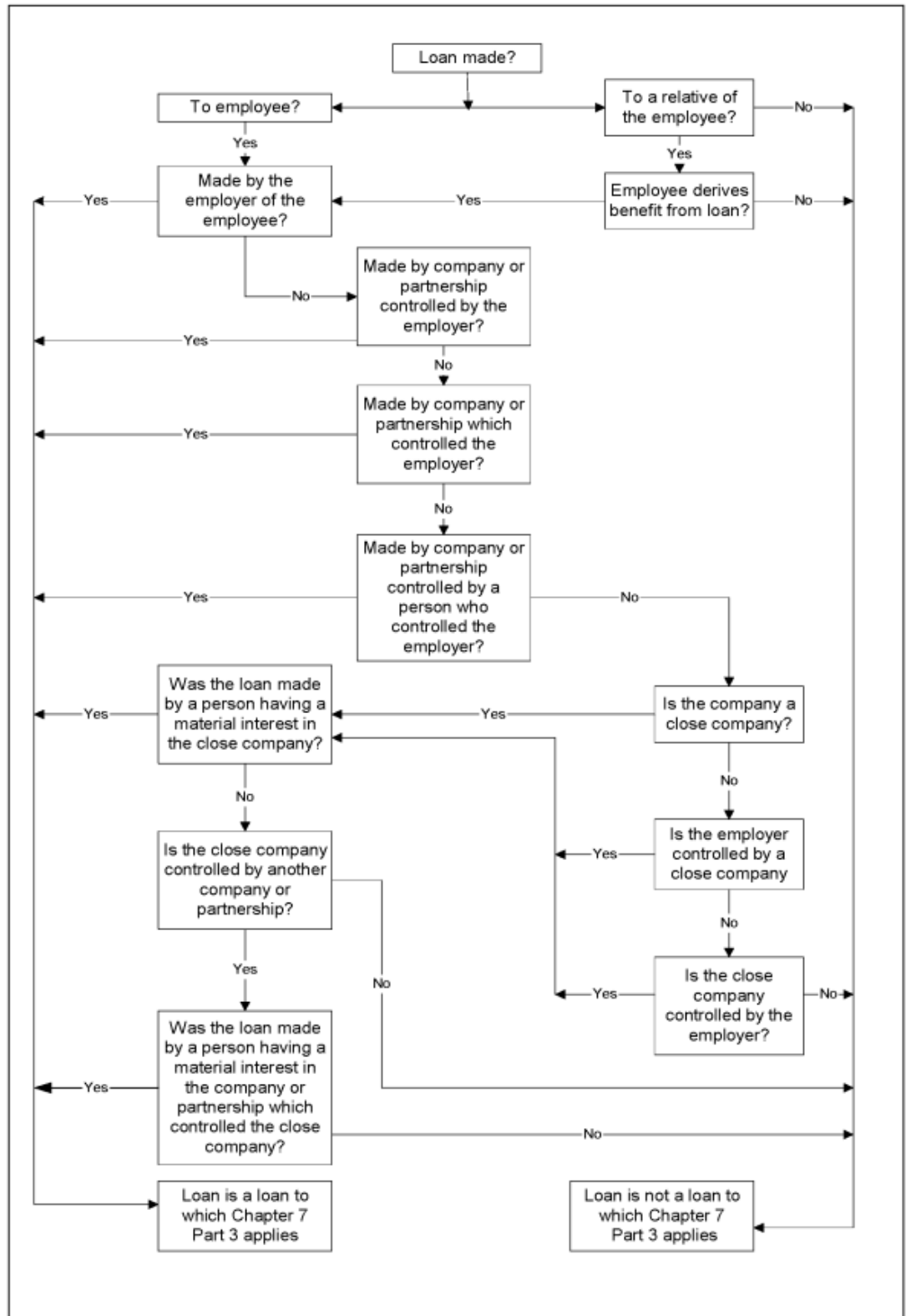
672. *Subsection (3)* provides that if a loan is made to an employee in anticipation of the employment commencing it is an employment-related loan, provided the employment is taken up. It derives from paragraph 2 of Schedule 7 to ICTA.

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- 673. *Subsection (4)* provides that loans made by a person who was not the original lender or who facilitates the continuation of an existing loan fall within the section.
- 674. *Subsection (5)* excludes from the charge certain loans of a personal or domestic nature.
- 675. *Subsection (6)* defines what is meant by a “relative” for the purposes of the section.

Section 175: Benefit of taxable cheap loan treated as earnings

- 676. This section brings within the charge to tax the benefit arising on certain employment-related loans (each of which is referred to as a “taxable cheap loan”) on which no interest is paid or interest is paid at a low rate.



677. Subsections (1) and (2) provide that the cash equivalent of the benefit of a taxable cheap loan is treated as earnings from an employment. They also describe the circumstances in which an employment-related loan is a “taxable cheap loan”. They derive from section 160(1) of ICTA. Subsection (1) sets out for which year the cash equivalent is to be treated as earnings. See Note 7 in Annex 2.

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678. *Subsection (3)* gives the broad rule for computing the cash equivalent of the benefit. *Subsection (4)* provides that in considering whether a loan falls within this Chapter it must be looked at separately from any other loan. They derive from section 160(4) and paragraph 3(1) of Schedule 7 to ICTA.
679. *Subsection (5)* is a signpost to section 180 of this Act (threshold for benefit of loan to be treated as earnings) which sets out the £5,000 threshold and to section 186 of this Act (replacement loans) which makes an exception to subsection (4).

Section 176: Exception for loans on ordinary commercial terms

680. This section deals with employers whose business includes the lending of money by preventing loans made on ordinary commercial terms from being taxable cheap loans. It derives from section 161B of, and Schedule 7A to, ICTA.
681. *Subsection (1)* provides that a loan on commercial terms is not a taxable cheap loan.
682. *Subsection (2)* provides a definition of “loan on ordinary commercial terms” which includes three conditions.
683. *Subsections (3) to (7)* set out those conditions and define terms used in them.
684. *Subsection (8)* provides that certain incidental expenses are to be ignored in determining, for the three conditions in subsection (2), whether loans are made or exercisable on the same terms or conditions.
685. *Subsection (9)* requires that certain amounts arising from variation of a loan are ignored for the purposes of ascertaining, for the second and third conditions, whether loans are held or exercised on the same terms.
686. *Subsection (10)* defines “member of the public” for the purposes of this section.

Section 177: Exceptions for loans at fixed rate of interest

687. This section exempts certain types of fixed interest loan. It derives from section 161(2) and (3) of ICTA.
688. *Subsection (1)* applies to loans made on or after 6 April 1978 at fixed rates for fixed periods. It applies when there is an increase in the official rate of interest for a year subsequent to that in which the loan was made. When that happens a calculation under section 182 or section 183 of this Act might show that the interest paid on the loan was less than what would have been paid if the official rate of interest had applied to the loan. In such a case, provided nothing other than the official rate of interest has changed, and provided the condition in subsection (2) is met, the loan is not to be regarded as a taxable cheap loan.
689. *Subsection (2)* provides as a condition for subsection (1) that the interest paid on the loan for the year in which it was made was not less than what would have been paid at the official rate for that year.
690. *Subsection (3)* exempts fixed rate loans from being taxable cheap loans if they were made before 6 April 1978, when there was no official rate of interest, and the condition in subsection (4) applies.
691. *Subsection (4)* sets out the condition for subsection (3), that the interest should be at an arm’s length rate when the loan was made.
692. *Subsection (5)* defines “fixed rate loan”.

Section 178: Exceptions for loans where interest qualifies for tax relief

693. This section provides that loans which would qualify for tax relief in a tax year if interest were paid on them are not taxable cheap loans for that year. *Paragraphs (a) to (d)* set out the types of interest. It derives from section 161A(2) of ICTA.

Section 179: Exception for certain advances for necessary expenses

694. This section provides that, where certain conditions are met, small temporary advances of expenses by an employer to an employee for necessary expenditure are not taxable cheap loans. It derives from Inland Revenue Statement of Practice 7/79. It is a minor change to law. See *Change 29* in Annex 1.

695. *Subsection (1)* provides that advances by an employer to an employee for necessary or incidental overnight expenses are not taxable cheap loans where certain conditions are met. *Subsection (2)* sets out those conditions.

696. *Subsections (3) and (4)* provide that the limits for two of the conditions can be extended.

697. *Subsections (5) to (7)* define terms used.

Section 180: Threshold for benefit of loan to be treated as earnings

698. This section prevents a tax charge on small amounts by providing a £5,000 threshold which applies in two circumstances. It derives from sections 161 and 161A(1) of ICTA.

699. *Subsection (1)* sets out the circumstances in which the cash equivalent is not treated as earnings.

700. *Subsection (2)* provides that all taxable cheap loans are aggregated to find whether the normal £5,000 threshold is exceeded for the purposes of subsection (1)(a).

701. *Subsection (3)* describes how the alternative threshold in subsection (1)(b) is calculated. This applies when the loan is a non-qualifying loan and total taxable cheap loans exceed the threshold. If qualifying loans are deducted and the total is then less than £5,000 the cash equivalent of the non-qualifying loans is not treated as earnings. That reflects the Inland Revenue practice of ignoring excepted loans and is a minor change to the law. See *Change 30* in Annex 1.

702. *Subsections (4) and (5)* define “non-qualifying loan” and “qualifying loan”.

Section 181: The official rate of interest

703. This section provides for the setting of the official rate of interest under section 178 of FA 1989 and allows special rates to be used for foreign currency loans. It derives from section 160(5) of ICTA.

704. *Subsection (1)* defines “the official rate of interest”.

705. *Subsection (2)* allows regulations made under section 178 of FA 1989 to specify a different official rate in the case of loans in another currency. “Normally lives” and “has lived at some time” are not defined in section 160(5) of ICTA. They therefore take their normal meaning. SE 26105 in the Inland Revenue Schedule E Manual provides guidance on this.

706. *Subsection (3)* provides that the power given under subsection (2) does not affect the general power under section 178 of FA 1989 to make different provisions.

Section 182: Normal method of calculation: averaging

707. This section sets out the normal method for calculating the amount of interest that would be payable at the “official rate for a tax year” by the averaging method. It derives from paragraph 4(1) of Schedule 7 to ICTA.

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708. This method of calculation does not explicitly apply in deciding whether a loan is within sections 160(1) or 161(2) of ICTA, although it is applied for those purposes in practice. Stating that the methods of calculation are used for all purposes of this Chapter legislates that practice. This is a minor change to the law. See *Change 31* in Annex 1.
709. A method statement sets out how to do the calculation, which applies the average official rate for the period to the average amount outstanding to arrive at the notional interest for that period.

Section 183: Alternative method of calculation

710. This section allows the use of a more precise method of calculating the interest at the official rate on a loan than the method given in section 182. It derives from paragraphs 5 and 5A of Schedule 7 to ICTA.
711. *Subsection (1)* allows either the Inland Revenue or the employee to choose this method of calculation. This is for the purposes of the Chapter and is not confined to the calculation of the cash equivalent. See *Change 31* in Annex 1. For the reference to the Inland Revenue see *Change 158* in Annex 1.
712. *Subsection (2)* sets out the time limit for making the election. This is different from the way the limit is expressed in paragraph 5(2) of Schedule 7 to ICTA which provides that the election must be made “before” the end of the period of 12 months beginning with 31 January following the end of the tax year. This subsection allows it to be made “on or before” that date. This is a minor change to the law. See *Change 32* in Annex 1.
713. *Subsection (3)* shows the calculation as a method statement. This arrives at the precise amount of interest on a day-to-day basis using the exact amount of the loan outstanding for each day. In paragraph 5(3)(c) of Schedule 7 to ICTA the total is divided by 365 days. As in a leap year the daily total would be based on 366 days, this subsection divides the total by the number of days in the tax year. This is a minor change to the law. See *Change 28* in Annex 1.
714. *Subsection (4)* requires that the alternative method should apply in certain circumstances where the cash equivalent of the benefit on the same loan is treated as the earnings of two or more employees.

Section 184: Interest treated as paid

715. This section treats the cash equivalent of an employment-related loan as if it were interest paid so that tax relief can be given where the loan is for a qualifying purpose. It derives from parts of section 160(1) and section 160(1A) of ICTA.
716. *Subsection (1)* sets out the circumstances in which the section applies.
717. *Subsection (2)* treats the employee as having paid interest equal to the cash equivalent of the benefit.
718. *Subsection (3)* prevents a claim that the interest should be treated as paid and so qualify as a deduction from the amounts treated as earnings by another chapter of the benefits code.
719. *Subsection (4)* provides the mechanism for allocating to a tax year the cash equivalent to be treated as interest.
720. *Subsection (5)* makes it clear that, although the cash equivalent is treated as if it were interest paid by the employee, it is not treated as interest received by the lender.

Section 185: Apportionment of cash equivalent in case of joint loan etc.

721. This section allows the apportionment of the cash equivalent of a loan between two or more employees who are chargeable under this Chapter in respect of the same loan. It derives from paragraph 5A(1) of Schedule 7 to ICTA.

Section 186: Replacement loans

722. This section prevents manipulation of the averaging method in section 182 of this Act where a loan which is later replaced is repaid part way through the month. So that complete months are included in the calculation the section treats the replacement loan as the original loan. It derives from paragraph 4(2) to (4) of Schedule 7 to ICTA.
723. *Subsection (1)* sets out the circumstances in which the provisions apply and deals with both the replacement by a further employment-related loan and the insertion of a loan which is not employment-related between two that are.
724. *Subsection (2)* treats all loans falling within subsection (1) as if they were one continuous loan.
725. *Subsection (3)* follows the practice of applying the treatment of one continuous loan not just to the calculation of the official rate of interest which would be paid for the year but also to any interest paid on the loans for the purpose of calculating the cash equivalent. This is a minor change to the law. See *Change 33* in Annex 1.
726. *Subsection (4)* defines “further employment-related loan”.

Section 187: Aggregation of loans by close company to director

727. This section provides for the aggregation of certain loans on an election where the borrower is a director of a close company which is the lender. It derives from section 160(1B) and (1BA) of ICTA.
728. *Subsection (1)* sets out the circumstances when the section applies.
729. *Subsection (2)* allows the lender to elect for aggregation for a tax year to apply to the borrower.
730. *Subsection (3)* explains the effect of the election.
731. *Subsection (4)* places a restriction on which loans may be aggregated.
732. *Subsection (5)* says by whom and how and within what time limit the election may be made. See *Change 158* in Annex 1 regarding the reference to “the Inland Revenue”.

Section 188: Loan released or written off: amount treated as earnings

733. This section treats employment-related loans which are released or written off as earnings. It derives from section 160 of ICTA.
734. *Subsection (1)* applies in the case of a continuing employment and treats the amounts written off as earnings for the year in which the loan is released or written off. It derives from section 160(2) but that section does not specify the tax year. See *Note 7* in Annex 2.
735. *Subsection (2)* applies subsection (1) where an employment-related loan is released or written off after the employment has ceased or at a time when the employee is lower-paid in accordance with Chapter 11 of Part 3 of this Act. If the employment has ceased there is no taxable employment and the section would not apply. Deeming that the employment has not ceased allows the section to apply in the case of a release or writing off for the year in which the event occurs. It is also necessary for the employment to be one which is not an “excluded employment”; otherwise the section would not apply. Where the employment has become an “excluded employment” this subsection deems it not to be “excluded”. This derives from section 160(3) of ICTA.

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736. *Subsection (3)* preserves chargeability where subsection (2) applies and a loan replaces the employment-related loan. It derives from section 160(3A) of ICTA.

Section 189: Exception where double charge

737. This section ensures that where the release or writing off of a loan might be chargeable to tax under other provisions there is only one charge to tax. It derives from section 161(5) of ICTA.
738. *Subsection (1)* provides the general rule that if another provision in the Income Tax Acts applies this section does not.
739. This clarifies the position that there will be no double charge if a loan made to a participator in a close company is written off and section 421 of ICTA applies. It is a minor change to the law. See *Change 34* in Annex 1.
740. *Subsections (2)* and (3) provide exceptions to subsection (1). In both cases it is made explicit which provision takes precedence when there is a possible double charge. This change in approach is described more fully in *Note 19* in Annex 2.

Section 190: Exclusion of charge after death of employee

741. This section provides a general exemption from the provisions of the Chapter if the employee dies. It derives from section 161 of ICTA.
742. *Subsection (1)* removes the charge on a taxable cheap loan for the period from the date of death where the employee has died but the loan is not repaid. It provides that the loan is treated as no longer outstanding as from the date of death for the purposes of calculating the cash equivalent. This change in approach is described more fully in *Note 20* in Annex 2.
743. *Subsection (2)* removes the charge if the loan is released or written off on or after the death of the employee.

Section 191: Claim for relief to take account of event after assessment

744. This section allows adjustments to the figures in cases where subsequent events affect the amount chargeable. It derives in part from section 160(4A) of ICTA.
745. *Subsection (1)* introduces the claim.
746. *Subsection (2)* allows for the fact that interest may be paid after the tax liability for the year has been determined.
747. *Subsection (3)* allows for repayment of a loan that has been released or written off. Allowing a claim for a loan that has been released or written off is a minor change to the law. See *Change 35* in Annex 1.
748. *Subsection (4)* provides for the situation where tax payable has been decided on the basis that the condition in section 288(1)(b) of this Act in respect of bridging loans will not be met and that condition is in fact met. It derives from section 191B(13) of ICTA.
749. *Subsection (5)* allows the adjustment to be made.