Beneficial Loans to Employees

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1 Introduction

"Beneficial loans to employees" designates interest-free loans or loans at less than a marked rate of interest received by reason of employment. For tax purposes it does not matter whether the employee has a regular employment or not, as long as the benefit is received by reason of labour or services rendered. Loans comprises in principle any form of credit.

Beneficial loans to employees transfers an economic value (the time value of capital) to the borrower which the lender renounce. This article discusses how this benefit in kind should be treated for tax purposes both on the lender/employer's hand and on the borrower/employee's hand.

The general rule as to the taxation of income from employment is that an employee's total labour compensation includes all benefits received in connection with the employment, The General Tax Act (GTA)[1] Sec. 5-1 paragraph 1 and Sec. 5-10. The general concept of income is not based on characteristics of the payment or manner in which it was derived. The total compensation may include a money wage and non-wage benefits as e.g. conventional fringe benefits. Conventional fringe benefits, like beneficial loans linked to the job, are often named benefits in kind.

Taxable benefits in kind must be valued to enter the tax base. The borrower can not convert the benefit of a beneficial loan into money. It may be argued that no realisable value is received by an employee receiving a beneficial loan, and therefore no taxation should be suffered by an employee receiving such a loan from his employer or otherwise by reason of his employment. However, the general rule in relation to the taxation under GTA Sec 5-12 paragraph 2 and Sec 5-3 of benefits in kind received by reason of employment is that the value of such benefits is to be taken as the marked value, namely, the value a non-employee would pay for similar goods or services. Therefore benefits in kind may be taxable even if they are not convertible into an amount of cash, as long as they have a marked value.

1 Enacted on March 16 1999 No 14; in force as from 1 January 2000.

However, the general rule is displaced in respect of beneficial loans to employees. According to GTA Sec 5-12 paragraph 4 the employees are taxed on the basis of a tax reference interest. If the agreed interest rate between the parties is below the tax reference interest, the difference is taxable in the hands of the employee. The tax reference interest is decided by the Parliament each year, and the intention is that this interest should reflect marked conditions. Historically the tax reference interest has normally been slightly below comparable marked interest. For all practical purposes, it would be difficult for an employee to challenge the tax reference interest in court.

To the extent that the parties have agreed on paying interest, this interest will be taxable income for the creditor and deductible interest expense for the debtor according to ordinary income tax rules. Norway generally allows a deduction for interest expenses, GTA Sec. 6-40. The value of the deduction is 28 % irrespective of the nature of the taxpayer's taxable income. On the other hand all interest income is taxable at a rate of 28 %, GTA Sec. 5-1 paragraph 1.[2]

In the following I presuppose that the principal of the loan actually is a loan properly so called, and not hidden salary for labour or services rendered. This depends mainly on whether or not an independent repayment agreement exists. I further presuppose that the employee receives the loan from his employer or otherwise by reason of his employment, and not in capacity as an owner of the company (owner-employee) as an illegally distributed dividend. Finally I presuppose that the employer has no shared interest with the employee, so that the tax authorities can not adjust for this effect on the transaction between the parties according to transfer pricing rules, GTA Sec. 13-1.

2 Taxation of the Employee

2.1 In General

For the employee the benefit of a beneficial loan is taxable as income from employment, GTA Sec. 5-1 paragraph 1 and Sec. 5-10. This applies either the benefit is structured as an exemption for an obligation to pay interest or as an advantage of collecting the yield of the employers capital.

As mentioned in the introduction, the computed interest income consists of the difference between the interest rate decided by the Parliament and the agreed interest rate between the parties, GTA 5-12 paragraph 4. If the agreed interest rate is below the tax reference interest, the difference is taxable on the employees hand as income from employment. The tax reference interest in 2002 is 6 %, Tax Resolution of the Parliament for the year 2002, Sec. 7-2.

The benefit is calculated each year. The loans are treated independently. If the employee receives one loan with interest below the tax reference interest and one loan with interest that exceed the tax reference interest, the first loan will be taxed without regard of the second loan.

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2 The general rules are described in; Hugo P. Matre, *Deductibility of Interest Paid on Profit-Participating Loans in Stock Companies*, Bulletin for International Fiscal Documentation, vol. 56 no. 8/9 2002 at 456- 457.

It makes no difference whether or not the employer has financed the capital on beneficial terms from an external source. Neither does it matter whether the employee could obtain the same loan conditions elsewhere. The benefit will be taxable even if the agreed interest rate was equivalent to the marked interest rate when the loan was established and there is no contractual opportunity to renegotiate the interest rate. An exception must be done if the employer offers loans on the same terms to other than employees, so that the benefit is not income from employment. An example of the latter may be employees in banks with regular bank loans at a fixed interest rate. If the fixed interest rate is based on marked conditions when the loans are established, there will be no taxation of the benefit if the fixed interest rate is below the marked interest rate later in the contractual period.

If the loan period is shorter than the fiscal year, the taxation of the benefit is proportional to the number of months that the loan is made for. Parts of a month are considered as a whole month, General Tax Act Regulations (GTAR)[3] Sec. 5-12-1.

Beneficial loans to employees are not taxable if the loan, when established, does not exceed 3/5 of a reference number (basic amount) in the National Insurance Act and the duration of the loan is at the most one year, GTA Sec 5-12 paragraph 4 third sentence. The available amount was NOK 32.502 as from May 1. 2002.

The Directorate of Taxes has stated in the publication Tax Assessment ABC (Lignings-ABC) 2001 at p. 615 that the exemption for smaller loans apply only for one loan per employee. In this authors view the exemption for smaller loans should be interpreted narrative so that the exemption does not encompass several loans which in sum exceeds the statutory amount. On the other hand the exemption is not limited to one loan at the time as long as the smaller loans together fulfil the requirements in GTA Sec 5-12 paragraph 4 third sentence.

When an employee is to be considered a borrower and the employer a lender is further developed in GTAR Sec. 5-12-2 to Sec. 5.12-4. As a general principle it does not matter which source the loan is originating from, as long as the loan is caused by the employment. There are also identification rules as regards spouses, decedent estates, earlier employment etc.

2.2 The Net Income Benefit Doctrine

When taxed, the benefit of beneficial loans to employees is subject to tax as ordinary income at a 28 % flat rate, GTA Sec. 5-1 paragraph 1, Sec. 5-10 and Sec. 5-12. In addition the benefit is also taxed as personal income at progressive rates rising to 27.3 % for wages and salaries, GTA Sec. 12-2 paragraph 1 letter a. However, the Norwegian Tax authorities have in practise applied a “net” income benefit doctrine. The arguing is that because all interest expenses are deductible in Norway, the higher salary that an employee could have sought but for the subsidised loan would have been offset by a higher interest deduction. Thus,

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3 Enacted on November 19 1999 No 1158 by Ministry of Finance; in force as from 1 January 2000.

exclusion of the subsidy benefit from tax does not alter the net taxable income that would have been determined if the subsidy were replaced with cash salary.[4] However, this administrative practise applies only to the calculation of ordinary income, and not to the calculation of personal income. Accordingly, beneficial loans to employees are subject to tax at progressive rates rising to 27.3 %.

In this authors view the grounds for the net income benefit doctrine is insufficient. Normally relief is only available for actual expenses. Hypothetical expenses are not deductible. The result of the net income benefit doctrine is that beneficial loans are subject to tax advantages compared to other income from employment. Principally there ought to be neutrality between various kinds of income from the same source.

It might be questioned whether taxation of beneficial loans as ordinary income will lead to double taxation. If the loan is not used for private consumption, the employee will regularly use the loan for income producing activities or reduce interest bearing debt. In either case the employee's taxable income will increase at the same time as the benefit of the beneficial loan is taxed. The question is then whether the benefit of the loan is taxed twice. The answer is no. The benefit of a beneficial loan is a benefit in kind received from the employer and taxable as income from employment, whereas the other benefits are taxed as capital income (or business income after the circumstances). The employee's situation may be clarified if compared to someone who borrows at a marked interest rate before the capital is used for income producing activity. Even if they both achieve the same income from the use of the capital, the employee will have the favour of not having to pay for the financing of the activity. Beneficial loans to employees may also be compared to housing benefits. An employee provided with free housing in an employer's house, will be taxed for the use of the employer's assets. If the employee leases the property to another tenant, the income from the (second) rent contract will be taxed separately.

3 Taxation of the Employer

3.1 In General

The concept of income comprises only actual benefits. Thus, as a starting point, a possible interest income should not be taxed at a capital owner's/employer's hand. If a capital owner/employer chooses not to use the capital for income producing activities, to the example by having large cash balance, the capital owner/employer will not be taxed for the income that could have been achieved if the capital had been used for income producing activities. This income represents only an income opportunity, not an actual income.

On the other hand every benefit the employer achieves from the loan is taxable as capital or business income, not only eventually interest income, GTA Sec. 5-1 paragraph 1.

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4 Utv. 1965 at. 13, the Directorate of Taxes.

At the tax assessment the tax authorities appliance of the net income benefit doctrine has caused that beneficial loans to employees have no immediate consequences for the employer as regard income tax. Hence, the employee deducts a fictitious interest expense, whereas the employer is not taxed for a fictitious interest income. In this authors view this administrative practise is not correct according to the GTA.

3.2 Analysis of the Transaction

Beneficial loans are made to favour the employee. The employer may reach the same result in different ways. The purpose is that the employee shall receive the yield of the capital in question for a fixed period. This can be achieved if the employer makes the capital interest-bearing and then assign the interest income to the employee. In this case the interest income will be taxable and the payment will be deductible as salary expenses on the employer's hand in accordance with the ordinary tax rules. With beneficial loans the tax treatment is different even though the economic reality might be considered the same to some extent; the employer lends the capital to the employee at zero or low interest rate, whereas the latter can make the capital interest-bearing on his own. However, even if the economic reality is similar as regards whom that may consume the yield; these are principally different transactions with unequal legal and economic reality in other respects. For instance, the employee is responsible debtor with a beneficial loan, whereas this is likely to be a financial institution if the employer makes the capital interest-bearing on his own. Thus, the choice is not between different constructions of the same economic reality, but between different transactions with unequal legal and economic reality. This leads to the conclusion that interest achieved on the employees hand can not be taxable on the employer's hand.

On the other hand, the employer receives another benefit; reduced wage expenses. The loan is used to pay the employee. Beneficial loans are normally not included in the salary agreement between the parties, but is clearly caused by the employment and hence an increment to the employee's regular wage. The employer receives thereby a benefit in kind as remuneration for the loan, namely, the employees work at a lower salary than without the loan. The amount that the employer otherwise would have had to increase the wage to compensate for the lack of the benefit will presumably normally be equal to the benefit of the beneficial loan for the employee. The employer achieves in other words a benefit in the shape of reduced wage expenses. This is a taxable benefit from capital or business on the employer's hand, GTA Sec. 5-1 paragraph 1.

As a starting point the benefit represents income from capital. It is unclear whether the interest concept comprises benefits in kind, but this question has no bearing on the matter of whether the benefit is taxable or not. Benefits in kind from capital are taxable in general according to GTA Sec. 5-1 paragraph 1.

The employers benefit is reduced, direct wage expenses. This income is not included in the yield of the employer's activity and should therefore be taxed separately. On the other hand, the benefit of the working result does form a part of the employer’s ordinary income which is already taxed according to the general tax rules.

Against this solution it may be argued that the employee would have performed the same work without the beneficial loan and that it is more a less a coincidence when a loan is made. However, comparisons with hypothetical arrangements can not justify omitting taxation according to the parties actual arrangement as long as the loan is caused by the employment. In comparison, even if an employee is willing to work for a lower cash wage, e.g. in order to help save the working place, there will be no question of treating the actual amount different than the rest of the remuneration until a reduction of the wage is actually made.

At the same time as the employer gains the benefit of reduced (direct) wages by the loan, the employer incurs an expense by relinquishing the (time) value of the capital amount. The expense for the employer by beneficial loans must be considered as a wage expense or be placed on equal footing as wage expenses. Since the employer uses the capital to remunerate the employee, the benefit in kind will be deductible as an operating cost, GTA Sec. 6-1 paragraph 1. However, a deduction can only be made after the benefit is taxed. As a general principle, only taxed benefits may be deducted. When the benefit of reduced wage expenses is taxed on the employers hand as a benefit from capital or business, this requirement is fulfilled. Practical reasons indicates that the tax reference interest rate ought to be used also to stipulate the benefit on the employers hand, even if the tax reference interest rate, as mentioned, normally has been below the marked interest rate.

3.3 Court Practise

The solution in 3.2 above is supported by the Selte-case.[5] It is a case about taxation of benefits in kind, namely housing. The company AS Hoeyvikssletta rented out flats to several tenants. The tenants had one share each with a nominal value of NOK 1.000 in the (housing) company. They all made a contribution to the company; approximately NOK 27.000 for tree room apartments and NOK 39.000 for four room apartments. The contributions were instalment and interest free, and secured by a joint second priority tenants bond. Some of the tenants, including Mr. Selte, contributed another interest free loan of NOK 50.000, secured by coordinated first priority mortgage deeds. The company reduced the rent for these last tenants with an amount equal to the interest expense saved by the company because of the loans. Mr. Selte paid a monthly rent of NOK 60, while the ordinary rent for this kind of flat for those who had not made an extra contribution was NOK 300.

The tax authorities taxed NOK 240 (the difference between the ordinary rent of NOK 300 and the actual rent of NOK 60 after the contribution of the interest free loan) as income from capital, and the Norwegian Supreme Court confirmed the assessment. The Court noted (unofficial English translation):

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5 Rt.1967 at. 897. ”Rt” is an abbreviation for ”*Norsk Retstidende*”, which is a collection of the decisions of the Norwegian Supreme Court.

> "It is clear that this reduction of the rent is an economic benefit from capital represented by the first priority loan, and I agree with the tax authorities (kommunen and Riksskattestyret) and the District Court (herredsretten) that this special benefit is subject to income taxation …"

Mr. Selte argued that the reduction of the rent because of the first priority loan, in principle should be treated the same way as the reduction of the rent because of the ordinary tenants bond, and claimed that neither was subject to tax because of binding tax assessment practice. The Supreme Court did not reject the administrative practise, but pointed out that the actual loan was "very large" and brought about "a very extraordinary low rent" which put the lenders "in an exceptional position compared with the other share holders". The Court also emphasised that the housing company and the lenders themselves had separated between the first priority loans and the ordinary tenants bonds.

There is no doubt that benefits in kind from capital are taxable. I have used the Selte case as an illustration because there are several similarities between the case and beneficial loans to employees. Just as Mr. Selte, the employer receives a benefit in kind from the loan, in this case the employees work at a lower wage. This benefit in kind is in principle taxable as income from capital, GTA Sec 5-1 paragraph 1. But just as in the Selte case, this benefit is not taxed in tax assessment practice. The importance of the administrative practise as regard beneficial loans is discussed in chapter 4 below.

To tax and deduct the same amount has seemingly no immediate tax consequences for the employer. However, it will display the real incomes and wage expenditures in the tax accounts. Theoretically taxation of the benefit might have effect on the taxation of ordinary income, e.g. as regards the tax limitation rules in GTA chapter 17 and the Tax Resolution of the Parliament for the year 2002 Sec. 7-6, but this is less practical.

4 Conclusions

The analysis above indicates that the benefit in kind of beneficial loans to employees is taxable on the employees hand both as ordinary income and as personal income. The employee is not entitled to a deduction of the same amount at the calculation of ordinary income. Further the interest subsidy is deductible on the employers hand as a wage expense, but correspondingly the benefit of reduced wage expenses is taxable income from capital or business as a benefit in kind – with for practical reasons the same amount.

However, tax assessment practice since at least 1965 differs from this solution as indicated above. The administrative practise is so extensive and consistent that it must be considered binding until changed by statute or eventually new practise with statutory weight.

However, if the beneficial loans are "very large" and brings about "a very extraordinary" benefit which put the employer "in an exceptional position compared with the other" employers, the Selte case indicates that the benefit will be taxable on the employers hand, and likewise as regards the taxation of ordinary income on the employees hand.