

LIMITED RECOURSE LOANS

Limited recourse loans and employee share schemes (ESS)

Under some ESS, employers offer to finance employee share acquisitions through low or no interest loans. These loans sometimes have limited recourse provisions so that an employee is not liable to fully repay the loan after selling the shares, if the sale proceeds are not sufficient to fully repay any outstanding loan amount. The use of capital protected products such as limited recourse loans protects employee shareholders from losses arising from drops in share value.

Proposed amendments

On 16 April 2003, the Treasurer announced that the *Income Tax Assessment Act 1997* would be amended to ensure that part of the expense on a capital protected product is attributed to the cost of its capital protection component, and is not interest and not deductible where this cost is capital in nature.

An effect of this announcement is that employers may be liable for fringe benefits tax (FBT) where they provide a limited recourse loan to an employee to purchase shares under an ESS, regardless of whether that loan is provided on a low or zero interest basis.

Impact of proposed amendments

For example, assume on 1 April 2004 an employer offers a limited recourse loan of \$10,000 to an employee to purchase shares under an ESS. The interest rate on the loan is 5 per cent per annum, and the loan period is 5 years. Intrinsic in the interest rate on the loan is a 10 per cent premium for providing the capital protection (0.5 per cent of the total interest rate).

The provision of the loan may constitute a loan fringe benefit. A loan fringe benefit arises where an employer provides a loan to an employee and charges a low rate of interest (or no interest) during the FBT year. A low rate of interest is one that is less than the statutory rate of interest.

For the FBT year commencing 1 April 2004 the statutory interest rate is 7.05 per cent. As the interest rate on the loan is less than the statutory rate, a loan fringe benefit will arise. The taxable value of the loan fringe benefit is the difference between the interest that would have accrued had the statutory rate applied, and the interest that actually accrued. In this case, the taxable value is \$205¹.

The taxable value amount may be reduced, however, under the otherwise deductible rule. Under the otherwise deductible rule, the taxable value of a loan fringe benefit may be reduced to the extent to which interest payable on the loan would be allowable as an income tax deduction if paid by the employee².

¹ $(\$10,000 \times 7.05\%) - (\$10,000 \times 5.00\%) = \205

² The hypothetical amount of interest that would be deductible to the employee is 90%.

In this example, only \$184.50³ would be otherwise deductible as that amount is attributable to the earning of assessable income. The amount of \$20.50⁴ which would not be deductible represents the interest amount paid on the loan to cover the capital protection component. This amount is not otherwise deductible as it is not attributable to the earning of assessable income; it is a capital cost. The employer is liable for FBT on a loan fringe benefit of \$20.50.

In the case of a zero interest loan, the capital protection component will still apply to some proportion of the statutory interest rate. Continuing the previous example, if the employee is offered a zero interest loan and the statutory interest rate is 7.05 per cent per annum, the loan fringe benefit provided to the employee is \$705. Assuming 10 per cent of this is attributable to the capital protection component of the loan, then only \$634.50 will come within the otherwise deductible rule. The employer will be liable for FBT on \$70.50.⁵

It is appropriate that FBT apply to the capital protection premium, as it is a benefit provided by an employer to an employee which is unrelated to the earning of income.

Other FBT consequences of limited recourse loans

A debt waiver fringe benefit arises where an employer waives or forgives an employee's debt. The taxable value of the benefit is the amount of the debt that is forgiven. It is appropriate that a debt-waiver fringe benefit arise where limited-recourse provisions are later triggered and used.

For example, an employee with a limited recourse loan decides to sell their ESS shares at a loss. At the time of the sale the outstanding balance of the loan is \$6,000. The employee receives \$4,000 from the sale of the shares. As the proceeds of the sale are not enough to fully repay the loan, the limited recourse facility is triggered so that the employee does not have to pay the \$2,000 shortfall. This is effectively a waiving of the employee's debt by the employer. The employee receives a debt waiver fringe benefit, in that they are not required to repay \$2,000 that they were loaned.

Industry Concerns

A submission received by Treasury has raised concerns that the proposed amendments to the treatment of capital protected products and limited recourse loans will adversely impact companies efforts to encourage employee share ownership. It claims that a significant number of companies provide limited recourse loans to employees to buy ESS shares.

The submission argues that the proposed amendments should not apply to limited recourse loans used for the purposes of purchasing shares under an ESS. That is, FBT should not apply to the capital protection premium, and not be payable on the debt waiver fringe benefit received if the limited recourse provisions are later triggered. This is based on the claim that a premium is rarely charged, in an ESS context, to compensate the employer for the limited recourse facility.

³ $\$10,000 \times 7.05\% = \705 . $\$705 \times 90\% = \634.50 . $\$500 \times 90\% = \450 . $\$634.50 - \$450 = \$184.50$.

⁴ $\$205 - \$184.50 = \$20.50$. Alternatively, this could have been calculated $\$205 \times 10\% = \20.50 .

⁵ $\$10,000 \times 7.05\% = \705 . $\$705 \times 10\% = \70.50 . $\$634.50 = \$705 - \$70.50$.

ESS and FBT

FBT is not payable when an employer provides an ESS share at a discount to an employee, as the issue of a share to an employee under an ESS is deemed to not constitute a fringe benefit under paragraph 136(1)(ha) of the *Fringe Benefits Tax Assessment Act 1986*:

“A fringe benefit...does not include...a benefit constituted by the acquisition by a person of a share or right under an employee share scheme (within the meaning of Division 13A of Part III of the *Income Tax Assessment Act 1936*).”

It should be noted that the granting of ESS shares at a discount is taxed as income in the hands of the employee, and that tax concessions already apply to the discount received from acquiring ESS shares below their market price. These tax concessions, which are contained in Division 13A of the *Income Tax Assessment Act 1936*, are designed to encourage the uptake of employee share ownership and align the interests of employees and employers.

Recommendation

It is not considered appropriate to extend the current FBT exclusion of ESS shares to the *means* by which ESS acquisitions are financed. That is, it is not considered appropriate to exempt from FBT discounted loans provided by employers to employees just because the loan will be used to purchase ESS shares.

Similarly, it is not considered appropriate to exclude the capital protection premium which would normally be paid on limited recourse loans from FBT just because the loan is provided in connection with the purchase of ESS shares.

The submission states that there are a “great number” of companies which use limited recourse loans to finance the acquisition of ESS shares. Research by the Department of Employment and Workplace Relations found that only a small number of companies use limited recourse loans to finance ESS share acquisitions.

There also does not appear to be a strong case that the aims of encouraging employee share ownership would be advanced by providing additional concessional treatment for ESS shareholders in relation to FBT.

Consequently, based on these arguments, it is considered to be inconsistent with the principles of FBT, and the principles behind the current ESS exclusion from FBT, to provide a specific carve out for limited recourse loans to purchase shares under an ESS.