In the midst of a struggling economy, firms understand the importance of finding and retaining top talent. To recruit and preserve such valuable resources, numerous firms have turned to offering traditional and compensation-related employee loans. Whether such loans are constructed for retention or to administer employee aid, their tax treatment should be closely considered.

There are three main types of employee loans:

- Traditional employee loans;
- Below-market employee loans; and
- Employee forgivable loans.

A traditional employee loan adheres to the strict definition of a loan and does not require the recognition of compensation by the employee. Below-market and employee forgivable loans represent two types of compensation-related employee loans. With a below-market loan, the employee must recognize compensation for the difference between the loan’s stated rate of interest and the higher market rate of interest. With an employee forgivable loan, companies typically forgive the employee of their interest and principal repayment obligation over time. Therefore, the interest and principal amounts are captured as compensation income to the employee. Each of these employee loans provides different benefits to employees and needs to be carefully structured in order to provide the desired income recognition and tax treatment for both the employee and employer.

Restrictions on Employee Loans
It is important to note that the Sarbanes-Oxley Act of 2002 (SOX) imposed restrictions on loans to certain employees. SOX made it unlawful for an issuer to extend or maintain credit in the form of a personal loan to a director or executive officer. Therefore, public companies subject to SOX should avoid offering employee loans to directors or executive officers; however, employee loans can still be offered to other rank and file employees. Non-public companies not subject to SOX can extend employee loans to employees of all levels.

Traditional Employee Loans
A traditional employee loan is commonly used to administer financial assistance to an employee, whereby an employer lends money to an employee with the full intention that the employee will repay the loan to the employer plus interest. The guidelines for administering a traditional employee loan hinge on the legal obligation of the employee to make monetary repayment of the advance, as well as the employer’s intention to impose repayment. To confirm these obligations, both parties must sign a loan document stating the provisions for repayment, the fixed maturity dates and the appropriate stated interest. The stated interest rate must be at least the Applicable Federal Rate (AFR) in effect as of the day on which the loan was made, compounded semiannually. Cash repayments are to be made in a timely manner and must be unconditional and not contingent upon future events. If a traditional employee loan is administered properly, the employee does not recognize compensation income and the employer will not receive a compensation expense deduction for the loaned amount.

Below-Market Loans
Below-market loans are provided to employees at a lower interest rate then they could otherwise receive in the market. Below—
market loans can be offered at either a reduced interest rate (below the AFR) or completely interest free, as an original issue discount. The spread between the reduced interest rate and the market rate of interest (the AFR) is recognized as compensation to the employee and deducted as compensation expense by the employer. The timing of the recognition of compensation depends on whether the loan is a demand loan or a term loan.

**Demand loans** are payable on demand of the lender. For a demand loan, the amount of forgone interest is recognized as taxable compensation to the employee and as a compensation expense deduction to the employer on the last day of the calendar year.

**Term loans** are traditional loans with a set repayment schedule and maturity date that cannot be altered at the demand of the lender. If a term loan is provided to an employee who leaves the company prior to repaying the loan, the employee must continue to make repayments of the loan, even after he or she is no longer employed, according to the original repayment schedule. For a term loan, the amount of forgone interest is transferred at the time the loan is made and is equal to the excess of the amount loaned over the present value of all payments that are required to be made under the terms of the loan agreement. Therefore, term loans are treated as original issue discount loans. The employee will recognize taxable compensation and the employer will recognize compensation expense on the date the loan is made.

**Employee Forgivable Loans**

A popular tool used to attract top talent is the employee forgivable loan. Employers often issue these loans as sign-on or retention bonuses to retain and attract top executives. The concept is for an employee to receive an upfront cash payment structured as a loan contingent on the employee’s continued service with the company. The income recognition from the employer’s forgiveness of the underlying principal and interest payments is generally intended to be tax deferred to the employee and recognized over the life of the loan.

For tax purposes, it is essential that this arrangement be structured as a loan so the upfront cash payment is not immediately taxed as compensation to the employee. However, there is an issue as to whether this payment is actually a cash advance instead of a bona fide loan arrangement.

To qualify as a loan, a loan document must be signed stating the legal obligation of the employee to make monetary repayment of the advance, the employer’s intention to impose repayment, the provisions for actual repayment, fixed maturity dates and appropriate stated interest. The determination whether a loan is considered a bona fide loan is a factual determination, and the presence of all of these characteristics does not guarantee loan status. The parties’ intention for the loan must be considered when evaluating the transaction.

In Technical Advice Memorandum (TAM) 200040004, the IRS concluded that a loan by an employer to an employee evidenced by a note agreement represented compensation, at the time of the loan, for tax purposes. The recognition of compensation requires the employee to include the lump-sum payment as income in the year it is received instead of deferring recognition of the income over the service period. In the case this TAM was addressing, an employer entered into a note agreement with employees and provided a lump-sum cash payment that was to be repaid in five annual installments at a stated rate of interest. The note agreement stipulated that the employer would forgive the repayment obligations in full upon an employee’s death, disability or termination from the company without cause. On the same day, the employer entered into a bonus agreement with employees that guaranteed a bonus to each employee to be paid on the same day and for the same amount as the principal and interest due each year for the note. The bonus agreement also stipulated that all bonus payments shall be applied in full to the payment of the note agreement.

In this TAM, the IRS concluded that the amount provided to the employees constituted compensation instead of loan proceeds for two main reasons. First, the employees did not have an unconditional or personal obligation to repay the loan. The employees were only obligated to repay the loan if they left the company before the end of the required service period. Otherwise, the principal and interest amounts were paid through the employer’s bonus agreement. Second, the employee’s repayment was not in the form of cash. In substance, the loan did not require cash repayment —— instead, the employee’s obligation was satisfied by the performance of services over the five—year period.

The TAM also addressed the tax treatment of the cash advance made to employees. The TAM concluded that economic performance does not occur and the employer cannot recognize a compensation deduction until the employee performs the services. Therefore, for tax purposes, the company recognizes the expense as the participating employees perform services over the five—year term of the note agreement, while the employee recognizes the income as compensation in the year it is received.
The fact pattern of the TAM is unique; however, it could be argued that forgiveness of debt over a service period is not unlike the bonus agreement provided in this scenario. Although TAMs are not authoritative guidance, the IRS has informally indicated that the conclusion reached in this TAM reflects its current position on employee forgivable loans. Therefore, the IRS would conclude that a loan scheduled to be forgiven based on continued employment is actually a salary advance taxable to the employee upon receipt.

Alvarez & Marsal Taxand Says:
Documentation is essential to ensure that loans to employees are treated as such for tax purposes. An arrangement may appear to be an employee loan, but if it does not look like one or sound like one on paper, it will not receive favorable tax treatment from the IRS. The best way to structure an employee loan is to satisfy all the formal requirements as though the company were loaning money to a third party.

The following factors indicate the existence of a bona fide loan arrangement:

- A promissory note signed by both parties;
- The receipt of cash payments according to a specified repayment schedule;
- Interest charged at a stated interest rate; and
- Security for the loan.

If these stipulations are not satisfied, you run the risk that the IRS may treat employee loans as advance payments that must be included as taxable compensation to the employee.

Disclaimer
As provided in Treasury Department Circular 230, this publication is not intended or written by Alvarez & Marsal Taxand, LLC, (or any Taxand member firm) to be used, and cannot be used, by a client or any other person or entity for the purpose of avoiding tax penalties that may be imposed on any taxpayer.

The information contained herein is of a general nature and based on authorities that are subject to change. Readers are reminded that they should not consider this publication to be a recommendation to undertake any tax position, nor consider the information contained herein to be complete. Before any item or treatment is reported or excluded from reporting on tax returns, financial statements or any other document, for any reason, readers should thoroughly evaluate their specific facts and circumstances, and obtain the advice and assistance of qualified tax advisors. The information reported in this publication may not continue to apply to a reader’s situation as a result of changing laws and associated authoritative literature, and readers are reminded to consult with their tax or other professional advisors before determining if any information contained herein remains applicable to their facts and circumstances.

Source URL:
https://www.alvarezandmarsal.com/insights/warning-employee-loans-could-have-adverse-tax-consequences

Links

Authors:
Ernesto Perez, eperez@alvarezandmarsal.com, +1 305 704 6720