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Tax Update

Perspectives on interest-free loans

Taxpayers often deliberate as to whether loans, particularly related party loans, should bear interest. Judgments, such as that in the case of *C:SARS v Brummeria Renaissance (Pty) Ltd and Others 69 SATC 205 2007 (SCA)* (Brummeria Renaissance case), and more recently assessments raised by SARS in respect of STC on pre-1 April 2012 interest-free loans to shareholders make taxpayers wary of using interest-free loans, and with good reason so. This does however not mean that interest-free loans are completely unacceptable from a tax perspective.

There are many reasons why an interest-free loan could be preferred over an interest-bearing loan. One of the main reasons is that the borrower would be incurring non-deductible interest[1]. This could include the case when a smallish company advances a loan to a shareholder who lives out of the funds of the company, or a loan to enable the borrowing party to acquire shares (for example, a loan to a share incentive vehicle). Charging interest on such a loan would result in the lender receiving interest that would be taxed, while the borrower cannot claim a deduction for the interest paid, creating a situation where tax leakage occurs between the related parties.

Aspects to consider from a tax perspective when dealing with interest-free loans

There are a number of aspects from a tax perspective that have to be considered when an interest-free loan is advanced.

In the case of shareholder loans, the risk of a deemed dividend must be considered. In accordance with section 64E(4) of the Income Tax Act (Act), a deemed dividend will arise for dividends tax purposes if a loan that bears interest at a rate lower than the official rate[2] is advanced by a company to a connected person in relation to the company who is a resident but not a company itself (or a connected person in relation to this person that is also not a company). Intercompany loans should therefore not result in such a deemed dividend. If a deemed dividend arises under the dividends tax regime, the deemed dividend will be based on the interest that should have been charged at the official rate on an annual basis, as opposed to the loan amount as used to be the case under the STC regime.

The judgment in the Brummeria Renaissance case highlighted the risk that the interest-free nature of a loan may give rise to an amount being received by the borrower, as the fact that a loan is interest-free is something that has money's worth in the commercial world. SARS have clarified in Interpretation Note 58 that the receipt of such an amount will only be included in gross income if it is not of a capital nature. The risk of an inclusion in gross income therefore exists in cases where the borrower has to do something to earn the benefit of an interest-free loan.[3]

The question of donations tax also often arises in when dealing with interest-free loans. Donations tax is imposed on "the value of any property disposed of ... under any donation by any resident". A donation in turn is defined as "any gratuitous disposal of property including any gratuitous waiver or renunciation of a right". An argument in the case of an interest-free loan is that if no right to receive interest has been established, it cannot be said that the lender waived or renunciated such a right. If this view is followed the granting of an interest-free loan should not trigger donations tax.

[1] Interest not incurred for purposes of a trade or in the production of income

[2] Defined as the repurchase rate plus 100 basis points

[3] In the case of Brummeria Renaissance where the borrower had to make the use of a housing unit available to the lender without charging rent

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Other tax issues to consider include possible attribution of income to the lender in terms of section 7 of the Act as it was held in case law that an interest-free loan could constitute a form of disposition that could trigger section 7, potential fringe benefits that may arise for tax purposes as well as transfer pricing issues if such loans are advanced across the borders of South Africa.

Changing an interest-bearing loan into interest-free loan

BPR152, which was issued on 13 August 2013, considers the issue of interest-free loans from yet another angle. One of the issues that this ruling deals with is whether the cancellation of the right to receive interest at a rate of JIBAR + 4.9% p.a. a loan from a company (lender) holding 74% of the shares of another company (borrower) would be subject to capital gains tax. This interest-bearing loan claim was acquired by the lender as part of an arrangement to acquire the 74% interest in the borrower. The main reason advanced in the ruling for the decision to cancel the right to interest is that the borrower was not in a position to service the interest on the loan.

Interestingly, the ruling in this regard is the following:

"The cancellation and extinguishment of the Applicant's right to interest based on the interest free portion of the loan claim will not trigger any capital gains tax liability for the Applicant under the provisions of the Eighth Schedule."

Unfortunately no reasons are given in the ruling for this view, but the following aspects may be relevant. In order for capital gains tax to arise, a person must dispose of an asset. The right to receive payment would constitute an asset. Similarly, the right to receive an amount such as interest in future (even though the amount has not yet accrued) should also constitute an asset. Cancellation of this right should in terms of paragraph 11(1)(b) of the Eighth Schedule result in a disposal of this asset (or at least a part disposal of the rights attached to the loan).

The capital gain or loss should then be calculated as the difference between the proceeds in respect of the disposal (nil as the right is given up for no consideration) and the base cost of the asset.

Paragraph 38 of the Eighth Schedule however states that where a person disposes of an asset by means of, firstly, a donation or, secondly, to a person who is a connected person for a consideration that does not reflect an arm's length price, the proceeds must be deemed to be equal to the market value of the asset. Both of these criteria could arguably be met in the case considered in the ruling and the proceeds must be deemed to equal the market value of the asset disposed of.

One could speculate that the reason for the ruling may possibly be the following: Market value in the context of capital gains tax is defined in paragraph 31(1)*(g)* as "the price which could have been obtained upon a sale of the asset between a willing buyer and a willing seller dealing at arm's length in an open market". The right to receive payment (including interest) would generally have a market value (and therefore an arm's length price); the right to receive interest from a party who is unable to service the interest on the loan may however not have such a value as no willing buyer would pay an amount to acquire such the rights attaching to such loan as this portion of the loan is effectively impaired. If this line of arguing is followed, the deemed proceeds may approximate nil, resulting in no capital gain on the transaction.

It should be noted that had companies not been part of the same group of companies, donations tax could also have been a concern. Similar views regarding the value of the property disposed may however be relevant in the context of donations tax.

Despite the lack of clarity on the reasons for the ruling, the ruling does show that similarly to making use of interest-free loans, a well-thought through opinion may provide grounds for an interest-bearing loan to be changed to an interest-free loan without tax implications.