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Tax Update

Perspectives on the structuring of intra-group loans

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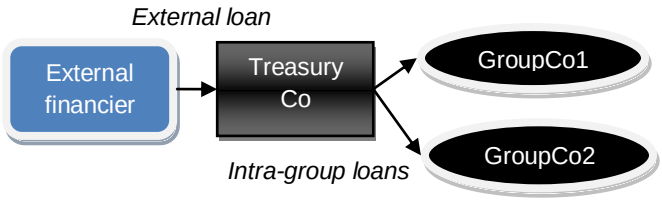
Groups of companies often have a separate entity to raise funding to make available to other group entities (hereafter referred to as a treasury company). The reasons for the use of these companies vary from central control and monitoring of loans to more favourable collective borrowing terms. The role of such a company is illustrated in the diagram:



A question that often arises when structuring treasury companies and intra-group loans is what the terms of these loans should be – in particular from a tax perspective. Binding Private Ruling (BPR 142) deals with the interest deductibility on an external loan if the treasury company on-lends the funds to group companies without adding a margin. The ruling states that the applicant will obtain the funding centrally because it has assets to be used as collateral, which the other companies do not have. The treasury company, rather than the external financier, therefore bears exposure to the credit risk of the group entities on the intra-group loans.

The question in the ruling arises from the interest deductibility requirement in section 24J(2) which among other requires that interest "must be deducted *from the income of that person derived from carrying on any trade*, if that amount is incurred in the production of the income." In *Burgess v CIR* it was confirmed in respect of the definition of 'trade' that this term was "...intended to embrace every profitable activity...". If the funds are on-lent to the group companies at no margin, this does not constitute a profitable activity for the treasury company and the interest incurred should strictly speaking not qualify for the deduction in terms of section 24J(2). The ruling is however in line with SARS' views in Practice Note 31 that the applicant may deduct the interest incurred in respect of the external loan to on-lend it, despite possibly not carrying on a trade. The ruling is limited to interest expenditure. It is submitted that the consideration of tax implications of other costs may be critical in structuring intra-group loans. A few of these other costs are considered below.

Operating expenses of the TreasuryCo

Costs that are not necessarily viewed as interest, such as transaction costs, together with general operating expenses like audit and accounting fees of the treasury company, may not be deductible for any person due to the lack of profits and consequent lack of trade in the treasury company.

Losses incurred on intra-group loans

It is a well-established principle in case law that a person who carries on the business of a money-lender may deduct losses incurred on loans that form part of its floating capital in terms of section 11*(a)*. It is debatable whether a company that only advances loans to related companies is carrying on the business of a money-lender. In the case of *Solaglass Finance Company (Pty) Ltd v CIR*, also a treasury company, the deduction of losses on group loans was disallowed on the grounds that the losses were incurred partially for purposes of the treasury company's own trade, but also for the purposes of trades of other group companies. At the time section 23*(g)* required that expenditure must be incurred *solely* for purposes of the taxpayer's (TreasuryCo) trade. It is submitted that on-lending without a margin to group entities with higher credit risk than the treasury company is a clear indication that the losses are not incurred for purposes of the treasury company's own trade, but rather those of group companies. This completely closes out any argument for a deduction in respect of such losses. This could place the group as a whole in a position where tax leakage occurs, as the extinguishment of the loan may have tax implications for the borrower.

Concluding thoughts

The brief discussion suggests that on-lending within a group at appropriate margins may hold certain benefits, in particular if the group is indifferent as to in which group entity profits accumulate. As with all things with tax, this decision however depends on the facts and circumstances of the arrangement.

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