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Tax News Update

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Private business loans to shareholders and directors

Shareholders and directors, usually the same person in private companies, sometimes owe monies to their businesses. These monies are disclosed as loans in the financial statements. The disclosed terms being the loan is unsecured, interest at prime linked rate and repayable on demand. But are these amounts actually loans? Are they not dividends or remuneration? A loan has different tax implications to those of a dividend or of remuneration. Let us explore the nature of each of these and their tax implications.

A loan places responsibility on the recipient to return what was loaned or similar or to repay monies loaned. Interest is paid for the use of the money; it is consideration for the loan. A borrowing, by its very nature, involves correspondence between what is obtained and the obligation to repay or redeliver.[1] A loan creates a repayment obligation for the borrower, what has been borrowed must be repaid. An obligation to repay what is received is part of the characteristics of a loan.

In the case of a loan of money the lender gives the money to the borrower, who in return incurs an obligation to repay the same amount of money at some future time and if the loan is one which bears interest, he also incurs an obligation to pay that interest. Though I use the words “gives the money” this must not be taken literally as the usual way of making a loan. As a rule the lender either gives credit to the borrower or transfers to him certain rights of obtaining credit which had previously belonged to the lender, and this supply of credit is the service which the lender performs for the borrower, in return for which the borrower pays him interest[2].

[1] Commissioner for Inland Revenue v Genn and Co (Pty) Ltd., 20 SATC 113

[2] Commissioner for Inland Revenue v Lever Brothers and Unilever Ltd, 14 SATC 1

AM PhakaMalele Inc.

A loan may create a further obligation to pay interest. This is so, especially if the loan repayment period is not within a short time. The interest payment compensates the lender for the loss of value arising from having to wait over a long period to receive what was lent. The payment of interest is another characteristic of a loan, especially one that is repayable over a long period.

One must endeavour to establish whether the purpose of each payment or distribution was to confer on the shareholder a benefit similar to that which he would have enjoyed if such payment or distribution had been made by way of a dividend. To determine such purpose in the case of a loan one must have regard to the circumstances in which the loan was made, the form, substance and effect of the transaction, the intention of the company and the shareholder, and whether or not such intention was duly implemented. If on a determination of these and any other relevant considerations the conclusion may properly be reached that the purpose of the loan was not to confer on the shareholder a benefit similar to that which he would have enjoyed had he been paid a dividend, then the payment is not a dividend.[3]

An assessment of the nature of the loan, the need/matter that gave rise to the loan, the factual terms and conditions, how the loan impacts the lender and how the borrower and lender actually effected their intention and obligations will indicate if the true nature of the transaction is a loan or not. The true intention of the parties as expressed and effected will indicate the true nature of the transaction.

Businesses that provide loans generally require security, fixed repayment period and interest on the balance outstanding. Security may be cession of life policy, a notarial bond over property or other form of security provided by the borrower. The repayment period is fixed at several months or years with stipulated repayment dates. A home loan repayable by monthly payments over a twenty-year period at prime linked interest rate is an example of a typical loan. Most privately owned business loans do not have monthly repayments, are unsecured and the repayment period is not fixed.

[3] 47 SATC 141 – this case was based on the old section 8. I am of the opinion that the rule it sets out for differentiating between a loan and dividend is applicable under the current dividend tax environment.

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In a typical loan, the loan amount is a fixed amount paid once off to the borrower. With privately owned business loans, the amount is made up of irregular drawings over time. There is no fixed amount paid or allowed to be drawn. The irregular drawings are indicative of a loose relationship between the lender and the borrower. They are not what would be expected between independent persons.

Furthermore, the borrower does not make a direct repayment to the business. Their salary is accounted for in the loan account as a form of repayment. They continue to draw funds from the business, either by using the company card for personal purposes or transferring monies to themselves, impacting the loan account. There is no real exchange of money that reduces the loan. The loan is an ever-changing ledger account based on drawings made, use of company bank card and reductions from the salary.

The company accountant calculates interest on the loan and accounts for it in the ledger account. The interest is based on the official rate, the repurchase rate plus 100 basis points. It is not based on an assessment of the ability to repay the loan, security provided, period of repayment and then set at an appropriate market rate, like a bank would do. The official rate is generally lower than what the bank would charge.

Given the above, owner managed business 'loans' do not appear to meet the commercial realities of a loan between independent parties. It appears the official interest rate is levied to avoid dividend tax and fringe benefit tax. These taxes would be payable when the drawings were made.

To have the transaction taxed as a loan, the business must prove that it is a loan and not another type of transaction. It is the responsibility of the company to prove that the loan is valid, and the parties have complied with its terms[4]. If it cannot do this, the loan may be a dividend or remuneration as defined.

In its ordinary legal sense, a loan cannot confer on a shareholder a benefit similar to that to enjoy on receipt of a dividend. A loan imposes an obligation to repay; a dividend is an outright benefit which is not repayable[5]. An interest free or low interest loan issued by virtue of a share held in the company gives rise to dividend. The dividend is the difference between the interest that would have been levied at market related rate and the actual interest levied on that loan[6]. Dividend tax is levied at 20% on dividends paid. Levying interest on the loan, at the official rate, is an attempt to avoid dividends tax and tax on an employment benefit.

Remuneration includes an amount of income paid by way of a salary, fee or stipend. It is taxed under Schedule 4 of ITA, employees' tax. It is a tax withheld from salaries paid to employees. This tax is based on the employee's tax bracket, which is determined with reference to the employee's taxable income. Remuneration does not have to be a regular payment. It can be unstructured, intermittent, and not regular, similar to the drawings discussed above. It can be as and when services are rendered, like board fees based on attendance at a board meeting. If payment is made for services rendered by an employee, it will be remuneration and employees' tax must be withheld from such payment. The intermittent drawings will be remuneration if they do not meet the requirements of a loan or of a dividend. They will be taxed at the owner's tax bracket and the business must make employees' tax deductions before these drawings are made.

Every person can arrange their affairs to pay the least amount of tax. The true nature of a transaction is matter of fact. Privately owned businesses are advised to ensure that they tax transactions based on their true nature. They must ensure that they have supporting documents, contracts, and approvals to prove the true nature of the transaction. Most importantly that their actions support what the documents indicate.

For any assistance contact Tshepo Phaka on 087 802 6376 or tshepo@amphaka.co.za.

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[4] Section 102 Tax Administration Act No 28 of 2011
[5] ITC 1396
[6] Section 64E (3) of Income Tax Act No. 58 of 1962 as amended (ITA)