



## Intra-group loans: tax complexities

The transfer pricing rules and interest deduction limitations sometimes apply to the same interest amount. This raises the question in what sequence these rules apply. This article considers SARS' views in Interpretation Note 127 in this regard.

### Interpretation note on intra-group loans

SARS recently published [Interpretation Note 127](#) ('IN127'). It mainly deals with applying the arm's length principle to intra-group loans, as the transfer pricing rules require. This complex area requires consideration of, amongst others, the loan's terms and the borrower's credit risk profile. No one-page article would do these complexities justice; interested readers should consult IN127.

IN127 also provides SARS' views on the interaction between the transfer pricing rules and various other provisions that affect the tax treatment of interest. In this article, I consider SARS' views on the interplay between the transfer pricing rules and the interest deduction limitations.

### Two sets of rules

Sections 23M and 23N limit the amount of interest taxpayers may deduct. Broadly, these rules apply to (a) interest paid to persons in controlling relationships who are not taxed (or not fully taxed) on the interest and (b) interest on loans that funded certain acquisitions or reorganisations.

Section 31 requires that a taxpayer determine its taxable income from international transactions with related parties as if those transactions were concluded at the terms and conditions that would have existed between persons dealing with each other independently. In the case of interest paid, the transfer pricing adjustment would typically be downward if the deductible interest paid exceeds the arm's length standard.

### SARS' views

The above provisions may apply to the same interest, which raises a question about the sequence of their application. SARS indicates in IN127 that the transfer pricing adjustment must occur first. The interest deduction limitation then follows.

The interest deduction limitation rules require taxpayers to determine *adjusted taxable income*. Sections 23M and 23N define this term as taxable income calculated before applying this section [being s 23M or 23N]. SARS indicates that:

"Since section 31 is applied in calculating taxable income and, if applicable, would have an impact of the amount received or accrued that is part of taxable income, and that is incurred and has been allowed as a deduction, it is clear that section 31 applies before section 23M or section 23N."

### Practical implication

Conceptually, it may well be that the amount of interest that is eventually deductible is similar, irrespective of whether the total amount of interest is first adjusted to arm's length and then limited, or the limitation is first applied, and this amount is then tested against the arm's length standard. The question of sequence, however, has a real impact. The interest deduction limitation rules do not require a secondary adjustment. The transfer pricing rules trigger a secondary adjustment for any primary adjustment made. In the case of a company, this is a deemed dividend that does not qualify for treaty relief.

