The Hidden Tax Risks in Intra-Group Financing Arrangements

Introduction

There has been a notable increase in investment flows into Tanzania in recent years, whether through equity contributions or debt financing arrangements. As businesses expand and new ventures emerge, it is essential for investors to carefully plan how capital is introduced into their companies, ensuring an appropriate balance between equity and debt to support both operational needs and long-term growth.

In practice, many companies are increasingly financed through loans obtained from related parties. While such arrangements are legally permissible, they carry specific characteristics that may give rise to tax risks if not properly structured and managed.

This article aims to highlight the potential tax implications associated with related-party loans, enabling businesses to better understand these risks and make informed decisions when designing their financing structures.

Key Insights when acquiring a foreign loan:

Local regulatory compliance

- ✓ Traceable loan deposit in the bank
- ✓ Registration with the Bank of Tanzania
- ✓ Thin Capitalization rule (interest restriction)
- ✓ Withholding tax on interest amounts
- ✓ Avoidance of net of tax agreements
- ✓ Compliance with foreign exchange regulations

Transfer Pricing Rules

- ✓ Arm's length interest rates
- ✓ Benchmarking report for the arm's length interest rates
- ✓ A contemporaneous transfer pricing document

Recharacterization Risk

- ✓ Substance over form of the loan with clear documents required to reduce risks of loan recharacterization to equity

Local regulatory compliance

Evidence of receipts of funds through traceable bank deposits

To ensure transparency of the transaction, it is important that the lender and the source of funds are clearly identifiable and consistent throughout the arrangement.

Proper supporting documentation like swift copies, bank transfers should be maintained to substantiate the transaction.

In addition, the narration in the bank transfer documents should clearly indicate that the transferred funds relate to a loan arrangement.

Withholding tax requirement

Interest charged on loans is generally subject to withholding tax in Tanzania at the rate of 10% with an exclusion of interest paid to resident financial institutions.

However, certain exemptions may apply where the lender has been granted a specific exemption under applicable law, an agreement with the Government of the United Republic of Tanzania, or any other relevant instrument.

Thin capitalization rules

The tax law provides that the total interest that an exempt controlled resident entity may deduct shall not exceed the sum of interest equivalent to debt-to-equity ratio of 7 to 3.

Therefore, need to ensure that the debt finance is within the 7:3 ratio, otherwise interest expense would not be tax deductible.

Registration with Bank of Tanzania

All loan agreements entered with a foreign person, whether related or unrelated, are required to be registered with the Bank of Tanzania (“BOT”) within 14 days from the day of fund injection.

As part of the registration process, the loan agreement should contain the necessary details and disclosures required by BOT, including the key commercial terms of the loan.

Avoid net of tax loan agreements

Some financing arrangements include “net of tax” or “gross-up” clauses, where the borrower bears the lender’s withholding tax cost in addition to the agreed interest. These are not tax-friendly structures and may result in additional tax liabilities to be penalized.

Loan agreements should provide that applicable withholding tax to be deducted and remitted from interest due to avoid ambiguity. The agreement should contain a clear withholding tax clause confirming that any applicable withholding tax will be deducted from the interest charged to the lender.

Forex Loss restrictions

For interest-free loans, realized foreign exchange losses are not fully deductible for tax purposes. Upon realization, such foreign exchange losses are subject to a restriction whereby only 70% of the loss is allowed as a deductible expense, while the remaining 30% is disallowed. Accordingly, the full foreign exchange loss cannot be claimed in the tax computation. This restriction applies exclusively to interest-free loans.

Signed loan agreements and repayment schedules

Entities should ensure that a formal and duly executed loan agreement is in place, clearly setting out the terms and purpose of the loan. This serves as evidence of a genuine lender-borrower relationship and enables the entity to demonstrate that the funds were advanced for business purposes and the generation of taxable income.

A clear record of loan repayments should be maintained, detailing repayment dates, amounts paid, and outstanding loan balances.

Wholly and Exclusivity rules

The tax law provides that interest expenses are only deductible where they are incurred wholly and exclusively in the production of the entity's income. Accordingly, the borrowed funds must be utilized for income-generating business activities. Where the loan proceeds are applied for non-business purposes, the related interest expense may be disallowed for tax purposes.

Capitalization of interest cost

Loans used to finance capital expenditure, such as construction or the acquisition and installation of plant and machinery, should generally be capitalized while the asset is under construction or being prepared for use.

This includes qualifying interest costs, should be capitalized until the asset is completed and available for use, after which subsequent interest may be recognized as an expense.

Transfer Pricing Rules

Transfer Pricing Documentation

To substantiate loans received, a contemporaneous transfer pricing document should be maintained to document and explain the commercial terms and conditions of the loan arrangement. The report should include a loan and interest benchmarking analysis to assess whether the interest rate applied on the loan aligns with market conditions. This analysis should compare the loan's key characteristics such as terms of the loan, currency, tenor, security, and credit rating with those of comparable uncontrolled transactions to determine an arm's length range of interest rates.

Arm's length interest rates

Interest rates on related-party loans should reflect the terms and conditions that independent parties would have agreed under comparable circumstances. Where the interest rate is significantly higher or lower than prevailing market rates, the arrangement may be subject to a transfer pricing adjustment.

Risk of loan recharacterization to equity

While ensuring compliance with key requirements is critical when obtaining foreign financing, this alone do not guarantee that a funding arrangement will be considered as debt for tax purposes.

Revenue authorities increasingly apply the principle of substance over form, meaning that they look beyond the title of a transaction and examine its actual economic characteristics. Consequently, a funding arrangement documented as a loan may still be challenged and recharacterized as equity where the facts and circumstances indicate that it functions as an equity (share) finance than a lender-borrower relationship.
Entities should therefore be aware of common red flags that may increase the risk of loan recharacterization. Some of the key red flags are highlighted below.

Common red flags to reduce risk of recharacterization of loan to equity

Loans not registered with the Bank of Tanzania (BoT) or lacking a formal, signed agreement. These can easily be disqualified as a loan and rather be termed as equity. Entities should ensure all foreign loans are properly documented, signed, and registered with Bank of Tanzania.

Loans with no fixed repayment date or those that have remained outstanding for years with no attempt at recovery may indicate that repayment was never intended. Entities should include clear repayment terms and maintain evidence of repayment or recovery efforts.

Interest rates that are either too favorable (including interest-free loans) or excessively high compared to market rates may attract scrutiny and raise questions as to whether the arrangement reflects a genuine lender-borrower relationship. Entities should maintain a detailed transfer pricing report supported by benchmarking analysis to justify arm's length interest rates.

Continued funding of an entity that consistently makes losses, particularly where interest continues to accrue or be paid despite limited repayment capacity, may suggest that the funding is in substance equity. Entities should periodically assess the borrower's repayment capacity and maintain commercial justification for the loans.

Entities operating with minimal paid share capital while relying heavily on shareholder loans to finance their operations may face scrutiny from revenue authorities.

It is essential to ensure that every loan is well supported to prove its existence, compliance and that it reflects genuine commercial intent. Key supporting documentation and arms length terms should be maintained. Proper structuring, consistent repayment discipline, and well-supported pricing all play a key role in demonstrating that the arrangement is truly debt in substance.

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