



July 2020

Important changes to the interest limitation provisions

The Draft Taxation Laws Amendment Bill 2021 (the DTLAB) released on 28 July 2021 proposes far reaching amendments to the current interest limitation rules for years of assessment commencing on or after 1 April 2022. These changes could see limitations being placed on tax deductible interest incurred by taxpayers who are currently unaffected by existing provisions.

The DTLAB contains proposed amendments to section 23M of the Income Tax Act No 58 of 1962 (the Income Tax Act).

Section 23M currently places a restriction on the deductibility of interest payable to a creditor who is in a controlling relationship with the debtor, where that creditor is not subject to tax in South Africa in respect of such interest or where a creditor, not subject to tax, sources the funding from a person who is in a controlling relationship with the debtor. Typically, this would be the case where the double tax agreement between South Africa and the country of residence of the foreign creditor reduces any withholding tax to zero.

Broadly, section 23M limits the amount of interest that can be deducted to the sum of:

- Interest received by or accrued to the debtor and
- A formula driven percentage of so-called 'adjusted taxable income'; less
- Interest incurred by the debtor in respect of debts, other than debts subject to section 23M, which has not been disallowed under the provisions of section 23N of the Income Tax Act (section 23N limits the deductibility of interest incurred on loans used to fund so called 'reorganisation' or 'acquisition' transactions).

Interest which is disallowed in a particular year of assessment can be carried-forward indefinitely and reconsidered for deductibility in subsequent years.

The DTLAB proposes the following key changes to section 23M.

Wider definition of 'interest'

The definition of interest for purposes of section 23M will be expanded to include:

- Amounts incurred or accruing under interest rate swap agreements (as defined in section 24K of the Income Tax Act);
- The finance cost element of lease arrangements, included in or deducted from income and recognised as finance leases under IFRS 16; and
- Taxable foreign exchange gains or losses which arise in respect of such debt.

The definition of interest for purposes of withholding tax (IWT) remains unchanged with the result that the above amounts, such as the finance cost element of a finance lease, may not be subject to tax in the hands of the creditor.

Interest on back-to-back loans

In its current form, section 23M considers whether the creditor is subject to tax, either in the form of normal tax or IWT.

It does not look beyond the creditor. Currently section 23M will only apply where the creditor is tax exempt or, as noted above, is a non-resident who is not liable for IWT as result of double tax treaty relief. Critical to note is that, in terms of the proposed amendment, section 23M may now apply even if the funds, which are lent out by a taxable person are sourced from a person who is not subject to tax.

This proposed amendment is best explained by a simple example:

Company A (the South African taxpayer) has an ultimate parent company (Company B) that is tax resident in the United Kingdom.

The double taxation agreement between South Africa and the United Kingdom grants taxing rights on interest to the United Kingdom, meaning no withholding tax applies on any interest payments made to Company B.

If Company B were to advance funds directly to Company A, section 23M would apply to limit the deduction of interest in the hands of Company A.

Where, however, the funds are advanced by Company B to a South African resident intermediate holding company (HoldCo) who, in turn, on-lends the funds to Company A, the position currently, under section 23M, is different.

The provisions of section 23M would not apply to Company A as the interest accrues to a person who is subject to tax. Company A would thus be entitled to claim a deduction of interest paid to HoldCo in full.

The provisions of section 23M would technically be applicable to the interest paid by HoldCo to Company B.

However, as a result of 'interest received' being a factor in the calculation of the interest limitation, HoldCo will be able to claim a deduction, at a minimum up, to the amount of interest received from Company A.

The DTLAB now proposes to apply section 23M to interest incurred by a debtor (Company A in the example) in circumstances where the creditor (HoldCo) sources the funds from another person (Company B) who is in a controlling relationship with the creditor and that person (being Company B) is not subject to tax on interest received from the creditor. This significantly widens the application of section 23M.

Interest deemed to be 'not subject to tax'

Where an applicable double tax treaty reduces the rate of IWT but does not entirely remove South Africa's taxing rights, the interest is currently regarded as being subject to tax and the provisions of section 23M would not limit the deduction of such interest in the hands of the South African taxpayer.

The DTLAB proposes to deem all or a portion of the interest to be 'not subject to tax' where the interest is not included in the income (i.e. gross income less exempt income) of the recipient. In determining the portion that is 'not subject to tax', a formula will be applied. The lower the IWT rate applicable to the interest, the higher the portion of the interest that will be deemed to be not subject to tax.

The inclusion of the deeming provision will result in interest, which attracts IWT falling into the section 23M net.

Percentage of adjusted taxable income to included

Currently, the percentage of adjusted taxable income that is included in the determination of the deductible interest is calculated based on a formula which is driven largely by the average repo rate. It is proposed that this formula be replaced by a flat rate of 30% of adjusted taxable income.

Adjusted taxable income for REITs

The taxation of listed Real Estate Investment Trusts (REITs) is governed by the section 25BB of the Income Tax Act. REITs are able to claim a tax deduction in relation to qualifying distributions made to investors. These amounts will now be added back in the adjusted taxable income calculation.

Carrying forward of disallowed interest

The proposals retain the current rules around the indefinite carrying forward of disallowed amounts. National Treasury has, however, indicated that they will review these rules after a period of 5 years.

The proposed amendments could significantly increase the number of taxpayers impacted by section 23M and will result in a higher proportion of interest being disallowed.

Based on the announcements made by the Minister of Finance in the 2021 Budget Speech, the implementation of the new interest limitation rules will likely be accompanied by a reduction in the Corporate Income Rate from 28% to 27%.

If you have any queries, or require any assistance, please contact us:



Elizabeth Lombaard
Director, Corporate Tax
E: elizabeth.lombaard@kpmg.co.za
M: +27827191988



Lesley Bosman
Head of Tax Technical,
Associate Director: Corporate Tax
E: lesley.bosman@kpmg.co.za
M: +27827195523

