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Interest limitation provisions to be widened

The Taxation Laws Amendment Bill 2021 (the TLAB) released on 11 November 2021 will introduce far reaching amendments to the current interest limitation rules to become effective on the date on which the corporate income tax rate is reduced. These changes could see limitations being placed on tax deductible interest incurred by taxpayers who are currently unaffected by existing provisions.

The TLAB contains 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 (IWT) 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 TLAB proposes the following key changes to section 23M.

Extension of 'controlling relationship' definition

The current definition of 'controlling relationship' envisages a person who directly or indirectly holds at least 50% of the equity shares or voting rights in a company, being the debtor. This definition will now be expanded to include arrangements in terms of which a person, whether alone or together with a connected person, holds at least 50% of the equity shares, voting rights or participation rights in a company. In addition, the "controlling relationship" definition will include connected persons in relation to a creditor where that connected person holds at least 50% of the equity shares, voting rights or participation rights in a company.

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 recognised for purposes of IFRS 16 in respect of finance leases;
- Taxable foreign exchange gains or losses which arise in respect of such debt; and
- Amounts treated as interest under the Sharia compliant financing arrangements

But reference is made that a dividend in specie, as referred to the hybrid equity rules, is not considered interest for purposes of section 23M.

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 therefore only applies where the creditor is tax exempt or, as noted above, is a non-resident who is not liable for IWT as a 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.

Interest on loans made by related companies

The provisions of section 23M will be extended to arrangements where the debt is owed to a company that would have formed part of the same group of companies had the group threshold been reduced to 'more than 50%' rather than 'at least 70%'.

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 do not limit the deduction of such interest in the hands of the South African taxpayer.

The TLAB 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 and is subject to IWT at a rate lower than the current rate of 15%. 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, that is subject to 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.

The amendments could significantly increase the number of taxpayers impacted by section 23M and will result in a higher proportion of interest being disallowed. Furthermore, the legislation contains certain terms which have not been clearly defined and which could result in implementation challenges. The effective date of the new interest limitation rules will be aligned with the timing of the reduction in the Corporate Income Rate from 28% to 27%.

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