KPMG
Private Enterprise

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Introduction

On 24 March 2022, the South African Reserve Bank's (**SARB**) Monetary Policy Committee (**MPC**) increased the repurchase (**repo**) rate by an additional 25 basis points (**bps**). The repo rate now stands at 4.25%. This is the third consecutive increase in the repo rate, the last increase having taken place in January 2022. Below, we set out an economic analysis of the implications of the increase in the repo rate as well as the tax consequences that section 7C[1] may have as a result of an increase in the repo rate.

Economic Analysis

With the onset of the Covid-19 pandemic in the first quarter of 2020, governments initiated large fiscal and monetary actions to support their economies. On the fiscal front, tax breaks, grants and loans were provided to those in need, while on the monetary front, central banks rapidly reduced interest rates to lower the debt service burden on borrowers and stimulate additional borrowing where required at reduced interest rates in order to support economic activity. The result of the monetary policy action was to reduce interest rates to all-time low levels. The repo rate settled at 3.5% while the prime lending rate bottomed out at 7%.

The availability of vaccines in South Africa from 2021 as well as less severe levels of lock-down for subsequent viral variants meant that economic activity could begin its gradual recovery to pre-Covid-19 levels. The global recovery was however very uneven, with some countries returning to a normal level of operation, while others remained in strict lock-down. A global consequence of the uneven recovery was that supply chains were disrupted causing upward pressure on prices. In addition, in some countries labour markets had changed with fewer workers returning to work, thus creating greater competition for that labour, and resulting in higher wages.

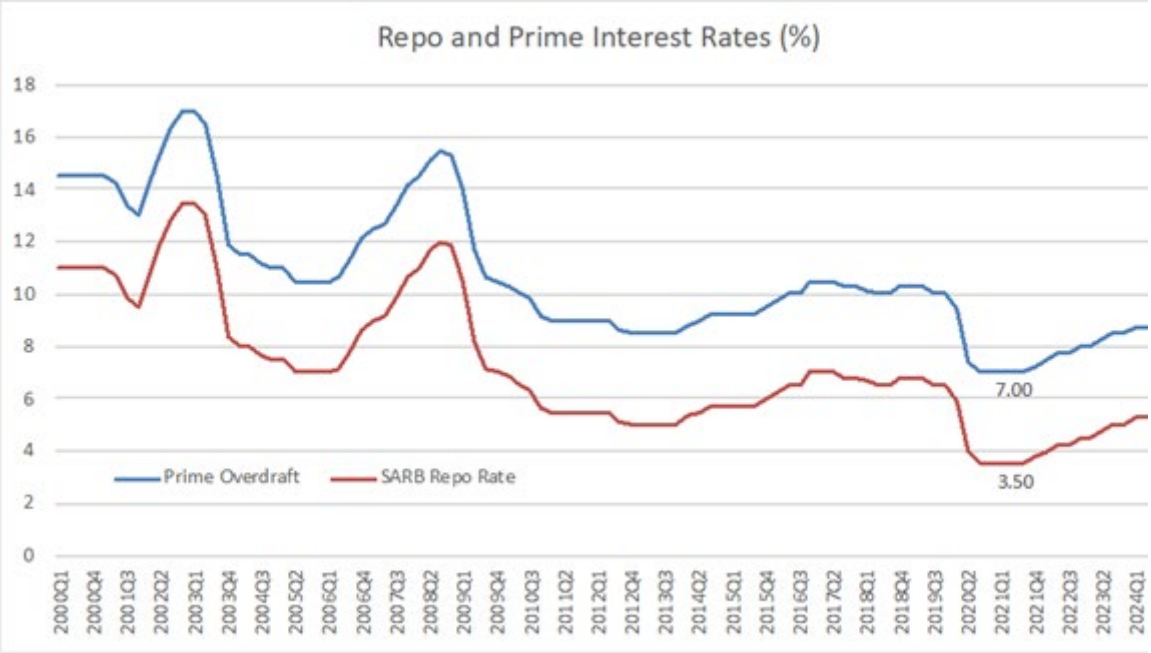
With economies gradually returning to pre-Covid-19 levels of economic activity and inflation starting to increase, it was clear that interest rates would need to start increasing back to their pre-Covid-19 levels. In November 2021 the SARB's MPC agreed to increase the repo rate by 25 bps to 3.75% and signalled that this increase would be the start of a process of *monetary policy normalisation* or increases in interest rates back to around pre-Covid-19 levels. In January 2022, the MPC agreed to a second 25 bps increase in the repo rate which was followed by a third in March 2022, leaving the repo rate at a current level of 4.25%.

There are four remaining MPC meetings scheduled over the course of 2022 and it is generally believed that, given the inflationary increases experienced currently around the world, that the SARB will increase the repo rate by 25 bps at each of those meetings resulting in a repo rate of 5.25% (prime

[1] Of the Income Tax Act, No 58 of 1962, as amended (**the Act**)

rate of 8.75%) by year end. A further four 25 bps increases or a combined 1.25% would be required through 2023 to get back to pre-Covid-19 levels.

The conflict in Ukraine can impact the pace of the policy normalisation and therefore the increases in interest rates. It is clear that because of the disruption to global energy markets (oil and gas) as well as the potential wheat harvest, additional inflationary pressure may cause an accelerated increase in interest rates and potentially to even higher levels that those experienced prior to Covid-19. Alternatively, higher inflation may result in a slower than anticipated global recovery, which may cause central banks to move more slowly in increasing interest rates. At this point there remains a lot of uncertainty on how the conflict will impact global markets, but what is certain is that we can expect interest rates to increase.



Tax considerations

The increases in the repo rate in turn increases the official rate of interest[2] (i.e. the repo rate plus 100 bps) and may impact the tax liability of many South Africans. For taxpayers who may have trusts, this is most notably seen in the deemed donations implications that is created by section 7C of the Act.

As discussed in previous alerts, the reasoning behind the introduction of section 7C was to target the tax leakage that came about when wealth was transferred by an individual to a connected trust whereby either a low interest or an interest free loan was provided to the connected trust ('affected loan'). With effect from 19 July 2017, section 7C triggers the deemed donation, which is then subject to donations tax[3] at 20%/25%[4], on any interest that is foregone in respect of the affected loan. The interest foregone is calculated as the difference between the official rate of interest and the interest charged on the loan.

Accordingly, the increases in the official rate of interest significantly affects the loans that are made between individuals and connected trusts. By way of a practical example, some taxpayers mange the

[2] As defined in section 1 of the Act
[3] In terms of section 54 of the Act
[4] In terms of section 64(1) of the Act, 20% for donations of R30 million or less, and 25% for donations of more than R30 million

amount of the loan provided to a family trust with reference to the R100 000 annual exemption provided by the donations tax provisions[5]. Prior to the November 2021 increase in the repo rate, the interest-free loan that could be maintained to ensure no donations tax liability arose was R2 222 222.22[6]. However, factoring the most recent 25 bps increase in the repo rate, to ensure no donations tax liability arises on the interest-free loan, the loan balance should be reduced to R1 904 761.90[7]. If the predictions of further repo rate increases discussed above holds true, the loan balance would need to be monitored and possibly reduced to R1 600 000[8].

Therefore, as discussed above, although the increase of the interest rate is necessary for monetary policy normalisation, taxpayers who have or are looking to legitimately transfer and manage wealth in a trust, should monitor their potential donations tax liability as a result of the increases in the repo rate.

In addition to the above tax implications an increase in the repo rate may also have the following tax implications:

- In circumstances where an employee receives a low interest or an interest-free loan from their employer, an increase in the repo rate will result in higher rates of employee's tax being payable by the employee who receives this loan
- Another tax implication is where there is a low interest or interest free loan between a company to a shareholder who is a connected person resident individual or trust, the increase in the repo rate may also result in higher dividends tax being payable by the individual or trust.
- Regarding the interest limitation provisions of the Act[9]:
  - For purposes of Section 23M the repo rate amendment will be amended for years of assessment ending on or after 31 March 2022. However, before such amendments are in force, the increases to the repo rate will impact on the interest limitation provisions of section 23M of the Act.
  - For purposes of section 23N, there are no proposed amendments and the average repo rate will still be applicable, and accordingly the increase in the repo rate will impact on the limitation provisions of section 23N of the Act.

Lastly, for any outstanding liabilities due to SARS or refunds due from SARS, SARS makes an amendment to its interest rate tables to be aligned with the changes in the repo rate.

Should you require any further information, please do not hesitate to contact the team members below.

[5] Section 56(1)(b) of the Act
[6] R100 000 / (3.5% + 1%)
[7] R100 000 / (4.25% + 1%)
[8] R100 000 / (5.25% + 1%)
[9] Section 23M of the Act

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Notes

1 Of the Income Tax Act, No 58 of 1962, as amended (**the Act**)
2 As defined in section 1 of the Act
3 In terms of section 54 of the Act
4 In terms of section 64(1) of the Act, 20% for donations of R30 million or less, and 25% for donations of more than R30 million
5 Section 56(1)(b) of the Act
6 R100 000 / (3.5% + 1%)
7 R100 000 / (4.25% + 1%)
8 R100 000 / (5.25% + 1%)
9 Section 23M of the Act

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