Interest deductions:

Beware of the limitation in section 23M

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Section 23M was introduced into the Income Tax Act No. 58 of 1962 ("the Act") with effect from 1 January 2015 to limit interest deductions in certain circumstances where the creditor is not subject to South African tax on the interest income.

Accordingly, the amount of interest which may be deducted by a South African tax resident may be limited if the foreign lender is in a controlling relationship with the South African tax resident and the interest is not subject to tax in the hands of the non-resident lender. For example, this could be the case where a foreign holding company ("OffshoreCo") provides funding to its South African subsidiary ("SACo").

Should, however, OffshoreCo be subject to South African interest withholding tax in respect of interest paid or due and payable by SACo, the limitation rules provided for in section 23M would not apply as OffshoreCo would be regarded as being subject to South African tax in respect of such interest.

Interest withholding tax may be levied at a rate of 15% in respect of interest paid or due and payable to a non-resident – subject to the application of a Double Tax Agreement ("DTA") concluded between South Africa with the foreign jurisdiction concerned.

In instances where a DTA provides the foreign jurisdiction with the exclusive taxing rights in respect of South African sourced interest income derived by OffshoreCo – no South African withholding tax would be triggered by SACo. As HoldCo would in such circumstances not be subject to South African tax in respect of its interest income, the interest deduction limitation in section 23M may be applicable.

In terms of current law, the limitation rules of section 23M will not apply should the foreign lender be subject to interest withholding tax at any rate. For example, where a DTA applies to reduce the interest withholding tax applicable in respect of interest paid by SACo to OffshoreCo to 5%, the limitation rules of section 23M will not be applicable.

In order to ensure a consistent treatment for all resident debtors paying interest to non-residents, National Treasury is proposing to amend section 23M to ensure its limitation rules are not dependent on which country the payment is routed through. Accordingly, The Draft Taxation Laws Amendment Bill, 2021 ("the Draft Bill") proposes to amend section 23M with the effect that, where SACo makes an interest payment which attracts withholding tax at any rate higher than zero, a portion of the deduction for interest expense will be subject to section 23M.

The amendment is proposed to enter into force with effect from 1 April 2022 in respect of years of assessment commencing on or after such date.

In terms of current law, the determination of the extent of the allowable interest deduction is to be considered in light of a complex formulae provided for in section 23M which is to be determined on an annual basis with reference to the average repo rate for such year. Additional proposed amendments contained in the Draft Bill may simplify this calculation in due course, although it is noted that submissions to National Treasury in respect of revised formula have highlighted some inconsistencies which are to be addressed prior to enactment.

On the basis of the complexities involved in the application of section 23M, it is advisable for taxpayers to seek advice regarding its application in respect of inward loan transactions from foreign holding companies.

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