30 November 2022

To: The National Treasury
240 Madiba Street
PRETORIA
0001

The South African Revenue Service
Lehae La SARS,
299 Bronkhorst Street
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Via email:	**National Treasury**	(2023AnnexCProp@treasury.gov.za); and
	SARS	(acollins@sars.gov.za)

RE: ANNEXURE C PROPOSAL: SAIT SUBMISSION - INTEREST PAID ON MONEYS BORROWED

We attach an Annexure C proposal from SAIT Tax Technical, as it pertains to technical proposals for possible inclusion in Annexure C of the 2023 Budget Review, and specifically in relation to the proposed withdrawal of Practice Note (PN) 31 of 1994 "*Interest paid on Moneys Borrowed*".

We value the opportunity to participate in the legislative process and would welcome further engagement where appropriate. Please do not hesitate to contact us should you need further information.

Yours sincerely

SAIT Tax Technical

Unless otherwise indicated, all references to sections are to sections of the Income Tax Act, No. 58 of 1962 (the ITA)

INTEREST PAID ON MONEYS BORROWED

[Applicable provisions: Proposed section 11B(?), section 24J]

1. Background

1.1. SARS has communicated its intention to withdraw PN 31 for years of assessment commencing on or after 1 March 2023.

1.2. According to the "Notice of Withdrawal", the intention to withdraw the Practice Note provides a window for the public to make representations for legislative amendments as part of the Budget 2023 Annexure C process by the deadline of 30 November 2022.

1.3. PN 31, which was issued on 3 October 1994, confirmed SARS's practice of allowing interest incurred in financing the production of interest income but limiting the deduction to the amount of that income. Any excess interest incurred was forfeited.

1.4. SARS' reasoning regarding the proposed withdrawal (Notice of withdrawal): "*There has been increasing abuse of the concession provided for in PN 31 where taxpayers have relied on the PN as a means to structure transactions or undertake transactions in order to obtain a deduction of interest or expenditure incurred, which would not otherwise have been allowed as a deduction under the Income Tax Act 58 of 1962. As tax legislation has developed over the years, resulting in the reclassification of certain income streams to interest, this has further allowed taxpayers the deduction under the PN against the reclassified income. Transactions are structured to maximise the deduction of interest or other expenditure incurred using PN 31 whilst there is no corresponding inclusion in gross income for the recipient. This is achieved where the transactions are concluded with either exempt or non-resident taxpayers*."

1.5. SAIT has received input from various members and provides the consolidated feedback below.

2. The legal nature of the problem

2.1. As discussed in more detail below, back-to-back loans are fairly common commercially, most of which are not driven by tax motivation. Taxing the gross receipts while disregarding corresponding deductions essentially violates the net income nature of income tax system. Income tax is based on the notion of net enrichment to wealth (before consumption). Hence, any anti-avoidance measure should be targeted.

2.2. As a general matter, we cannot see why back-to-back loans should cause an excess of cross-border interest deductions, more than any other set of transactions in the face of the various anti-avoidance rules currently in existences (e.g. section 23M, 23N, section 31 transfer pricing and the withholding tax of section 50B). If a problem of excessive deductions due to interest incurred exists, these sections should be amended as opposed to an outright denial of interest deductions in terms of back-to-back loans. We note that many of the back-to-back loan arrangements subverting section 23M appear to have been terminated by virtue of the 2021 amendments.

2.3. However, we do note, that PN 31 is technically flawed given that section 11(a) deductions require an underlying trade. Hence, an amendment is needed in this area as opposed to an unsubstantiated practice note. We would accordingly suggest that a legislative amendment be made that revives the concept with the appropriate safeguards.

2.4. It is also noted that PN 31 is outdated in that it does not refer to section 24J, and does not cover taxable local dividends, such as dividends derived from Real Estate Investment Trusts (REITs)

2.5. To assist, we illustrate the various scenarios wherein business currently legitimately makes use of the dispensation in PN 31 or alternatively, where the same dispensation would be appropriate under specific circumstances.

2.5.1. <u>Intra-group lending between domestic group companies</u>

2.5.1.1. South Africa does not have group taxation rules. As a result, loans between group companies are not set-off against each other.

2.5.1.2. From a funding perspective, there are generally two scenarios:

- The holding companies borrow from a financier and then on-lends the funds to various group subsidiaries in back-to-back loan arrangements.
- Alternatively, the 'finance company' within the group borrows from a financier and then on-lends to group companies with back-back loans (pure intra-group finance company).

2.5.1.3. As opposed to a group that houses a money-lending company that provides finance to third parties, the 'finance company' in the example above cannot claim 'money-lending' as a trade due to the fact that they provide no third-party financing (especially if the finance company does not render any services). The 'finance company' or group subsidiaries therefore rely on PN 31 at present to deduct the interest paid on the loans from its parent company or the 'finance company'.

2.5.1.4. An additional scenario that should be considered is how the financing enters the group; that is, some groups of companies acquire funding from listed bonds that in turn provides financing for the rest of the group. These companies typically rely on PN 31 where the interest paid is set-off against interest received, since these companies are not regarded as moneylenders/trading.

2.5.2. Small/medium businesses

2.5.2.1. In the case of small/medium businesses, the newly set-up business typically does not have access to finance in its own right. However, the shareholder does have a credit record, and as such is able to access funding from a bank. As a result, the shareholder typically uses funding that is in the shareholder's name and advances the loan to the company. The company then essentially reimburses the shareholder for the interest incurred on the loan.

2.5.2.2. The withdrawal of PN 31 may preclude the shareholder from deducting the interest incurred against the interest earned from the company. Due to the lack of creditworthiness of start-up small/medium companies, the current structure is critical for many small businesses to continue.

2.5.3. Professional partnerships

2.5.3.1. In the case of professional partnerships, an individual is often required to borrow in order to on-lend to the partnership, thereby providing working capital to the partnership. This form of borrowing is similar to the small business borrowing just described. At present, the partners rely on PN 31 to ensure that the on-lending arrangement is financially feasible.

2.5.4. REITs

2.5.4.1. The REITs tax regime treats REITs as a conduit for rental income. Rental income earned by the REIT can be deducted if distributed to the holders of REIT units. The investor is taxed on dividends declared by the REIT as ordinary revenue (as opposed to the 20% dividends tax). In effect, the REIT regime is seeking to treat the REIT unit holders as if they received the rental income directly.

2.5.4.2. In the same way that individuals require financing in order to acquire real estate, the same holds true for REIT investors. In terms of the financing of REIT units, individual and other investors often borrow a large part of their acquisition funds (typically up to 50%) to acquire units. As stated, REIT unit income is really a proxy for rental trade income. Under these circumstances, the individual/investor should be able to claim the expenses incurred in producing the rental income, which as per the legislation is characterised as taxable dividends.

2.5.4.3. There is an argument to be made that since the underlying property companies are conducting a trade with risk and reward (the letting of property), and the resultant taxable dividends from the REITs are derived indirectly from rent, borrowing to fund such activities should be viewed as a venture which involves risk.

3. The nature of the business / persons impacted

3.1. Should PN 31 be withdrawn without being replaced by a suitable legislative amendment that provides more certainty and clarity, the business arrangements discussed above would need to find alternative methods of financing. Gross taxation for these arrangements would be prohibitive.

4. Proposal

4.1. Codifying PN 31

4.1.1. At the outset, we propose that the principles laid down in PN 31 be codified regarding interest. Specifically, under the circumstances where interest paid on funds borrowed for the purposes of lending them out at a lower rate of interest will not qualify, in terms of section 11(a), as an admissible deduction from the interest so received by virtue of the fact that the activity is not perceived as constituting a profit-making venture.

4.1.2. It has been the practice of SARS (and confirmed through the application of PN 31), to nevertheless allow a person that does not carry on a trade, but who earns interest on capital or surplus funds invested to allow expenditure incurred in the production of the interest to the extent that it does not exceed such income.

4.1.3. On that basis we suggest that the term "interest actually incurred" may be defined with reference to the definition of interest in section 24J, which includes amongst others, the gross amount of any interest or similar finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement.

4.2. Dividends: We recommend that the scope of the deduction be extended to taxable local dividends, such as dividends derived from a REIT. It is noted that the ambit of 'taxable local dividends' could be significant and further investigation would have to be conducted to determine which transactions would be impacted should taxable local dividends be included. However, the proposal particularly addressed the taxable local dividends derived from a REIT.

4.3. Royalties: At this point it is not certain whether if any reference to royalties is required.

4.4. Bad debts: We recommend that provision additionally be made for taxpayers to claim a bad debt deduction for interest income that has accrued, but which turns out to be irrecoverable. It appears to be inequitable to tax entities on accrued interest but then not allow a deduction when the interest becomes irrecoverable.

4.5. Ringfencing: To align with PN 31, we proposed that the expenses so claimable be limited to the related interest or dividends produced by such interest expense and any excess is forfeited. Therefore, that aggregation of all sources of interest and dividends for the purposes of determining the amount allowable is impermissible. The administrative requirement would under these circumstances be to match loan and expenses directly.

4.6. Precedent: We recommend that the new section be aimed at interest or dividends derived *otherwise than in carrying on a trade*. Specific examples exist of similar legislative interventions, such as section 11A, and 11F, should a precedent be required for allowing a deduction in instances where the fact that the 'trade requirement' might be unclear.

4.7. Effective date: As stated above, SARS has communicated its intention to withdraw PN 31 for years of assessment commencing on or after 1 March 2023. Should the legislative proposals be accepted, the earliest that the legislation would be enacted (and could be relied on), is for years of assessment commencing on or after 1 March 2024. We therefore recommend that SARS reconsider the retraction date of PN 31 to allow the Legislature to provide the measures required to support those businesses that currently rely on PN 31.

End.