



Changes to the limitation on interest deductions



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Section 23M applies to taxpayers who pay interest to persons with whom they are in a controlling relationship and in whose hands the interest is not subject to tax in South Africa. The payer's deduction of such interest is limited. The rules for this limitation were amended significantly in 2021. These amendments take effect when the reduced corporate tax rate starts to apply to a company. This article briefly highlights some changes to the limitation threshold as well as the amounts to which section 23M applies.

The reduction in South Africa's corporate tax rate to 27% coincides with two base-broadening measures that come into effect at the same time as the reduced rate. I considered the changes to the utilisation of assessed losses in an earlier article. This article focusses on some elements of the other base broadening measure, the amendments to the interest deduction limitation in section 23M.

Introduction to section 23M

Section 23M limits the deductibility of interest for the payer in instances where the interest is not subject to tax in South Africa in the hands of a creditor who is in a controlling relationship with the payer. The limitation was introduced in 2013 as a measure to counter base erosion that arises when deductible interest is paid to an exempt person. One can deduce from the discussion in the explanatory memorandum that the restriction was primarily aimed at exempt foreign lenders. It however also applies to interest paid to other exempt persons with whom a debtor is in a controlling relationship.

Reduction of the threshold

The first significant amendment involves the rate to calculate the amount to which the deductible interest is limited. The limitation is:

- the debtor's interest income
- *plus* a percentage of the adjusted taxable income of the debtor (in many regards adjusted taxable income resembles the tax equivalent of EBITDA)
- *minus* interest incurred other than the interest to which section 23M applies.

Before the amendment, the percentage was determined using a base rate of 40%. This rate was adjusted depending on the repurchase rate. It was capped at 60%. The amendment replaces this variable percentage with a fixed rate of 30%. This reduces the threshold and therefore the amount of interest that the debtor may deduct.

Interest subject to withholding tax

A further aspect of the amendments affect arrangements where the interest is subject to the

withholding tax on interest, which applies to interest paid to foreign persons. This interest is considered to not have been subject to the tax, and therefore be subject to the limitation in section 23M, to the extent that the withholding tax on interest was levied at a rate lower than 15%. The withholding tax on such interest is generally less than 15% in instances where a tax treaty reduces the rate. This means that where the lender enjoys treaty relief, the borrower's ability to deduct interest incurred is limited.

Amounts considered to be interest

The last element of the amendments that I consider in this article relates to the amounts that are subject to the interest deduction limitation. The definition of interest in section 23M includes, as one would expect, interest as contemplated in section 24J and amounts in respect of sharia arrangements that deemed to be interest under section 24JA. The definition however broadens the meaning of interest to also include:

- Amounts incurred or accrued under interest rate agreements (these include interest rate swaps),
- Exchange differences taken into account under section 24I, and
- Any finance cost element recognised for purposes of IFRS in respect of any lease arrangement that constitutes a finance lease as defined in IFRS16.

Effective date

The amendments take effect for years of assessment that start on or after the date on which the company tax rate is first reduced. The reduced company tax rate applies for years of assessment ending on or after 31 March 2023. For a company with a 12-month financial year, this translates into a year of assessment that begins on or after 1 April 2022.

In conclusion

This article only considers a few of the changes to section 23M. Entities to whom this provision applies, or potentially applies, should consider the detailed amendments sooner rather than later to determine the impact but also identify possible areas where the application of the revised rules may be unclear.

