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TAX ALERT

IN THIS **ISSUE**

'INTEREST' FOR PURPOSES OF WITHHOLDING TAX ON INTEREST (WTI)

The Taxation Laws Amendment Bill 2015 (Bill) proposes the insertion of a definition for the term 'interest' in s50A of the Income Tax Act, No 58 of 1962 (Act) to clarify the meaning of interest for purposes of the WTI. 'Interest' is to be defined in s50A of the Act with reference to paragraphs *(a)* and *(b)* of the definition of 'interest' under s24J(1), meaning that for WTI purposes, 'interest' includes "the gross amount of any interest or related finance charges, discount or premium payable or receivable in terms of or in respect of a financial instrument;" or "the amount (or portion thereof) payable by the borrower to a lender in terms of a lending arrangement as represents compensation for any amount which the lender would, but for such lending arrangement, have been entitled".

CDH
CLIFFE DEKKER HOFMEYR

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Uncertainty has prevailed regarding the meaning to be ascribed to 'interest' for purposes of the WTI.

The Explanatory Memorandum to the Bill states that while the meaning of 'interest' is defined in terms of s24J of the Act, which definition is referenced in the hybrid instruments rules and source rules; uncertainty has prevailed regarding the meaning to be ascribed to 'interest' for purposes of the WTI.

'Interest' is defined in s24J(1) of the Act as the:

(a) gross amount of any interest or related finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement;

(b) amount (or portion thereof) payable by a borrower to the lender in terms of any lending arrangement as represents compensation for any amount to which the lender would, but for the lending arrangement, have been entitled; and

(c) absolute value of the difference between all amounts receivable and payable by a person in terms of a sale and leaseback arrangement as contemplated in s23G throughout the full term of such arrangement, to which such party is party, irrespective of whether such amount is:

(i) calculated with reference to a fixed rate of interest or a variable rate of interest; or

(ii) payable or receivable as a lump sum or in unequal instalments during the term of the financial arrangement.

A 'lending arrangement' in turn is defined in s24J of the Act as:

any arrangement or agreement in terms of which:

(a) a person (in this section referred to as the lender) lends any instrument to another person (in this section referred to as the borrower); and

(b) the borrower in return undertakes to return any instrument of the same kind and of the same or equivalent quantity and quality to the lender.

Section 23G of the Act is an anti-avoidance provision which effectively treats sale and leaseback arrangements

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CLIFFE DEKKER HOFMEYR

‘INTEREST’ FOR PURPOSES OF WITHHOLDING TAX ON INTEREST (WTI)

CONTINUED

‘Interest’ is exceedingly broadly defined under s24J of the Act, embracing interest on all forms of debt, payments economically equivalent to interest, and expenditure incurred in relation to raising finance.

involving payments to lessors or lessees that do not constitute income in their hands under the Act, as financing arrangements and denies any capital allowances that would otherwise be available in respect of the asset sold and leased back. Qualifying repurchase and resale agreements are effectively treated as loans and the differential between the sale price and resale price of the underlying asset constitutes interest for purposes of s24J of the Act.

As is apparent, ‘interest’ is exceedingly broadly defined under s24J of the Act, embracing interest on all forms of debt, payments economically equivalent to interest, and expenditure incurred in relation to raising finance.

The WTI was introduced into the Act in terms of s50A – H, and came into effect on 1 March 2015. In order for the WTI to be levied in terms of s50B of the Act, interest is required to be paid by any person to or for the benefit of any foreign person to the extent that such amount is regarded as having been received or accrued from a source within South Africa in terms of s9(2)(b) of the Act.

When the initial WTI legislation was released, the provisions contained a definition of interest which included, *inter alia*, interest as defined in s24J of the Act. However, no such definition found its way into the current incarnation of s50A, and while the Standing Committee on Finance reported that the WTI would apply to common law interest, this comment does not have the force of law.

With reference to the s24J definition of ‘interest’, it is noted that s50B of the Act refers to the source provisions contained in s9(2)(b) of the Act, which apply exclusively to interest as defined in s24J. On this basis, the interest subject to WTI could have been interest as defined in s24J. However, the s24J definition of ‘interest’ exceeds what is understood as common law interest. The definition includes any discount or premium in respect of a financial arrangement as well as compensation payable by a borrower to a lender in terms of any lending arrangement. In addition, as noted above, the provisions of s24J of the Act treat qualifying repurchase and resale agreements as loans and deem the differential between the sale price and resale price of the underlying asset to be interest.

As such, the former absence of a definition of ‘interest’ in s50A meant that the application of the WTI could conceivably exceed the ambit originally foreseen by the legislator. In addition to the foregoing uncertainty, another concern arises regarding the application of the WTI. The WTI is required to be levied on interest that “is paid by any person to or for the benefit of any foreign person to the extent that the amount is regarded as having been received or accrued from a source within the Republic in terms of s9(2)(b);” that is, interest incurred by a South African resident, unless that interest is attributable to a permanent establishment located outside South Africa; or interest received in respect of the utilisation or application in South

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CLIFFE DEKKER HOFMEYR

‘INTEREST’ FOR PURPOSES OF WITHHOLDING TAX ON INTEREST (WTI)

CONTINUED

This potential inter-jurisdictional quagmire brings another issue to light: the definition of ‘interest’ in the double taxation agreements (DTAs) to which South Africa is party.

Africa by any person of any funds or credit obtained in terms of any form of interest-bearing arrangement. This means that interest paid by a non-resident borrower to a foreign lender may be subject to the WTI should the non-resident borrower have utilised or applied the funding obtained from the foreign lender in South Africa. In consequence, it would be incumbent on a non-resident to withhold the tax on interest.

This potential inter-jurisdictional quagmire brings another issue to light: the definition of ‘interest’ in the double taxation agreements (DTAs) to which South Africa is party. Since the bulk of DTAs to which South Africa is party are formulated in accordance with the OECD Model Tax Convention on Income and on Capital (MC), the logical point of departure is Article 11 (Interest) of the MC:

The term ‘interest’ as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor’s profits, and in particular, income from government securities and income from bonds and debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purposes of this Article.

The above constitutes a wholly autonomous definition of ‘interest’ which the Commentary on the MC states is preferable because it encompasses practically everything regarded as interest in the various states’ domestic laws, offers greater security because it is unaffected by changes in domestic laws, and references in the MC to domestic law should be avoided if at all possible. However, the Commentary goes on to provide that states are at liberty to include items covered by the domestic law definition of interest.

Certain of South Africa’s DTAs contain an ‘interest’ definition that is wholly autonomous and corresponds with the MC ‘interest’ definition (eg South Africa’s DTAs with France, the Netherlands and the United Kingdom (UK)). Other DTAs, however, extend the definition of ‘interest’ to include all other income treated as interest by the domestic tax law of the state in which such income arises (eg South Africa’s DTAs with Australia, Germany and the United States (US)).

In addition to the potential interpretational issues referred to above, many of South Africa’s DTAs deny the right to tax interest in the jurisdiction where it arises, effectively emasculating South Africa’s WTI (eg South Africa’s DTAs with France, the Netherlands, the UK and the US); alternatively they limit the rate at which such interest may be taxed at source (eg South Africa’s DTAs with Australia and Germany limit the rate at which interest may be taxed in the jurisdiction of source to 10%).

As such the WTI will apply predominantly when the non-resident

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‘INTEREST’ FOR PURPOSES OF WITHHOLDING TAX ON INTEREST (WTI)

CONTINUED

Where a DTA does exist between South Africa and the non-resident’s country of residence, the DTA terms will have to be renegotiated or a protocol signed to take cognisance of the WTI.

interest recipient’s country of residence does not have a DTA with South Africa. Where a DTA does exist between South Africa and the non-resident’s country of residence, the DTA terms will have to be renegotiated or a protocol signed to take cognisance of the WTI. As is apparent from the DTAs referred to above, most of which are modelled on the MC, the rate at which withholding tax may be levied at source is limited. This does not bode well for South Africa. Given the WTI rate of 15%, DTAs to which South Africa is party, require renegotiation. Regrettably DTA amendments progress very slowly.

Since the implementation of the WTI was motivated by the desire to protect South Africa’s tax base from erosion, one must question its ability to achieve such end given South Africa’s extensive DTA network.

At least the Bill provides clarity as to the meaning of interest’ for the WTI, but whether the WTI itself is capable of shoring up South Africa’s tax base against erosion remains unclear.

Lisa Brunton

CDH
CLIFFE DEKKER HOFMEYR

OUR TEAM

For more information about our Tax practice and services, please contact:

Emil Brincker
National Practice Head
Director
T +27 (0)11 562 1063
E emil.brincker@cdhlegal.com

Dries Hoek
Director
T +27 (0)11 562 1425
E dries.hoek@cdhlegal.com

Mark Linington
Director
T +27 (0)11 562 1667
E mark.linington@cdhlegal.com

Ben Strauss
Director
T +27 (0)21 405 6063
E ben.strauss@cdhlegal.com

Ruaan van Eeden
Director
T +27 (0)11 562 1086
E ruaan.vaneeden@cdhlegal.com

Lisa Brunton
Senior Associate
T +27 (0)21 481 6390
E lisa.brunton@cdhlegal.com

Heinrich Louw
Senior Associate
T +27 (0)11 562 1187
E heinrich.louw@cdhlegal.com

Tessmerica Moodley
Senior Associate
T +27 (0)21 481 6397
E tessmerica.moodley@cdhlegal.com

Mareli Treurnicht
Senior Associate
T +27 (0)11 562 1103
E mareli.treurnicht@cdhlegal.com

Gigi Nyanin
Associate
T +27 (0)11 562 1120
E gigi.nyanin@cdhlegal.com

Nicole Paulsen
Associate
T +27 (0)11 562 1386
E nicole.paulsen@cdhlegal.com

JOHANNESBURG

1 Protea Place, Sandton, Johannesburg, 2196. Private Bag X40, Benmore, 2010, South Africa. Dx 154 Randburg and Dx 42 Johannesburg.
T +27 (0)11 562 1000 F +27 (0)11 562 1111 E jhb@cdhlegal.com

CAPE TOWN

11 Buitengracht Street, Cape Town, 8001. PO Box 695, Cape Town, 8000, South Africa. Dx 5 Cape Town.
T +27 (0)21 481 6300 F +27 (0)21 481 6388 E ctn@cdhlegal.com

CDH
CLIFFE DEKKER HOFMEYR