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TAX & EXCHANGE CONTROL **ALERT**

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2021 Draft Tax Laws Amendment Bill: Welcome relief for REITs?

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2021 Draft Tax Laws Amendment Bill: Welcome relief for REITs?

Essentially, section 23M of the Income Tax Act 58 of 1962 (Act) furthers the aim of the Government to ensure that base erosion and profit shifting (BEPS) from South Africa does not occur.

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Two of the tools which National Treasury and South African Revenue Service (SARS) wish to use to further this objective include the limitation of assessed losses and the limitation on the deduction of excessive interest. The 2021 draft Taxation Laws Amendment Bill (Draft TLAB) published on 28 July 2021 for public comment gives further insight in relation to these two proposed limitation rules. In this article, we discuss the latter proposal including specifically the impact of the proposed changes on real estate investment trusts (REITs).

Background: Section 23M of the Income Tax Act

Essentially, section 23M of the Income Tax Act 58 of 1962 (Act) furthers the aim of the Government to ensure that base erosion and profit shifting (BEPS) from South Africa does not occur. In particular, section 23M limits excessive interest deductions in respect of debts owed to persons not subject to tax in South Africa if the debtor and the creditor are in a controlling relationship (or a debt owed to a creditor where that creditor obtained funding for the debt from a person in a controlling relationship with the creditor). A controlling relationship basically encompasses the scenario where the creditor holds at least 50% of the equity shares or voting rights in the debtor. To the extent that section 23M applies, then the deduction of interest in the hands of the debtor is limited by way of a specific calculation.

The calculation is set out in section 23M(3) and has undergone one or two changes since it first came into effect, but essentially provides that interest deducted cannot exceed the sum of:

- the total interest received or accrued to the debtor;
- plus a percentage (linked to the repo rate) of *"adjusted taxable income"* of the debtor;
- less interest incurred in respect of debts owed (other than debts caught by section 23M).

Importantly the limitation hinges on the definition of *"adjusted taxable income"* which is essentially the tax equivalent of earnings before interest, taxation, depreciation and amortisation (EBITDA). The definition of *"adjusted taxable income"* is currently calculated as follows:

Starting point	Taxable income (before applying section 23M)
(Less)	Interest received or accrued
	Controlled foreign company income
	Recoupments on capital allowance assets
Plus	Interest incurred that is allowed as a deduction
	Capital allowances
	Assessed losses

2021 Draft Tax Laws Amendment Bill: Welcome relief for REITs?*...continued*

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Proposed changes: General

A review of the tax treatment of excessive debt financing has been in the making for the last couple of years in order to align South Africa's rules more closely with the OECD/G20 BEPS Action 4 recommendation. As a result of the review, National Treasury has proposed making several changes as per the Draft TLAB including the following:

- an expansion of the definition of "*interest*" beyond the current definition contained in section 24J of the Act which shall also include foreign exchange gains and losses taken into account in determining taxable income in terms of section 24I(3) and 24I(10A);
- the percentage of "*adjusted taxable income*" to be fixed at 30% as opposed to being flexible and linked to the repo rate;
- broadening the scope of the application of section 23M to include back-to-back loans within a chain of companies that are in controlling relationships with each other; and
- where a resident debtor makes an interest payment and the payment attracts the withholding tax on interest at a rate higher than zero, a portion of the deduction of the interest expense will be subject to section 23M.

The proposed changes will thus broaden the scope of interest to which section 23M applies. According to the Explanatory Memorandum to the Draft TLAB (Memo), National Treasury is of the view that the current definition of "*interest*" is too narrow when compared to the OECD/G20 BEPS recommendations. In particular, it does not consider avoidance scenarios where interest can be labelled as other types of payments to circumvent the application of these rules. The proposal intends specifically including payments under interest rate swap agreements, any finance cost element included in finance lease payments and foreign exchange differences.

Furthermore, the limitation will be fixed to 30% of adjusted taxable income. In the Memo, National Treasury states that SARS data shows that applying a fixed ratio of 30% would be fair in that the majority of taxpayers will be able to deduct all their interest and equivalent payments without restriction. Over and above this, the Memo states that introducing a fixed ratio limitation of 30% based on adjusted taxable income does not result in much change given that the existing formula yields a 30% restriction in any event. This is driven by the current low repo rate, which is unlikely to continue indefinitely.

Proposed changes: REITs

Subject to various provisos, a REIT is not taxed on the income it derives due to a deduction for "*qualifying distributions*" made by it. In other words, REITs are treated as "*flow-through vehicles*" as per the special taxation regime afforded to REITs in section 25BB of the Act. However, in the Memo, National Treasury accepts that section 23M currently provides for no distinct treatment for REITs.

In certain instances, the deduction of a qualifying distribution may result in zero-taxable income for a REIT. National Treasury has identified that the deduction for qualifying distributions of REITs would distort their "*tax EBITDA*" and would result in them having a much lower "*tax EBITDA*" than other taxpayers. As a result of this, it is proposed (as per the Draft TLAB) that a change be made to the definition of "*adjustable taxable income*" in section 23M(1) to take into account a "*qualifying distribution*" of a REIT.

2021 Draft Tax Laws Amendment Bill: Welcome relief for REITs?*...continued*

With the broadening of the scope of the definition of "*interest*" as well as the application of section 23M to back-to-back loans within a chain of companies in controlling relationships with one another, section 23M may apply to a broader set of circumstances from now on.

Discussion

In instances where a REIT is funded by a tax exempt entity (say a pension fund or non-resident) and that pension fund or non-resident is in a "*controlling relationship*" in relation to that REIT, then any debt advanced between these two entities may be caught within the provisions of section 23M. With the broadening of the scope of the definition of "*interest*" as well as the application of section 23M to back-to-back loans within a chain of companies in controlling relationships with one another, section 23M may apply to a broader set of circumstances from now on. This is in addition to the proposed amendments that are intended to ensure that interest subject to the withholding tax on interest does not altogether escape the application of section 23M.

As indicated in the Memo, under current legislation, a REIT's "*adjusted taxable income*" may be zero as its starting point taxable income may be zero to the extent that it makes sufficient qualifying distributions in that relevant year of assessment to fully reduce its income. Under those circumstances, the REIT would in essence be limited in its deduction of interest to the extent that it receives interest. However, a REIT's main forms of income are more likely to be dividends, qualifying distributions from subsidiaries and rental income. Hence under the current dispensation, a REIT would be discouraged from raising funding from a related party creditor that is not subject to tax given that it will only be allowed to deduct a portion of that interest that equals the interest it receives (if any).

Say, for example, where a REIT, that makes sufficient qualifying distributions and has an "*adjusted taxable income*" of nil, receives or accrues interest in an amount of R100 in a year of assessment and incurs interest of R200 to a creditor that is caught by section 23M, the REIT would only be able to deduct R100 of the R200 interest incurred. R100 of the section 23M interest will be subject to tax in the REIT's hands and to the extent that that amount is distributed as a "*qualifying distribution*" it will be subject to further tax in the hands of the REIT shareholder.

The proposed amendment to the legislation now makes provision for the fact that a REIT makes qualifying distributions and this must be taken into account when calculating a REIT's "*adjusted taxable income*" for section 23M purposes. In following the example above, if the REIT now has an adjusted taxable income of R500 given that the REIT's qualifying distributions will be added back in full as per the amended section 23M formula, the REIT will be able to fully deduct the interest incurred in relation to the controlling creditor. In other words, in terms of the section 23M calculation, the REIT would theoretically be able to deduct up to R250 interest on the loan funding advanced by controlling creditors on the basis that it received R100 interest and 30% of R500 is R150.

The proposed legislation is still in draft form and it remains to be seen what the final legislation will look like, however, REITs would be well advised to consider the proposed legislation and its impact on their tax position and funding requirements. The closing date for the submission of public comments is 28 August 2021.

Jerome Brink

Assessing the losses: Draft TLAB proposes restrictions on the use of assessed losses

South Africa has historically taken a generous position on the use of assessed losses by taxpayers by allowing the full extent of assessed losses to be set off against current income and any remaining balance to be carried forward to be set off against future income.

Suffering financial losses is a near inevitable part of doing business. International and South African tax policy has customarily allowed taxpayers that expend more than they earn to set off these losses against current or future income. This shields start-up businesses yet to turn a profit and cyclical businesses subject to low income or high expenditure periods from a tax cost until the income earned is deemed sufficient to warrant a tax burden.

South Africa has historically taken a generous position on the use of assessed losses by taxpayers by allowing the full extent of assessed losses to be set off against current income and any remaining balance to be carried forward to be set off against future income. Section 20 of the Income Tax Act 58 of 1962 contains the provisions dealing with the use of assessed losses. Section 20 provides that where a taxpayer carries a balance of an assessed loss from any previous year, this balance may be set off against the taxable income earned in the current year. Meaning that where a taxpayer has incurred a great loss in previous years, this loss may be set off against taxable income until the full loss is exhausted.

In the 2020 Budget Speech, the Minister of Finance announced that government intends to reduce the ability for corporate taxpayers to set off past assessed losses. This announcement and proposal were discussed in our 2020 Special Budget Alert.

The proposal to restrict the use of assessed losses by corporate taxpayers is now contained in clause 19 of the Draft 2021 Taxation Laws Amendment Bill (Draft TLAB). Public comments are open on the full Draft TLAB and written submissions are to be submitted to the National Treasury at 2020AnnexCProp@treasury.gov.za and the South African Revenue Service at acollins@sars.gov.za by close of business on 28 August 2021.

Proposal

The explanatory memorandum to the Draft TLAB (Memo) indicates that Government has proposed restricting the use of assessed losses, mainly in order to provide it with alternative revenue to facilitate the lowering of the corporate tax rate to below the current 28%.

The Memo also notes that the proposal is in line with international tax policy trends. It states that:

> *"In 2015, out of a group of 34 OECD [Organisation for Economic Co-operation and Development] and non-OECD countries, 16 countries limit carry-forward periods to between three and 20 years, while eight countries limit the amount of tax losses that can be offset in any given year. The latter are restricted to a percentage of either taxable income (ranging from 50 to 80%) or accumulated assessed losses (ranging from 25 to 50%) per year."*

Assessing the losses: Draft TLAB proposes restrictions on the use of assessed losses*...continued*

While the proposal does remove some of the shielding provided to taxpayers who have suffered significant assessed losses, it allows the majority of an assessed loss to be utilised and the balance carried forward to subsequent tax years. Meaning the full assessed loss may still be utilised, but over a longer period.

Clause 19 of the Draft TLAB proposes that corporate taxpayers be limited to setting off a maximum of 80% of any balance of assessed loss carried from any previous tax year. Therefore, despite carrying a balance of an assessed loss, corporate taxpayers will always face taxation on at least 20% of their taxable income for a given year.

Comment

While the proposal does remove some of the shielding provided to taxpayers who have suffered significant assessed losses, it allows the majority of an assessed loss to be utilised and the balance carried forward to subsequent tax years. Meaning the full assessed loss may still be utilised, but over a longer period.

The indications from the policy pronouncements are that the proposals are part of a set of measures aimed at ensuring there is sufficient fiscal space for a reduced corporate income tax rate. However, it remains to be seen whether corporates and investors value the certainty of a lower corporate income tax rate more than flexibility in the system of taxation, which takes into account the economic position of businesses that have suffered significant past losses and may yet struggle with cash flow constraints.

Tsanga Mukumba

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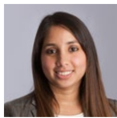

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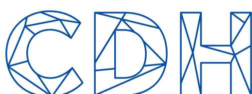

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