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# TAX & EXCHANGE CONTROL ALERT

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### Interest not always deductible? SARS issues interesting ruling

In the income tax context, one of the issues that has been considered by our courts on a number of occasions, is the issue of deductibility of interest. On 5 November 2021, the South African Revenue Service (SARS) issued Binding Private Ruling 369 (Ruling), which deals with the deductibility of interest pursuant to the liquidation of a company.

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## Interest not always deductible? SARS issues interesting ruling

Persons reading the Ruling should not immediately become concerned that the Ruling, in and of itself, reflects a shift in SARS' view regarding the deductibility of interest, as the context in which the interest arose is rather unique.

In the income tax context, one of the issues that has been considered by our courts on a number of occasions, is the issue of deductibility of interest. On 5 November 2021, the South African Revenue Service (SARS) issued Binding Private Ruling 369 (Ruling), which deals with the deductibility of interest pursuant to the liquidation of a company. We briefly discuss the Ruling below.

### Facts

- The applicant in the Ruling is a resident company in liquidation and its liquidators.
- The company ceased trading and the liquidators commenced with its winding-up and the realisation of its assets.
- The resultant proceeds were invested and consequently earned interest.
- The liquidators are legally required to apply the nett proceeds against the capital and interest of all proven claims, all of which related to trade debt.
- Only the trade debts carried any provision for interest and hence no interest was incurred by the applicant in relation to the trade debts, with the exception of one creditor.
- The applicant will therefore actually incur interest in relation to the proved claims when the Master of the High Court (Master) confirms the Liquidation and Distribution Account (L&D Account).

### SARS Ruling

Based on the above facts disclosed in the Ruling, SARS found that:

- The interest payable by the applicant will be actually incurred in the year of assessment when the Master confirms the L&D Account.
- The interest payable by the liquidators will not qualify for any deduction under sections 24J or 11(a) of the Income Tax Act 58 of 1962 (ITA) on the basis that it will not be incurred in the production of income.
- Practice Note 31 does not apply to the proposed transaction.

### Discussion and analysis

Persons reading the Ruling should not immediately become concerned that the Ruling, in and of itself, reflects a shift in SARS' view regarding the deductibility of interest, as the context in which the interest arose is rather unique.

Generally speaking, a taxpayer that incurs interest and meets the requirements of sections 24J(2) and 11(a) of the ITA, will be able to deduct the interest. The key issue in the context of the Ruling is the requirement that for interest to be deductible, it must be incurred in the production of income. Some of our readers will be aware of the judgments that have dealt with the "production of income" requirement, for example, *Sub Nigel Limited v CIR* 1984 (4) SA 580 (A) where the Supreme Court of Appeal (SCA) held that the "in production of income" requirement is met if the expenditure

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The only limitation of PN 31 is that the interest deduction is limited to the interest earned on the surplus funds invested.

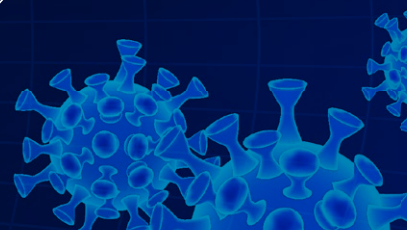
was incurred for the purpose of earning income. Furthermore, in the oft-quoted *Port Elizabeth Electric Tramway Ltd v Commissioner for Inland Revenue* 8 SATC 13, the SCA held that for expenses to be incurred in the production of income, one must consider whether the expenses are "...attached to the performance of a business operation bona fide performed for the purpose of earning income... provided they are so closely connected with it that they may be regarded as part of the cost of performing it." While SARS' reasoning is not known as it is not included in the Ruling, it appears that in this case, SARS was of the view that the interest incurred on confirmation of the L&D Account by the Master was not sufficiently closely connected to the applicant's trade. Taxpayers must also be mindful that although the introduction of section 24J changed some of the rules regarding interest deductions, it still requires that the "production of income" and "trade" requirements are met for interest deductibility. This was made clear in the Explanatory Memorandum to the Revenue Laws Amendment Bill, 2004.

The fact that Practice Note 31 (PN 31) does not apply according to the Ruling is also of interest. In terms of PN 31, which was issued by SARS in 1994, where a taxpayer earns interest on capital or surplus funds invested, it is SARS' practice to allow expenditure incurred in the production of interest, even though it is evident that the taxpayer does not trade as a moneylender. The only limitation of PN 31 is that the interest deduction is limited to the interest earned on the surplus funds invested. What the Ruling therefore appears to potentially suggest, is that the interest incurred on approval of the L&D Account by the Master cannot be deducted from the interest earned from the proceeds of the liquidation that were invested, even if the interest income was earned in anticipation of and to pay the interest due to the Master on approval of the L&D Account.

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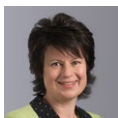
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