

Tax Alert

4 August 2011

Section 45 re-instated – Interest deductions restricted

On 3 August 2011 National Treasury announced the withdrawal of their previous proposal to suspend the intra-group roll-over provision contained in s45 of the Income Tax Act. Instead, the focus will turn to the purchaser's deduction of interest on any debt used to fund the deal.

Notably, this interest-deduction-restriction regime will extend also to amalgamation transactions (s44 ITA) as well as liquidation transactions (s47 ITA).

Redrafted versions of s45 and certain other provisions were released on 3 August, to form part of the 2011 Taxation Laws Amendment Bill. Apart from the proposed revisions to s45, the main new proposal is the insertion of a new s23K which governs the interest-deduction-restriction proposal.

The main thrust of the new regime (it is proposed) is that taxpayers using interest-bearing debt to fund s44, s45 or s47 transactions will in some cases first have to apply to SARS for approval for the interest to be allowed as a deduction. It appears that:

- Pre-approval will not be required for transactions that do not involve debt or use only interest-free debt.
- There is also an exemption from the pre-approval requirement in the case of interest-bearing debt that is purely intra-group. This is

likely to open the way for many vendor-financed acquisition deals, such as certain BEE transactions.

- Interest deductions for debt funding that is directly or indirectly sourced from outside the group of companies will require an application to SARS. In assessing applications for interest deductibility, the main factor to be considered by SARS (it is proposed) will be the “erosion” of the SA tax base. Essentially this appears to involve a review of debt:equity ratios, interest-flows, funding instruments, and lender-borrower relationships.

These new measures are proposed to take effect on 3 June 2011 in respect of s45 deals, and on 3 August 2011 in respect of amalgamations (s44) and liquidations (s47). However, National Treasury maintains that these are temporary measures and, as such, they are proposed to be replaced with a different system (which presumably will not require an application-and-approval process) from 1 January 2014.

As a separate matter, the proposed rules for hybrid and third-party backed instruments are also softened. Notably, the previous proposal to extend the “tainted” redemption period for hybrid instruments to ten years is withdrawn and the rules relating to third-party backed shares are narrowed so as to exclude commercial arrangements.

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