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Let's talk

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2023 Draft tax legislation – Reviewing the Practice Note 31 principles

In brief

The proposal is to withdraw Practice Note 31 of 1994 (PN31) and to insert a new section in the income tax legislation to allow a deduction for expenditure incurred by a company in the production of interest income accruing from another group company (as defined) provided certain requirements are met. The proposed amendments will come into effect on 1 January 2024 and apply in respect of years of assessment commencing on or after that date.

In detail

General

On 31 July 2023, National Treasury and the South African Revenue Service (SARS) published the 2023 draft tax legislation for comment (due by 31 August 2023).

The draft legislation proposes to introduce a new section 11G to allow for an income tax deduction for expenditure incurred by a company in the production of interest income accruing from another group company (as defined in section 1 of the Income Tax Act) provided certain requirements are met.

Reasons for the amendment

The draft Explanatory Memorandum (EM) states that it has come to Government's attention that PN31 is abused by certain taxpayers who enter into transactions that are structured to maximise the deduction of interest or other expenditure incurred whilst there is no corresponding inclusion in gross income for the related recipient or where debt funding is ultimately used to fund non-income-producing activities or assets.

Accordingly, SARS considered withdrawing PN31.

Government has now considered submissions by stakeholders regarding the impact of the proposed withdrawal of PN31 on legitimate transactions and proposes to insert a new section 11G to accommodate legitimate transactions — specifically to allow efficient access to funding for businesses, e.g. the existing practice for groups of companies to raise funding centrally in a non-trading treasury company and on-lending to a fellow group company in return for interest.

Proposed deduction (section 11G)

A company will be allowed to claim a deduction (limited to the interest income) for expenditure incurred in the production of interest income accruing from another group company (as defined) if the following requirements are met:

- The expenditure incurred by that company must be in respect of amounts owing for purposes of providing funding directly or indirectly to one or more companies that form part of the same group of companies as that company; and
- The deduction of the expenditure incurred by that company during any year of assessment must be limited to the interest income accruing from that other company during that year of assessment.

The objective is to avoid tax leakage where the funding is raised by one group company for purposes of another group company for productive purposes.

Withdrawal of PN 31

The withdrawal of PN31 is proposed to be aligned with the effective date of the proposed legislation, i.e. 1 January 2024, applying in respect of years of assessment commencing on or after that date.

Takeaway

The proposed replacement for PN31 is significantly narrower than what is currently the position in PN31 and could have a significant impact on the deductibility of expenditure that is incurred in the production of interest income.

Taxpayers should carefully consider these proposals in the context of their businesses and make submissions (by 31 August 2023) on the potential impact of these proposals on their legitimate business structures. Structures that are impacted may include, for example:

- The use of special purpose vehicles for debt securitization or the issue of debt to third parties;
- Small business owners borrowing amounts in their own capacity and funding their businesses by on-lending these funds to the business; and
- Back-to-back loan arrangements outside of a group of companies.