Please remove the elephant in the room - Interest deductions on foreign debt

The Budget states that there will be some changes to section 23M. This section is a fairly complex piece of legislation, which could limit your interest deduction for tax purposes.

It would usually apply when the SA company borrows funds from its related offshore group company (there are other scenarios).

Per a recent amendment, when checking which “interest” may be disallowed, the section was amended and unfortunately (in my view) expanded to include certain foreign exchange losses as “interest”.

One usually has some control of the interest you will be paying but very little control over your foreign exchange gains or losses, being subject to the whims of the market.

The Budget acknowledges that including foreign exchange losses creates complexity and states that interest will now simply (in broad terms) be interest without foreign exchange losses.

Unfortunately, the Budget continues to discuss foreign exchange gains, stating that their treatment is unclear in certain cases, and it will be clarified.

The linking of the above two proposals creates some uncertainty. We were hoping that all references to foreign exchange gains and losses would be removed and decrease the acknowledged complexity.

On the same topic, section 23M, along with transfer pricing provisions, can limit interest deductions. The further complexity is determining which to apply first, the transfer pricing provisions or indeed section 23M.

There is certainly room for debate, with SARS of the view that transfer pricing is to be applied first. We fail to see why Treasury does not remove the debate and uncertainty and legislate which section is applied first. Please remove the elephant in the room!

Enjoying the high tax exemption with your Controlled Foreign Company?

Currently, no tax is attributed back to the SA shareholder if their controlled foreign company (CFC) meets the high tax exemption.

In essence, if the CFC pays tax that is at least 67.5% of the tax that would have been paid had the CFC been a South African tax resident then the high tax exemption is met.

Ascertaining whether a CFC meets this exemption, accordingly, requires two tax calculations. The first in the foreign country applying local law, and the second applying South African law to the foreign company, which is a hypothetical calculation to ascertain if the high tax exemption will be met. Yes, it’s a bit complicated and administratively intensive.

At issue presently is that a particular well known foreign (tax friendly) jurisdiction has a regime which allows a “decent” rate of tax to be applied to its resident company (X), and then when X’s shareholder receives a dividend, the shareholder can claim a refund of the tax paid by X.

In effect the tax rate of X is reduced, albeit at X’s shareholder level.

The Budget suggests that if a shareholder receives such refund, that refund should be taken into account when determining whether X meets the high tax exemption.

In our view, that would be levelling the playing field, as such structures are often only put in place to gain a tax advantage.

Confirmed, your foreign tax on employment income is tax deductible!

From a theoretical point of view, a taxpayer should be able to claim taxes charged legally in a foreign jurisdiction, when calculating their tax liability in their country of residence. One would expect the relief to take the form of a tax credit.

According to the Explanatory Memorandum supporting the legislation that amended section 6quat, tax credits are only available to the extent foreign taxes arise on foreign source income, not against domestic source income. Countries are only prepared to surrender primary jurisdiction if the underlying activity (i.e. source) arises outside its border.

When section 6*quat* was amended in 2007, the reason for the amendment was that it has come to Government's attention that a number of countries were incorrectly claiming source jurisdiction in respect of services occurring within South Africa and accordingly claiming that withholding tax is required.

South Africa was not prepared to give section 6*quat* rebates for South African source activities. However, South Africa was prepared to treat these foreign taxes as a deductible expense incurred in the production of income. Hence, section 6*quat* was amended to allow these deductions.

It was announced in the Budget Speech that taxpayers should be allowed to claim their foreign tax on employment income as a deductible expense. This appeared to have been the original intention of the legislature, and the proposed amendment per the Budget Speech, though unfortunately applicable in limited circumstances, seems intended to clarify the legislation on that point.

For example, if you have income which is not from a foreign source, and such income is correctly taxed by a foreign government, you can claim such foreign tax as a tax deduction (there are a few additional requirements).

In essence and for the purposes of this article, if you are working in South Africa, but your employment income is correctly taxed by a foreign government you could claim the foreign tax paid as a tax deduction.

Technically at issue was if you read the various legislative provisions together (section 6*quat*(1C), section 11 and section 23(m)), you arguably could not claim such foreign tax as a deductible expense.

The negative result was not the intention of the legislature.

While certain requirements would need to be met in order to qualify for such a deduction, this is a welcome proposal in the Budget!