

TAX

Proposed draft legislation to replace Practice Note 31 of 1994

2 August 2023 8 min read

An indispensable requirement for the claiming of an income tax deduction is that the taxpayer must be carrying on a trade and the expenditure in question must be incurred in the production of the income derived from carrying on such trade. Our courts have held that the carrying on of a trade involves an active step and something far more than merely watching over existing investments that are not, and are not intended or expected to be, income-producing during the year in question.

In the context of a money lending business, the carrying on of a trade requires that the lender derives a profit by lending at higher interest rates than those incurred on its borrowings. In such case, the lender will be allowed to claim the interest incurred on its borrowings as a deduction against the interest accruing to it on its lending transactions as it is clearly carrying on a trade. A person who is not a money lender will not be carrying on a trade where such person borrows money at interest for purposes of lending such money to a third party at an equal or lower rate of interest or to fund the acquisition of passive investments. In such case, such person is clearly not carrying on a trade as there is no profit-making venture. Absent an administrative concession, such person will not be entitled to claim a deduction in respect of the interest incurred on its borrowings.

Practice Note 31, issued in 1994, contains such an administrative concession which specifically allows a person who is not a money lender to claim a deduction in respect of expenditure incurred in the production of interest income on capital or surplus funds invested, notwithstanding that such interest income is not derived from the carrying on of a trade. The deduction may not, however, exceed the interest income (i.e. the deduction cannot result in a loss). The effect of Practice Note 31 is, therefore, to disregard the legal requirement that the taxpayer must be carrying on a trade in respect of its passive investment activities in order to claim the expenditure incurred in respect of such activities as a deduction. It is not unusual for tax authorities internationally to grant such administrative concessions in circumstances where applying the law strictly would be unreasonable.

A practice note qualifies as a practice generally prevailing. The latter covers a binding general ruling, interpretation note, practice note or public notice issued by the South African Revenue Service (SARS) regarding the application or interpretation of a tax Act. Taxpayers who base their tax positions on a practice generally prevailing and who have been assessed have the certainty that SARS will not be able to re-assess them in a manner contrary to what is set out in the practice generally prevailing. SARS is, however, entitled to withdraw a practice generally prevailing, in which case, taxpayers will no longer be able to rely thereon.

SARS announced on 16 November 2022 its intention to withdraw Practice Note 31 due to its perceived abuse and requested representations to be made on possible legislative amendments during the 2023 legislative cycle. This announcement was followed by National Treasury confirming in the Budget Review of 2023 that government will consider the impact of the proposed withdrawal of Practice Note 31 and whether legislative amendments could accommodate legitimate transactions that will be affected by such withdrawal. It was confirmed that the withdrawal of Practice Note 31 will be delayed until the effective date of the proposed legislation.

The first draft of the proposed legislation was published on 31 July 2023 in the form of section 11G of the draft Taxation Laws Amendment Bill, 2023 (Bill). If adopted, the proposed provision will come into effect on 1 January 2024 in respect of years of assessment commencing on or after such date. The proposed provision extends the concession provided in Practice Note 31 only to intra-group loans in limited circumstances. The Draft Explanatory Memorandum on the Bill, 2023 (Draft EM) states that a company may deduct the expenditure it incurs in the production of interest income accruing on a loan, advance or credit provided by such company to a fellow group company if (i) such expenditure is incurred in respect of amounts borrowed by the lending company for purposes of providing the interest-bearing funding on a direct or indirect basis to the fellow group company; and (ii) the fellow group company applies the borrowed funds for purposes of producing non-exempt income in the course of carrying on a trade. The deduction will, however, be limited to the interest income accruing to the lending company on the intra-

group loan. The actual wording of section 11G does not, however, specify that the money lent must come out of moneys borrowed, as set out in requirement (i), nor does it incorporate requirement (ii) above and these discrepancies between section 11G and the Draft EM should be rectified by National Treasury prior to the promulgation of the Bill.

The definition of “group of companies” refers to two or more companies where one company (referred to as the controlling group company) directly or indirectly holds at least 70 per cent of the equity shares in another company (referred to as the controlled group company), whether alone or together with any other controlled group company. Section 11G will, therefore, allow a holding company to claim a deduction in respect of the interest incurred on, for example, a bank loan to the extent that such loan is utilized by the holding company for purposes of advancing an interest-bearing loan to a subsidiary. The holding company may also claim any relevant administrative expenditure. The subsidiary must, however, form part of the same group of companies as the holding company and the subsidiary must utilize the loan capital in the course of its trade for purposes of producing non-exempt income (though, as stated, this requirement is not in the draft legislation itself).

The rationale behind considering the application of the loan funding by the subsidiary to determine the deductibility of the interest in the hands of the holding company is questionable. As a starting point, the subsidiary will not be entitled to claim the interest incurred on the loan owing to the holding company as a deduction if the subsidiary utilizes the loan capital for non-trade purposes or to fund the production of exempt income. In such case, the holding company will also not be allowed to claim the interest incurred on its borrowings from the ultimate funder as a deduction under the proposed section 11G. The holding company will, however, be subject to income tax on the interest income accruing on its loan claim against the subsidiary. The result is unrelieved economic double taxation on the back-to-back funding arrangement.

Another notable issue with the proposed legislation is its narrow scope. By only extending the principles of Practice Note 31 to intra-group loans, the proposed legislation will require various individual, trust and family transactions to be restructured. For example, individuals are allowed to externalize funds for foreign investment purposes through the Foreign Investment Allowance (FIA) exchange control dispensation. A common pattern followed here is that a resident family trust with surplus capital would lend such capital at interest to its resident beneficiaries who would then utilize such loan capital to fund a non-resident trust via interest-bearing loans through the FIA exchange control dispensation. The terms of the loans to the beneficiaries typically mirror those of the loans to the non-resident trusts. The proposed legislation in its current form will result in the beneficiary being taxable on the interest received from the offshore trust, the beneficiary not being allowed a deduction of the interest paid to the local trust, while the local trust will still be taxable in the interest it receives from the beneficiary. In this case, the result will be economic double taxation as the individuals and the resident trust will be subject to income tax on essentially the same amount of interest.

The proposed section 11G must still go through the public participation phase prior to being promulgated and Practice Note 31 remains effective at least until the effective date of section 11G (the section is to take effect from tax years commencing on or after 1 January 2024, so that for most taxpayers likely to be affected adversely, it will apply from 1 March 2024). It is anticipated that section 11G in its current form will trigger strong resistance from the public and hopefully further amendments will be made to the proposed legislation prior to its promulgation.



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