Pieter van der Zwan
& Associates
Technical Advisory Services
Tax · IFRS

Tax update

Withholding tax on interest to non-residents

The Government's intention to introduce a withholding tax on cross-border interest was announced during 2010. The long anticipated withholding tax on interest is contained in Part IVB of Chapter II of the Income Tax Act (the Act) in sections 50A to 50H and becomes effective from to 1 March 2015.[1] This leaves South African taxpayers with just over a month to consider the impact and put the necessary measures in place to comply with the withholding obligations. This newsletter provides a high level overview of the mechanics of the new withholding tax regime and its potential impact.

Interest affected by the withholding tax

The withholding tax must be withheld and paid over to the SARS by any person paying South African sourced interest to a foreign person (non-resident).

Interest would be from a South African source if incurred by a resident (unless the interest is attributable to a business of the resident outside South Africa) or is received from the utilisation or application of funds in South Africa.

It is important to note that unlike provisions affecting the deductibility of cross-border interest (see later), the application of the withholding tax is not limited to interest paid to connected persons. The withholding obligation applies to interest on any loan which is payable to a foreign person, whether connected or not.

Exclusions

In the context of non-government borrowers, the withholding tax does not apply to interest paid by banks, in respect of listed debt, interest accruing to funds in a trust account in terms of s 21(6) of the Financial Markets Act and certain interest paid by headquarter companies (refer section 9I of the Act).

In addition, a foreign person would be exempt from the withholding tax in terms of section 50D(3) if:

- The person is a natural person who was physically present in South Africa for a period exceeding 183 days during a twelve month period; or
- The debt in respect of which the interest is paid is effectively connected with a permanent establishment of that person in South Africa, if the person is registered as a taxpayer in terms of the Tax Administration Act.

This last exemption must however be read in its full context. Section 10(1)*(h)* provides that interest received from a South African source by a foreign person would generally be exempt, unless the person has a sufficient presence in South Africa, as evidenced by the same two criteria as listed above, in which case the exemption in section 10(1)*(h)* does not apply. This therefore means that if a foreign person is not subject to the withholding tax based on his/her or its presence in South Africa or the fact that the interest relates to a loan effectively connected to a permanent establishment in South Africa, the interest would be taxed at the normal tax rates, rather than the withholding tax rates. The exemption in section 50D(3) is therefore not an overall exemption from all taxes on South African interest for a non-resident lender.

Obligation to withhold and pay tax to SARS

The foreign person is ultimately liable for the tax on its interest income. Section 50E however contains a withholding mechanism that requires the payer of the South African sourced interest, which will often be a South African taxpayer, to the foreign person to withhold the tax when the interest is paid. The interest payer who must withhold will be required to submit a return and pay the tax over to the Commissioner by the end of the following after which the tax was withheld.

A person paying interest to a foreign person would not be obliged to withhold if the foreign person submits certain declarations to the person paying the interest stating that it is exempt from the withholding tax. Failure to withhold and/or pay the taxes to SARS without such documentation, would expose the withholding agent to personal liability for such taxes, as contemplated in section 157 of the Tax Administration Act.

[1] This has been extended from 1 January 2015 by the Tax Laws Amendment Act, which has not yet promulgated at the time of writing

Pieter van der Zwan & Associates
Technical Advisory Services
Tax · IFRS

Tax Update

Withholding tax on interest to non-residents

Rate at which the tax is withheld

The rate at which the tax should be withheld is 15% of gross interest amount paid to the foreign person.

As this is a tax imposed on South African source income earned by a resident of another jurisdiction for tax purposes, the rate may be reduced if a double tax agreement has been concluded between South Africa and the state of residence of the recipient of the interest. Most treaty provisions contain specific allocations or limitations of the source country's (in this case, South Africa) taxing right to interest income of the resident of the other state. The application of the relevant article of the DTA dealing with interest would vary from case to case and requires consideration of factors such as beneficial ownership and presence of the recipient in the source country.

If the foreign recipient of the interest qualifies for a reduced rate in terms of the DTA, the withholding agent paying the interest to such foreign person can only withhold at a reduced rate if the following documentation has been obtained from the foreign person by a date determine by the payer or the date of payment, if no such date has been determined. The documentation required are:

- A declaration, in a form prescribed by SARS, confirming that the interest is subject to the reduced rate in terms of a double tax agreement; and
- a written undertaking in such form as may be prescribed by the Commissioner to forthwith inform the person making the payment in writing should the circumstances affecting the application of the agreement change.

It would therefore be of critical importance before the first interest payment has to be made to a non-resident lender to obtain the above documentation. In the event that the documentation is not obtained, the tax must be withheld and paid over at the rate of 15%. The legislation makes provision for the non-resident recipient to claim a refund for the portion that would not have been payable had the declaration been submitted. This would however be an unnecessary administrative burden from the transaction.

Impact of the withholding tax regime

In addition to the compliance requirements for the South African borrower, the withholding tax regime is likely to add to the cost of the investing in South Africa and could affect the ultimate return earned by foreign funders.

Many loan agreements between South African borrowers and foreign lenders, which were negotiated at a time when the return for the lender was tax free in terms of section 10(1)*(h),* contain provisions that cater for an increase in the interest rate should the taxation of interest in South Africa change. It is advisable that taxpayers identify foreign person funding and scrutinize the loan agreements to determine the immediate and direct economic effect of the withholding tax on their borrowing rates.

The withholding tax regime should generally not affect the deductibility of the interest incurred by the South African borrower. In the case of loans from foreign connected persons, the transfer pricing provisions of section 31 still apply to prevent excessive extraction of value from the South African tax base in the form of interest deductions. The statutory interest deduction limitation in section 23M, which took effect from 1 January 2015, may have some linkage to the withholding tax regime as the limitation only applies if the interest is not subject to tax in the hands of the lender in South Africa. For these purposes, tax is defined as any tax imposed in terms of the Act, which includes the withholding tax on interest.

Concluding thoughts

The withholding tax will impose an administrative burden but possibly also an economic cost on South African taxpayers. In many cases, the economic effect may be significantly less where a double tax agreement has been entered into between South Africa and the lender's state of tax residence. It is recommended that taxpayer use the period before 1 March 2015 to critically assess the impact that the withholding tax regime will have on its business and its foreign funding cost in order to implement the necessary steps to implement procedures to comply with the regime when it takes effect in just over a month.

If you require technical tax or IFRS assistance or an inhouse seminar please feel free to contact Pieter van der Zwan at **083 417 5904** or **pieter@pvdz.co.za** or to visit **www.pvdz.co.za** and submit a request on the relevant page.