SOUTH AFRICAN REVENUE SERVICE

INCOME TAX INTERPRETATION NOTE NO. 2 (Second Version)

DATE: 28 August 2002

ACT : INCOME TAX ACT, 1962 ("the Act")
SECTION : SECTION 9E(5A)
SUBJECT : FOREIGN DIVIDENDS - DEDUCTIBILITY OF INTEREST

1. Background

Foreign dividends which were received by or accrued to on or after 23 February 2000, or which accrued before 23 February 2000, but were received on or after this date, are subject to income tax in the hands of all residents. Interest incurred in purchasing shares in respect of which the dividends accrue would normally not qualify for deduction in terms of section 11(a) and 23(g) of the Act. Section 9E(5A) of the Act, however, provides for a special deduction in order to alleviate the problem.

The purpose of this Note is to provide guidance regarding a resident who is a natural person and a portfolio investor in relation to the deduction of interest expenditure. A portfolio investor is any person that holds less than ten per cent of the equity share capital of a company.

This section overrides the "trade" requirement to a certain degree in that it allows a resident to deduct interest actually incurred in the production of income derived from both exempt and taxable <u>foreign dividends</u>.

2. The law and application

2.1 In terms of section 9E(5A)(a) of the Act a resident will be allowed a deduction from taxable foreign dividends derived during any year of assessment, any interest actually incurred in the production of foreign dividends as defined in section 9E. This will apply notwithstanding the provisions of sections 11(a) and 23(g) of the Act, but subject to certain limitations and conditions.

- The amount of interest deductible for a particular year of assessment is limited to the amount of **income derived from foreign dividends** during that year of assessment.

- The excess interest may qualify as a deduction in the following year of assessment against taxable foreign dividends. The excess amount must, however, first be reduced by the amount of exempt foreign dividends that accrued during that year. The amount remaining after the deduction of the exempt foreign dividends is carried forward to the

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following year of assessment and qualifies as interest actually incurred during that year of assessment. [Section 9E(5A)(b)]

- If for any year of assessment the amount of exempt foreign dividends is equal to or greater than the amount of excess interest, then the balance of excess interest carried forward to the following year of assessment is equal to R Nil.

Income derived from foreign dividends is equal to the amount of gross foreign dividends less the amount of foreign dividends exempt from tax in terms of the provisions of sections 10(1)(i)(xv) and 10(1)(k)(i).

2.2 Foreign dividends, (i.e. taxable foreign dividends and foreign dividends exempt from tax in terms of section 9E(7)) are included in "gross income" in terms of paragraph (k) of the definition of "gross income".

2.3 Foreign dividends which are taxable in terms of section 9E are excluded from the exemption for dividends in terms of section 10(1)(k)(i).

2.4 A natural person is entitled to a basic exemption in respect of interest and foreign dividend income which would otherwise not be exempt from tax. [Section 10(1)(i)(xv)]

For the 2002 year of assessment the basic exemption amounts to R4 000 for natural persons under 65 years of age and R5 000 for natural persons who are 65 years of age or older.

The basis on which the basic exemption will apply has been amended from the commencement of assessment years ending on or after 1 January 2003. The consequences of the amendment are as follows:

- The exemption applicable to foreign sourced interest and dividends is limited to R1 000. [Section 10(1)(i)(xv)]

- The R1 000 exemption must first be applied to foreign dividends and the balance, if any, to foreign sourced interest. [Section 10(1)(i)(xv)(aa)]

- The exemption applicable to locally sourced dividends and interest which are not otherwise exempt from tax, *viz.* R10 000 (in the case of persons aged 65 and older at the end of the relevant tax year) or R6 000 (in the case of persons not yet 65 years of age at the end of the relevant tax year), as the case may be, must be reduced by the R1 000 referred to above (if fully allowed) or such portion thereof allowed as an exemption against foreign sourced dividend and interest income. The reason for this deduction is because the total exemption may not exceed R6 000 or R10 000, as the case may be. [Section 10(1)(i)(xv)(bb)]

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Examples to illustrate:

Example A:

	Foreign dividends/ interest	**Local dividends/ interest**	**Total income**
	R	**R**	**R**
Actual investment income	800	5 800	6 600
Less:			
Basic exemption applicable to foreign investment income - limited to lesser of R1 000 or the actual foreign investment income of R800 [section 10(1)(i)(xv)(aa)]	(800)	Nil	(800)
Less:			
Basic exemption applicable to total investment income reduced by portion utilised for foreign investment income (R6 000 – R800) [section 10(1)(i)(xv)(bb)]	Nil	(5 200)	(5 200)
Taxable income	Nil	600	600

Example B:

	Foreign dividends/ interest	**Local dividends/ Interest**	**Total income**
	R	**R**	**R**
Actual investment income	1 200	5 400	6 600
Less:			
Basic exemption applicable to foreign investment income – limited to lesser of R1 000 or the actual foreign investment income of R1 200 [section 10(1)(i)(xv)(aa)]	(1 000)	Nil	(1 000)
Less:			
Basic exemption applicable to total investment income reduced by portion utilised for foreign investment income (R6 000 – R1 000) [section10(1)(i)(xv)(bb)]	Nil	(5 000)	(5 000)
Taxable income	200	400	600

2.5 The following exemptions provided for in section 9E(7) are of particular importance to a resident that is a natural person and a portfolio investor:

- shareholding of less than 10% in a company listed on the Johannesburg Stock Exchange [Section 9E(7)(c)]

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- foreign dividends declared from profits already subject to normal tax in the hands of the shareholder [Section 9E(7)(e)(ii)]
- foreign dividends declared from profits that arose from dividends declared by a South African resident company [Section 9E(7)(e)(iv)]
- foreign dividends declared from profits that were derived from foreign dividends exempt in terms of section 9E(7) [Section 9E(7)(f)]

3. Examples

Example 1: 2003 year of assessment

Ms A is ordinarily resident in South Africa, 50 years of age and unmarried. She elected to be taxed on the net amount of her foreign dividends i.e. the amount of the dividends received by her after the deduction of foreign withholding taxes.

	R
Gross foreign dividends (taxable and exempt)	10 000
Basic investment income exemption [section 10(1)(i)(xv)(aa)]	1 000
Foreign withholding tax payable in respect of gross foreign dividends	Nil
Exempt foreign dividends [section 9E(7)]	1 000
Interest income earned	Nil
Interest actually incurred in the production of foreign dividends (taxable and exempt)	15 000

Calculation of the amount of interest deductible in terms of section 9E(5A)(a):

	R
Interest expenditure	15 000
Plus: Balance of interest brought forward from the previous year of assessment [section 9E(5A)(b)]	Nil
Total amount of interest available for deduction in the current year of assessment	15 000
Less: Allowable interest – (Deduction limited to the amount of income derived from foreign dividends – see note)	8 000
Excess interest	7 000
Less: Exempt dividends (R1 000 + R1 000)	2 000
Balance of interest carried forward to the 2004 year of assessment [section 9E(5A)(b)(ii)]	5 000

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Calculation of taxable income derived from foreign dividends

	R
Gross foreign dividends [section 9E(3)]	10 000
Less: Gross foreign dividends exempt in terms of section 9E(7) [section 10(1)(k)(i)]	1 000
Basic interest and dividends exemption [section 10(1)(i)(xv)(aa)]	1 000
Income derived from foreign dividends	8 000
Interest expenditure [section 9E(5A)(a)]	8 000
Taxable income derived from foreign dividends	NIL

Note:

Calculation of income derived from foreign dividends

	R
Gross foreign dividends [section 9E(3)]	10 000
Less: Gross foreign dividends exempt in terms of section 9E(7) [section 10(1)(k)(i)]	1 000
Basic interest and dividends exemption [section 10(1)(i)(xv)(aa)]	1 000
Income derived from foreign dividends before deductions	8 000

Example 2:

Refer to the spreadsheet attached. The purpose of this example is to illustrate how the amount of excess interest must be carried forward on an annual basis.

Law Administration
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