

Taxability of Local Interest Income

In a circular dated February 2010, we advised clients and associates of a "Secret Extra Tax" proposed by the Minister of Finance.

More details are now available in the form of draft tax legislation.

Currently, the first amount of interest income from all local sources up to R22 300 p.a. (R32 000 p.a. for those 65 years and over) is exempt from normal income tax in the hands of a natural person. These amounts are reduced by an amount of up to R3 700 of foreign dividends and interest earned during the year.

With effect from 1 March 2011, it is proposed that this exemption for natural persons will apply only in respect of interest from (inter alia) the following sources.

- Government debt instruments.
- Listed debt instruments (i.e. on JSE).
- Bank interest.
- By virtue of membership of a Benefit Fund e.g. medical aid scheme.
- Collective investment schemes i.e. Unit Trust portfolios.

It is not clear whether such interest income earned by a trust and awarded to a trust beneficiary who is a natural person will also be entitled to the exemption. We would argue that the exemption does apply as the conduit pipe principle ensures that trust income awarded to a beneficiary retains its character and nature.

It is clear however that other forms of interest income will no longer form part of tax exempt interest e.g.

- Interest on loans to companies and close corporations (even if it is a member lending to his/her own entity).
- Interest on loans to other natural persons

We repeat for the sake of emphasis the example in our February circular.

Mr "Big Salary" has R278 750 to invest in a 8% fixed deposit earning interest of R22 300 p.a. Although his tax rate is 40%, the tax on this interest is zero. His company needs working capital of R278 750. He cashes in the fixed deposit and lends the funds to his company at the same interest rate of 8% p.a. The interest he earns amounts to R22 300 and, although he has no other interest income, he enjoys no tax exemption and his tax liability on this interest at 40% is R8 920. If he had ceded his fixed deposit to the bank to secure a loan from the bank to his company, the R8 920 extra tax would have been saved and would have more than compensated for any additional interest charged by the bank on the loan. If the company has surplus cash to invest, it should repay his loan to enable him to invest at tax free interest rather than for the company to invest to earn taxable interest.

It is important that arrangements are put in place before 1 March 2011 to ensure that the benefit of this tax exemption and saving is effectively utilised.

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