INCOME TAX INTERPRETATION NOTE NO. 2

DATE: 1 February 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 foreign dividends.

2. The law

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 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. The exemption must first be applied to taxable foreign dividends and then to any other interest income and taxable dividends (other than taxable foreign dividends). [Section 10(1)(i)(xv)]

For the 2001 year of assessment the basic exemption amounts to R3 000 for natural persons under 65 years of age and R4 000 for natural persons who are 65 years of age or older.

In respect of 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.

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)]

• 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: 2001 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 dividend received by her after the deduction of foreign withholding taxes.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross foreign dividends (taxable and exempt)</td>
<td>R 10 000</td>
</tr>
<tr>
<td>Basic investment income exemption [section 10(1)(i)(xv)]</td>
<td>R 3 000</td>
</tr>
<tr>
<td>Foreign withholding tax payable in respect of gross foreign dividends</td>
<td>Nil</td>
</tr>
<tr>
<td>Exempt foreign dividends [section 9E(7)]</td>
<td>R 1 000</td>
</tr>
<tr>
<td>Interest income earned</td>
<td>Nil</td>
</tr>
<tr>
<td>Interest actually incurred in the production of foreign dividends</td>
<td>R 15 000</td>
</tr>
<tr>
<td>(taxable and exempt)</td>
<td></td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expenditure</td>
<td>R 15 000</td>
</tr>
<tr>
<td>Plus: Balance of interest carried forward from the previous year of assessment [section 9E(5A)(b)]</td>
<td>Nil</td>
</tr>
<tr>
<td>Total amount of interest available for deduction in the current year of assessment</td>
<td>R 15 000</td>
</tr>
<tr>
<td>Less: Allowable interest – (Deduction limited to the amount of income derived from foreign dividends – see note)</td>
<td>R 6 000</td>
</tr>
<tr>
<td>Excess interest</td>
<td>R 9 000</td>
</tr>
<tr>
<td>Less: Exempt dividends (R1 000 + R3 000)</td>
<td>R 4 000</td>
</tr>
<tr>
<td>Balance of interest carried forward to the 2002 year of assessment [section 9E(5A)(b)(ii)]</td>
<td>R 5 000</td>
</tr>
</tbody>
</table>
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)] 3 000

Income derived from foreign dividends 6 000

Interest expenditure [section 9E(5A)(a)] 6 000

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)] 3 000

Income derived from foreign dividends before deductions 6 000

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.