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SCHOOL OF ACCOUNTANCY

University of the Witwatersrand, Johannesburg

TAX DEDUCTIBILITY OF INTEREST AND FINANCE CHARGES: THE REAL COST OF CREDIT

Chantelle Haines

A research report submitted to the Faculty of Commerce, Law and Management, University of the Witwatersrand, Johannesburg, in partial fulfilment of the requirements for the degree of Master of Commerce (Specialising in Taxation)

Johannesburg, 2017

ABSTRACT

Borrowers will commonly incur various finance charges when acquiring loan funding, which may include, inter alia, interest expenditure, guarantee fees, introduction fees, commitment fees and service fees. The tax deductibility of these finance charges is an important consideration for borrowers. Prior to the amendment of the definition of 'interest' in section 24J of the Income Tax Act 58 of 1962 (as amended), related finance charges were deductible for tax purposes. The term related finance charges was interpreted very widely by the Supreme Court of Appeal in *C:SARS v South African Custodial Services (Pty) Ltd*[1] to include guarantee fees, introduction fees, commitment fees and even selected service fees. It is submitted that following the recent amendment of the interest definition by the Taxation Laws Amendment Act 15 of 2016, to now allow the deduction of 'similar finance charges' rather than 'related finance charges' the tax treatment of finance charges are uncertain. The objective of this study is to evaluate how this amendment will affect the deductibility of finance charges incurred by borrowers for tax purposes. The study proposes to first evaluate whether finance charges will be deductible in terms of section 24J, consider the definition of 'interest' and provide some general tests aimed at assessing the 'trade requirement' and the meaning of the phrase 'in production of income'. The impact of the anti-avoidance legislation in sections 8F and 8FA will be considered, and finally, a brief discussion of the deductibility of finance charges in terms of the general deduction formula in section 11(*a*) read with section 23(*g*).

Keywords: Interest deductibility, similar finance charges, related finance charges, section 24J, section 8F, section 8FA, raising fees, guarantee fees, commitment fees, general deduction formula.

[1] (2012) (1) SA 522 (SCA),

DECLARATION

I declare that this research report is my own unaided work. It is submitted for the degree of Master of Commerce at the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination in any other university.



Chantelle Haines

15 March 2018

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1. INTRODUCTION

1.1 BACKGROUND

The use of interest-bearing debt to finance specific investments is commonplace in South Africa. According to News 24[2], 'South Africans were the biggest borrowers in the world in 2014, according to a report issued by the World Bank'.

Beech and Thayser[3] state that

> …using debt instead of shareholder investments to fund the operations of a company…has numerous benefits. The key benefit to a company is that the interest payments associated with debt are deductible for income tax purposes (assuming the debt is used to fund income-generating pursuits). This is often referred to as the 'tax shield.

It is submitted here that the key benefit attributed to the use of debt funding is lost in instances where the finance charges incurred on debt funding are not deductible for tax purposes. The tax deductibility or so-called 'tax shield' provided by interest and other finance charges incurred on loan funding is therefore an important consideration for borrowers when considering whether to use debt or shareholder investments to fund the operations of a company.

Prior to the amendment of the definition of 'interest' in s 24J of the Income Tax Act, 'related finance charges' were deductible for tax purposes. The term related finance charges was interpreted very widely by the Supreme Court of Appeal (SCA) in the *South African Custodial Services* case to include guarantee fees, introduction fees, commitment fees and even selected service fees. It is submitted that following the recent amendment of the definition of interest by the Taxation Laws Amendment Act of 2016[4], to now allow the deduction of 'similar finance charges' rather than 'related finance charges' the tax treatment of finance charges is uncertain. The purpose of this study is to answer the question of how finance charges incurred by borrowers should be treated for tax purposes, following the amendment of s 24J.

The study will evaluate the specific statutory provisions that should be considered when assessing whether finance charges incurred on debt funding will be deductible and provide general guidelines on the interpretation and application of these sections. The applicable statutory provisions will be discussed in order of application, starting with

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2 News24, 2016
3 Beech & Thayser, 2015
4 Act 15 of 2016

s 24J governing the general deductibility of interest, followed by anti-avoidance ss 8F and 8FA and will lastly consider the general deduction formula contained in s 11(*a*) read with s 23(*g*).

1.2 PURPOSE STATEMENT

The purpose of this study is to answer the question of how finance charges incurred by borrowers should be treated for tax purposes, following the amendment of s 24J.

The study will evaluate the specific statutory provisions that should be considered when evaluating whether finance charges incurred on debt funding will be deductible, and provide general guidelines on the interpretation and application of these sections.

Following this, the report will consider the specific anti-avoidance legislation aimed at limiting these deductions. The applicable statutory provisions will be discussed in order of application, starting with section 24J governing the general deductibility of interest, followed by anti-avoidance sections 8F and 8FA and lastly the general deduction formula. The report will critically evaluate the legislative requirements of the Income Tax Act as it applies to finance charges incurred by borrowers by considering a number of statutory provisions as well as case law that may find application.

1.3 PROBLEM STATEMENT

Borrowers may incur various finance charges, including interest, guarantee fees, commitment fees and raising fees when obtaining debt funding. The main problem that this study will attempt to address is, how these finance charges incurred by borrowers should be treated for tax purposes?

1.4 RESEARCH SUB-PROBLEMS

A number of sub-problems will assist in attempting to answer the main research problem.

First, do finance charges constitute ‘interest’ as defined in s 24J, and to what extent can the provisions of s 24J of the Income Tax Act be applied to claim a deduction in respect of finance charges incurred by borrowers?

Secondly, where s 24J does not apply, what alternative deductions are available to the taxpayer?

Thirdly, what is the impact of ss 8F and 8FA where it is found that finance charges do constitute ‘interest’ as defined in s 24J(1) of the Income Tax Act?

Fourthly, where finance charges qualify as 'interest' as defined in s 24J, and the lender is a non-resident, will the finance charges attract Withholding Tax on Interest as envisaged by s 50A of the Income Tax Act?

1.5 IMPORTANCE AND BENEFITS OF THE STUDY

From a theoretical perspective, the proposed study initiates research around the application of basic principles governing interest deductions, but focuses on the interpretation of the term 'similar finance charges'.

The concept of 'similar finance charges' was introduced by the Taxation Laws Amendment Act of 2016[5] and is therefore new and no legal precedent exists to assist with the interpretation thereof.

From a practical perspective, the findings of this report may assist South African tax residents incurring interest and similar finance charges to comply with the Income Tax Act and claim deductions in respect of similar finance charges to which they are entitled.

1.6 RESEARCH METHODOLOGY

The research method adopted is of a qualitative, interpretive nature, based on an interpretation and analysis of the Income Tax Act, Income Tax Amendment Act of 2016, explanatory memoranda supporting the Taxation Law Amendment Bills of 2013 and 2016, interpretation notes issued by the South African Revenue Service and applicable case law.

The literature review will include reference to the following sources:

- Books
- Dictionaries
- South African Acts of Parliament
- Cases published in law reports
- Electronic resources - internet
- Journals
- Government Publications

[5] Act No. 15 of 2016

1.7 LIMITATIONS OF SCOPE

Because the tax deductibility of finance costs is determined based on the facts and circumstances surrounding a specific transaction, this study will seek to provide guidance to borrowers seeking to finance capital projects using loan funding. This study will not address finance charges incurred in the course of the trade of a moneylender as considered in *Solaglass Finance Co (Pty) Ltd v CIR*[6].

The study will not examine the tax implications of the lender as the recipient of the interest and similar finance charges.

The provisions of s 31 as they apply to interest incurred on affected transactions between connected persons are beyond the scope of this study.

The study is limited to interest and similar finance charges incurred by South African tax residents. As a result the study will not examine the impact of interest and similar finance charges incurred by non-residents. It will also not address the deductibility of interest and other finance charges incurred in respect of debt funding used to acquire share investments.

The impact of the various Double Tax Agreements (DTAs) entered into between South Africa and other countries, specifically in relation to Dividends Tax and Withholding Tax on Interest are considered to be beyond the scope of this study.

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6 53 SATC 1

2. GENERAL PROVISIONS OF SECTION 24J AND THE DEFINITION OF INTEREST

2.1 INTRODUCTION

Chapter One has motivated the need for research on deductions of interest and other finance charges incurred. This chapter provides an understanding of the background of s 24J as it applies to interest and other finance charges. It also provides an understanding of the concepts 'instrument' and 'interest' used in s 24J. This chapter further seeks to explore the definition of 'interest' as included in para (a) of s 24J(1).

2.2 APPLICATION OF SECTION 24J

Section 11(*a*) read with s 23(*g*) of the Income Tax Act is commonly referred to as the 'general deduction formula'. This general deduction formula provides the basic guidelines that may be used by taxpayers to claim tax deductions. The Income Tax Act does, however, also contain specific provisions which are tailored to the deduction of particular expenditures.

By applying the generalia specialibus non derogant maxim, it is submitted that the provisions of the general deduction formula must yield to specific provisions providing for the deduction of expenditure. Section 24J is one such specific provision, which intends to allow taxpayers a deduction for interest expenditure incurred irrespective of whether the interest would qualify as a deduction under the general deduction formula.

The provisions of s 24J are complex and involve a number of defined concepts. The interpretation of these concepts influences the timing and calculation of the interest deduction. These defined concepts, as they apply to the study, will be explored throughout the remainder of this study.

As stated in Chapter One, this study is intended to provide guidance to the borrower incurring interest and other finance charges. Accordingly, the provisions of s 24J will be considered from the perspective of the borrower, or the 'issuer' as defined in that section. Section 24J contains separate provisions dealing with the tax position of the 'issuer' and the 'holder' respectively. The definition of the 'holder' of the instrument and the tax position of the 'holder' is beyond the scope of this study.

The issuer in relation to any instrument is defined in s 24J(1) to mean

(a) any person who has incurred any interest or has any obligation to repay any amount in terms of such instrument; or

(b) at any particular time, means any person who, if any interest payable in terms of such instrument was due and payable at that time, would be liable to pay such interest.

In other words, the issuer in relation to any instrument is the person incurring the interest, and ultimately the person seeking to claim a deduction in respect of the interest incurred.

While it is fairly straightforward to conclude whether a taxpayer will be classified as the issuer for purposes of s 24J by virtue of the fact that he has a contractual obligation to incur interest, repay an amount borrowed or to pay interest due and payable, the consequential application of s 24J(1) is founded on the definition of 'instrument'[7]. It seems that it would be necessary to determine what is meant by the term 'instrument' before proceeding to assess whether the interest and finance charges will be deductible.

Section 24J(1) defines the term 'instrument' to mean

(c) any interest-bearing arrangement or debt;
(d) any acquisition or disposal of any right to receive interest or the obligation to pay any interest, as the case may be, in terms of any other interest-bearing arrangement; or
(e) any repurchase agreement or resale agreement,

which was—

i. issued or deemed to have been issued after 15 March 1995;
ii. issued on or before 15 March 1995 and transferred on or after 19 July 1995; or
iii. in so far as it relates to the holder thereof, issued on or before 15 March 1995 and was unredeemed on 14 March 1996 (excluding any arrangement contemplated in subparagraphs (i) and (ii)),

but excluding any lease agreement (other than a sale and leaseback arrangement as contemplated in section 23G) or any policy issued by an insurer as defined in section 29A.

It is submitted that the essence of the concept of 'instrument' is contained in the phrase 'interest-bearing arrangement or debt' in para (*a*). The extension of the definition of instrument to include any right to receive interest or the obligation to repay interest, as well as the inclusion of a repurchase or resale agreement, is beyond the scope of this study. Accordingly, for the purpose of this study the focus will be on whether a borrower incurring interest and other finance charges can be said to have incurred interest in respect of an interest bearing arrangement debt. In order to achieve this, this phrase will be considered in two parts – first interest-bearing arrangement, and secondly debt.

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7 Commentary on Income Tax, 2017, at Part I Normal Tax (ss 5-37H) - 24J Incurral and accrual of interest

2.2.1 DEFINING THE TERM 'INTEREST-BEARING ARRANGEMENT'

The term 'interest bearing arrangement' is not defined in the Income Tax Act. It is therefore necessary to consider the ordinary meaning thereof. This will be done by first assessing what an 'arrangement' is, and then considering what is meant by 'interest bearing'.

The normal meaning of 'arrangement' is very wide and is defined in the Oxford Dictionary[8] to mean *'an agreement with someone to do something'*.

The Free Dictionary[9] further defines this term to include, amongst others,

> a conception, schema, scheme, system, agreement, compact, compromise, contract, mutual agreement, mutual assent, mutual promise, mutual undertaking, pact.

It is submitted that wherever there is an agreement between a debtor and creditor giving rise to debt funding, there should be an arrangement in place, regardless of the terms thereof.

When considering whether an arrangement can be said to be interest-bearing, it is necessary to consider what the term 'interest' entails. In *Taxation Principles of Interest and other Financing Transactions,* Brincker[10] states that[11]

> It seems that the concept of an interest bearing arrangement should be determined with reference to the definition of interest, and that it should thus be confined to the types of transaction envisaged in that definition.

This means that wherever an expense is incurred in respect of an 'arrangement', which expense would meet the definition of 'interest' contained in s 24J and discussed in detail in Chapter Three, this arrangement can be said to be interest bearing.

Although the term 'interest' is defined in s 24J, and the definition is fairly complex, it is submitted that any loan on which normal common law interest is payable, can be said to be interest bearing. Accordingly, debt financing obtained from an independent third party would ordinarily attract interest, and would therefore qualify as 'interest bearing'. Where 'interest-free' debt financing is obtained, the taxpayer should consider whether the financing could qualify as 'debt' as per the discussion below.

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8 OED Online, 2017, at 'arrangement'
9 Farlex Inc, 2013, at 'arrangement'
10 Brincker, 2004, pp. V-13
11 Brincker, 2004, pp. V-13

2.2.2 DEFINING THE TERM 'DEBT'

The second part of the definition of instrument refers to any debt. 'Debt' is not defined for income tax purposes and should therefore be interpreted based on its ordinary meaning. The Oxford Dictionary[12] defines debt as 'a sum of money that is owed or due'.

Accordingly, debt is regarded as an obligation between two parties, and it is submitted that debt includes any obligation, whether it is interest bearing or not. At first glance, one may assume that interest-free loans are not regarded as an 'instrument' for purposes of s 24J, but this may not always be the case. In instances where interest-free loans are acquired at a premium or discount, it is submitted that these loans may be regarded as an instrument for purposes of s 24J[13]. The application of s 24J to interest-free debt is considered to be beyond the scope of this study.

The phrase 'interest bearing arrangement or debt' appears to then encompass virtually all interest-bearing agreements between parties, and it is submitted that the inclusion of the term 'debt' will extend its application to all obligations, whether interest bearing or not.

For the purpose of this study, the focus will be on interest incurred in respect of ordinary loan funding acquired by a borrower. It is submitted that this form of funding will fall within the definition of instrument as discussed above. The interpretation of subsections (*d)* and (*e)* of the definition of instrument is beyond the scope of this study.

It is submitted that based on this analysis, where a taxpayer obtains loan funding to finance an investment in a capital asset, the taxpayer will qualify as an issuer of an instrument.

Once it is concluded that a person qualifies as an issuer of an instrument, the deduction of interest is governed by the provisions contained in s 24J(2):

> Where any person is the **issuer** in relation to an **instrument** during any year of assessment, such person shall for the purposes of this Act be deemed to have incurred an amount of **interest** during such year of assessment, which is equal to—
>
> (a) the sum of all accrual amounts in relation to all accrual periods falling, whether in whole or in part, within such year of assessment in respect of such instrument; or
> (b) an amount determined in accordance with an alternative method in relation to such year of assessment in respect of such instrument,

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12 Oxford University Press, 2017, at 'debt'
13 Brand, A. 2010.

> which must be deducted from the income of that person derived from **carrying on any trade**, if that amount is incurred in the **production of the income**.

It follows that the deduction provided for in s 24J(2) will available only in respect of 'interest' incurred. A taxpayer therefore has to consider whether finance charges incurred during a year meet the definition of 'interest'. This definition will be explored in the remainder of this chapter.

For purposes of this study, the mechanics around the calculation of the amount of interest to be deducted in terms of s 24J of the Income Tax Act are not considered. Suffice to say that the section spreads the interest deduction over the term of the loan on a yield to maturity basis, even if the interest is capitalised and not actually paid unless the taxpayer selects to determine the interest to be deducted in accordance with an alternative method in respect of such instrument.

An alternative method refers to a method of calculating interest for a specific class of instruments which conforms to generally accepted accounting practice, is consistently applied to all such instruments and achieves a result a similar result as would be the case where the yield to maturity method has been applied. The application of an alternative method is also considered to be beyond the scope of this study.

2.3 THE DEFINITION OF INTEREST

The definition of 'interest' as included in para (*a*) of s 24J(1) will now be explored. Since the thrust of the section is the deemed incurral and accrual of interest, this definition is of fundamental importance[14]. 'Interest' is defined in s 24J(1) to include, the following:

> (a) gross amount of any interest or similar finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement;
> (b) …
> (c) …
> irrespective of whether such amount is—
> i. calculated with reference to a fixed rate of interest or a variable rate of interest; or
> ii. payable or receivable as a lump sum or in unequal instalments during the term of the financial arrangement.

From the above, it can be deduced that for an amount to constitute 'interest' in the context of s 24J, it must constitute, *inter alia*, one of the following:

- interest;
- similar finance charges; or

[14] Juta's Commentary on Income Tax, 2017.

- a discount or premium payable or receivable in terms of a financial arrangement[15].

For purposes of this study, only the words 'interest' and 'similar finance charges' as used in s 24J's definition of 'interest' will be discussed in more detail.

This chapter first explores the meaning of interest and subsequently investigates the meaning of the phrase 'similar finance charges'. The term 'similar finance charges' is not defined in the Act, nor is there any case law having a particular bearing on this term in the context of s 24J. Therefore, the ordinary and common law meaning of the term will be investigated. In support of the meaning of the term, this study will also analyse the ambit of related finance charges as interpreted by the Supreme Court of Appeal (SCA) in *CSARS v South African Custodial Services (Pty) Ltd*[16]. The interpretation by the SCA will be explored, and then contrasted with SARS's policy position, in respect of raising fees, guarantee fees, commitment fees as well as legal and related service charges.

2.4 THE CONCEPT OF INTEREST

Although the definition of interest in s 24J is extensive, it is not exhaustive. In addition, it is also important to note that the definition of interest in s 24J circularly includes the word *interest*, and therefore does not ascribe any specific meaning to this word. The term interest is also not further defined in any other section of the Act. According to ENSafrica[17]:

> In everyday language, one can correctly state that interest is not the only cost of credit, and that instead, the cost of credit further includes other types of finance charges, such as commitment fees and arrangement fees. However, in the context of section 24J, the accuracy of such a statement, which assumes that there is a clear distinction between 'interest' and such other finance charges as commitment fees and arrangement fees, depends on how wide the parameters of the notion of 'interest' are.

It is submitted here that, to establish how wide the parameters of the notion of interest are, the definition of interest should be subjected to further interpretation. Based on the 'golden rule' in interpreting statutes as set out in Venter v R[18]

> … the most important (golden) rule of statutory construction is to ascertain the intention of the legislature. This was to be done by taking the language of the instrument, or of the relevant portion of the instrument as a whole and where the words are clear and unambiguous to place upon them their grammatical construction and to give them their ordinary effect. Under certain circumstances it would, however, be permissible to depart from the ordinary meaning of the words…

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15 ENSafrica, 2016
16 74 SATC 61 (SCA)
17 ENSafrica, 2016
18 (1907) TS 910 at 913

The literal rule of statutory interpretation will first be applied. The word interest must be given its ordinary meaning, provided that such ordinary meaning does not lead to an absurdity so glaring that it could not have been intended by the Legislature.

In determining the ordinary meaning of a word, a court will normally have recourse to dictionaries. In this regard, the Shorter Oxford English Dictionary (6ed) defines the word 'interest' as '*money paid for the **use of money** or for the forbearance of a debt'*[19].

This definition is in line with the common law definition attributed by the South African courts.

In ITC 1496[20] and ITC 1587[21] interest is defined as

> an expense to compensate a lender for the time period during which the money is lent to a second party.

In *Riches v Westminster Bank Ltd*[22], Lord Wright described the essential nature of interest in a manner broadly applicable to all payments received for the use of money:

> …the essence of interest is that it is a payment which becomes due because the creditor has not had his money at the due date. It may be regarded either as representing the profit he might have made if he had the use of the money, or, conversely, the loss he suffered because **he had not that use**. The general idea is that he is entitled to compensation for that deprivation.

In *Bennett v Ogston*[23], interest was defined as

> a payment by time **for the use** of money lent, calculated by reference to the principal sum lent.

It is held in the above case that, where a lender makes money available to a borrower, the lender will be compensated by a charge made, which is normally expressed as a percentage of the loan amount outstanding, which for the purposes of this report will be termed 'pure interest'. It is here submitted that this 'pure interest' charged on loan funding is clearly compensation for the use of funding, and would therefore qualify as interest for purposes of s 24J. Furthermore, it is submitted that 'pure interest' is what is being referred to in s 24J(1), as a circular reference in the definition of interest.

Based on the analysis of the common law meaning of interest, it appears that to the extent that the interest rate, and accordingly the interest charge incurred by a borrower,

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19 ENSafrica, 2015b
20 (1991) 53 SATC 229 at 249
21 (1995) 57 SATC 97 at 105
22 (1947) 1 All ER 467 at 472
23 (1930) 15 TC 374, 379

is compensating the finance provider for the use of money, it will constitute interest as envisaged by s 24J of the Act.

In conclusion, it is submitted that pure interest will meet the definition of 'interest' as envisaged by s 24J(1). The term 'similar finance charges' as included in the definition of interest in s 24J(1) will now be explored.

2.4.1 SIMILAR FINANCE CHARGES – THE ORDINARY MEANING

The definition of 'interest' in s 24J as contained in section 2.3 above, includes 'similar finance charges'. The term 'similar finance charges' is not defined in the Act, nor is there any case law with a particular bearing on this term in the context of s 24J. Therefore, according to the literal approach to statutory interpretation explained above, the term must be given its ordinary dictionary meaning.

The dictionary does not contain a definition for 'similar finance charges'. This study will therefore attempt to attribute a meaning to 'finance charge', and then assess how the addition of the word 'similar' affects this meaning.

The *Dictionary of Banking Terms*[24] defines the term 'finance charge' as

> The borrower's total cost of credit, including loan interest, commitment fees, and prepaid interest, in a consumer loan.

A Dictionary of Accounting[25] further defines a 'finance charge' as

> A charge levied for the benefit of being able to delay payment of a sum due.

As is evident from the definitions of 'finance charge' included above, financial institutions may charge an array of fees for the use of credit, which extends beyond 'pure interest'. These fees may compensate financial institutions for the services rendered *in lieu* of the loan as well as the use of funds provided.

The question arises whether any of these fees may be claimed as a deduction by virtue of the fact that they qualify as 'similar finance charges', as envisaged in para (*a*) of the definition of interest as included in s 24J(1) of the Income Tax Act included above. The deductibility of other finance charges will hinge solely on the interpretation of the word 'similar' included in the definition of 'interest' in the Income Tax Act.

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24 Fitch, TP., 2012, 'finance charge'
25 Law, J., 2016, 'finance charge'

The common law meaning of similar can be found in *SAR&H v Town Council of Springs*[26]:

> A thing is 'similar' to another if without being identical with it, there is a resemblance in some relevant respect

The Oxford Dictionary[27] further defines 'similar' as '*having a resemblance in appearance, character or quantity, without being identical*'. This means that finance charges having a resemblance in appearance, character or quantity to pure interest, without being identical to pure interest, will be regarded as similar finance charges and may be claimed as a deduction in terms of s 24J. It is submitted that at the very least the finance charges must compensate the lender for the use of money and not for services rendered.

Based on the literal approach, finance charges that resemble interest in some relevant respect would qualify as 'similar finance charges' and consequently meet the definition of interest in s 24J. It is submitted that assessing whether a finance charge resembles interest in some relevant respect is subjective, the meaning of the phrase 'similar finance charges' is still rather imprecise.

It is held that the literal interpretation does not provide much clarity on the intended meaning of the phrase 'similar finance charges' used in the Income Tax Act. Accordingly, in addition to the literal approach, we also consider precedents laid down in case law.

2.4.2 SIMILAR FINANCE CHARGES – THE COMMON LAW MEANING

There are no legal precedents which specifically define '*similar finance charges'*.

Prior to the amendment of s 24J by the Taxation Laws Amendment Act 2016[28], the definition of interest referred inter alia to '***related*** *finance charges*' as opposed to '***similar*** *finance charges.'*

Because the word 'related' has now been substituted by the word 'similar', it would be necessary to further explore the purpose of the amendment made by the legislator.

The change in s 24J has left taxpayers in an unenviable position in that uncertainty has been created regarding whether or not finance charges incurred and deemed to be

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26 1949 2 SA 34 (T)
27 Oxford University Press, 2017, 'similar'
28 Act 15 of 2016

deductible in terms of the *CSARS v South African Custodial Services* case are deductible or not for income tax purposes.

Understanding the purpose of the change, why it was enacted and how it came to be, is essential in establishing its meaning.

According to Edward Nathan Sonnenbergs[29]:

> When considering the weight that should be attributed to the above-mentioned quote from the Explanatory Memorandum, statements made in the Explanatory Memoranda have historically been inadmissible as evidence of legislative intent. However there is recent authority that one may in certain circumstances have regard to Explanatory Memoranda (see Chaskalson CJ's judgment in the *Minister of Health and Another No v New Clicks South Africa (Pty) Ltd and Others (Treatment Action Campaign and Another as AMICI CURIAE) [2006] (2) SA 311 (CC) at 391)*… in recent years courts have placed emphasis on the purpose with which the Legislature has enacted the relevant provision. The interpreter must endeavour to arrive at an interpretation which gives effect to such purpose. The purpose (which is usually clear or easily discernible) is used, in conjunction with the appropriate meaning of the language of the provision, as a guide in order to ascertain the legislator's intention

The Explanatory Memorandum on the Taxation Laws Amendment Bill of 2016 (hereinafter the 2016 Explanatory Memorandum)[30] states that the purpose of this amendment is to '*clarify the policy position that s 24J applies to finance charges of the same kind or nature as interest*'.

The stated purpose remains vague and does not provide much assistance in interpreting the ambit of 'similar finance charges'. Although it may be argued that the purpose of the amendment appears to be to narrow the ambit of finance charges which will be regarded as interest, the interpretation of 'related finance charges' prior to the amendment promulgated in the Taxation Laws Amendment Act of 2016; as well as SARS's policy position will be explored to obtain more clarity on the purpose of the amendment.

2.4.3 RELATED FINANCE CHARGES - THE SOUTH AFRICAN CUSTODIAL SERVICES[31] CASE

The ambit of related finance charges was interpreted by the Supreme Court of Appeal (SCA) in the *South African Custodial Services* case. The interpretation by the SCA will be explored, and will then be contrasted to SARS's policy position.

South African Custodial Services (hereinafter SACS) was a joint venture between a South African company, Kensani Consortium (Pty) Ltd (hereinafter Kensani), and the

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[29] Edward Nathan Sonnenbergs. 2011.
[30] National Treasury, 2016
[31] (2012) (1) SA 522 (SCA), 74 SATC 61

GEO Group, an American entity that specialised in the operation of correctional, detention and health facilities throughout the world. SACS concluded a concession contract with the Minister of Correctional Services in terms of which it would design, construct and operate a prison in Louis Trichardt with a projected life of 25 years.

SACS financed this project and other obligations arising from the concession contract by entering into various loan agreements with banks. The total sum of the capital advanced amounted to R384 000 000. The banks required security, which was provided as guarantees by the shareholders of SACS and the government of South Africa. In terms of a guarantee and put agreement, SACS was required to pay a company in the group providing the guarantee, Wackenhut Corrections Corporation (Wackenhut) what was termed a guarantee fee of R15 561 131. Later, during the tendering stage, SACS was required to pay a bid guarantee fee to its financial advisor, African Merchant Bank (AMB) of R77 333. The guarantee fees thus totalled R15 638 464. Kensani was unable to provide a guarantee in the same way. Instead, it advanced a loan to SACS equivalent to the liability guaranteed by Wackenhut. In consideration for this, SACS agreed to pay Kensani an introduction fee of R47 484 608. Additionally, in consideration for the financial advisory services provided to SACS by AMB, SACS agreed to pay AMB a financial advisory fee of R6 209 274, as well as a margin fee of R2 545 077 in respect of its negotiations for loans with BoE Merchant Bank and First Rand Bank.

In addition, SACS was obliged to pay a commitment fee and an initial fee to BoE Merchant Bank and First Rand Bank, administration fees to First Rand Bank and legal fees to its attorneys, Deneys Reitz. It also incurred interest on the loan facilities.

The deductibility of the interest and other finance charges incurred was one of the issues concerning the court of appeal. As to the deductibility of the interest and other charges, the court held[32]:

> (x) That the interest that SACS had incurred was deductible in terms of s 11(*bA*) of the Act as it had been 'actually incurred' by SACS on its loans from BoE Merchant Bank and First Rand Bank to pay CGM for the construction of the prison.
>
> (xi) That the various fees were also deductible in terms of s 11(*bA*) of the Act because of their close connection to the obtaining of the loans and the furtherance of SACS's project and they qualified as 'related finance charges' for purposes of the section.
>
> (xii) That the assessment is referred back to the Commissioner for him to determine the precise amount that is deductible from the Appellant's income in terms of s 11(*bA*) of the Act in the light of the principle set out in Caltex Oil (SA) Ltd v SIR

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32 74 SATC 61 (SCA) at 65

> 37 SATC 1 that the interest and fees had to have been actually incurred during the year of assessment in which the deduction was sought'.

It is clear that the court held that all of the various fees incurred would qualify as 'related finance charges' for purposes of s 11(*b*A) of the Income Tax Act.

The various fees incurred by SACS and described above included:

(a) Guarantee fees paid to Wackenhut and AMB in exchange for guarantees provided as security for the loan;
(b) Introduction fees paid to Kensani in exchange for the loan advanced as security for the loan;
(c) Financial advisory and margin fees to BoE Merchant Bank and First Rand Bank in respect of its negotiations for loans;
(d) Commitment fees to BoE Merchant Bank and First Rand Bank;
(e) An initial fee to BoE Merchant Bank and First Rand Bank;
(f) Administration fees to First Rand Bank; and
(g) Legal fees to SACS's attorneys, Deneys Reitz.

Accordingly, the SCA held that

> all of these related finance charges should be treated as deductible expenditure for the purpose of s 11(bA) because of their close connection to the obtaining of the loans and the furtherance of SACS's project.

This interpretation by the SCA is very comprehensive, and even went so far as to include administration fees and legal fees paid to the attorneys for drafting the legal agreements as part of 'related finance charges'.

Although s 11(*b*A) was deleted from the Act with effect from 1 January 2012, it is appreciated that s 24J previously defined the concept of interest to include 'related finance charges', which wording can be compared to the wording used in s 11(*b*A). The now repealed s11(*bA)* read as follows (prior to its repeal):

> For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived:
>
> (bA) any interest (including related finance charges) which is not otherwise allowable as a deduction under this Act, which has been actually incurred by the taxpayer on any loan, advance or credit utilised by him for the acquisition, installation, erection or construction of any machinery, plant, building, or any improvements to a building…to be used by him for the purposes of his trade, and which has been so incurred in respect of a period prior to such machinery, plant, building, improvements…being brought into use for the purposes of the taxpayer's trade, such deduction to be allowed in the year of assessment during which such machinery, plant, building, improvements…is or are brought into use for the said purposes.'

Even though the court specifically interpreted 'related finance charges' in the context of the now repealed s 11(*b*A), it is submitted that, in accordance with the legal precedent '*stare decisis'*, statutes should be interpreted according to legal precedent. For that reason it is submitted that the legal precedent set in the *South African Custodial Services* case would remain valid when interpreting the phrase 'related finance charges'.

Consequently guarantee fees, introduction fees, financial advisory and margin fees, commitment fees, initial fees, administration fees and even legal fees would qualify as 'related finance charges' as envisaged by section 24J and the issuer of an instrument will therefore be entitled to claim a deduction in respect of these fees incurred, in line with the provisions of s 24J(2) on an accrual basis.

Respectfully, this interpretation by the SCA appears unreasonably comprehensive. It may be argued that the judgement by the SCA appears contrary to existing SARS interpretation, partly motivating the amendment to the definition of 'interest' as explained above. SARS' interpretation is considered below.

2.4.4 RELATED FINANCE CHARGES AND SARS's POLICY POSITION

Notwithstanding the interpretation of the court that upfront raising fees (introduction and initial fees), guarantee fees, commitment fees, and service fees (financial advisory and margin fees, administration fees and legal fees) all qualify as deductible related finance charges, SARS's view on what constitutes deductible related finance charges is documented in the Income Tax Practice Manual[33].

In summary, in SARS' view documented in the Income Tax Practice Manual, where finance charges are incurred, the nature thereof should be investigated in order to determine the deductibility, rather than claiming a deduction in respect of these fees based merely on their close connection to the loan funding incurred. Various other tax experts have also addressed this subject and their views are considered below.

2.4.4.1 UPFRONT RAISING FEES

SACS incurred various upfront initial fees and introduction fees to BoE Merchant Bank, First Rand Bank and Kensani respectively. These fees appear to be payable upfront by SACS to the financiers in exchange for making funds available to them.

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[33] Zulman, R.H., Stretch, R., & Silke, J. 2013 at [A:D10] Deductions – Raising fees – Section 11(*b*A) and Section 11(*b*B). & [A:R2] Raising fees – Deduction

It is submitted that the nature of initiation fees and introduction fees paid by SACS appear to be akin to raising fees. The term 'raising fee' is not defined in the Income Tax Act and no section in the Income Tax Act refers directly to raising fees. The nature of raising fees was described by De Jager[34]:

> Especially in times when loans are hard to come by, borrowers find themselves in the unenviable position that they are required to pay raising fees or commissions to persons or institutions *for the service of introducing borrowers to would be lenders*, the raising fees being payable only in the event of an agreement of loan being concluded.

As stated earlier, the SCA allowed both the initiation fees and introduction fees as a deduction 'because of their close connection to the obtaining of the loans[35].' The judgment by the SCA appears to be contrary to the existing SARS practice, and it is submitted that even prior to the amendment of the definition of interest in 2016, income tax experts held differing views on the income tax deductibility of raising fees.

This study will now attempt to define raising fees, and consider whether these fees can be said to constitute 'similar finance charges'.

According to Barkhuizen & Willemse[36]:

> Raising fees can take the form of a percentage of a loan or a fixed amount.

In *CIR v Genn & Co*[37] it was held by the Appellate Division that because no distinction in principle could be made between the interest paid to the actual lenders of the moneys borrowed and the raising fees paid to the company which arranged the loans; the raising fees should be deductible:

> It was not possible to differentiate between the interest on the loans and the commissions (raising fees) in effect they formed one consideration which the company had to pay for the use of the money for the period of the loan, and the principles to be followed were equally applicable to both.

The salient facts in the *Genn & Co* case were that the company had deducted commissions (called 'raising fees') and interest incurred on loans from a trust and an investment company to finance stock in trade. Genn & Co informed the trust and the investment company that it was willing to pay 10% per annum interest on loans, which included raising fees. The investment company then arranged a loan at 8%, and the raising fee was the difference between the two

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34 De Jager, 1988, p 1
35 74 SATC 61 (SCA) at 65
36 Barkhuizen & Willemse. 2015 at 649.
37 1955 (3) SA 293 (A), 20 SATC 113 at 119

rates of interest (10% minus 8%), calculated on the sum advanced over the period of the loan. It appears that the raising fees, in this specific case, was directly proportionate to the amount of the loan outstanding and the period of the loan.

In the *Genn & Co* case, the court found that the raising fees were deductible

> on the basis that it was not possible to differentiate the interest from the raising fees

and therefore this case does not provide authority for the deduction of raising fees in all circumstances.

In the *Income Tax Practice Manual*[38] the following principles are enunciated:

> i. Raising fees (which appears to be similar in nature to the introduction fees paid by SACS) is a cost of *raising capital* and whilst interest is a payment for the use of capital.
> ii. A raising fee is a once-off payment whilst interest is normally a recurring payment.
> iii. Interest is calculated by reference to time whilst a raising fee is usually unrelated to time.
> iv. Interest, even pre-production interest, is not an expense of a capital nature because of its recurring nature (see SA Tax Journal Vol2 No1: "The Deductibility of Raising Fees" by Theo de Jager).
>
> Accordingly, the view is held that raising fees are either not a finance charge, or alternatively not a related finance charge within the context of s 11(bA) of the Act. Assessors and auditors must therefore not allow such amounts as a deduction'.

It appears that even in the extract from the *Income Tax Practice Manual* included above, no conclusion is reached as to whether raising fees are even considered to be finance charges. Having regard to the definition of '*finance charge'* set out above, it is submitted that raising fees would generally not be regarded as a finance charge based on the following factors:

- Raising fees are ordinarily directly linked to the advancement of the loan.
- Raising fees are paid as compensation for the borrower's use of money advanced by the lender.
- The raising fees have to be incurred in order for the borrower to receive the funds in question.
- The raising fees are ordinarily part of the total costs factored in by the financier for the loan funding provided.

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[38] Zulman, R.H., Stretch, R., & Silke, J., 2013 at [A:D10] Deductions – Raising fees – Section 11(*b*A) and Section 11(*b*B)

It is submitted that these principles, which conclude that raising fees do not constitute related finance charges, are contrary to the findings by the SCA.

As mentioned above, the explanatory memorandum specifically stated that the purpose of the amendment to the Income Tax Act per the 2016 Explanatory Memorandum[39]was to

> clarify the policy position that section 24J applies to finance charges of the same kind or nature as interest'.

It is submitted that based on the principles in the Income Tax Practice Manual above, SARS's policy position contends that raising fees of the same kind or nature as interest will exhibit the following characteristics:

- The fees will be paid as compensation for the use of capital and not the acquisition of capital.
- The payment of the raising fees will be recurring.
- The calculation of the raising fees will be with reference to the time value of money and the amount outstanding.

It is submitted that these characteristics can be used to formulate a basis for an inquiry into the nature of finance charges, and specifically raising fees, with the intention of evaluating whether these constitute 'similar finance charges' deductible in terms of the provisions of s 24J(2), regardless of what the type of finance charge incurred per the finance agreement. This is supported in *Juta's Commentary on Income Tax*[40] in the phrase 'similar finance charges':

> This term is not defined and takes the normal meaning, which is any kind of charge levied, irrespective of name, with the intention, and having the effect, of raising the effective interest burden on the transaction as a whole. The charge must be similar to the amount concerned, and the time period for which interest will be paid.

It may be argued that similar finance charges will include only recurring finance charges, paid as compensation for the use of capital and calculated with reference to the loan period and the outstanding loan amount.

Furthermore, it is submitted that where finance charges, and particularly raising fees, do not constitute 'similar finance charges' and can therefore not

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39 National Treasury, 2016
40 Davis et al. 2017.

be said to be interest as envisaged by s 24J, the normal requirements of the general deduction formula should be considered to determine the deductibility thereof. Please refer to Chapter Five for a detailed discussion of this analysis.

2.4.4.2 UPFRONT RAISING FEES – THE ALTERNATIVE VIEW

Based on the fact that the term 'similar finance charge' is not defined in the Income Tax Act, nor is there any case law with a particular bearing on this term in the context of s 24J, it is submitted that there is uncertainty with regards to the nature of similar finance charges.

Accordingly, arguments may be presented in support of the fact that raising fees may qualify as similar finance charges, regardless of the fact that these are payable upfront.

The first argument that may be presented is that raising fees are merely a part of the total compensation payable for the use of capital. It is submitted that the receipt of raising fees is often a prerequisite for the lender, and that these fees have to be received to enable the lender to advance the funds to the borrower. The raising fees therefore form a part of the total cost of the loan, creating a direct link between the raising fees and the *use* of the loan capital.

In addition, it may be argued that where raising fees are quoted as a percentage of the loan amount advanced, the raising fees are calculated as part of the total compensation payable by the borrower to the lender. It may be contended that the raising fees are not independent of the interest payable, but rather part and parcel of the total interest payable to the lender. It may be argued that on this basis had the terms of the loan agreement been structured differently, the raising fees could be eliminated, resulting in a higher interest rate over the period of the loan agreement. Comparing the two alternatives reveals that the interest incurred on the loan funding would have been more expensive for the borrower, had it not been for the raising fees. On this basis, it may be argued that the raising fees are merely a component of interest payable by the borrower, and are determined with reference to a specified rate of interest.

In addition, it may be argued that the payment of the raising fee is determined with reference to the time value of money, in that the lender requires initial early compensation for the use of the loan funding, and that raising fees paid on a once-off basis do not detract from the fact that the raising fees compensate the lender for the time value of money. This argument is in line with the proviso

contained in the definition of interest, which state that interest is defined irrespective of whether the amount is payable or receivable as a lump sum.

Whilst it is agreed that uncertainty exists around the interpretation of the phrase ‘similar finance charges’ by virtue of the fact that the phrase is not defined in the Income Tax Act, nor is there any case law with a particular bearing on this term in the context of s 24J, it is submitted that this alternative argument is flawed based on two observations.

The first observation is that this view argues that raising fees are payable for the use of capital. It is submitted that the raising fees are payable rather to the lender to compensate him for making loan funding available.

The second observation is that upfront raising fees are payable in full at the commencement of the loan term, irrespective of how much money is in fact utilised, and irrespective of the loan term. This can be contrasted with interest, which is payable and dependent on the amount of money utilised by the borrower, as well as the loan term. It is submitted that the difference between upfront raising fees, payable in full at the commencement of the loan term and interest, payable dependent on the amount of money utilised and the loan term, is so material that it is not reasonable to conclude that upfront raising fees are so closely related to interest that they would constitute ‘similar finance charges’.

It is accepted however that this alternative argument may also contain merit leading one to conclude that the upfront raising fees would constitute ‘similar finance charges’ and consequently ‘interest’ as defined in s 24J. This conclusion necessitates the consideration of the potential impact of the application of s 8FA, as it applies to ‘interest’ as defined in s 24J of the Income Tax Act. Please refer to Chapter Four hereof for a detailed discussion of the potential impact.

2.4.4.3 GUARANTEE FEES

The second type of expenditure allowed as a deduction by the SCA in the *South African Custodial Services* case, by virtue of the fact that these expenses constitute related finance charges are guarantee fees. As with raising fees, however, it will first be necessary to understand what guarantee fees are, and what they are compensating the lender for, prior to assessing whether they resemble interest.

The Dictionary of Legal Words and Phrases[41] defines a guarantee as follows:

> The word is capable of a number of meanings, but the ordinary meaning is to assure a person of the receipt of possession of something" (per GREENBERG, J in *Walker's Fruit Farms Ltd v Sumner* 1930 TPD 398). This word held use in the sense of a promise to pay in a certain event.

A guarantee fee is therefore paid to the guarantor as compensation for the promise to assume the debt obligation of the borrower in the event of a default. It is submitted that it is common cause that guarantee fees are paid as compensation for a guarantee provided by the guarantor of the loan, and not directly to the lender. The question then arises whether it can be argued that the guarantee fees are closely related to the loan funding advanced.

The description of 'similar finance charges' as a charge for the use of credit entails that at the very least, there must be a factual causal link between the obligation to pay the amount in question and the extension of credit by the lender. This means that one must be able to say that as a matter of fact, the borrower would not have incurred the obligation to pay the guarantee fees but for the lender's extension of credit.

The findings in the *South African Custodial Services* case supports the contention that the guarantee fees are closely related to the loan amount and that a factual causal link exists between the obligation to pay and the extension of credit[42]:

> (xi) That the various fees were also deductible in terms of s 11(*bA*) of the Act because of their close connection to the obtaining of the loans and the furtherance of SACS's project and they qualified as 'related finance charges' for purposes of the section.

It is submitted that the *causa* for the guarantee fees usually relate to the provision of the loan, and hence the guarantee fees arise only because of the loan. It is further submitted that the fact that the guarantee fee may be payable in terms of a separate contractual agreement, does not, detract from the connection between the loan and the guarantee, and therefore it is concluded that the guarantee fees are closely related to the loan funding obtained.

Accordingly, it is submitted that the test formulated to ascertain whether finance charges constitute 'similar finance charges' in the above discussion on

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41 Claassen, RD, 2017 at 'guarantee'
42 74 SATC 61 (SCA) at 65

raising fees may again be applied to evaluate whether guarantee fees would constitute 'similar finance charges' as envisaged by 24J, and accordingly constitute interest as defined.

Furthermore it is submitted that guarantees may relate to the repayment of a loan or alternatively to the acquisition of assets. If it relates to the acquisition r assets, it may be argued that the fees may be deducted on a similar basis to a normal insurance premium. However, if the guarantee relates to the repayment of a loan, the position may well be similar to a raising fee. The argument may be enhanced by virtue of the fact that one pays an insurance premium (relating to the repayment of the loan) as opposed to a raising fee or a commitment fee that relates to the acquisition of the loan. If the wording of the guarantee makes reference to the delivery of assets, the argument is enhanced that the guarantee fee may relate more to the acquisition of the asset as opposed to the raising of the loan funding.

Where it is concluded that the guarantee fee relates to the repayment of a loan and the position is similar to a raising fee, the same principles considered when assessing the deductibility of raising fees will apply. The principles documented in the Income Tax Practice Manual:[43] dealing specifically with guarantee fees are as follows:

> - Where a fee for guaranteeing a loan partakes of the nature of interest in that it is a **regular and recurring** liability **dependent upon the amount of the loan** outstanding, it is a necessary concomitant expense incurred in the production of income and is allowable. (Unreported case.)
> - The position is different, however, if the guarantee fee is a single payment made when the loan is granted. In such a case the payment is another expense incurred in connection with the raising of the loan and as such is of a capital nature and not allowable

Therefore, to the extent that the guarantee fees:

- will be paid as compensation for the use of capital and not the acquisition of capital;
- will be recurring;
- will be calculated with reference to the time value of money;

it is submitted that these fees should be deductible in terms of s 24J.

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43 Zulman, R.H., Stretch, R., & Silke, J. 2013 at [A:R2] Raising fees – Deduction

Again, the principles documented in the Income Tax Practice Manual as SARS's practice view, appears to be in contrast to the legal precedent set by the SCA, where the total upfront guarantee fee of R15 638 464 was held to be deductible related finance charges. It is submitted that, following the change legislated by the Taxation Laws Amendment Bill in 2016, the principle of stare decisis will no longer apply and guarantee fees would be deductible only where the nature thereof is similar to interest in that it is a regular and recurring liability dependent upon the amount of the loan outstanding.

GUARANTEE FEES – PAYABLE IN TERMS OF AN INSTRUMENT?

A further requirement for the deduction of guarantee fees, as noted in the definition of interest discussed above, is that it should be payable in terms of an 'instrument', in order to qualify as a deduction.

It may be argued that guarantee fees are often calculated with reference to a separate guarantee agreement entered into between the borrower, the guarantor and the lender, and not with reference to the loan agreement between the borrower and the lender. Because s 24J allows a taxpayer to claim a deduction in respect of interest incurred in relation to an 'instrument', it would be necessary to further explore the definition of 'instrument' contained in s 24J.

An 'instrument' is defined to mean, inter alia, '*any interest-bearing arrangement or debt*'. It is submitted that it is common cause that an ordinary loan agreement would constitute an interest bearing arrangement or debt, and would accordingly qualify as an 'instrument'.

Furthermore, it is submitted that the guarantee fees are only payable by the borrower to the guarantor as a result of entering into the original loan agreement, which includes reference to a guarantor. It is submitted that, the mere fact that the guarantee fee is calculated with reference to a separate agreement, does not, detract from the fact that it is directly connected to the interest bearing arrangement as the originating cause.

Accordingly strong arguments exist to support the contention that the guarantee fees are incurred in relation to an instrument, and therefore, should the guarantee fees be similar to interest as discussed in the extract from the *Income Tax Practice Manual* above, these fees should be deductible in terms of s 24J.

2.4.4.4 COMMITMENT FEES

The third type of finance charges incurred and allowed as a deduction in the *South African Custodial Services Case* on the basis that these expenses constitute related finance charges, are commitment fees.

The *Dictionary of Banking Terms*[44] defines a commitment and commitment fee respectively as:

> Lender's agreement to make a loan at a quoted rate during a specific future period, and
>
> A lender's charge for holding credit available. In business credit commitment fees are often charged for an unused portion of a line of credit.

The *Income Tax Practice Manual* also addresses the tax treatment of these types of fees[45]:

> 3) Holding fees, which are payments made by a borrower in respect of money held available for him for purposes of his business by a lender are regarded as payments made for the use of money and as such are allowable. (When the money is actually drawn, the agreed rate of interest becomes payable and is allowable.)

While interest is normally paid as compensation to the lender for the use of monies, the commitment fee is paid to compensate the lender for having to keep undrawn funds available for immediate release. The lender can therefore not apply the funds for more lucrative purposes and is compensated for this so-called opportunity cost by way of a commitment fee.

By applying the test laid down in respect of finance charges, it is submitted that, where the commitment fees are recurring charges, calculated with reference to the time value of money and payable to secure the future availability of capital to be used, they should constitute similar finance charges for the purposes of s 24J. It is submitted that commitment fees are ordinarily recurring and calculated as a percentage of the unused portion of the loan over

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44 Fitch, TP, 2012, at 'commitment fees' and 'commitment'

45 Zulman, R.H., Stretch, R., & Silke, J. 2013 at [A:R2] Raising fees – Deduction

the loan term, to compensate the lender for the period during which the lender is unable to use the money for his own benefit.

Accordingly, it is submitted that commitment fees should ordinarily qualify as similar finance charges and be deductible in terms of s 24J.

2.4.4.5 SERVICE FEES

The last type of expenditure found to be deductible by the SCA in the South African Custodial Services Case are service fees, consisting of legal fees, financial advisory fees and margin fees. These were all found to constitute related finance charges as a result of the close connection to the obtaining of the loans.

Although the SCA found that the fees paid to attorneys for drafting loan agreements should qualify as related finance charges, it is submitted that the very nature of these costs would exclude them from the ambit of s 24J. Generally, these fees are not paid for the use of money, but are paid rather as compensation for services rendered by the finance and legal advisors. These costs are also not determined with reference to the loan amount outstanding, but rather with reference to the time spent on the services rendered and are normally payable upfront. In addition, the incurral of these costs bears no relation to the term of the loan agreement.

It is submitted that these costs are not similar to interest, but rather constitute service fees charged by the legal counsel and the financiers. It is also respectfully submitted that the deductibility of legal fees should be determined with reference to s 11(*c*), while other services fees like financial advisory and margin fees should be evaluated using the general deduction formula in s 11*(a)*, and not the principles in s 24J. A discussion of s 11(*c*) is outside the scope of this study. A brief discussion of the general deduction formula is included in Chapter Five, but an evaluation of the deductibility of service charges is beyond the scope of this study.

Suffice it to say that it does not appear that the amended definition of interest, which refers to ‘similar finance charges’ would encompass service charges such as legal fees, financial advisory and margin fees.

2.5 CONCLUSION

Section 24J contains a number of defined concepts, which include, 'issuer' and 'instrument'. While s 24J governs the tax treatment of interest for both the issuer and the holder of an instrument, this study deals only with its application to the issuer, who is the person incurring the interest or the obligation to pay the debt and/or interest due and payable.

The application of s 24J is founded on the interpretation of 'instrument'. It is submitted that the term instrument is defined to include all debt agreements, and that an ordinary loan agreement would qualify as an 'instrument'.

Where it is concluded that a person qualifies as an issuer in relation to an instrument, the provisions of s 24J(2) of the Income Tax Act will govern the deductibility of interest.

This chapter explored the vital definition of 'interest' as included in para (*a*) of s 24J(1), which includes both interest and similar finance charges. It was concluded that the common law meaning of interest includes payments aimed at compensating the finance provider for the use of money.

The meaning of similar finance charges was explored, with reference to the ordinary meaning and case law. It was concluded that the deductibility of the finance charges should not be determined with reference to what the expenditure is entitled to be, but rather with reference to the nature thereof. A number of guiding principles were established.

Finance charges of the same kind or nature as interest will exhibit the following characteristics:

- The fees will be paid as compensation for the use of capital and not the acquisition of capital;
- The payment of the fees will be recurring; and
- The calculation of the fees will be with reference to the time value of money and the amount outstanding.

Finally, it was concluded that upfront raising fees would ordinarily not constitute similar finance charges, on the basis that they are payable once and for all and not calculated with reference to the time value of money or the loan amount outstanding. Guarantee fees and commitment fees, on the other hand, may qualify as similar finance charges and accordingly be deducted in line with the provisions of s 24J(2). Service fees should be evaluated for deductibility in terms of the general deduction formula.

This study will now continue to explore the remaining requirements relating to the trade principle and the production of income.

3. THE TRADE AND INCOME REQUIREMENTS OF SECTION 24J

3.1 INTRODUCTION

This chapter examines the remaining requirements for deductibility included in s 24J, which is that the taxpayer must be '*carrying on a trade*' and that interest should be incurred '*in the production of income*', prior to being allowed as a tax deduction. This chapter will explore these two concepts and provide some tests aimed at assisting the taxpayer in assessing whether these requirements have been met.

It is submitted that the phrases 'carrying on a trade' and 'in the production of income' included in s 24J of the Income Tax Act should be interpreted based on the principles as set out in case law regarding the 'carrying on a trade' and 'in the production of income' tests historically referred to in s 11(*a*) of the Act, in accordance with the legal precedent 'stare decisis'

The term '*trade*', is very broadly defined in s 1 of the Act to include

> every profession, trade, business, employment, calling, occupation or venture, including the letting of property and the use of or grant of permission to use any patent…

Although this definition is extensive, it is submitted that it is not exhaustive. It is submitted that it is not possible to devise a precise universal test for when a trade occurs and that it is an issue that has to be decided in light of the facts and circumstances of each particular case. This chapter will therefore highlight a number of common law principles laid down by the South African courts to assist in assessing whether a taxpayer can be said to be carrying on a trade.

The phrase '*in the production of income*' is not defined in the Act, but a number of tests have been laid down by South African courts when interpreting this phrase. Some case law dealing specifically with interest and the deductibility thereof is discussed in this chapter, within the framework provided by the *Port Elizabeth Electric Tramway Co Ltd v CIR*[46] case.

It is further important to note that the capital/revenue requirement in the general deduction formula is ignored in s 24J(2) of the Act. Accordingly for the purposes of determining the application of s 24J(2) of the Act, the deduction of the interest

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46 1936 8 SATC 13

expenditure is only subject to two requirements, being *'carrying on a trade'* and '*in the production of income*', .

3.2 CARRYING ON A TRADE

A taxpayer will first have to evaluate whether it can be said that that person is 'carrying on a trade'. The term 'trade', is broadly defined in s 1 of the Act to include, *inter alia*,

> every profession, trade business, employment, calling, occupation or venture, including the letting of property and the use of or grant of permission to use any patent.

Although this definition is extensive it is submitted that it is not exhaustive. In addition, as stated in SARS's Interpretation Note 33[47]:

> Although the "trade" requirement may have been firmly established, difficulties still arise in determining whether a company's activities constitute the carrying on of a trade.

In ITC 1529[48], it was held that since the words 'carrying on of a trade' are not defined in the Act, it is not possible to devise a precise universal test for when it occurs and that it is an issue that has to be decided in light of the circumstances of the particular case. An objective test must be applied in determining whether trading is being carried on.[49] A number of principles laid down by the South African courts may be applied to assist in applying the objective test.

In *Burgess v Commissioner for Inland Revenue*[50], it was stated that

> it is a well-established rule that the definition of trade should be given a wide interpretation.

Although the term 'trade' is broadly defined according to the principle laid down in *t*his case, it is submitted that not all endeavours by a taxpayer would necessarily constitute a trade. In ITC 1476[51] it was held that the carrying on of a trade involves an active step and involves something more than merely watching over existing investments that are not income-producing and are not intended or expected to be so. It is submitted that tho include active steps e activities of the taxpayer should extend beyond passively watching over investments..

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47 SARS, 2017
48 54 SATC 252
49 Davids, et al., 1999
50 1993 (4) SA 161 (A), 55 SATC 185 at 189
51 52 SATC 141

Accordingly, with respect to this requirement and whether it can be said that a taxpayer is 'carrying on any trade' in relation to the interest paid on borrowings, one would be required to conduct a detailed analysis of the activities undertaken by the taxpayer which lead to the interest paid on the borrowings, based on the surrounding facts and circumstances.

In ITC 1274[52], it was held that:

> The definition of "trade" …includes the word "business", and the issue frequently arises whether a company's investing activities constitute a business of moneylending. If they do, the company would be able to meet the "trade" requirement.

The evaluation of whether a company's investing activities constitute a business of moneylending is beyond the scope of this study, suffice it to say that taxpayers should remain cognisant of the trade requirement when considering the deductibility of interest in terms of s 24J. It is submitted that evidence should be maintained to support the contention that a trade is being carried on.

3.3 IN THE PRODUCTION OF INCOME

A further requirement of s 24J is that interest should be incurred in the production of income, prior to being allowed as a tax deduction. The phrase 'in the production of income' is not defined in the Act, but a number of tests have been laid down by the South African courts. The leading authority in this regard is contained in the *Port Elizabeth Electric Tramway Co Ltd v CIR* case. The common law principle established in this case is that if the expenditure is so closely connected with the taxpayer's business that it can be regarded as part of the cost of performing it, the expenditure is usually regarded to be incurred in the production of income. Watermeyer JA[53] held that:

> Income is produced by the performance of a series of acts, and attendant upon them are expenses. Such expenses are deductible expenses, provided they are **so closely linked** to such acts as to be regarded as part of the cost of performing them.
>
> A little reflection will show that two questions arise
>
> (a) whether the act, to which the expenditure is attached, is performed in the production of income, and
>
> (b) whether the expenditure is linked to it closely enough. Now, at first sight, it would appear that only acts necessary to earn the income and expenditure necessarily attendant

52 (1977) 40 SATC 185 (T).
53 (1936) 8 SATC 13 at 16

> upon such acts should be deducted; but this is not so. As pointed out above, businesses are conducted by different persons in different ways. The purpose of the act entailing expenditure must be looked to. If it is performed for the purpose of earning income, then the expenditure attendant upon it is deductible.

Where these two questions can be answered in the affirmative, it can be said that the expenditure has been incurred in the production of income. In addition to the general principle laid down in the *Port Elizabeth Electric Tramway* case, some case law dealing specifically with interest and its deductibility has also been developed by the South African courts. The principles laid down in these cases are discussed below.

First, in *Financier v COT*[54], a taxpayer borrowed a sum of money and used this money for the general purposes of his business. Some of his investments, however, produced no income. The portion of the interest incurred in relation to the non-productive investments was disallowed, on the basis that the money on which the interest liability was incurred was borrowed for the purpose of an investment that is non-productive of income.

It is submitted that where money is borrowed for use in the general purpose of a taxpayer's business, an assessment should be performed to identify the portion of the money borrowed to fund assets not producing income, and the interest incurred on these borrowings should be disallowed.

Secondly, Tredgold J, who delivered the judgment of the High Court of Southern Rhodesia, referred to the case of *Producer v COT*[55], in which the position of a taxpayer who borrowed money for purposes of his business but thereafter invested it in shares which produced exempt income was assessed. From the decision in that case and the cases on which it was based, Tredgold J said that the following principles could be extracted:

> (1) Where a taxpayer borrows a specific sum of money and applies that sum to a purpose unproductive of income, and not directly connected with the income-earning part of his business, then the interest paid on the borrowed money cannot be deducted as expenditure incurred in the production of income.
>
> (2) Where a taxpayer has for good and sufficient reasons borrowed money for use in the business producing his income, despite the fact that he subsequently, in pursuit of a legitimate business purpose, invested such money in an investment which does not produce taxable income, the interest is still deductible for income tax purposes…
>
> …It would seem that the test to be applied is the purpose for which the money was borrowed.

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54 (1950) 17 SATC 34

55 (1948) SR 62

In light of the above, it appears that the ultimate use or destination of the money borrowed is not necessarily a decisive factor but is relevant only in determining the purpose of the borrowing. It is submitted that the purpose of the borrowing would be based on the facts and circumstances surrounding each case.

Ogilvie Thompson JA, who delivered the majority and the unanimous views of the Appellate Division of the Supreme Court in *CIR v Allied Building Society*[56] , said:

> *In my view, the ultimate use or destination of all the money borrowed is not … on the facts of the present case to be elevated into a decisive factor in determining the deductibility or otherwise of the interest payable on that money. In determining the purpose of the borrowing, the ultimate user of the money may, no doubt, in certain cases be a relevant factor; but the dominant question remains: what was the true nature of the transaction. In the particular circumstances of the present case,* ***the most important factor in that inquiry is, in my opinion, the purpose of the borrowing***.' (Emphasis added)

In the *Allied Building Society* case, it was absolutely vital that the building society borrowed money and, as a matter of commercial necessity, accepted all money tendered to it by the public. On this basis, all the interest incurred on the borrowed moneys was held to be deductible, regardless of the fact that some of the funds may have been used for the purpose of acquiring investments that were non-productive of income.

The principle that the purpose of the borrowing is the most important fact was confirmed in *CIR v Standard Bank of SA Ltd*[57].

This case involved a bank that, as a matter of commercial necessity, accepted all moneys tendered to it by depositors, paying interest on the moneys thus borrowed, as in the *Allied Building Society* case.

All the deposits accepted by the bank were placed into a common pool. The pool was then used to fund transactions, which included the acquisition of shares producing exempt dividend income.

In this case, the deductibility of interest was determined with reference to the nature of the operational activities undertaken by the bank, which was. to borrow cheaply and lend these funds at a profit. The purpose of the borrowing was to obtain floating capital, and it was held that the receipt of dividends was not closely connected to the interest incurred.

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56 1963 (4) SA 1 (A)
57 1985 (4) SA 428 (A)

Corbett JA, who delivered the majority and unanimous views of the Appellate Division of the Supreme Court, alluded to the importance of the purpose of the expenditure concerned and the **closeness of its connection** with the relevant income-earning operations formulated the following principles:

> (1) Generally, in deciding whether moneys outlaid by a taxpayer constitute expenditure incurred in the production of the income (in terms of the general deduction formula) **important and sometimes overriding factors are the purpose of the expenditure** and what the expenditure actually effects; and in this regard the **closeness of the connection** between the expenditure and the income-earning operations must be assessed. The same general test applies to the provisions of s 23(*f*) of the Act.
>
> (2) More specifically, in determining whether interest (or other like expenditure) incurred by a taxpayer in respect of moneys borrowed for use in his business is deductible in terms of the general deduction formula and its negative counterparts in the Act, a distinction may in certain instances have to be drawn between the case where the taxpayer borrows a specific sum of money and applies it to an identifiable purpose, and the case where, as in the instance of the Society in the *Allied Building Society* case and the Bank in the present case, the taxpayer **borrows money generally** and upon a large scale in order to raise **floating capital** for use in his (or its) business.
>
> (3) In the former type of case both the purpose of the expenditure (in the form of interest) and what it actually effects can readily be determined and identified: a clear and close **causal connection** can be traced. Both these factors are, therefore, important considerations in determining the deductibility of the expenditure.
>
> (4) In the latter type of case, however, and more particularly in the case of institutions like the Society and the Bank, there are certain factors which prevent the identification of such a causal connection and **one cannot say that the expenditure was incurred in order to achieve a particular effect**. All that one can say is that in a general sense the expenditure is incurred in order to provide the institution with the capital with which to run its business; but it is not possible to link particular expenditure with the various ways in which the capital is in turn utilised.

Furthermore, this case also placed reliance on the fact that the purpose of the loan would be the overriding factor in determining the deductibility of interest where the loan was for a fixed period. Where the loan was payable on demand, however, the actual utilisation of the money might be more important in determining the deductibility of the interest.

A concern may be raised as to whether commitment fees calculated with reference to a fixed rate of interest based on an undrawn facility are incurred in the production of income. It is submitted that the test laid down by the court in the *Port Elizabeth Electric Tramway* case will still apply to these costs. The taxpayer's intention in securing the availability of the undrawn facility should be evaluated. Furthermore, the taxpayer would have to consider what the expenditure actually effects. Where the purpose of the undrawn facility is to fund future payments owing on income generating assets, it is submitted that the commitment fees are incurred in the production of income.

In conclusion, it is apparent from the discussion above that where taxpayers are evaluating whether interest incurred on borrowings to fund general business operations, the following factors should be considered:

- The overriding factor in determining the deductibility of loan interest is the purpose for which the funding was acquired as opposed to what the loan funding was actually used for;
- A distinction is made between funding for a general purpose (deductible) versus funding for a specific purpose (depending on specific purpose);
- Where the original purpose was to fund, in general, legitimate business operations which are inherently productive in nature, the interest will always be deductible, unless a direct connection between the money borrowed and the money applied exists;
- If the taxpayer has good and sufficient reasons to borrow money and subsequently uses the money unproductively, the interest will still be deductible;
- If the funding is used to finance floating capital requirements, the interest would be tax deductible; and
- Consideration is also given to the proportion of the loan funding used for productive and unproductive purposes. Where a significant portion is used for unproductive purposes it may be difficult to claim the interest.

3.4 POTENTIAL INTEREST WITHHOLDING TAX

The Interest Withholding Tax 'IWT) provisions are contained in ss 50A to 50H of the Income Tax Act. Section 50B provides that IWT applies in respect of interest (as contemplated in para (*a*) or (*b*) of the definition of 'interest' in s 24J (1)); that is paid or becomes due and payable on or after 1 March 2015.

IWT must be levied in terms of s 50B on any amount of interest received or accrued from a South African source in terms of s 9(2) of the Act, by any person, to any non-resident person, at a rate of 15% on the gross amount of interest paid.

While the liability for IWT is imposed on the non-resident recipient of the interest, the person paying the interest amount is responsible for withholding the IWT (and making payment of the withheld amount to SARS) on or before the end of the month immediately following the one in which the interest is paid or becomes due and payable.

Section 50D provides specific exemptions from IWT. Section 50E(2) provides relief from the obligation to withhold IWT to the extent that the interest is exempt from the Withholding Tax on Interest in terms of s 50D(1).

Based on the conclusion that certain raising fees, guarantee fees and commitment fees may qualify as 'interest' as defined in s 24J(1) of the Income Tax Act, it is submitted that a taxpayer may have an obligation to withhold Interest Withholding Tax on these amounts, where these amounts are payable to a non-resident recipient. Whilst the Interest Withholding Tax rate is normally 15%, one should examine whether a reduced rate of interest may be applied by virtue of Double Taxation Agreement between South Africa and recipient's country of residence. The impact of the various Double Tax Agreements (DTAs) entered into between South Africa and other countries is considered to be beyond the scope of this study.

3.5 CONCLUSION

This chapter has considered the two remaining requirements of s 24J, namely that the interest should be incurred in carrying on a trade and in the production of income.

It is not possible to formulate a universal test which can be applied to conclude whether a trade is being carried on, and the facts and circumstances surrounding each case should be evaluated. In addition, when determining whether interest has been incurred in the production of income, it is necessary to evaluate the purpose of the expenditure and what it actually effects, and the closeness of the expenditure and the income earning operations.

When specifically considering whether interest incurred on funds borrowed can be said to have been incurred in the production of income, the overriding factor to consider is the purpose for which the funding was acquired.

This chapter has also briefly considered the potential IWT liability which may arise where finance charges fall within the definition of interest as defined in s 24J.

The next chapter will evaluate the application of ss 8F and 8FA to finance charges which are deemed to be deductible in terms of s 24J. .

4. THE APPLICATION OF SECTIONS 8F AND 8FA TO OTHER FINANCE CHARGES

4.1 INTRODUCTION

Based on the analysis of the various fees incurred on the debt funding, it was concluded that 'pure' interest and in specific circumstances other finance charges may qualify as 'interest' as envisaged in s 24J. In addition, an alternative argument was presented in section 2.5.4.2, which aims to conclude that upfront raising fees also constitute 'similar finance charges'.

Where similar finance charges qualify for deductibility in terms of s 24J, on the basis that these fees are 'interest', it is necessary to consider the remaining provision of the Income Tax Act which deals with the deduction of interest. Included in these ss are the specific anti-avoidance provisions contained in ss 8F and 8FA. These provisions seek to limit interest deductions incurred on debt instruments with equity-like features, or 'hybrid instruments' and 'hybrid interest'.

For purposes of ss 8F and 8FA, 'interest' is defined to mean '*interest as defined in s 24J(1)*'. Please refer to Chapter Two for a detailed analysis of the definition of 'interest' in s 24J. Based on the detailed analysis included above, it is concluded that in instances where upfront raising fees, guarantee fees, commitment fees or other finance charges meet the definition of 'interest' as envisaged by s 24J, these finance charges will also qualify as 'interest' for purposes of ss 8F and 8FA. Accordingly, it would be necessary to evaluate whether the underlying instrument would fall within the ambit of the anti-avoidance provisions in ss 8F and 8FA.

This chapter considers the provisions of s 8F and s 8FA and the application of the legislative provisions contained in these sections specifically with reference to other finance charges.

4.2 SECTION 8F AND HYBRID INSTRUMENTS

S 8F is an anti-avoidance provision which provides that any amount of interest incurred in respect of a 'hybrid debt instrument' will be deemed to be a dividend in specie in respect of a share. S 8F(2)(*a*)(ii) further provides that the interest payable would not be allowed as a deduction in terms of s 24J.

A 'hybrid instrument' is defined to mean

any instrument in respect of which a company owes an amount during a year of assessment if in terms of any arrangement as defined in section 80L—

(a) that company is in that year of assessment entitled or obliged to—
    (i) convert that instrument (or any part thereof) in any year of assessment to; or
    (ii) exchange that instrument (or any part thereof) in any year of assessment for

shares unless the market value of those shares is equal to the amount owed in terms of the instrument at the time of conversion or exchange;

(b) the obligation to pay an amount so owed on a date or dates falling within that year of assessment has been deferred by reason of that obligation being conditional upon the market value of the assets of that company not being less than the amount of the liabilities of that company; or

(c) that company owes the amount to a connected person in relation to that company and is not obliged to redeem the instrument, excluding any instrument payable on demand, within 30 years from the date of issue of that instrument: Provided that, for the purposes of this paragraph, where the company has the right to—

(aa) convert that instrument to; or

(bb) exchange that instrument for,

a financial instrument other than a share—

(A) that conversion or exchange must be deemed to be an arrangement in respect of that instrument; and

(B) that instrument and that financial instrument must be deemed to be one and the same instrument for the purposes of determining the period within which the company is obliged to redeem that instrument.

Based on the definition of 'hybrid debt instrument', it is submitted that section 8F aims to target instruments where the features relating to the instrument itself resembles equity rather than debt. The anti-avoidance rules aim to achieve this by focusing on three types of instruments[58] namely:

i. instruments with features that enable a conversion or exchange into shares whose market value is less than the amount of the outstanding debt;
ii. instruments where the obligation to repay is based on the solvency of the issuer; or
iii. instruments which have features indicating that redemption is unlikely within a reasonable period where a debt instrument exists between connected persons.

The application of s 8F would therefore depend on the characteristics exhibited by the debt instrument, in terms of which the interest and similar finance charges are incurred. It is submitted that taxpayers should carefully scrutinise the repayment terms included in a loan agreement to identify any potential hybrid instruments. Where these types of instruments are identified, it would be necessary to adjust the expected cost of debt of the entity to reflect the fact that s 8F will deem the interest, which will include similar

58 National Treasury, 2013

finance charges, to be non-deductible in terms of the Income Tax Act. In addition, the interest would be deemed to be a dividend in specie. As a result of the fact that the s 8F deems the interest incurred to be a dividend in specie, it may also create a liability for Dividends Tax in terms of s 64E of the Act.

Section 64E provides that Dividends Tax should be levied on the amount of any dividend paid by a company at a rate of 20%, subject to certain exemptions.

Furthermore, s 64EA states that the company declaring a dividend is liable for Dividends Tax on a dividend *in specie.* Accordingly, where a company incurs interest that is deemed to be a dividend *in specie* by virtue of the application of s 8F, the company as the deemed declarer of the dividend, would be liable for the payment of Dividend Withholding Tax.

The deemed dividend may be exempt from Dividends Tax in terms of s 64FA of the Act. A detailed discussion of the exemptions from Dividends Tax in terms of s 64FA is beyond the scope of this study. Suffice to say that, where the lender is a company which is a South African tax resident, the deemed dividend should be exempt from Dividends Tax if a declaration and written undertaking to this effect was received from the lender.

The scope of this study is limited to interest-bearing debt or arrangements. It is submitted that the provisions of s 8F would have to be considered, regardless of whether additional finance charges are incurred and whether it is concluded that these finance charges constitute interest for purposes of s 24J.

Accordingly, it is submitted that, for the purpose of this study, the conclusion as to whether an instrument would constitute a hybrid debt instrument or not would not be affected by the classification of finance charges as interest, but the total interest that would be disallowed as a deduction for income tax purposes, and the calculated value of the deemed dividend, would include any finance charges that qualify as ‘interest’ by virtue of the fact that these finance charges constitute ‘interest’ as defined in s 24J.

4.3 SECTION 8FA AND HYBRID DEBT

Section 8FA provides that any amount incurred by a company in respect of ‘hybrid interest’ will be deemed to be a dividend in specie and not deductible in terms of the Income Tax Act. In addition, as a deemed dividend in specie, it may attract Dividend Withholding Tax at a rate of 20%.

‘Hybrid interest’ is defined to mean

(a)any interest where the amount of that interest is—
(i) not determined with reference to a specified rate of interest; or
(ii) not determined with reference to the time value of money; or
(b) if the rate of interest has in terms of that instrument been raised by reason of an increase in the profits of the company, so much of the amount of interest as has been determined with reference to the raised rate of interest as exceeds the amount of interest that would have been determined with reference to the lowest rate of interest in terms of that instrument during the current year of assessment and the previous five years of assessment;

Accordingly, the anti-avoidance provisions of s 8FA will be triggered where the interest yield is not based on the time value of money or where the yield is subject to change based on the profit of the issuer.

Any similar finance charges which meet the definition of interest, should be interrogated to identify possible hybrid interest.

4.3.1 RAISING FEES

Although it is argued in this report that upfront raising fees would not constitute interest as defined in s 24J, an alternative view is considered in Chapter Two above. In terms of this alternative view, it may be argued that upfront raising fees are similar to interest, regardless of the fact that these fees are payable upfront.

In terms of s (*a*) of the definition of hybrid interest included in s 8FA referred to above, any interest where that amount is not determined with reference to the time value of money would constitute hybrid interest, which would not be deductible in terms of the Income Tax Act.

Should it be concluded that upfront raising fees are in fact similar to interest, it is submitted that there is a substantial risk that s 8FA may find application where it is concluded that the raising fees are not determined with reference to a specified rate of interest or the time value of money.

According to of the *Dictionary of Banking Terms*[59], the time value of money is defined as

> the concept that today's value of a stream of cash flows is worth less than the sum of the cash flows to be received over time.

Accordingly, where it is concluded that the raising fees are not determined with reference to a rate of interest or to compensate the lender for the fact that the repayments of the loan in future will be worth less than the capital sum advanced, the upfront raising fees will fall within the ambit of s 8FA.

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59 Fitch, T.P., 2012, at 'time value of money'

Where upfront raising fees are payable in full regardless of the term of the loan and regardless of the actual repayment period, it is submitted that strong arguments exist that the upfront raising fees are not calculated with reference to the time value of money as they do not represent compensation to the lender for the fact that money received in future is worth less than money received upfront.

On this basis, the raising fees will be deemed to be a dividend by virtue of the application of s 8FA, and will be a deemed dividend *in specie*. No deduction will be allowed in respect of the raising fees incurred by the borrower, and in addition, this amount may attract Dividends Tax at a rate of 20% in terms of s 64E of the Income Tax Act, subject to the specific exemptions contained in s 64FA. Further arguments exist that the Dividends Tax may be reduced by virtue of a Double Tax Agreement where the lender is a not a South African tax resident. This analysis extends beyond the scope of this study and it is submitted that this is a field for further research.

4.3.2 GUARANTEE FEES

In order to determine whether guarantee fees may fall within the ambit of s 8FA, the contractual terms governing the calculation of the said guarantee fees should be examined. Where the guarantee fee is calculated at a specified rate of interest of the outstanding loan amount, and payable over the period of the loan, it is submitted that these fees will not qualify as 'hybrid interest' as defined and will not fall within the ambit of s 8FA.

4.3.3 COMMITMENT FEES

It is submitted that, to the extent that commitment fees are calculated with reference to a fixed rate of interest based on the undrawn facility, and determined over the period during which an undrawn facility is made available by the lender, it can be said that these commitment fees are determined with reference to the time value of money and should arguably not qualify as 'hybrid interest' as defined. It is submitted that, on this basis, commitment fees are not expected to fall within the ambit of s 8FA.

4.4.4 CONCLUSION

This chapter considered the application of ss 8F and 8FA to finance charges.

The application of s 8F would depend on the characteristics exhibited by the debt instrument in terms of which the interest and similar finance charges are incurred. It is submitted that taxpayers should carefully scrutinise the repayment terms included in a loan agreement to identify any potential hybrid instruments.

The application of s 8FA will depend on the method applied in calculating the interest yield. It is submitted that, in instances where it is concluded that the raising fees are not determined with reference to a rate of interest or to compensate the lender for the fact that the repayments of the loan in future will be worth less than the capital sum advanced, the upfront raising fees will fall within the ambit of s 8FA. This means that a deemed dividend *in specie* may arise, which will not be deductible for tax purposes.

It is further submitted that guarantee fees and raising fees are not expected to fall within the ambit of s 8FA.

5. THE POTENTIAL APPLICATION OF SECTION 11(a) AND OTHER SECTIONS OF THE ACT

Where it is concluded that finance charges incurred by a borrower in respect of loan funding obtained does not meet the definition of 'interest' as defined in s 24J, the deductibility of the finance charges should be determined with reference to the general deduction formula contained in s 11(*a*) read with s 23(*g*) of the Income Tax Act.

Section 11(*a*) provides that in order for expenditure to be deductible it must be actually incurred in the production of income and not be of a capital nature. Section 23(*f*) forbids the deduction of expense incurred in respect of amounts received or accrued which do not constitute 'income' as defined in s 1 (that is exempt income), while s 23(*g*) forbids the deduction of expenditure not laid out or expended for the purposes of trade. For the purpose of this study, the point of departure is that the finance costs represent expenditure that has actually been incurred in terms of the loan agreement entered into between the borrower and the lender. For a detailed discussion of the trade requirement an analysis of the phrase 'in the production of income' is provided in Chapter Three.

The remaining requirement to be considered is whether the finance charges are of a capital nature or not.

5.1 CAPITAL vs REVENUE

The determination of whether expenditure incurred is of a capital or revenue nature is a question of fact that a court will decide based on the circumstances of each case. There are, however, a number of useful guidelines that have been introduced into South African common law which may assist the taxpayer in determining whether the expenditure is of a capital or revenue nature. The nature of finance charges, and specifically raising fees, have previously been a matter of contention.

RC Williams[60] briefly addresses the issue of the deductibility of raising fees:

> It is possible that the payment of a 'raising fee' could in some situations be of a capital nature, but a raising fee, in my opinion, **is qualitatively different** from interest. It is usually levied as a percentage of the amount borrowed, **without reference to the period of the loan.**

This view can be contrasted with that of De Jager[61]:

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60 Williams, 1997, p 644
61 De Jager, 1988, p 11

> Raising fees are by their very nature intimately related to interest on loans. They are both part of the cost of the borrowed money. Where the agreement relating to raising fees expressly refers to this relationship and where the amount of the raising fee is directly proportional to the amount and terms of the loan concerned, it is submitted that he raising fee should be treated in exactly the same way as interest payable on the transaction concerned. But even when this relationship is not spelt out in so many words, the raising fee should be treated in the same way as the interest on the same transaction, even though it may be paid once and for all.. It should be regarded as the cost of performing the income earning operations of the trade whenever the interest on the loan concerned is so regarded.

It is submitted that, for the purpose of this study, where it is concluded that the raising fees exhibit characteristics similar to interest, the approach suggested by De Jager is supported. However, where the nature of the raising fees appear to differ from interest as considered above, the taxpayer has to consider the provisions of the general deduction formula and cannot ignore the principles laid down in case law.

As stated above, s 24J of the Income Tax Act does not require an assessment as to whether interest claimed as a deduction is capital or revenue in nature. However, this only applies to interest as defined in s 24J of the Act. It is submitted that, the deductibility of interest expenditure which does not fall within the ambit of s 24J, would have to be determined with reference to the general deduction formula. Accordingly, even if the approach suggested by De Jager is followed and the raising fees are treated in the same way as interest, raising fees which do not qualify as interest as defined in s 24J would still be deductible only to the extent that they have been incurred in the production of income and is not of a capital nature. Based on the decision held in *CIR v121 Castle Street Cape Town CC*[62] case, these raising fees would not necessarily be deductible merely by virtue of the fact that the raising fees are regarded as the cost of performing the income earning operations.

Notwithstanding the views discussed above, the deductibility of raising fees and other finance charges should be determined in line with the common law principles developed by the South African courts. The common law principles which are considered to be relevant for the purpose of this study, are considered next.

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62 63 SATC 185

5.1.1 INCOME PRODUCING STRUCTURE VERSUS INCOME EARNING OPERATIONS

In *New State Areas v CIR*[63], it was held that expenditure incurred for the purpose of acquiring a capital asset for the business is capital expenditure even if it is paid in annual instalments.

Money spent in creating or acquiring an income-producing concern must be capital expenditure. It is invested to yield future profit; and while the outlay does not recur, the income does. There is a great difference between money spent in creating or acquiring a source of profit, and money spent in working it. The one is capital expenditure, the other is not. (*CIR v George Forest Timber Co Ltd)*[64]

5.1.2 ENDURING BENEFIT TEST

The enduring benefit test has been repeatedly affirmed. In *Anglo-Persian Oil Co v Dale*[65]it was held that by 'enduring' it is meant 'enduring in the way that fixed capital endures'. This introduces into the test the distinction between 'fixed' capital and floating capital of a trade as applied in *New State Areas* (supra).

SARS's view on this the enduring benefit test as it applies to raising fees specifically, is included in the *Income Tax Practice Manual*[66].

> The general rules to expenditure also apply to raising fees – if incurred for an enduring purpose, they are capital and therefore not deductible. However, if the use is for floating capital purposes which is frequently turned over it is of a revenue nature and consequently deductible

SARS' view on the treatment of raising fees is further documented in the *Income Tax Practice Manual*[67] as follows:

> Any raising fee, whether in the form of a single or an annual payment, relating to a loan raised in connection with the **acquisition of fixed assets** is not allowable as a deduction from income.
>
> Generally, expenditure is allowable if, in respect of the carrying on of a business, it is incurred in the ordinary course of the business, including the **acquisition of floating assets**. Expenditure incurred in order to acquire fixed assets is of a capital nature and disallowable.

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63 (1946) 14 SATC 155

64 (1926) AD 516 (15 SATC 20)

65 (1931) AD 516 (15 SATC 20)

66 Zulman, et al., 2013 at [A:D10] Deductions – Raising fees – Section 11(*b*A) and Section 11(*b*B)

67 Zulman, R.H., Stretch, R., & Silke, J. 2013 at [A:R2] Raising fees – Deduction

Based on the view expressed by SARS above, it would be necessary to assess the purposes of the loan funding acquired in order to determine whether the finance charges incurred can be said to be capital or revenue in nature.

One of the early cases dealing with the deductibility of raising fees is ITC 33[68]. In this case, the taxpayer incurred expenses in negotiating a loan on his wife's house, which loan he intended to use for business purposes. The court held that the expenditure incurred was not deductible, on the basis that such expenditure was incurred once and for all and accordingly capital in nature.

Following on this case was ITC 85[69]. In this case the appellant owned a block of flats generating rental income. The flats were bonded, and the bond financing had to be renewed. The court held that the cancellation fees, renewal fees and raising fees incurred in connection with the capital asset had no relationship to the actual earning of income of the company and were therefore capital in nature. Maritz, G.J. held that the expenditure:

> is closely identified with the raising of the loan and therefore it is expenditure connected with the capital asset and consequently expenditure of a capital nature.

The capital nature of transaction fees is further solidified by the various cases which have contemplated the deductibility of raising fees. In ITC 882[70] the taxpayer paid raising fees in respect of a loan to be utilised to acquire fixed property. The fixed property was to be used by the taxpayer for purposes of rental (earning rental income from the letting of the property). The court held in this case that the raising fees had been incurred as part of the money expended in order to produce a revenue producing asset and was therefore of a capital nature.

It would therefore appear that although the purpose of the loan is to acquire assets and thus the transaction fees to raise the loan are considered to be in the production of income, the fees are capital in nature and would thus not be deductible in terms of s 11(*a*) of the Act.

This view is supported by Brincker[71]:

> There seems to be a general misconception that raising fees associated with a loan will always be of a revenue nature and therefore deductible. It seems as if the general approach is that raising fees will be deductible if they are incurred in the ordinary course of business, including where they are incurred pursuant to the raising of a loan to acquire floating

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68 (1925) 2 SATC 59
69 (1927) 3 SATC 146 (U)
70 (1959) 23 SATC 239 (T)
71 Brincker, 2004, at M1 - 2

assets. However, if fixed assets are to be acquired with the proceeds of a loan, the raising fees will be disallowed.

With regard to loan funding obtained to on-lend to another company, the courts have held that the raising fees in respect of such loans would also be capital in nature. Thus no deduction may be claimed in respect of transaction fees incurred on loans obtained for purposes of on-lending. In ITC 1723[72], the courts considered the deductibility of raising fees incurred in respect of a loan obtained by the taxpayer in order to on-lend to a subsidiary. In terms of the on-lending agreement, the taxpayer would earn interest on the loan to the subsidiary. The courts argued inter alia that the appellant did not carry on the business of a money lender and did not deal with money as its stock in trade and, that being the case, the money lent to the subsidiary formed part of fixed capital and not floating capital and thus fees and legal costs incurred to raise the capital, unlike interest, were of a capital nature.

The raising fees incurred in respect of loans obtained to acquire trading stock have been held not to be of a capital nature and therefore deductible. (*CIR v Genn & Company (Pty) Ltd* [73]). (This would be because trading stock is floating capital and considered to be of a revenue nature.)

In ITC 1019[74], the appellant derived his income mainly from the letting of four immovable properties, financed through loans. The appellant incurred raising fees and renewal fees on a regular basis, because the bonds were arranged for periods ranging from three to five years. The appellant stated that these fees were recurring expenditure and should therefore be deductible under s 11(*a*) of the Income Tax Act. It was held in this case that the bond raising or renewal fees were connected to the fixed capital of the enterprise and as such were of a capital nature.

In ITC 995[75] it was held that expenditure incurred in cancelling an existing bond over a building, that forms part of the fixed capital of the company, and obtaining new loans providing for a reduced rate of interest, is of a capital nature and accordingly not deductible. It was also confirmed that the fact that the interest then paid was less than before could not make the change a profit-making scheme by the reduction of the running expenses of the appellant.

Kuper J stated at 139 that:

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72 (1999) 64 SATC 165
73 (1955) (3) S(A 293 (A) (20 SATC 113
74 (1962) 25 SATC 411(N)
75 (1962) 25 SATC 137(T)

> In the view of this Court the transaction remains what it always was, a transaction whereby the fixed capital of the appellant was maintained, the expenditure incurred in connection therewith being an expenditure of a capital nature.

Thus, in effect, only transaction fees incurred in respect of loans utilised to acquire floating capital will be deductible in terms of s 11(a) of the Act.

5.1.3 CAPITAL GAINS TAX

Where it is concluded that the finance charges incurred on loan financing acquired is capital in nature and not deductible in terms of s 11(*a*) of the Income Tax Act, it should be considered whether any of the finance charges may be added to the base cost of the capital assets acquired. The provisions of the Income Tax Act dealing with Capital Gains Tax are contained in the Eighth Schedule to the Income Tax Act.

The base cost of an asset is determined in terms of para 20(1)(*c*)(i) of the Eighth Schedule to the Act which sets out that the expenditure actually incurred and directly related to the acquisition of an asset will be included in the base cost.

However, para 20(2)(*a*) of the Eighth Schedule specifically excludes borrowing costs, including interest or raising fees from the base cost of an asset. It is submitted that, the non-deductible finance charges may also not be added to the base cost of the assets funded.

The final consideration is whether finance charges may be capitalised as part of the cost of assets on which wear and tear allowances may be claimed as provided in ss 11(*e*), 12B and 12C and other sections allowing for wear and tear.

These sections typically deem the cost of an asset to be an amount incurred '*under a cash transaction concluded at arm's length*'. It submitted that finance charges cannot be said to form part of the cost of an asset for the purpose of these sections, as these finance charges would not be incurred had the asset been acquired under a cash transaction. It follows that no wear and tear allowance may be claimed on these finance charges incurred in the acquisition of fixed capital or fixed assets.

5.1.4 CONCLUSION

Following the case law provided above the following important principles arise when assessing whether finance charges incurred will be capital or revenue in nature:

- Raising fees incurred in obtaining floating capital should be deductible in terms of s 11(*a*) of the Act.
- Raising fees incurred for the acquisition of fixed capital or fixed assets should not be deductible in terms of s 11(*a*) of the Act being capital in nature.
- Raising fees incurred in a scheme of profit making should generally be deductible.

6. STUDY CONCLUSION

This study was intended to answer the question of how finance charges incurred by borrowers should be treated for tax purposes, following the 2016 amendment of s 24J.

The study has evaluated the specific statutory provisions that should be considered when evaluating whether finance charges incurred on debt funding will be deductible, and has provided general guidelines on the interpretation and application of these sections and considered the specific anti-avoidance legislation aimed at limiting these deductions.

The research has addressed a number of sub-problems.

The first question that the study attempted to address was whether finance charges constitute interest as defined in s 24J.

The study also included a detailed analysis of the definition of 'interest' as well as the meaning of the terms 'similar finance charges' contained in the definition of interest.

Based on the conclusion that the term 'similar finance charges' is not defined in the Income Tax Act, nor is there any case law with a particular bearing on this term in the context of s 24J, the study attempted to define similar finance charges using the ordinary dictionary meaning. This meaning was enhanced by considering the purpose of the amendment of the definition of interest in s 24J of the Income Tax Act to include similar charges as opposed to related finance charges. This necessitated an in-depth analysis of the *South African Custodial Services* case, and contrasting this to SARS's policy position.

It was concluded that the nature of finance charges should be investigated in order to determine the deductibility thereof, rather than claiming a deduction in respect of these fees based on their close connection to the loan funding incurred. Accordingly, the study continued to evaluate the deductibility of raising fees, guarantee fees, commitment fees and service fees in light of SARS's policy position documented in the Income Tax Practice Manual.

Following this assessment, the study continued to explore the remaining requirements of s 24J of the Income Tax Act, which is that the taxpayer must be '*carrying on a trade*' and that interest should be incurred '*in the production of income*', prior to being allowed as a tax deduction. The study explored these two concepts and provided some tests aimed at assisting the taxpayer in assessing whether these requirements have been met.

Based on the analysis of the various fees incurred on the debt funding, it was concluded that 'pure' interest, and, in specific circumstances, other similar finance charges, may qualify as 'interest' as envisaged in s 24J. In addition, an alternative argument was presented which aims to conclude that upfront raising fees also constitute 'similar finance charges'.

Where similar finance charges qualify for deductibility in terms of s 24J, on the basis that these fees are 'interest', the study considered the specific anti-avoidance provisions contained in ss 8F and 8FA of the Income Tax Act, which seek to limit interest deductions incurred on debt instruments with equity-like features, or so-called 'hybrid instruments' and 'hybrid interest'. It was concluded that, in instances where upfront raising fees, guarantee fees, commitment fees or other finance charges meet the definition of 'interest' as envisaged by s 24J, these finance charges will also qualify as 'interest' for purposes of ss 8F and 8FA. Accordingly, where underlying instrument falls within the ambit of the anti-avoidance provisions in s 8F, the finance charges would also constitute a deemed dividend as envisaged by this section and may give rise to a Dividends Tax liability. In addition, the nature of the finance charges may lead to the application of the provisions of s 8FA, also giving rise to a deemed dividend in specie and a possible Dividends Tax liability.

Following this assessment, where it was concluded that finance charges incurred by a borrower in respect of loan funding obtained does not meet the definition of 'interest' as defined in s 24J, the deductibility of the finance charges should be determined with reference to the general deduction formula contained in s 11(*a*) read with ss 23 (*g*) of the Income Tax Act. The study then presented a selection of common law principles which have been laid down by South African courts, which may be used to assess whether finance charges are of a capital nature. In addition, the study also briefly addressed whether, where it is found that the finance charges are of a capital nature, it could be added to the base cost of the assets acquired.

Lastly, this study also briefly concluded that, where finance charges qualify as 'interest' as defined in s 24J and these finance charges are payable to a person who is not a tax resident of South Africa, there is a risk that these finance charges may attract Withholding Tax on Interest as envisaged by s 50A of the Income Tax Act.

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