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SCHOOL OF ACCOUNTANCY

University of the Witwatersrand, Johannesburg

THE TAX IMPLICATIONS OF RAISING FEES FROM THE PERSPECTIVE OF THE BORROWER

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

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Abstract

The tax implications of raising fees play a role in the determination of a company's capital structure. Raising fees represent charges by lenders on borrowers for services relating to obtaining funding. This research report analyses the historic tax implications of raising fees incurred by debtors in the course of obtaining funding, commencing with its deductibility under the general deduction formula. The report then considers the introduction of section 11(*b*A) to the Income Tax Act 58 of 1962 ('the Act') and its subsequent repeal. The research will also extend to the judicial precedent arising from the recent Supreme Court of Appeal decision, *Commissioner: South African Revenue Service v South African Custodial Services (Pty) Ltd (2012),* 74 SATC 61. This research report submits findings on the current tax implications of raising fees from the perspective of the borrower, with particular consideration for its possible deductibility under section 24J of the Act as 'related finance charges', and the practical implications thereof.

Key words: raising fees, borrowing costs, related finance charges, section 11(*b*A), South African Custodial Services, section 24J, deductibility, yield to maturity, interest-bearing arrangement, general deduction formula.

Declaration

I declare that this research report is my own unaided work. It is submitted in partial fulfilment of the requirements for the degree of Master of Commerce (specialising in Taxation) at the University of Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination at any other institution.



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With gratitude to

My Creator.

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Chapter One: Background

Raising fees

Raising fees represent the collective charges imposed by lenders on borrowers for various services relating to obtaining funding. Payable in the event that a loan agreement is concluded, raising fees would typically include origination fees, commitment fees, guarantee fees, and agency fees. In contrast to interest, raising fees may be considered as the cost of acquiring capital, whereas interest represents the cost of using capital (Silke & Stretch 2000). When incurred by a company in the course of obtaining funding for its business, the tax implications of raising fees comes into question. This is particularly pertinent as the tax implications of funding options do, to some extent, influence companies' capital structure decisions. Such fees form the subject matter of this research report.

Historical tax implications

Historically, companies would seek a deduction under s 11(2)(*a*) of the Income Tax Act31 of 1941, with consideration of the prohibitions under s 12(*f*) of the same legislation. After the repeal of this legislation, the general deduction formula of s 11(*a*) read with ss 23(*f*) and 23(g) of the Income Tax Act 58 of 1962 (hereinafter, 'the Act') was applied in order to determine the deductibility of raising fees. Section 11(*a*) of the Act considers, inter alia, the capital or revenue nature of the expenditure, and only allows the deduction of raising fees which are not of a capital nature (Coetzee 2000).

In 1982, the introduction of s 11(*b*A) led to an alternative avenue for the deductibility of various fees incurred in relation to the acquisition of certain assets (PwC 2012). This section broadly allowed the deduction of interest and 'related finance charges,' terms which were not specifically defined in the Act (Silke & Stretch 2000). A recent Supreme Court of Appeal decision, *Commissioner for South African Revenue Service v South African Custodial Services (Pty) Ltd*, allowed a broad range of fees to be deducted under this section. Section 11(*b*A) was, however, repealed in 2012 and is thus no longer available as an avenue for the deductibility of raising fees.

Research problem

Taxpayers incurring raising fees for expenditure of a capital nature would be precluded from deducting such costs under the general deduction formula (Silke & Stretch 2000). In light of

the repeal of s 11(*bA*), an alternative avenue for the deduction of raising fees is seemingly absent. This research report will examine the current tax implications of raising fees for borrowers with specific emphasis on the judicial precedent arising from the *South African Custodial Services* case and consequently, s 24J of the Act as a possible section for the deduction of such expenditure. This paper will propose to answer the following question: what are the current tax implications of raising fees from the perspective of the borrower?

Research sub-problems

1. Historically, raising fees were only deductible in terms of the general deduction formula of the Income Tax Act, provided that certain criteria were met. One such criterion disallowed expenditure of a capital nature (Preiss et al 2014: para A:R2). Section 11(*bA*) was introduced to permit the deduction of related finance charges actually incurred for the acquisition, installation, erection or construction of certain capital assets (De Koker & Williams 2014: para 8.90). However, since its repeal in 2012, an alternative avenue for the deduction is required for raising fees which are of a capital nature. The first sub-problem is therefore to assess the current tax implications of raising fees incurred in relation to funding of a capital nature.

2. While section 24J deals primarily with interest, this report focusses on the deductibility of raising fees in terms of section 24J. Raising fees may be considered 'related finance charges' for the purposes of section 24J. This term is not defined in the legislation, but was also referred to in the now-repealed section 11(*bA*). This report will consider judicial interpretation of this term, in order to assess its applicability to raising fees for the purposes of section 24J.

3. If raising fees are considered deductible under section 24J, a further sub-problem arises in determining the practical implications of such a deduction. For example, the timing and amount of the raising fees to be deducted in a particular year is of particular concern for the determination of the yield-to-maturity in cases where the amount of a fee changes over the course of the loan funding arrangement, as is the case for commitment fees. Furthermore, raising fees cover a broad range of charges imposed by a lender on the borrower for the service provided in relation to obtaining a loan which include, but are not limited to, origination fees, agency fees, guarantee fees and commitment fees (Silke & Stretch 2000). This report will also consider

whether the tax implications for raising fees can be applied equally for all such fees, or whether the nuances of these various charges have an impact on the tax implication thereof. Guarantee fees, for example, are sometimes charged by a third party in relation to the lender, and the tax implications thereof may therefore be different from other raising fees in the context of section 24J.

4. The fourth sub-problem arises if raising fees are not considered deductible in terms of section 24J. This report will also assess when such circumstances would arise and the viability of any alternative tax implications for such fees. The possibility of capitalising raising fees to the cost of assets for which allowances are claimable will also be addressed (Coetzee 2000).

Previous research

Previous research into the deductibility of raising fees has been limited to the context of either the general deduction formula (for example, de Jager 1987), which would exclude raising fees of a capital nature, or the now repealed s 11(*b*A) (for example, Silke & Stretch 2000). Limited research has been undertaken into the judicial precedence set by the *South African Custodial Services* case, and its impact on the deductibility of such fees in terms of s 24J of the Act.

Scope and limitations

This research report will consider the income tax implications of raising fees from the perspective of the borrower, and does not address the tax implications for the lender. A consideration from a money-lender's perspective is also excluded from the scope of this research, aside from a brief overview. In addition, this research report will limit its focus to the more common types of raising fees, with acknowledgement that there are many types of such fees, each with its own nuances, specifically in terms of the timing and calculation thereof. The detailed mechanics of the yield to maturity calculations within the application of s 24J of the Act are also beyond the scope of this research report.

Research methodology

Research will be conducted via a literature study analysing the income tax implications of raising fees in the context of previous and current tax legislation. Published data which addresses this issue includes literature and case law, and statutory law (both current and

repealed). Discussions with Ian Wilson, a former PwC Tax Director, and a review of his unpublished work, will also assist in formulating certain points to be submitted by this research report. In assessing the research problem and sub-problems, reference will be made to the ordinary, grammatical meaning of words in the specific provisions legislated by the Act in conjunction with the meanings thereto as derived from judicial decisions.

Chapter Two: The Deductibility of Raising Fees under the General Deduction Formula

Raising fees may be considered deductible under s 11(*a*) of the Act, provided that all the requirements of the general deduction formula are met (De Jager 1987). Section 11(*a*), read with ss 23(*f*) and 23(*g*) of the Act, require the following to be met in order for an expense to be deductible:

1. The taxpayer must carry on a *trade (the 'trade requirement')*;
2. Income, as defined, must be *derived from the trade*;
3. The taxpayer must have *actually incurred* expenditure or losses;
4. The expenditure or losses must have been actually incurred *during the year of assessment*;
5. The expenditure or losses should be incurred *in the production of income (the 'in the production of income requirement')*;
6. The expenditure or losses must *not be of a capital nature (the 'capital requirement')*; and
7. Even if the above six requirements are met, the deduction would only be allowed to the extent that the loan was laid out or expended for the *purposes of trade* (s 23(*g*) of the Act) and *not in the production of exempt income* (s 23(*f*) of the Act).

This Chapter will address requirements 5 – 7 above of the general deduction formula in the context of raising fees. The first four requirements will not be dealt with as it is submitted that their applicability in the context of raising fees is not dissimilar in comparison to any other general expenditure. Notable case law will be covered to provide a historical background on the judicial interpretation of the tax implications of raising fees.

In the production of income

There is no legislative definition for the term 'in the production of income' and it is therefore necessary to consider judicial interpretation thereof.

The test to determine whether an expense has been incurred 'in the production of income' was established in the locus classicus on the interpretation of s 11(*a*) of the Act (Williams 2001), *Port Elizabeth Electric Tramway Company Ltd v Commissioner for Inland Revenue*. In this case, Watermeyer AJP called for two criteria to be considered, as follows:

1. Whether the expenditure is attached to the bona fide performance of activities the purpose of which is to produce income; and

2. Whether the expenditure is *sufficiently closely linked* to such activities so as to be considered part of the cost of performing them.

Applying the above test, if raising fees are incurred by a taxpayer in performing its business operations for the purpose of producing income, this would constitute expenditure incurred in the production of income if the raising fees are linked closely enough to this purpose. There should thus be a close link between the raising fees incurred and the income which the taxpayer intends to produce.

In *Commissioner for Inland Revenue v Genn & Co (Pty) Ltd*, it was stated that, in assessing whether a causal link exists between the expenditure and the income-producing activities of a taxpayer's business, one must consider both the purpose of the expenditure, and what it actually affects. This case is discussed in further detail below.

In *Commissioner for Inland Revenue v Allied Building Society*, where the causal link between borrowed monies and income earned was in question, Thompson JA held at page 357 that the purpose of the borrowing was the focal point of the inquiry:

> 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.

Purpose of the borrowing

Based on the above, in considering whether raising fees are incurred in the production of income, it is necessary to assess the purpose of the borrowing.

1. *Refinancing of debt: replacement loans*

Taxpayers may enter into new loan or funding agreements for a multitude of reasons. The reason may be in order to repay existing indebtedness, whereby existing facilities are refinanced on improved terms and conditions, sometimes with fewer restrictions on the replacement loan (Coulson 2007).

When a company is in a position to actively manage its debt position, it may be able to repay existing debt, thereby effectively applying a current asset (that is, cash) in order to reduce long-term borrowings in favour of a more favourable loan agreement. One of the attractive features of more favourable debt could be proportionately lower interest expense (Coulson 2007). Such refinancing may be expected by fixed-rate borrowers when the economic climate moves towards reduced interest rates. It follows that, by entering into a lower interest rate funding arrangement, a company will incur proportionately less interest expense which will result in increased income. It is submitted that the purpose of such refinancing can thus be viewed as to produce income.

An analogous principle was confirmed in ITC 817, where Price JP held that although expenditure may be directed at minimising expenses, the costs are nonetheless viewed as expended in producing income, for the lower the expense the higher the income.

2. *Funding business expenditure*

Aside from refinancing, taxpayers may enter into new funding arrangements to finance business expenditure, for example capital, working capital or general corporate expenditure. Capital expenditure would entail purchasing capital assets to serve as the taxpayer's income-producing capacity (De Koker & Williams 2014: para 7.9), while working capital and general corporate expenditure may be to support the taxpayer's business operations (Van Schalkwyk 2014: para 7.5). Where loans are undertaken to finance business expenditure, the expenditure would be considered as incurred by the taxpayer in performing its business operations for the production of income (Van Schalkwyk 2014: para 7.5).

Applying the above, raising fees incurred in securing funding for refinancing or to finance business expenditure would be considered as incurred in the production of income, and the expenditure thereof linked closely enough to the underlying loan agreement, provided that the definition of 'income' is borne in mind.

Income

It must be noted that 'income' as referred to in s 11(*a*) of the Act is, as defined in s 1 of the Act, as follows:

> 'income' means the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax under Part I of Chapter II;

In essence, income is defined as gross income less exempt income (Clegg & Stretch 2015: para 10.2). For the expenditure to be incurred in the production of income, it therefore follows that if expenditure generates exempt income, the expenditure would not be considered as incurred in the production of income for the purposes of s 11(*a*) of the Act. This would, for example, be the case if the funding is used to acquire an investment through which local dividend income is earned, as such income would be exempt in terms of s 10(1)(*k*) of the Act (De Koker & Williams 2014: para 9.22). If the funding from a loan agreement is used for such a purpose, the raising fees would not be considered as incurred in the production of income, and a deduction in terms of s 11(*a*) of the Act would thus be disallowed.

The deductibility of such expenditure would also be affected by s 23(*f*) of the Act, which prohibits the deduction of any expenditure incurred in respect of any amounts received or accrued which do not constitute income as defined in s 1 of the Act (De Koker & Williams 2014: para 9.22). Thus, s 23(*f*) of the Act, which is addressed later in this Chapter, fortifies the 'production of income' requirement contained in s 11(*a*) of the Act.

Capital or revenue nature of the expenditure

Introduction

The assessment of raising fees as either capital or revenue in nature has historically been the most critical aspect when attempting to obtain a deduction for raising fees in terms of s 11(*a*) of the Act (Silke & Stretch 2000). The Act does not provide a definition for expenditure of a capital nature, and it is therefore necessary to consider judicial interpretation thereof, both generally and in the context of raising fees.

In distinguishing whether expenditure is on capital or revenue account, there is no single test which may be applied but rather, certain judgments have laid down useful principles in assessing this against the facts of each case (De Koker & Williams 2014: para 7.9). In *New State*

Areas Ltd v Commissioner for Inland Revenue, Watermeyer CJ's judgment indicated that it must be established whether the expenditure is part of either the cost to perform the income-earning operations (thus revenue in nature) or the cost of establishing, improving or adding to the income-earning structure (thus capital in nature). In the English case *British Insulated and Helsby Cables Ltd v Atherton*, the test formulated was that if the expenditure was made with a view to bring an asset or advantage for the enduring benefit of the trade, it would be regarded as capital in nature. Where an enduring benefit was not the taxpayer's intention behind the expenditure, it would be regarded as revenue in nature (De Koker & Williams 2014: para 7.9).

In line with the indications of the Income Tax Practice Manual, the applicable test in classifying raising fees as either capital or revenue in nature is to analyse the purpose for which the funding which resulted in the raising fees was raised (Preiss *et al.* 2014: para A:D9).

Based on the abovementioned judgments dealing with the nature of the expenditure, if the raising fees arise from funding which is used for a purpose which has an enduring benefit or is to establish or improve or add to the income-earning structure, the raising fees would be regarded as expenditure of a capital nature which would not be deductible in terms of s 11(*a*) of the Act (Jooste *et al.*2000; Silke & Stretch 2000). This would, for example, be the case where funding is used to purchase fixed capital assets. This principle was applied by Kuper JP in ITC 882, where a raising fee paid in regard to a bond raised for the purpose of acquiring business premises was considered to be part of the capital expenditure incurred in the acquisition of the revenue-producing asset and a deduction therefore was disallowed (Brincker 2004).

This principle would be applicable irrespective of whether the raising fee is paid in one lump sum or in instalments (Preiss *et al.* 2014: para A:D9), as highlighted by Watermeyer CJ at page 627 of the *New State Areas Ltd* judgment:

> ...[I]f, on the other hand, it is in truth no more than part of the cost incidental to the performance of the income-producing operations, as distinguished from the equipment of the income-producing machine, then it is revenue expenditure, even if it is paid in a lump sum.

On the contrary, if the funding obtained is used for floating capital purposes (for example, trading stock), the raising fees would be regarded as expenditure of a revenue nature which would be deductible in terms of s 11(*a*) of the Act (Jooste *et al.* 2000; Silke & Stretch 2000). This principle was applied in the *Genn & Co* case where the loan was considered to be for the immediate purposes of the business as it was for the purchase of trading stock, and the raising fee expenditure incurred was thus deductible in terms of s 11(2)(*a*) of the Income Tax Act 31 of

1941 and not prohibited by s 12(*f*) within the same legislation, both of which were legislated at the time. In addition to the revenue nature of the fees, the court considered the fees to be sufficiently closely connected with the taxpayer's income-earning operations, and therefore regarded the raising fees as incurred in the production of income. Before the *Genn & Co.* case, SARS practise was to treat raising fees as deductible only in the case where the borrower was considered a money-lender (De Koker & Williams 2014: para 7.39).

Early case law

In ITC 33, which dealt with a taxpayer that had incurred expenses in negotiating a loan on his wife's house to enable her to lend the money to him for business purposes, the court held that expenditure incurred in raising a bond was capital in nature and therefore not deductible. This decision was made primarily on the grounds that the expenditure was once-off costs, and not recurring.

Two years later, in ITC 85, the court dealt with raising fees incurred by the taxpayer on the renewal of an existing loan secured by a bond. The taxpayer in this case traded as a lessor of apartments in the bonded building. The court held that the raising fees were closely connected to capital, bearing no relationship to the production of income for the taxpayer, and thus treated as non-deductible, in line with the ruling in ITC 33.

In a later case, ITC 471, the facts were that company A had erected a building for company B and, in addition, incurred expenditure in raising a loan for company B, to enable the latter to pay company A's progress payments. Here, too, the court held that the raising fees were of a capital nature on the basis that the expenditure was incurred to enable company B to pay A, and not for the purpose of carrying on the taxpayer's business as a contractor and builder (De Jager 1987).

Genn & Co case

The earlier cases referred to above were decided prior to the *Genn & Co* case. As the *Genn & Co* case was one of the first cases where raising fees were treated as deductible, a misconception arose that thereon after, raising fees would always be deductible (Brincker 2004). In the particular circumstances of that case, it was not possible to differentiate between the interest on the loan and raising fees, as the raising fees were calculated with reference to the duration of the loan and as a difference between an agreed percentage of the loan and the interest rate applied, and therefore the interest and raising fees were treated as forming one

consideration (Brincker 2004). In light of how it was calculated, the raising fees were, akin to interest, directly proportional to the capital amount and the period of the loan (De Jager 1987).

This judgment is in line with the following general principle per the Income Tax Practice Manual at [A.R2]: if a raising fee *'partakes of the nature of interest in that it is a regular and recurring liability dependent on the amount of the loan outstanding, it is a necessary concomitant expense incurred in the production of income and is allowable'* (Preiss *et al.* 2014: para A:D9).

Due to the specific circumstances of the above case, whereby the raising fees were, by virtue of its calculation method, considered akin to interest, the precedent set by the *Genn & Co* judgment did not necessarily apply to all raising fees. Thus, the merits of each case had to be assessed separately. In later cases such as ITC 1019, the deductibility of raising fees in the *Genn & Co* case was further distinguished on the basis that the loan in *Genn & Co* was obtained to purchase trading stock and therefore treated as expenditure which was sufficiently closely connected to the income-earning operations of the business (Brincker 2004). In ITC 1019, James PJ stated the following at page 413:

> In our view the judgment (Genn & Co) as a whole lends support for the proposition that if the raising fee in that case had been directly connected with the raising of fixed capital as opposed to floating capital, it could not have been deductible.

It was thus clarified by James PJ that not all raising fees would be considered deductible, and the circumstances of each case was to be considered. In ITC 1019, the raising fees were held to be non-deductible on the grounds that they were related to the avoidance of a loss of capital, and thus attributed with a capital nature.

Having regard to case law, Professor Brincker (2004) deduces that it would appear as if *'the general approach is that raising fees are 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 assets. However, if fixed assets are to be acquired with the proceeds of a loan, the raising fees will be disallowed.'*

Money-lenders

In the case where the taxpayer is a money-lender, the raising fees would most likely be considered deductible as the money would constitute floating capital in the hands of such a taxpayer (Brincker 2004). This presumption is based on the principle laid down in *Sentra-Oes Koöperatief Beperk v Commissioner for Inland Revenue* where the taxpayer was not considered to be in the business of money-lending, and money lost as a result of a loan becoming irrecoverable was fixed capital and thus 'of a capital nature', and hence not deductible in terms of s 11(*a*) of the Act.

Reliance was placed on the *Genn & Co* case in ITC 1723, where the taxpayer attempted to deduct bond raising fees and legal fees in respect of a loan obtained from a bank, the proceeds of which were on-lent to a newly-formed second company at a favourable interest rate (Brincker 2004). Wunsh J held at page 166 that the taxpayer, who owned rental-producing property, *'did not carry on business as a money-lender and did not deal with money as its stock trade.'* It was further held that the money lent by the taxpayer to the newly-formed company formed part of its fixed capital as opposed to its floating capital and, on this basis, the raising fees and legal costs incurred to raise this capital was distinguished from interest and considered to be of a capital nature. Consequently, the bond raising fees and legal fees were treated as non-deductible.

According to Professor Brincker (2004), the conclusion reached in ITC 1723 may be achievable through the facts, but the reasoning applied is questionable – that is, that the raising fees were of a capital nature since the taxpayer was not a money-lender and the money which it on-lent formed part of its fixed capital. Professor Brincker (2004) asserts that this reasoning is based on the anomaly that only moneylenders (and thus, generally meaning, banks) can treat money as their stock, and adds that the raising fees in the *Genn & Co* case were treated as deductible on the basis that it was not possible to distinguish between the interest and the raising fees, due to the way in which the latter was calculated, as indicated earlier in this Chapter.

Purpose of the funding

Having considered early case law, it is submitted that it is necessary to ascertain the nature of the purpose of the funding in order to establish the nature of the corresponding raising fees. In the case of formal funding agreements, the purpose of the financing may be explicitly stated therein. The purpose of the funding may be of a capital nature or a revenue nature, or there may be a dual purpose for the funding which is partly revenue in nature and partly capital in nature. This Chapter will consider two purposes for which taxpayers commonly obtain loan funding: 1) refinancing of existing debt and 2) funding of business expenditure.

1. Refinancing of debt: replacement loans

Where raising fees are incurred in respect of a loan for which the proceeds will be used to repay an existing loan, the purpose of the original loan is to be analysed to determine the nature of the raising fees on the new loan, that is, the replacement loan (Brincker 2004). If the original loan was raised for the purpose of acquiring fixed assets, the capital nature of the

original loan would flow to the raising fees on the replacement loan. The raising fees of the replacement loan would therefore have a capital nature, and would also not be deductible (Preiss *et al.* 2014: para A:D9).

This principle was established in ITC 995, where a mortgage loan to fund the acquisition of a capital asset (a building) was refinanced for a new loan at a lower interest rate. Kuper JP, who was also the judge presiding over the case in ITC 882, held that the change in the mortgage represented a transaction whereby the fixed capital of the company was maintained and the expenditure incurred in connection therewith was of a capital nature and accordingly, not deductible. This decision was in spite of the fact that the raising fees incurred resulted in reduced interest expense and were thus regarded as in the production of income. The principle which arose was that raising fees on a replacement loan may be deductible if the original loan was for the purpose of acquiring floating assets, or if it was acquired in the ordinary course of business (Brincker 2004).

The decisions by Kuper JP in ITC 995 and ITC 882 have been criticised by Kruger & Scholtz (2003) on the basis of inconsistency with the principles laid down by the Appellate Division in the *Genn & Co* case. Kruger & Scholtz further advised that taxpayers should consider challenging the disallowance of any deduction for raising fees which they have incurred.

In considering the deductibility of interest on a replacement loan, the court in *Commissioner for Inland Revenue v Sunnyside Centre (Pty) Ltd*, noted at page 156 that:

> *'The interest expenditure attached to the new loan remains as deductible as it was in respect of the old loan'.*

In ITC 1827, the Court contemplated the purpose of a replacement loan. Claasen CJ held at [23] that:

> ...[T]he deductibility of expenditure incurred in respect of such 'new loan' has to be determined by reference to the purpose for which the 'original loan' was raised. Thus the interest payable on the new loan replacing the old one will be deductible if the interest paid on the old loan was deductible.

It is submitted that the same principle would be applicable to raising fees incurred in relation to a replacement loan.

2. *Funding of business expenditure*

Where raising fees are incurred in respect of a loan for which the proceeds will be used to fund business expenditure, the nature of such business expenditure is to be analysed. If applied in financing ongoing capital expenditure, such expenditure would generally be of a capital nature, and the nature thereof would flow through to the attendant raising fees. Expenditure on working capital will generally be regarded as having a revenue nature (Jooste *et al.* 2000). General corporate expenditure may be capital or revenue in nature, or a combination, depending on the specific expenditure.

Practical implications

Although it has been simplistically set out in the previous paragraph, the analysis of expenditure can potentially become more complicated depending on the complexity of the funding arrangement and the timing of expenditure. If, for example, the funding arrangement is a facility with a term spanning a number of years, and the full facility is not drawn upfront, the exercise of assigning a nature to raising fees (which are often paid in full at the commencement of the loan) in accordance with expenditure yet to be incurred over the period of the loan may be impracticable. This poses a number of practical issues, such as whether it is possible to prove when the remaining debt will be drawn upon, for what purpose(s) this will be used, and whether the raising fees which are actually incurred are to be apportioned according to the nature of such expenditure which has not yet been actually incurred.

In addition, the manner in which funding is eventually applied may be inconsistent with the original intended purpose of the funding as per the loan agreement or per the taxpayer's original intentions. In such cases the tax implications in the year in which the raising fees are actually incurred may change in a subsequent year, if the funding is expended differently to its original intended purpose. Large corporates with adequate internal controls may be able to mitigate such issues by the implementation and monitoring of tools such as an allocation key for each funding agreement entered into by the company. These practical implications are beyond the scope of this paper, but have been highlighted nonetheless in acknowledgement that the attribution of the nature of funding to raising fees is not a simple matter. These practical challenges posed also suggest the need for an alternative avenue for the deductibility of raising fees, where the capital requirement is not applicable, as this may be more viable in practice for taxpayers.

Funding with a dual purpose: apportionment

Where the funding obtained is applied to incur expenditure for a dual purpose, it is necessary to apportion the expenditure between that which is of a capital nature and that which is of a revenue nature (Preiss *et al.* 2014: para A:D9). This apportionment of the funding will thereafter be applied to the raising fees in order to consider the deductibility thereof.

Where the raising fees are apportioned to expenditure of a revenue nature, the fees are to be considered deductible in terms of s 11(*a*) of the Act, assuming that the other criteria of the general deduction formula are satisfied. Where the raising fees are apportioned to expenditure of a capital nature, no deduction in terms of s 11(*a*) of the Act will be allowed.

As held at page 113 in *Secretary for Inland Revenue v Guardian Assurance Holdings (SA) Ltd*, where expenditure is incurred for a dual purpose, *'it did not necessarily follow that the whole of the expenditure must be regarded as being of a capital nature since, in the absence of any prohibition or direction in the Act, there existed no objection in principle to an apportionment; nor would apportionment be inconsistent with s 23(g) of the Act.'* It was further held that it would be contrary to the basic principles of the Act not to permit an apportionment, where expenditure is incurred with the express object of producing income (as opposed to for the purposes of acquiring capital). This judgment is referred to in the Income Tax Practice Manual as the basis for an apportionment of raising fees which is consistent with s 23(*g*) of the Act, applicable where expenditure is incurred for dual purposes (Preiss *et al.* 2014: para A:D9).

Despite the absence of a statutory provision which allows apportionment (or one which prohibits apportionment), the courts have generally approved of the principle of apportionment when seeking a practical solution to expenditure with a dual purpose or income with dual causation (De Koker & Williams 2014: para 7.11A). Case law dealing with apportionment is mainly aligned with the principle that apportionment is to be done on a fair and reasonable basis in the circumstances of the particular case.

In *Commissioner for Inland Revenue v Nemojim (Pty) Ltd*, which dealt with the apportionment between expenditure incurred for the purpose of exempt income and that for the purpose of income, a formula for the apportionment of expenditure incurred for a dual purpose was propounded. In that particular case, Corbett JA indicated that an apportionment is to be considered in light of what is fair and reasonable in all circumstances of the case.

The apportionment of loan expenditure was applied by the court in ITC 1020, where the taxpayer had obtained an interest-bearing loan for dual purposes of firstly, repaying an existing debt and thereafter, paying dividends to shareholders. The Court held that the proportion of the interest incurred which was attributable to the amount borrowed to repay the loan was deductible, as the interest on the original loan was treated as deductible for tax purposes.

In a later case, *Tuck v Commissioner for Inland Revenue*, the apportionment between the capital and revenue of a single receipt was in question. Here Corbett CJ held that the principle of apportionment provided a sensible and practical solution (notwithstanding the absence of a specific statutory provision dealing with apportionment of income), and further held that a 50/50 apportionment was considered fair and reasonable in that case, where it was not possible to infer that one element was more important than the other.

Applying the above principles, it is submitted that where raising fees are incurred in respect of a loan applied for dual or multiple purposes, the apportionment principle may be applied in assessing the nature of the corresponding raising fees as either revenue or capital in nature, provided that such apportionment is done on a fair and reasonable basis, in accordance with a formula similar to that per the *Nemojim* case.

Section 23 of the Act

Where a taxpayer has actually incurred raising fees during a year of assessment as part of carrying on a trade from which income is derived, and the expenditure thereof is considered to be in the production of income and not of a capital nature, it is submitted that such raising fees will qualify for a deduction in terms of s 11(*a*) of the Act.

Once this has been established, it still remains to be considered whether the raising fees are disqualified from deduction by reason of the application of the provisions of ss 23(f) and (g) of the Act.

Not in the production of exempt income

The definition of 'income' per s 1 of the Act has been included earlier in this Chapter. Applying s 23(*f*) of the Act, a deduction for raising fees would be allowed in terms of s 11(*a*) of the Act provided that it is not incurred in the production of exempt income.

The principles noted in respect of the 'in the production of income requirement' would apply similarly to satisfy s 23(*f*) of the Act. It will therefore be necessary to consider whether a causal link exists between the expenditure incurred and the exempt income which is received or accrued by the taxpayer, in line with the principle laid down in the *Port Elizabeth Electric Tramway Co Ltd* case (Clegg & Stretch 2015: para 10.2). Where there is a causal link between expenditure incurred and both exempt income and non-exempt income, the expenditure as apportioned to the non-exempt income will be considered deductible for tax purposes.

If a taxpayer incurs raising fees as a result of loan funding to acquire an investment in shares in a resident company, the dividend income derived from the investment would constitute exempt income in terms of s 10(1)(*k*) of the Act and s 23(*f*) of the Act would then apply to disallow the deduction of raising fees (Van Schalkwyk 2014: para 7.10).

The general principle applied is as per *Commissioner for Inland Revenue v Shapiro*, where interest paid on money borrowed to buy shares was held as not in the production of income, as the shares produced exempt dividend income (Van Schalkwyk 2014: para 7.10).

In the *Genn & Co* case, it was stated that the prohibition laid down by s 23(*f*) of the Act referred only to expenditure incurred in respect of amounts received or accrued which form part of 'gross income' as defined in s 1 of the Act but are exempt in terms of s 10 of the Act. For that reason, the Court interestingly concluded that s 23(*f*) of the Act had no bearing on the deductibility of raising fees paid in respect of moneys borrowed by a company to finance its trading operations, since borrowed money does not constitute a receipt or accrual of 'gross income' (Preiss *et al.* 2014: para A:R2).

Loan laid out for the purposes of trade

Section 23(*g*) of the Act provides that no deduction shall be made in respect of moneys claimed as a deduction from income derived from trade to the extent to which they are not 'laid out or expended for the purposes of trade.' Generally, this would be the case where the incurral of expenditure is accompanied with a profit motive (Clegg & Stretch 2015: para 10.2).

Section 1 of the Act widely defines 'trade' as including the following:

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

> or any designed as defined... or any trade mark as defined... or any copyright as defined... or any other property which is of a similar nature.

The general understanding thereof is an active trade, and thus passive investments are not considered as 'trade', except where this is by share dealers and money-lenders (Van Schalkwyk 2014: para 7.2). A detailed analysis of the 'trade requirement' is not considered necessary for the purposes of this research report.

The decisive consideration in testing the 'trade requirement' is the taxpayer's purpose in incurring the expenditure (Van Schalkwyk 2014: para 7.2). As dealt with previously in this paper, the purpose of the funding arrangement is to be determined, here in the context of identifying if it is pursuant to the taxpayer's trade. Where raising fees are incurred for the purposes of the taxpayer's trade, the negative test in s 23(*g*) of the Act would not disallow a deduction for the fees.

Conclusion

This Chapter has provided an assessment of the deductibility of raising fees in terms of the general deduction formula, which has historically been the route chosen by taxpayers seeking a deduction for such expenditure. Relevant case law has highlighted that the capital or revenue nature of raising fees is the most crucial aspect in determining the deductibility thereof. Practically, too, this requirement poses its own challenges, particular where the purpose of the loan expenditure is not known with certainty upfront. It would therefore be beneficial for taxpayers to have an alternate avenue for the deductibility of raising fees. This is discussed in later chapters of this research report.

Chapter Three: The Introduction and Subsequent Repeal of s 11(*b*A)

Introduction

Having discussed the deductibility of raising fees in the context of the general deduction formula in Chapter Two, this Chapter will focus on the deductibility thereof in terms of the now repealed s 11(*b*A).

Section 11(*b*A) was first introduced into the South African tax legislation on 1 January 1982, and allowed for a once-off deduction of what was commonly known as 'pre-production interest.' It has been speculated that this section was legislated in response to the case of *Secretary for Inland Revenue v Eaton Hall (Pty) Ltd*, where it was held that pre-production interest did not form part of the cost of a building erected by the taxpayer, and thus could not qualify for a building allowance (Stein 1986).

The deduction in terms of s 11(*b*A) was for interest, including 'related finance charges,' actually incurred by a taxpayer on a loan, advance or credit used by him for the acquisition, installation, erection or construction of a qualifying asset to be used by him for the purposes of his trade that had been so incurred for a period prior to the asset being brought into use for the purposes of the taxpayer's trade. Qualifying assets were listed as machinery, plant, building, improvements to a building, or any pipeline, transmission line or cable or railway line as referred to in s 12D of the Act, or any airport infrastructure as referred to in s 12F of the Act. Section 11(*b*A) specifically excluded expenses such as administration costs, rent, and rates and taxes. The cumulative interest and related finance charges were treated as a lump sum deductible in the tax year during which the qualifying asset was brought into use for the purposes of the taxpayer's trade. Section 11(*b*A) restricted the deduction to qualifying interest and finance charges which were not otherwise deductible under the Act.

Section 11(*a*) of the Act allows the deduction of expenditure only in relation to a taxpayer carrying on a trade, and as such, any pre-production expenditure, irrespective of its nature, which is incurred prior to the commencement of a taxpayer's trade, would not qualify for a deduction under the general deduction formula (De Koker & Williams 2014: para 8.50). In addition, s 11(*a*) of the Act prohibits the deduction of expenditure of a capital nature and would therefore disallow interest and finance charges incurred by a taxpayer on a loan relating to fixed assets, as discussed previously in Chapter Two. The introduction of s 11(*b*A) thus

provided a welcome relief for taxpayers to deduct their pre-production interest and finance charges, in particular easing the burden of land developers (De Jager 1987).

This respite was not without its own limitations. The relief afforded by s 11(*b*A) to taxpayers after the pre-production phase of their business did not extend to interest and finance charges incurred on loans used for fixed assets after these assets were brought into use, nor did it extend to pre-production interest and finance charges in relation to non-qualifying assets such as land (as held in ITC 1619), ships and aircraft (Mitchell 2004). These categories of expenditure would also be disqualified from deductions in terms of s 11(*a*) of the Act as they would be considered to be of a capital nature. In addition, the deductibility of interest under s 24J of the Act was only legislated in 2004 (National Treasury 2004). Despite of these limitations, pre-production interest and finance charges relating to qualifying assets was deductible under s 11(*b*A) until its repeal.

Raising fees as 'related finance charges'

Section 11(*b*A) did not define the term 'finance charges' nor 'related finance charges', which created uncertainty as to the interpretation thereof (Moosa & Holt 1999). The term 'finance charges' was understood to mean finance charges payable in respect of assets acquired under a suspensive sale, although it was suggested that such suspensive sale finance charges fell within the ambit of s 11(*b*B) which was enacted at the time, and were therefore excluded from application of s 11(*b*A) (De Koker & Williams 2014: para 8.90) . 'Related finance charges' appeared to encompass raising fees, guarantee costs and surety fees which were incurred in respect of a particular loan, advance or credit falling within the scope of s 11(*b*A), and in this way seen as 'related' (Mitchell 2004; De Koker & Williams 2014: para 8.90).

The term 'related finance charges' is also used in s 8(4)(*l*) of the Act, for the purposes of determining a recoupment of 'interest or related finance charges (including a discount or premium)' if certain criteria are met. Through an assessment of the grammatical context of 'related finance charges' therein, it appears as though the term covers an extensive range of charges which would include, but is not limited to, discounts or premiums, and is thus submitted to be different from interest, discounts and premiums.

Meyerowitz (1999) commented that the use of the word 'related' implies that the finance charges must be of a nature or kind similar to interest, for example raising fees. He also adds the following (at 13.34):

> The Revenue Department's view, which I consider to be correct, is that a raising fee payable in respect of the qualifying loan, advance or credit is a related finance charge.

Meyerowitz' reference to the Revenue Department's view related to a letter from the Commissioner to *The Taxpayer*, dated 19 January 1982, which, according to Meyerowitz (1999), stated that related finance charges would include any item treated as a finance charge in terms of the Limitation and Disclosure of Finance Charges Act No. 73 of 1968, as was enacted at the time (now referred to as The Usury Act, No. 73 of 1968). The legislation referred to included raising fees as part of the definition of 'finance charge.'

By classifying raising fees as related finance charges, s 11(*b*A) thus served as a possible alternative to deduct raising fees incurred in respect of pre-production qualifying assets (Silke & Stretch 2000), which would otherwise be considered non-deductible in terms of s 11(*a*) of the Act.

Circular Minute

In 2000, eighteen years after s 11(*b*A) was first legislated, SARS issued *Circular Minute No. 2/2000* to all its regional head offices, departmental receivers of revenue, heads of sections (heads of office), inspectors of SARS and tutors, setting out SARS position on the deductibility of raising fees in terms of s 11(*b*A) (Coetzee 2000). The *Circular Minute* noted that the pertinent issues for consideration in this regard were firstly, whether raising fees constituted 'related finance charges' for the purposes of s 11(*b*A), and secondly, whether the loan was obtained to acquire qualifying assets.

The *Circular Minute* reaffirmed that the term 'interest and related finance charges' was not defined in the Income Tax Act, nor any other statute of the Republic. Through inclusion of the word 'related' in the term 'related finance charges,' it was considered implicit that there are many types of finance charges, but only those related to qualifying interest would be deductible in terms of s 11(*b*A). SARS therefore considered it necessary to firstly determine whether raising fees constituted finance charges and secondly, consider whether they were 'related' to interest (Coetzee 2000).

The *Circular Minute* referred to The Usury Act No. 73 of 1968, which contained a definition for finance charges, in order to ascertain whether or not raising fees constituted finance charges. This reference is consistent with the Commissioner's letter to *The Taxpayer*, as mentioned earlier in this Chapter. The definition was considered complex and comprehensive, however not conclusive, and as a result, may have been applicable to raising fees, depending on the

circumstances and nature of the raising fees (Coetzee 2000). In any case, the Income Tax Act did not specifically refer to the Usury Act definition, and its usefulness in this context was considered questionable, according to the *Circular Minute* (Coetzee 2000).

At the time of the *Circular Minute* (Coetzee 2000), the term 'raising fees' was used in the Income Tax Act, specifically in s 24F where it was included within part (*e*) of the definition of 'production cost,' as follows:

> *'(e) interest, finance charges and raising fees incurred for the purposes of or in connection with the production of the film;'*

The *Circular Minute* drew attention to the fact that, in the above definition, the legislature listed raising fees separately to finance charges and thus, for the purposes of s 24F, the legislature considered raising fees as separate and distinct from finance charges (Coetzee 2000). It is noted that s 24F was repealed in 2013.

Having noted the above, the *Circular Minute* continued by questioning whether, even if raising fees are assumed to be finance charges, could they be considered as 'related' to interest for the purposes of s 11(*b*A). The *Circular Minute* did so by comparing the characteristics of interest and raising fees, thereby noting the following: related finance charges are considered to be a cost of raising capital, whereas interest represents the cost of using capital; raising fees are typically also once-off charges, whereas interest generally takes the form of recurring payments; interest is calculated with reference to a period of time (usually the term of the loan), unlike raising fees which is typically unrelated to any aspect of time (Coetzee 2000).

The *Circular Minute* also noted that the recurring nature of pre-production interest results in it not being of a capital nature, whereas once-off raising fees for the acquisition of fixed assets are of a capital nature. It was further submitted that the intention of the legislature underpinning s 11(*b*A) was not to grant a deduction for capital expenditure, but rather a deduction for finance charges which would not qualify on the basis that the taxpayer has not commenced trading (Coetzee 2000).

It is submitted, with respect, that this reasoning is arguably incorrect as the wording of s 11(*b*A) did not refer to 'pre-trade' expenditure but actually allowed for the deduction of related finance charges incurred in respect of assets prior to an asset being brought into use for the purposes of the taxpayer's trade, and would thus be applicable even in the case where such related finance charges was incurred after the commencement of the taxpayer's trade.

On the basis of their points as noted above, the *Circular Minute* indicated that, in SARS view, raising fees represented either not a finance charge or not a related finance charge within the context of s 11(*b*A), and assessors and auditors were instructed not to allow the deduction of such amounts under this section (Coetzee 2000).

Commentary by Silke & Stretch (2000) noted that, although the above interpretation may be correct in terms of law, the prohibition of deductions of expenditure bona fide incurred for legitimate business reasons is an absurdity on the part of SARS. According to De Koker & Williams (2014: para 8.90), in practice SARS regarded raising fees in respect of a loan or credit arrangement as constituting 'related finance charges'. This was contrary to the view presented in the *Circular Minute.*

Commissioner for South African Revenue Service v South African Custodial Services (Pty) Ltd

In a noteworthy recent case, *Commissioner for South African Revenue Service v South African Custodial Services (Pty) Ltd*, the Supreme Court of Appeal held that various fees incurred by the taxpayer in order to finance the construction of a prison were deductible in terms of s 11(*b*A) as they qualified as 'related finance charges' for the purposes of the section because of their close connection to the obtaining of the loan and the furtherance of the taxpayer's project in this particular case. These fees included guarantee fees, introduction fees, financial advisory fees, margin fees, commitment fees, administration and legal fees all incurred in connection with a concession contract to design, construct and operate a prison. The judicial interpretation of 'related finance charges' in this case therefore included such raising fees for the purposes of s 11(*b*A). This case is discussed in further detail in the ensuing Chapter.

Repeal of s 11(*b*A)

This Supreme Court of Appeal decision provided much-needed clarity for the deductibility of raising fees under the provisions of s 11(*b*A), however this case was decided on 30 November 2011, merely one month before the repeal of this section, and the precedent set by the *South African Custodial Services* case therefore appeared to be limited in terms of its application to a now-repealed section. The repeal of s 11(*b*A) came into operation on 1 January 2012, with effect from years of assessment commencing on or after that date (National Treasury 2011).

According to the *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011,* s 11(*b*A) was rendered obsolete in light of the introduction of s 11A of the Act, which allowed for the deduction of business startup expenditure, including pre-startup interest expenditure

(National Treasury 2011). Section 11A of the Act applies to deduct expenditure which is incurred prior to the commencement of trade, and expenditure incurred in preparation for carrying on such trade. Section 11A of the Act, however, would only allow the deduction of pre-production expenditure (including interest) prior to the commencement of a trade, and a void was thus created whereby the repeal of s 11(*b*A) resulted in no deduction for taxpayers that had already commenced trade but incur interest on a new qualifying asset which is not brought into use immediately (Jooste *et al.* 2012). In addition, s 11A of the Act ring-fenced the expense to the income from that specific trade, which was not the case for s 11(*b*A) (Kotze 2011).

Conclusion

Although the *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011,* indicated that s 11(*b*A) was rendered obsolete by the introduction of s 11A of the Act, various subtle differences as highlighted above meant that, practically, the repeal of s 11(*b*A) resulted in certain scenarios where there would be no avenue for the deduction of pre-production interest and related finance charges.

The question thus arises – did the landmark decision in the *South African Custodial Services* case, whereby related finance charges was judicially defined, provide any respite for taxpayers in the wake of the repeal of s 11(*b*A)? This judgment is analysed in further detail in the following Chapter.

Chapter Four: The *South African Custodial Services* Case

This Chapter will assess the judicial precedent arising from a recent Supreme Court of Appeal decision by a full bench comprising Plasket AJA, Brand JA, Maya JA, Cachalia JA and Mhlantla JA. In *Commissioner for South African Revenue Service v South African Custodial Services (Pty) Ltd,* the taxpayer, South African Custodial Services (hereinafter, 'SACS'), represented a joint venture between a South African entity and an American entity which specialised in the operation of correctional, detention and health facilities throughout the world. SACS entered into a concession contract with the Ministry of Correctional Services whereby SACS would design, construct and operate a prison in Makhado (formerly, Louis Trichardt) in the Limpopo province, for a period of 25 years, at a contract price of R303 million.

SACS incurred interest and various charges in raising finance for its role as a contractor in this public-private partnership.

When the above scenario was presented before the Tax Court in ITC 1845, Claassen J allowed the deductions for interest and various charges as they were found to be of a revenue nature.

When presented before the Supreme Court of Appeal, there were three matters under consideration, the last of which was the deductibility of the interest incurred on the loan and the additional finance charges. In paragraphs 13 to 17, the Supreme Court of Appeal judgment detailed the specific fees which the taxpayer attempted to deduct under the provisions of s 11(*b*A), which was in legislation at the time.

> [13] In order to finance the project and to meet its other obligations in terms of the concession contract, SACS entered into agreements with BoE Merchant Bank and First Rand Bank for loans of R384 000 000. These banks required security which was provided in the form of guarantees given by the South African Government and the shareholders of SACS.
>
> [14] The government undertook to guarantee 80 percent of the loan while the shareholders of SACS guaranteed the remaining 20 percent. The GEO Group's share of the guarantee was provided by a company in the group, Wackenhut Corrections Corporation. In terms of a guarantee and put agreement, SACS was required to pay 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.
>
> [15] 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.
>
> [16] 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.

> [17] 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.

At paragraph 49, in a unanimous judgment delivered by Plasket AJA (in which all five Justices of Appeal concurred), the Supreme Court of Appeal upheld the Tax Court's decision regarding the deductions of the interest and various charges:

> [49] The interest that SACS has incurred is, in my view, deductible in terms of s 11(bA): it has 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. I am also of the view that the various fees are deductible in terms of s 11(bA): because of their close connection to the obtaining of the loans and the furtherance of SACS's project, they qualify as 'related finance charges' for purposes of the section.

Although the judgment above dealt specifically with s 11(*b*A) as it referred to 'interest (including related finance charges)', the judgment broadly addressed the tax deductibility of fees paid to lenders, guarantors, facilitators and providers of legal services, and held that all of these were 'related finance charges' because of their close connection to the obtaining of the loans and the furtherance of the taxpayer's project. Through this judgment, Plasket AJA established the principle that the term 'related finance charges' includes charges that have a close connection to the obtaining of the loan and the furtherance of the taxpayer's business intentions.

On the basis of the above judgment, it is submitted that the term 'related finance charges' should be interpreted as fees or charges which have a close connection to the obtaining of a loan and the furtherance of the taxpayer's business intentions. This is not in line with the commercial interpretation of finance charges being charges similar to interest charges in circumstances where the underlying nature of the arrangement is not a loan (for example, a suspensive sale) (Mitchell 2004; De Koker & Williams 2014: para 8.53).

In the above judgment, the Plasket AJA then referred the assessment back to the Commissioner in order to determine the precise quantum of the deduction in light of the principle set out in *Caltex Oil (SA) Ltd v Secretary for Inland Revenue*, that the expenditure claimed was actually incurred during the year of assessment in which the deduction was sought.

As an aside, it is noted, with respect, that the question of whether the expenditure is actually incurred in the year of assessment in which the deduction was sought is irrelevant for the purposes of s 11(*b*A), which provided a deduction in the year of assessment when a

qualifying asset is first brought into use, for expenditure incurred in years of assessment prior to the qualifying asset being brought into use. Section 11(*b*A) thus did not require that the expenditure be actually incurred in the year of assessment in which the deduction was sought.

During the process of the Commissioner determining the amount of the deduction, the Commissioner and the taxpayer were in conflict as to which expenses exactly were to be regarded as related finance charges, as the *South African Custodial Services* judgment referred to 'various fees' but the exact constituents of this category of deductible expenses was not specified in the judgment (ITC 1870 2013). An assessment was issued by the Commissioner which disallowed the deduction of a category of 'further costs' on the basis that this grouping of expenditure was a new issue which had not been specifically addressed by the Supreme Court of Appeal. The taxpayer contended this assessment of the category of 'further costs,' which included bid expenses, developer fees, legal fees, insurance, start-up costs, specialist advocate costs and lenders technical advisors cost. The taxpayer contended that the Supreme Court of Appeal referred the matter back to the Commissioner only for the determination of whether the expenses had been actually incurred in the relevant year of assessment, and thus the taxpayer argued that the Commissioner was not at liberty to disallow the deduction of the 'further costs' (ITC 1870 2013).

This matter was taken to the Special Tax Court in ITC 1870, for interpretation of the Supreme Court of Appeal's decision. Victor J noted, in paragraph 28 of her judgment in the Special Tax Court, that certain words used in Plasket AJA's judgment, such as 'other costs', 'financial costs', 'in order to bid for the tender', 'raise the loans', 'various fees' and 'furtherance of the *SACS*' project' had the effect of extending the principle of deductibility beyond a very limited interpretation of finance charges. In doing so, the Special Tax Court indicated that the Supreme Court of Appeal had adopted a broad approach and considered related finance charges to include all costs that were closely connected with the furtherance of the project. Raising fees, in particular, were characterised by the Supreme Court of Appeal as a related finance charge for the purposes of s 11(*b*A) (Silke & Stretch 2014).

In response to the Commissioner's contention that the s 11(*b*A) deduction in the *South African Custodial Services* case was limited to 'guarantee fees, introduction fees and other

finance charges', Victor J stated the following at paragraph 35 of her judgment in the Special Tax Court:

> [35] This argument must fail in the light of the broader approach by the SCA to the various categories of costs. If the only s 11(bA) category was the guarantee fees, introduction fee and other finance charges then the allowable deductions would have been limited to those categories only. Instead the SCA went much wider in allowing raising fees (margin fee, financial advisory fee, commitment fee, bid guarantee fee) to be deductible because of 'the close connection to the obtaining of loans and the furtherance of the SACS' project'. The SCA characterised the various fees as a related finance charge for the purpose of s 11(bA).

In concluding her judgment, Victor J stated the following at paragraphs 41 and 42:

> [41] Some of the items in the 'further costs' category are the same as those which the SCA ruled deductible. The interpretation and application of the principle cannot be limited because of an absence of an express reference to a category known as 'further costs' in the SCA judgment. Principles emanating from judgments are meant to be applied to different facts otherwise the law would be a static process. A sensible objective observer looking at the judgment in its entire context would note the import of the principles of allowing the deductions of a wide variety of fees and the like. The category 'further costs' is but a descriptive outline or a convenient label perhaps for accountants. On the whole the items listed in 'further costs' are a 'close connection' to the furtherance of the project.
>
> [42] Once that is so, in the absence of an express reference to disallowing 'further costs', I conclude that the judgment must be interpreted to include further costs. I direct that the Commissioner must deduct the category of costs labelled as 'further costs.'

The judicial interpretation of 'related finance charges' by the Supreme Court of Appeal is therefore fortified by Victor J's judgment in the Special Tax Court.

Conclusion

Although the cases discussed in this Chapter dealt with the deductibility of 'related finance charges' in the context of legislation which has since been repealed, there is nonetheless merit in analysing the judicial precedent of the Supreme Court of Appeal as a means to consider the meaning of 'related finance charges' in the context of s 24J of the Act, and possibly support the deductibility of raising fees in terms of that section. This is further discussed in Chapter Five.

Chapter Five: Deductibility of raising fees in terms of s 24J of the Act

Introduction

As discussed in the previous Chapter, the *South African Custodial Services* case confirmed s 11(*b*A) as an alternative avenue for the deductibility of raising fees, if considered to be closely connected to the obtaining of loans and the furtherance of the taxpayer's business intentions. Since its repeal, however, s 11(*b*A) is no longer available for taxpayers and the deductibility of raising fees may again need to be considered in terms of the general deduction formula. The analysis in Chapter Two highlighted the historically crucial aspect of whether raising fees are to be classified as capital or revenue in nature, a key determinant for possible deductibility under the general deduction formula. The question thus arises for raising fees which are considered to be capital in nature: does the legislation allow for the deductibility thereof, since the repeal of s 11(*b*A)?

This Chapter will consider the possibility of a deduction for raising fees under s 24J of the Act, applying the judicial precedent set by the *South African Custodial Services* case.

Judicial interpretation of 'related finance charges'

The *South African Custodial Services* case, as examined in Chapter Four, provided a judicial interpretation for the term 'related finance charges', albeit in the context of s 11(*b*A). In assessing this judicial precedent, the stare decisis principle is to be applied. Van Dijkhorst (2003) provides the following description:

> The expression 'stare decisis' means 'to stand by decisions' and refers to a doctrine that must be borne in mind by every court when rendering a decision involving a legal principle, both as to common law and statutory law. The object of the doctrine is to avoid uncertainty and confusion, to protect vested rights and legitimate expectations as well as to uphold the dignity of the court. Therefore, when a decision on a legal principle has been delivered by a superior court it should, in general, as far as possible be followed by all courts of equal and inferior status, until such time as that judgment has been overruled or modified by a higher court or by legislative authority. In general, it can be stated that a court is bound by the ratio of a decision of a higher court or a fuller court on its own level unless the decision was given per incuriam.

De Koker & Williams (2014: para 25.4) expand on the application thereof as follows at 25.4:

> Although the two parties to a case are bound by the judgment pronounced by the court (as between them the matter becomes res judicata, that is, conclusive and binding), it does not necessarily follow that all courts are bound by the decision. But the court that gave the decision and all courts subordinate to that court are bound by the decision. This principle by which a decision of a court is authoritative and binding and must be followed in subsequent cases in which the facts are similar is called 'stare decisis'.

The quotations above make reference to the ranking of the court and the effect thereof on the application of stare decisis. The *South African Custodial Services* case was ruled by the Supreme Court of Appeal, which is the highest court in South Africa, second only to the Constitutional Court. Van Dijkhorst (2003) provides the following commentary at 169 on the precedent arising from a decision by this particular court:

> The Supreme Court of Appeal is, except in constitutional matters, since the abolition of appeals to the Privy Council in 1950, the highest court and its decisions are binding on it and on every other court but subject to the overriding jurisdiction of the Constitutional Court in constitutional matters.
>
> It is to be noted that a decision of this court consisting of three members (even if not unanimous) is as binding as a unanimous decision of a bench of five. The Supreme Court of Appeal considers itself bound by its own decisions, unless a decision has been arrived at on some manifest oversight or misunderstanding, that is, there has been something in the nature of a palpable mistake. Consequently the court will only depart from its previous decision if it is clear that the court has erred or that the reasoning upon which the decision rested was unsound. It will not perpetuate a mistake and will depart from its previous incorrect decision unless people have acquired rights in reliance thereon. The ratio decidendi will also not be binding, unless concurred in by the majority of judges who heard the case.

The *South African Custodial Services* judgment was a unanimous decision by a full bench of five Justices of Appeal at the Supreme Court of Appeal where the term 'related finance charges' was judicially defined and applied in the judgment as the ratio decidendi to allow certain charges as deductible for tax purposes.

It is thus submitted that the judicial definition of 'related finance charges', as set by the Supreme Court of Appeal, is as follows: raising fees will qualify as 'related finance charges' if they have a close connection to the obtaining of a loan and the furtherance of a taxpayer's business intentions. This was also the ratio decidendi in the *South African Custodial Services* case, leading to the court ruling that the various charges were deductible in terms of s 11(*b*A). There is no evidence to suggest that the *South African Custodial Services* decision was arrived at on a manifest oversight or misunderstanding, and no reason to suggest that the court's decision was unsound.

Applying stare decisis, and with appreciation for the ranking of the Supreme Court of Appeal, this decision is binding on the Supreme Court of Appeal and every other court, with the exclusion of the Constitutional Court in constitutional matters.

Related finance charges: s 24J(1) of the Act vs. s 11(*b*A)

Although the *South African Custodial Services* case provided a judicial definition of related finance charges, this was done so in the context of the since repealed s 11(*b*A). As the term 'related finance charges' is also included in s 24J of the Act, the applicability of the judicial definition thereof to the latter section is considered in this Chapter.

The question arises as to whether the Supreme Court of Appeal's judicial interpretation of 'related finance charges' in the context of s 11(*b*A) may be applied to the term as it is included in s 24J(1) of the Act. This was alluded to by Wilcocks (2014) who viewed the *South African Custodial Services* case as suggestive that certain fees relating to an instrument may constitute finance charges and therefore be included in interest, even though the judgment did not deal with finance charges in the context of s 24J of the Act.

In applying stare decisis, with cognizance of the Supreme Court of Appeal's ranking, the interpretation of the term 'related finance charges' may only be deviated from by that same court if it is clearly proven that the unanimous decision in the *South African Custodial Services* case was arrived at in err or unsound reasoning, or if there is cause to distinguish between the context of the term's usage in different sections of the legislation, repealed or not. It is therefore necessary to compare the context in which the term appears in s 24J(1) of the Act against the wording of the now-repealed s 11(*b*A).

Section 24J(1) of the Act: definition of 'interest'

In the definition of 'interest' in s 24J(1) of the Act, the term 'related finance charges' is included as follows:

> 'interest' includes the—
> (a) gross amount of any interest or related finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement ...

The terms 'interest' and 'related finance charges' are not specifically defined in the Act, and it is thus necessary to assess the judicial interpretation thereof for the purposes of s 24J(2) of the Act.

In *Commissioner for Inland Revenue v Cactus Investments (Pty) Ltd*, 'interest' was judicially defined as the stipulated return which a lender would require if he lends money to a borrower.

Previously, the term 'related finance charges' appeared in s 11(*b*A) as 'interest (including related finance charges) actually incurred ... on any loan, advance or credit', which differs from

the wording used in s 24J(1) of the Act as provided above. It is thus necessary to compare the diction in s 11(*b*A) to s 24J of the Act, in considering the applicability of the judicial definition of 'related finance charges' to the latter section.

The *Explanatory Memorandum on the Income Tax Bill, 1995,* which provided commentary on the introduction of s 24J of the Act did not provide guidance on the legislature's intention behind the inclusion of the term 'related finance charges' in the definition of interest, but merely indicated that the interest definition was 'not exhaustive' (National Treasury 1995).

The interest definition also includes any 'discount or premium' payable in respect of a financial arrangement, with both forming part of the overall yield of an instrument. According to Wilcocks (2014), the treatment of discounts and premiums as interest overrides the general capital versus revenue principle whereby such amounts may constitute amounts of a capital in nature, depending on the particular circumstances, thus backing the suggestion that interest for the purposes of s 24J of the Act is wide-ranging and extensive. Despite this, Wilcocks (2014) noted that some doubt exists as to whether the term 'related finance charges' incorporates related transaction costs (such as fees to arrange the instrument).

*Section 11(b*A*) vs. section 24J of the Act*

In comparing the context in which 'related finance charges' appears in the two sections, the interest definition in s 24J(1) of the Act refers to a 'financial arrangement' whereas s 11(*b*A) made reference to the term 'loan, advance or credit'. Although the term 'financial arrangement' is not defined in the Act, on its own, 'arrangement' is defined in s 80L of the Act as 'any transaction, operation, scheme, agreement or understanding...'. It is submitted that a financial arrangement, based on the ordinary grammatical meaning of 'financial', would include debt financing agreements and other funding agreements which give rise to raising fees, and it is submitted that a 'financial arrangement' has a wider application than the term 'loan, advance or credit' which refers to specific types of financial arrangements. It is therefore submitted that there is no significant difference between the terms 'loan, advance or credit' and 'financial arrangement', as the latter term would comprise the former.

Another difference in wording between the two sections is that s 11(*b*A) required that the related finance charges were to be incurred 'on' a loan, advance or credit, whereas s 24J(1) of the Act refers to related finance charges 'in terms of or in respect of' a financial arrangement. The *South African Custodial Services* judgment did not expand on this aspect of s 11(*b*A) in

detail, but held that if there was a close connection between the raising fees and the loan, the related finance charges were incurred 'on' the loan.

It is debatable whether the term 'in respect of' may be construed as having a narrower meaning, thus requiring a direct causal relationship, or if a wider interpretation is to be applied. This phrase has been analysed in a number of decisions (De Koker & Williams 2014: para 25.7A), as indicated in the following extract from ITC 1340at 212-213:

> As was pointed out by Solomon JA in CIR v Crown Mines Ltd 1923 AD 121 at 128, the expression 'in respect of' may be used in various senses, and in each case it is necessary to examine the context in order to ascertain the sense in which it is used. Of the numerous decided cases in which the interpretation of the words 'in respect of' was discussed, I need refer only to two of the more recent decisions in which the earlier decisions are referred to: SBI v Raubenheimer 1969 (4) SA 314 (A) at 320 (31 SATC 209)76 and SIR v Wispeco Housing (Pty) Ltd 1973 (1) SA 783 (A)77 where Ogilvie Thompson CJ said the following at 792:
>
> "No doubt the expression 'in respect of' must, in certain contexts, be restricted to a direct or causal relationship (cf eg De Villiers v CIR 1929 AD 227 at 229);78 but, as was pointed out in CIR v Butcher Bros (Pty) Ltd 1945 AD 301 at 320,79 the expression 'in respect of' does not necessarily or invariably indicate such relationship. In that case, it was held to be used in the sense of 'in relation to' or 'in reference to'. (Cf also SBI v Raubenheimer . . . .) The expression 'in connection with' prima facie extends the ambit of matters comprehended in casu, the consideration upon which duty is payable. As Kitto J put it in Berry's case . . . at 658,80 'a consideration may be 'in connection with' more things than that 'for' which it is received."
>
> As appears from all the aforegoing, the context wherein the expressions 'in respect of' and 'in connection with' occur is of vital importance. The true position was, in my opinion, happily summarized by Schreiner JA, in Rabinowitz and another v De Beer's Consolidated Mines Ltd and another 1958 (3) SA 619 (A) at 631, as follows:
>
> "Expressions like 'in respect of' and 'in connection with', though they may sometimes be used to cover a wide range of association, must in other cases be limited to the close or more direct forms of association indicated by the context."

The court in ITC 1340 accordingly concluded that there was no reason why the words 'in respect of,' as they were used in s 11*bis*(4)(*f*) of the Act, should be interpreted as referring to a direct or causal relationship.

The *South African Custodial Services* decision applied a broad interpretation to the term 'on a loan, advance or credit' for the purposes of s 11(*b*A). This was further confirmed by Victor J in ITC 1870. Based on the above, it is thus submitted that a wider meaning of the term 'in respect of' should also be applied when interpreting related finance charges in the context of s 24J(1) of the Act, and a direct causal relationship is not considered necessary.

Having analysed the wording of the two sections above, it is submitted that there is no substantial difference in the context of 'related finance charges' as they appeared in s 11(*b*A) and as included in the 'interest' definition per s 24J(1) of the Act. It is thus submitted that the judicial definition of related finance charges arising from the *South African Custodial Services* case may be applied to s 24J(1) of the Act.

Thus, applying the judicial interpretation laid down by Plasket AJA, there should be a close connection between the expenditure incurred and the obtaining of the 'financial arrangement' and the furtherance of the taxpayer's business intentions for the expenditure to be regarded as 'related finance charges' for the purposes of s 24J(1) of the Act.

In the *South African Custodial Services* case, raising fees were regarded as 'related finance charges' for the purposes of s 11(*b*A). In addition, an analysis of raising fees constituting 'related finance charges' was set out in Chapter Three of this research report. Accordingly, it is submitted that, as in the *South African Custodial Services* case, raising fees which meet the criteria set by the judicial definition will constitute related finance charges payable in terms of a financial arrangement and therefore, interest for the purposes of s 24J(1) of the Act.

Deductibility of raising fees in terms of s 24J of the Act

The *South African Custodial Services* decision provided a judicial interpretation of 'related finance charges' as including raising fees and, per the analysis above, it is submitted that this interpretation may be applied to 'related finance charges' in the context of the 'interest' definition per s 24J(1) of the Act. On this basis, taxpayers may seek to treat raising fees as 'related finance charges', and therefore as 'interest' (as defined), for the purposes of s 24J(1) of the Act. The references to 'interest' for the remainder of this Chapter are therefore deemed to include 'related finance charges' and therefore raising fees, for the purposes of s 24J of the Act.

A deduction for interest incurred by a taxpayer is allowed in terms of s 24J(2) of the Act which provides:

> 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,

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.

In order for s 24J(2) of the Act to apply, there are certain criteria which need to be met. As a starting point, there must be an 'issuer' who has incurred 'interest' in terms of an 'instrument.' The definition of 'interest' has been provided earlier in this Chapter.

Issuer

One of the prerequisites of s 24J(2) of the Act, is that there is an 'issuer', defined in s 24J(1) of the Act as follows:

'issuer', in relation to any instrument—

(a) means 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;

It is submitted that a taxpayer will typically be considered to be an 'issuer' in relation to an instrument for the purposes of s 24J(2) of the Act if they have obtained funding from a bank and have an obligation to repay interest in terms of such instrument.

Instrument

In addition to an issuer, s 24J(2) of the Act also requires that there must be an 'instrument'. An extract from the definition of 'instrument' in s 24J(1) of the Act is included below:

"instrument' means—

... (c) any form of interest-bearing arrangement or any debt; ...'

This is a broad definition encompassing interest-bearing debt obtained by a taxpayer (the 'issuer', or borrower) from a financial institution.

Accrual amount

Section 24J(1) of the Act defines an 'accrual amount' (in relation to an accrual period) as the yield to maturity multiplied by the adjusted initial amount.

Accrual period

The accrual period, which has been defined in s 24J(1) of the Act, is the interval at which regular payments are required to be made, but cannot exceed twelve months.

Adjusted initial amount

Section 24J(1) of the Act also provides a definition for the 'adjusted initial amount'. The adjusted initial amount in relation to an issuer of an instrument for an accrual period is the original loan capital plus accrual amounts (interest) for all previous accrual periods less payments made by the issuer during previous accrual periods in terms of the instrument. The adjusted initial amount is thus the outstanding loan balance for tax purposes at the beginning of the accrual period.

Yield to maturity

The term 'yield to maturity' is defined in s 24J(1) of the Act as *'a rate of compound interest per accrual period at which the present value of all amounts payable or receivable in terms of any instrument in relation to a holder or an issuer, as the case may be, of such instrument during the term of such instrument equals the initial amount in relation to such holder or issuer ...'*.

Applying the above definitions, s 24J(2) of the Act deems any interest (as defined) incurred by an issuer in terms of an instrument to have been incurred on a compounding accrual basis. Similarly, raising fees which are submitted as falling within the ambit of the 'interest' definition (as 'related finance charges') would therefore be deemed to have been incurred on a compounding accrual basis (Kruger 2010). It is thus submitted that raising fees would be spread over the period from the date a taxpayer acquires an instrument until the date of its disposal or maturity, and this is achieved by application of the yield to maturity over the term

of the instrument. Such raising fees would be deductible over the period of the instrument, in accordance with section 24J(2) of the Act.

The above submission must, however, be cautioned by a closer look at the yield to maturity and adjusted initial amounts definition. Both definitions are critical, as they both form part of the accrual amount formula, and the deduction in terms of s 24J(2) of the Act refers specifically to accrual amounts. The adjusted initial amount definition refers to 'amounts ... in terms of such instrument.' The yield to maturity definition refers to 'amounts payable ... in terms of any instrument,' which may be construed as restricting the calculation of the compound interest rate to exclude any amounts that are not payable by the issuer in terms of the instrument. This would be the case if a narrow interpretation of the phrase 'in terms of' is adopted to limit the applicability to amounts which are expressly stated in the terms of the instrument (for example, the loan agreement). If a raising fee is not payable in terms of the same agreement as the underlying debt agreement (that is, the instrument), it may be interpreted as not being an amount payable 'in terms of' the instrument, and thus excluded from the yield to maturity or adjusted initial amount calculations, and consequently the accrual amount formula.

This could be the case where a raising fee is paid to someone other than the holder of an instrument, for example a guarantee fee paid to a guarantor. While it has been submitted in this Chapter that raising fees are deductible in terms of s 24J(2) of the Act, this treatment might not extend to raising fees which are not considered amounts payable in terms of an instrument (as defined). The practical implications of the above cautionary are addressed further in Chapter Six.

Alternatively, if a wider interpretation of the phrase 'in terms of' is adopted, it may suffice for there to be a causal link between the fee and the instrument. It is submitted that, in the context of the definition of interest per s 24J(1) of the Act, which was previously in this Chapter noted as not being exhaustive, a broader interpretation of 'in terms of' should be adopted. Thus, it is submitted that a mere causal relationship between fees charged and an instrument will suffice for the purposes of a fee's inclusion within the yield to maturity calculation.

Section 23 of the Act

The limitation on deductions legislated by s 23 of the Act, specifically ss 23(*f*) and (*g*), has been discussed in Chapter Two of this research report, in the context of the general deduction formula. This section is also applicable to s 24J(2) of the Act, as the limitations apply to deductions in general, and the deductions in terms of s 24J(2) of the Act are not excluded from its ambit.

Trade requirement

The deduction in terms of s 24J(2) of the Act must be made from income derived from carrying on any trade. This is in line with s 23(g) of the Act, as addressed in Chapter Two, which limits the deduction of expenditure to the extent that it is 'laid out or expended for purposes of trade.'

In the production of income requirement

Section 24J(2) of the Act requires that a deduction is allowed only if that amount is incurred in the production of income. The reference to 'income' is to be made in the context of the definition of 'income' per s 1 of the Act, as included in Chapter Two of this research report.

As with the general deduction formula as discussed in Chapter Two, specifically s 23(*f*) of the Act, no deduction will be allowed in terms of s 24J(2) of the Act where the funds obtained via an instrument are used for an investment in shares, the return on which is in the form of local dividend income which is exempt from tax in terms of s 10(1)(*k*) of the Act. Interest and related finance charges incurred for such a purpose would be treated as non-deductible in terms of s 24J(2) of the Act on the basis that the expenditure is not in the production of income.

Section 11(*a*) of the Act vs. s 24J(2) of the Act

When s 24J of the Act was first introduced in 1995, it was not a deduction provision and merely provided a means for the determination of the amount of interest incurred each year, and such amount was thereafter deductible under s 11(*a*) of the Act. In 2004, s 24J of the Act was amended fundamentally to become a deduction provision specifically for interest incurred by taxpayers. Prior to 2004, interest therefore had to be tested against the capital requirement of the general deduction formula. This was no longer required after 2004, as thereafter

interest was deductible under the provisions of s 24J(2) of the Act, provided the relevant criteria were met (Manzansky 2008).

It has been submitted in this Chapter that a deduction for raising fees may be possible as a 'related finance charge' under the provisions of s 24J(2) of the Act, assuming that the necessary criteria are met. The deductibility of raising fees under the general deduction formula has also been addressed in Chapter Two of this research report. The key difference between the requirements of these two sections is the capital requirement of the general deduction formula, which is absent from s 24J(2) of the Act.

In considering whether to seek a deduction in terms of s 11(*a*) of the Act or s 24J of the Act, the legal maxim generalia specialibus non derogant may be applied in interpreting the applicability of these two statutory provisions. Thus, in case of a conflict between the two sections, the terms of the specific provision (here, s 24J(2) of the Act) are more likely to take preference over the general provision (in this case, s 11(*a*) of the Act read with ss 23(*f*) and (*g*) of the Act) (De Koker & Williams 2014: para 25.15A).

Furthermore, s 23B(3) of the Act specifically prohibits a deduction in terms of s 11(*a*) of the Act when such expenditure is deductible in terms of the provisions of another section of the Act, irrespective of whether the other provision contains a limitation on the deduction, or is in respect of a different year of assessment (Kruger 2010). This will be the case where related finance charges meet the criteria of s 24J(2) of the Act. For related finance charges which are not considered to fall within the ambit of that section, a deduction may be allowed under s 11(*a*) of the Act, provided the relevant requirements are met (Kruger 2010).

The application of s 24J(2) of the Act instead of the general deduction formula results in a more favourable position for the taxpayer claiming a deduction for raising fees, as the most contentious issue under s 11(*a*) of the Act (the capital requirement), will no longer serve as an obstacle in terms of s 24J(2) of the Act. An added benefit is that a deduction in terms of s 24J of the Act is greater in the earlier years of assessment covering the term of the instrument, and is therefore more advantageous for borrowers from a cash flow perspective (Kruger 2010).

Conclusion

Although the *South African Custodial Services* case dealt with legislation which has since been repealed, it is nonetheless still a landmark case with relevance for taxpayers that incur raising fees and are seeking a deduction therefore. Through Chapters Four and Five of this research report, it has been submitted that the judicial precedent set by the Supreme Court of Appeal in the *South African Custodial Services* decision regarding related finance charges, and specifically, raising fees, may be applied in considering the deductibility of raising fees in the context of s 24J of the Act. It is thus submitted that, in determining the deductibility of raising fees, the 'capital requirement' is no longer a consideration with which taxpayers need be concerned, as this is not a requirement of s 24J of the Act.

Chapter Six: Practical Implications of the Deductibility of Raising Fees in terms of s 24J of the Act

Since the deductibility of raising fees under s 24J of the Act has been submitted in the previous Chapter, this Chapter will address the practical implications thereof. Raising fees can take on many different forms, each with its own variations (Silke & Stretch 2000). The most common types of raising fees, and the tax implications of their nuances (if any), will be addressed in this Chapter, as follows:

- Origination fees
- Commitment fees
- Agency fees
- Guarantee fees

In assessing the above, this Chapter will address the amount and timing of the deduction of raising fees. The focus of this Chapter will be limited to common variations in the computation of raising fees, and the impact thereof on the yield to maturity calculations for the purposes of s 24J of the Act. A detailed analysis of yield to maturity calculations is beyond the scope of this research. This Chapter will also consider whether s 23H of the Act could apply to disallow the deduction of raising fees in terms of s 24J of the Act.

Common types of raising fees

This Chapter addressed the following four common types of raising fees: origination fees, commitment fees, agency fees, and guarantee fees. It is assumed that these fees would all be considered to be raising fees, and thus deductible as related finance charges in terms of s 24J of the Act, as submitted in Chapter Five. This assumption has been made as these types of fees were either included within, or bear resemblance to, the various charges dealt with in the *South African Custodial Services* decision, and for that reason it is submitted that they constitute raising fees in the context of related finance charges. Although the scope of this Chapter is limited to discuss the above-mentioned four types of raising fees, it is noted that raising fees may also encompass investigation fees, procurement fees, margin fees, renewal fees, etc., some of which were mentioned by Coetzee (2000) in the *Circular Minute*.

An 'origination fee' is charged by lenders for the processing of a new loan application and

serves to recompense the lender for putting the loan in place. This is analogous to the 'introduction fee' as referred to in the *South Africa Custodial Services* case. Such fees are generally charged up-front, non-refundable, and quoted as a percentage of the total loan (Investopedia n.d.), in which case it is submitted that they will be entitled to a deduction under s 24J(2) of the Act, in the manner described in Chapter Five.

'Commitment fees,' also known as holding fees, represent fees charged by lenders to borrowers for an unused facility, unused credit line or undisbursed loan, and is generally quoted as a fixed percentage of the undisbursed loan amount (Investopedia n.d.), payable annually over the term of the loan. This type of fee was also included within the broad range of fees dealt with in the *South African Custodial Services* case, as deductible under s 11(*b*A).

Where a funding arrangement includes an agent bank, responsible for the co-ordination of the loan between the borrower and participating banks (Investopedia n.d.), the borrower may also be charged 'agency fees' as compensation for the agent bank. This type of fee may be considered similar to the fees charged by African Merchant Bank to SACS. The specifications of such fees vary, but may be fixed annual amounts, with an additional variable component charged when the agent bank is required to perform additional services, obligations or duties not provided for in the loan agreement, or in the event of a default on the loan. The annual agency fee may also escalate in line with inflation.

In considering the deductibility of commitment fees, it is noted that such fees typically vary on an annual basis as they are dependent on the balance of the unused facility, which may change from year to year. Likewise, agency fees may fluctuate according to inflation, or vary where the agent bank is required to perform additional services. For both of these categories of fees, and other raising fees which fluctuate annually, it may be difficult to accurately forecast these future fees at the time of commencement of the loan. In calculating the deductibility thereof under the provisions of s 24J(2) of the Act, it will thus be necessary for the yield to maturity to be re-calculated on an annual basis, once the quantification of the fees payable can be accurately determined.

This is in line with proviso (*c*) of the yield to maturity definition in s 24J(1) of the Act, which indicates that where a change or any variation occurs in relation to any amount payable in terms of the instrument which would result in a change to the compound interest rate of such

instrument, the yield to maturity is to be re-determined. This must be done with reference to the appropriate adjusted initial amount in relation to the instrument as determined prior to this change occurring. The re-determined yield to maturity will then applied to calculate the accrual amounts for future amounts payable, after the change in the rate. Thus, accrual amounts which were already taken into account in a taxpayer's taxable income would not be affected by the change in an amount payable (De Koker & Williams 2014: para 17.65).

This research report has thus far only addressed raising fees which are either charged upfront or on an annual basis. A particular financing arrangement may levy fees on a more frequent basis, such as quarterly. In such cases, if the quantum and timing of the raising fees are known upfront, the yield to maturity calculation will not need to be re-determined. Where, however, the quantum and / or timing are not known upfront, it is necessary for the yield to maturity to be recalculated at each instance when the amount and timing of accrual amounts can be accurately determined, as required by proviso (*c*) of the yield to maturity definition.

A 'guarantee fee' is charged by guarantors for providing security on debt arrangements, in light of the guarantor's legal duty to fulfil guarantee obligations. Such fees are usually calculated as a percentage of the guaranteed sum, but sometimes as a fixed fee (Investor Words n.d.). Guarantee fees were also dealt with in the *South African Custodial Services* judgment.

Where the guarantee fee is specified in terms of the same agreement as the debt financing, and the amount is fixed upfront, it is submitted that deductibility under s 24J(2) of the Act will be as proposed in Chapter Five. If the guarantee fee fluctuates over the period of the loan, the yield to maturity calculation will need to be revised at each interval, as indicated above. Where the guarantee fee is levied in terms of a separate agreement (between the taxpayer and the guarantor), the guarantee fee may possibly not represent an 'amount payable... in terms of any instrument' for the purposes of the yield to maturity definition in s 24J(1) of the Act. Thus, as described in the previous Chapter, if a narrow interpretation of the phrase 'in terms of' is adopted, the guarantee fee may not qualify for deduction under s 24J(2) of the Act, and alternative recourse would need to be considered. Chapter Seven addresses such alternatives.

Section 23H of the Act

Raising fees which are, for example, paid upfront at commencement of the loan, may represent expenditure actually incurred in respect of services, all of which will not be rendered

during that year of assessment, or in respect of any other benefit, the period to which the expenditure relates extending beyond such year of assessment. The expenditure incurred upfront may relate to services or benefits obtained for the duration of the loan period.

In certain instances, the deductibility of such 'prepaid' expenditure is limited in terms of s 23H of Act, that is, only the portion of expenditure which relates to services rendered or benefits obtained during that particular year of assessment may be claimed (Van Schalkwyk 2014: para 7.4). The risk of such limitation is, however, not applicable to raising fees which are submitted as deductible under the provisions of s 24J of the Act, as s 23H of the Act only applies to expenditure allowable as a deduction in respect of any of the following sections: ss 11(*a*), (*c*), (*d*), (*w*) or s 11A of the Act.

Thus, s 23H of the Act will not apply to limit the deductibility of raising fees under s 24J of the Act, however it must be considered if taxpayers seek deductions for raising fees in terms of the general deduction formula (as detailed in Chapter Two), or s 11A of the Act, if incurred prior to commencement of the taxpayer's trade. Where s 23H of the Act is considered applicable in limiting the deductibility of raising fees, the apportionment of raising fees over the period of the loan must represent a fair apportionment of such expenditure in respect of the services or benefits to which it relates, in terms of s 23H(2) of the Act. If SARS is not satisfied with this apportionment, the Commissioner may direct that the apportionment be made in another manner which to him appears to be fair and reasonable.

Chapter Seven: Non-deductibility in terms of s 24J of the Act

For raising fees that are considered non-deductible in terms of s 24J of the Act, this Chapter will consider when such circumstances would arise and whether there is any alternative recourse for borrowers in respect of such expenditure. The possibility of capitalising raising fees to the cost of assets for which allowances are claimable will also be addressed.

The requirements for the deductibility of raising fees under the provisions of s 24J of the Act were discussed in detail in Chapter Five. In the instance when one of the requirements is not met, the raising fees would be disallowed under that section. For example, if raising fees are charged in relation to a funding arrangement which does not meet the definition of an 'instrument' in terms of s 24J(1) of the Act, such arrangement would fall outside the requirements of s 24J of the Act, and thus the attendant raising fees would not be deductible under that section.

Alternatively, if raising fees are not explicitly included in terms of an agreement, there is a possibility that they would not be considered to be 'in terms of' the instrument as per the definition of yield to maturity, and for this reason may be excluded from s24J of the Act. This may be the case for guarantee fees, as noted in Chapter Six.

Where raising fees are considered non-deductible in terms of s24J of the Act, the general deduction formula may be applied to provide an alternative avenue for the deductibility thereof. The requirements of s 11(*a*) of the Act read with ss 23(*f*) and 23(*g*) of the Act will need to be met. These were addressed in detail in Chapter Two, specifically in the context of raising fees. Most notably, the general deduction formula contains one critical requirement which is not found within s 24J of the Act: the 'capital' requirement, that is, raising fees would only be considered deductible in terms of the general deduction formula if they are not of a capital nature. This requirement was also addressed in Chapter Two.

Where, however, the 'trade' or 'in the production of income' requirements of s 24J of the Act are not met, the general deduction formula would also not be available for the taxpayer in such circumstances, as s 11(*a*) of the Act also contains these requirements. Such raising fees would not be considered deductible under both s 24J of the Act and the general deduction formula.

For raising fees that are not deductible under s 24J of the Act and, in addition, are categorised as capital in nature and therefore non-deductible in terms of the general deduction formula, the question then arises as to whether such fees may be capitalised for the purpose of claiming an allowance through another provision of the Act. Some of the possible sections which deal with tax assets are considered below.

Capital allowances

In terms of s 11(*e*) of the Act, the wear and tear allowance is applied to the cost of the asset where the cost is deemed to be the cost which would have been incurred under a cash transaction concluded at arm's length for the direct cost of the acquisition of the asset. In terms of the allowances provided by ss 11B, 12B, 12C, 12D, 12DA, 12E, 12F and 12I of the Act, the deduction is applied to the cost of the asset which is deemed to be the lesser of the actual cost to acquire that asset or the cost which would have been incurred under a cash transaction concluded at arm's length for the direct cost of the acquisition of the asset. This same deeming cost provision is included for deductions in terms of ss 13quin, 13sex, 14bis and 37B of the Act. For the purposes of the sections mentioned in this paragraph, raising fees would not be included as the arm's length cash cost of the asset, as cash transactions do not result in raising fees (De Koker & Williams 2014: para 8.39; Coetzee 2000).

In the case where an asset's actual cost (including finance charges such as raising fees) is lower than the arm's length cost, De Koker & Williams (2014: para 8.39) submit that the actual cost (and not the deemed cost) will constitute the cost of the asset for the purposes of calculating a capital allowance. They note this in contrast to the primary objective of the deemed cost provision, which is to exclude any finance charges incurred upon the acquisition of such assets.

Contrary to the above, ss 13, 13bis, 13ter and 14 of the Act do not contain these deeming provisions for the cost of an asset. On this basis, it is submitted by De Koker & Williams (2014: para 7.38) that where the Act grants capital allowances calculated with reference to the cost of an asset but does not deem it to be the cost as would have been incurred in terms of a cash transaction, then the allowance should be calculated based on the taxpayer's actual cost, including finance charges such as raising fees.

For taxpayers seeking an additional industrial investment allowance in respect of industrial

assets used for qualifying strategic industrial projects, s 12G of the Act defines the 'cost of an industrial asset' as excluding 'any borrowing or finance costs, including interest as contemplated in s 24J of the Act or raising fees.' Similarly, s 13quat of the Act, which legislates deductions in respect of buildings in urban development zones, defines 'cost' as excluding borrowing or finance costs. Thus, ss 12G and 13quat of the Act would also exclude raising fees from the cost of assets for the purposes of allowances granted in terms of these sections.

Where taxpayers dispose of a low-cost residential unit to an employee via an interest-free loan, s 13sept of the Act provides an allowance for the taxpayer which is calculated with reference to the amount owing to the taxpayer by the employee in respect of that unit. If the employee's liability to the taxpayer includes raising fees, then arguably s 13sept of the Act would indirectly afford the taxpayer an opportunity to deduct such raising fees. In terms of s 13sept(3)(*b*) of the Act, however, the employee must not be charged interest on the amount owing, and thus it is submitted that while raising fees may possibly be included in calculating the allowance, interest would certainly be excluded.

If the taxpayer conducts a mining trade, the provisions of s 36 of the Act are to be considered. In calculating the unredeemed balance of capital expenditure in connection with mining operations, s 36(11) of the Act defines capital expenditure. Section 36(11)(*a*) of the Act specifically excludes interest or finance charges, thus raising fees would be excluded in terms of this subparagraph. Section 36(11)(*b*) of the Act specifically includes interest and other charges payable on loans utilised for mining purposes, but only in respect of expenditure prior to the commencement of production or during any period of non-production. If it is submitted that raising fees are included within 'other charges payable on loans', then a taxpayer incurring a loan used for mining purposes prior to the commencement of production or during a period of non-production would be able to capitalise such raising fees in terms of s 36(11)(*b*) of the Act.

In addition, if funding is used on expenditure as contained in s 36(11)(*d*) of the Act, the raising fees may be included as such capital expenditure, as there is no provision to the contrary. This would be the case for expenditure (excluding the cost of land, surface rights and servitudes) for the use of employees in respect of housing and furnishing for residential occupation, infrastructure in respect of residential areas, recreational buildings and facilities, motor vehicles and garage or carport therefor, and on any hospital, school, shop or similar amenity,

as well as a railway line or system of transportation of minerals from the mine to the nearest public transport system or outlet.

Disposals of capital assets

Where expenditure is incurred to purchase a capital asset which is subsequently disposed of, the raising fees incurred on the acquisition thereof may not be included for the purposes of calculating the base cost of such asset, as this is specifically excluded in terms of para 20(2)(*a*) of the Eighth Schedule to the Act. Nevertheless, this does not apply to borrowing costs and expenditure as contemplated in para 20(1)(*g*) of the Eighth Schedule. This sub-para allows for one-third of interest as contemplated in s 24J of the Act (excluding interest per s 24O of the Act) to be included in the base cost where incurred in relation to money borrowed to finance expenditure in respect of a listed share or participatory interest in a portfolio of a collective investment. It is noted that the above would apply in respect of disposals made on or after 1 January 2014.

As it has been submitted that raising fees constitute related finance charges for the purposes of the definition of 'interest' per s 24J(1) of the Act, it thus follows that one-third of raising fees incurred in relation to expenditure as referred to in para 20(1)(*g*) of the Eighth Schedule would be included in the base cost of such assets. Aside from this specific instance, all other raising fees would be excluded from the base cost in terms of paragraph 20(2)(*a*) of the Eighth Schedule (De Koker & Williams 2014: para 24.54).

Conclusion

Where raising fees are considered non-deductible in terms of s 24J of the Act, the general deduction formula is to be considered firstly and thereafter, if the expenditure is disallowed on the basis that it is of a capital nature, there is a possibility of deduction through capital allowances as part of the cost of an asset, but this is limited to a few sections of the Act as indicated above.

Chapter Eight: Conclusion

This research report commenced with an analysis of the deductibility of raising fees in terms of the general deduction formula, where it was shown through case law that the capital or revenue nature of raising fees has, historically, been the most critical aspect in determining the tax implications of such fees. Respite was offered to taxpayers through the introduction of s 11(*b*A) in 1982, which did not have a capital requirement, and thus, until its repeal, allowed taxpayers to deduct raising fees incurred in respect of the acquisition of certain qualifying assets prior to these assets being brought into use.

In 2012, thirty years after being introduced, s 11(*b*A) was repealed. Although this section was considered to have been rendered obsolete in light of the introduction of s 11A of the Act, it has been submitted in Chapter Three that the latter section would not apply in respect of all pre-production interest and related finance charges. Thus, there was seemingly a gap left by the repeal of s 11(*b*A), which this research report sought to investigate.

Prior to the repeal of s 11(*b*A), the *South African Custodial Services* judgment, ruled by a full bench of the Supreme Court of Appeal, allowed the deductibility of raising fees as 'related finance charges' for the purposes of that section. The landmark decision in the *South African Custodial Services* case has, it has been submitted, provided a judicial definition for the term 'related finance charges.' Although ruled in the context of s 11(*b*A), this research report considered its application for the purposes of s 24J of the Act, where the term 'related finance charges' is included within the definition of 'interest.'

In Chapter Six of this research report it was submitted that the judicial precedent set by the Supreme Court of Appeal in the *South African Custodial Services* case may be applied in the context of s 24J of the Act, and thus serves as a means for the deductibility of raising fees over the period of the instrument. It was thus submitted that, in determining the deductibility of raising fees, the capital requirement is no longer a consideration with which taxpayers need be concerned, as this is not a requirement of s 24J of the Act.

Having submitted that raising fees are deductible in terms of s 24J of the Act, provided that the necessary requirements are met, the practical implications thereof were briefly addressed in Chapter Six. While this research report does not cover the full spectrum of raising fees, the nuances in the timing and calculation methods of four common types of raising fees were highlighted. It was submitted that, in applying proviso (*c*) of the yield to maturity definition

within s 24J(1) of the Act, the yield to maturity is to be re-determined at each change in the quantum or timing of related finance charges. This would, for example, be the case where raising fees are charged annually, escalating with the rate of inflation.

If one or more of the requirements of s 24J(2) of the Act are not met and, as a result, raising fees are considered non-deductible in terms of that section, the general deduction formula is to be considered firstly. Thereafter, if the expenditure is disallowed on the basis that it is of a capital nature, there is a possibility of deduction through capital allowances as part of the capitalisation to the cost of an asset, but this is limited to very few sections of the Act as submitted in Chapter Seven.

The key submission of this research report was that the *South African Custodial Services* case's provided a judicial definition of 'related finance charges' which can be applied to this phrase as it appears in s 24J(1) of the Act. This judicial definition was that raising fees are fees that have a close connection to the obtaining of a loan and the furtherance of a taxpayer's project.

It was thus submitted that raising fees incurred by a borrower, ruled as deductible for tax purposes in the *South African Custodial Services* case, could be treated as deductible in terms of s 24J of the Act. This submission provides clarity for companies, as the tax implications of funding options and the deductible of the associated costs play a key determinant in capital structure decision-making.

Annexure 1

Repealed legislation

Section 11(2)(*a*) of the Income Tax Act No. 31 of 1941:

11. Determination of Taxable Income. –

(1) For the purpose of determining the taxable income derived by any person from carrying on any trade within the Union, there shall be deducted from or set off against the income of such person so derived as defined by section *seven* the amounts set out in this section.

(2) The deductions allowed shall be –

(*a*) expenditure and losses actually incurred in the Union in the production of income, provided such expenditure and losses are not of a capital nature; ...

2. Section 12(*f*) of the Income Tax Act No. 31 of 1941:

12. Cases in Which no Deductions shall be Made: -

No deduction shall in any case be made in respect of the following matters : - ...

(*f*) any expenses incurred in respect of any amounts received or accrued which are not included in the term "income" as defined in this Chapter; ...

3. Section 11(*b*A) of the Income Tax Act No. 58 of 1962:

11. General deductions allowed in determination of taxable income. –

... (*b*A) 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 utilized by him for the acquisition, installation, erection or construction of any machinery, plant or 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 or 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 or improvements is or are brought into use for the said purposes;...

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