TAX & EXCHANGE CONTROL
ALERT

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CLIFFE DEKKER HOFMEYR

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Another year, another amendment: Timing matters when tax legislation changes

In the recent Tax Court judgment of *Taxpayer A v Commissioner for the South African Revenue Service* (IT 25042) (14 July 2022), the court was tasked with determining whether the finance charges incurred by the taxpayer stood to be deducted in terms of section 24J of the Income Tax Act 58 of 1962 (ITA).

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FACTS

The taxpayer in this case was a company that conducted the business of property investment and property management, including the letting out of property for purposes of earning rental income and property management income. During the 2016 year of assessment (YOA), the taxpayer entered into various loan agreements in terms of which it borrowed funds for the purposes of facilitating property development and investment. It was in respect of these loans that the taxpayer contended that it had incurred finance charges.

In its tax return for the 2016 YOA, the taxpayer claimed a deduction in respect of the aforementioned finance charges that it had incurred. These finance charges comprised of raising fees, debt origination fees and structuring fees.

Subsequent to a request from the South African Revenue Service (SARS) for further information pertaining to (amongst other things) the finance charges, the taxpayer provided SARS with a breakdown of the expenses that were incurred, including the dates on which they were incurred, the amounts involved and the nature of the expenses.

In May 2018, SARS raised an additional assessment in respect of the taxpayer's 2016 YOA wherein it disallowed the finance charges expense in the amount of R19,500,000. The reason provided by SARS for the adjustment it made was that the taxpayer had provided no or insufficient information. SARS also imposed an understatement penalty of 50%, attributed to an incorrect statement made by the taxpayer in its return.

In disputing the additional assessment that was raised by SARS, the taxpayer contended that the finance charges (or upfront fees, as referred to by the court) together with the loan amounts constituted one and the same lending package such that the finance charges were directly connected to the loan and formed part of the total cost of borrowing. On the other hand, SARS argued that since the fees (i) were payable upfront; (ii) constituted a "*once-off payment*"; and (iii) were not linked to the duration of the loan terms, they were not the same or related to interest.

JUDGMENT

At issue before the court was whether the finance charges in question constituted interest for purposes of section 24J of the ITA.

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At the outset, the court noted that the definition of "*interest*" as provided in section 24J(1) was amended to include "*similar finance charges*" with effect from 19 January 2017. In respect of the 2016 YOA, the definition of "*interest*" in section 24J was defined as including the "*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*".

In summary, in the 2016 YOA, the definition referred to "*related finance charges*" whereas the subsequent amendment referred to "*similar finance charges*".

On the basis that the present case pertained to the 2016 YOA, which is the period prior to that in which the amendment came into effect, the court could not have regard to the amended definition in making its determination regarding the deductibility of the finance charges in the present matter.

It was therefore necessary for the court to determine whether the upfront fees/finance charges in question constituted "*related finance charges*" as contemplated in the 2016 YOA definition of "*interest*".

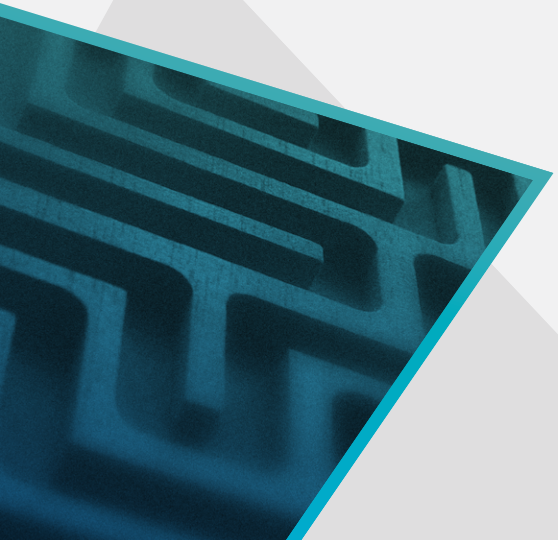
The court noted that: "*In deciding how the expenditure should properly be regarded the court clearly has to assess the closeness of the connection between the expenditure and the income-earning operations, having regard both to the purpose of the expenditure and to what it actually effects.*"

It was held that the taxpayer had presented sufficient evidence to establish that the upfront fees, together with the interest, made up the cost of borrowing on the basis that, had the fees not been paid, the taxpayer would not have been able to acquire the loan. There was thus no reason to justify a difference between the interest on the loans and the upfront fees.

To this end, the court reiterated that the fact that (i) the upfront fees were not linked to the duration of the loans; and (ii) the taxpayer was liable to pay value-added tax on the upfront fees but not on the interest, did not constitute a basis to find that the upfront fees were not "*related [to] finance charges*". The court therefore agreed that the upfront fees constituted "*interest*" as defined in the legislation applicable to the 2016 YOA.

SARS then contended that the upfront fees were not deductible because they were capital in nature.

Section 24J permits a taxpayer to claim an interest expense deduction to the extent that the interest is incurred in the production of income from the carrying on of a trade. There is no requirement in section 24J that the interest (or related charges) claimed must not be of a capital nature and the court held that a deduction in terms of section 24J must not be conflated with a claim for deduction under section 11(a) (which imposes the requirement that the expense being claimed must not be of a capital nature).



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In the present matter, the taxpayer claimed the deduction in terms of section 24J of the ITA and not in terms of section 11(a) of the ITA and the court agreed with the taxpayer's contention that "*section 24J constitutes a stand-alone deduction provision in relation to interest as defined*". As the deductibility test in terms of section 24J does not include an element regarding the capital nature of the expense, SARS' contentions in this regard were held to be unfounded.

Having regard to the specific requirements of section 24J, the court held that the upfront fees (which constituted "*interest*" as defined) were incurred in the production of income in the course of a trade that was carried on by the taxpayer. As such, the upfront fees stood to be deducted by the taxpayer in terms of section 24J and the taxpayer succeeded with its appeal.

On the basis that the taxpayer had succeeded with its deduction claim in terms of section 24J, the issue surrounding the understatement penalty imposed by SARS fell away.

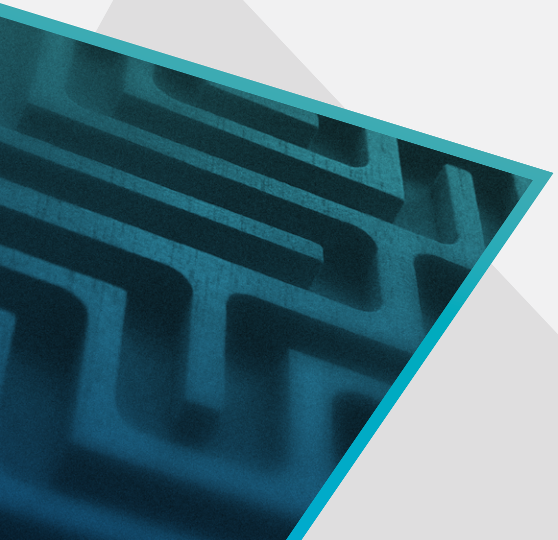
COMMENT

A fundamental legal principle is that the law is not intended to be retrospective unless a clear contrary intention appears in the legislation. In South Africa, the tax statutes are amended regularly and it is imperative that taxpayers and practitioners keep up to date with the legislative amendments that affect them.

This judgment serves as reminder that it is necessary to take cognisance of the dates on which the amendments come into effect and to ensure that tax returns are submitted having regard to the correct legal provisions applicable to the relevant YOA.

This judgment is also noteworthy because it reiterates the importance of (i) understanding and applying the specific requirements prescribed in each section of the ITA; and (ii) not conflating provisions that overlap but are in fact stand-alone provisions.

LOUISE KOTZE



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Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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