

11 November 2024

To: The South African Revenue Service
Lehae La SARS
PRETORIA
0001

Via email: **SARS:** (policycomments@sars.gov.za)

RE: COMMENTS RE: DRAFT INTERPRETATION NOTE ON MEANING OF FINANCE CHARGES

We are writing to provide our comments on the draft interpretation note regarding the meaning of “similar finance charges” under section 24J of the Income Tax Act, No. 58 of 1962 (**the Act**). Our analysis indicates that the current interpretation may not fully align with the legislative intent and practical application of the section. We proceed to set out our rationale below.

Discussion

1. Purpose of Section 24J

1.1. We believe that the primary purpose of section 24J of the Act is to determine whether an instrument exists, rather than to assess the nature of the interest incurred thereon. According to the section, if a person is an issuer in relation to an instrument, they are deemed to have incurred an amount of interest. This deeming provision simplifies the process by focusing on the existence of an instrument rather than the specific nature of the charges.

2. Definition of Interest

2.1. It is our understanding that the definition of interest under section 24J of the Act is not intended to assess deductibility but to confirm the presence of an instrument. As mentioned above, the section deems the issuer to have incurred interest, which includes all amounts payable in terms of the instrument. This approach ensures that all finance charges related to the instrument are considered, regardless of their specific classification.

3. Accrual Amount

3.1. The accrual amount is a critical component in calculating the interest for tax purposes. It is determined by the yield to maturity, which is the rate of compound interest that equates the present value of all amounts payable or receivable under the instrument to the initial amount. This method ensures a comprehensive calculation of interest, including all finance charges payable under the instrument.

4. Inclusion of Various Fees

4.1. It is our view that all fees payable in terms of the instrument, including raising fees and other similar charges, should be included in the yield to maturity calculation. The current interpretation by SARS, which attempts to classify these fees separately, may not align with the legislative intent. It is our view that, as long as these fees are payable under the terms of the instrument, they should be included in the interest calculation under section 24J, there should not be a further enquiry.

5. Analysis of Case IT 25042 and the Definition of Interest under Section 24J

5.1. Reference is made to the Tax Court decision in Case IT 25042, which dealt with the disallowance by SARS of certain finance charges incurred before the amendment of the definition of interest under section 24J(1) of the Act. The amendment, effective from 19 January 2017, changed the phrase “related finance charges” to “similar finance charges.” The focus of the judgment was whether certain finance charges incurred by the taxpayer constituted interest for the purposes of section 24J and were accordingly deductible under section 24J(2) of the Act.

5.2. Case Background

5.2.1. The taxpayer, a property developer, borrowed funds from two financial institutions to finance the redevelopment of a shopping mall. The finance charges included raising fees, debt origination fees, and structuring fees, collectively referred to as “upfront fees.” For the 2016 assessment year, the taxpayer claimed a deduction for these upfront fees as “related finance charges” under the definition of interest in section 24J. SARS disallowed the deduction, arguing that the taxpayer did not provide sufficient material to justify it.

5.3. Court’s Analysis and Judgment

5.3.1. The court focused on whether the finance charges constituted interest under section 24J and were deductible. The amendment to the definition of interest was not applicable to the 2016 assessment year as it came into effect in 2017. The taxpayer argued that the lending arrangement was a “total package” and that the upfront fees were part of the cost of obtaining capital. The fees were directly associated with the finance charges and should be deductible. SARS contended that the upfront fees and interest were distinct and could not be treated as the same. It referred to the Explanatory Memorandum (EM) on the Taxation Laws Amendment Bill, 2016, to support its interpretation. The court rejected SARS’s reliance on the EM, stating that the amendment could not be applied retroactively. Therefore, the court found that the upfront fees, together with interest, made up the cost of borrowing and should be treated as such. The court allowed the taxpayer’s appeal, permitting the deduction of the upfront fees.

5.4. Key Legal Interpretations

5.4.1. Section 24J(2) allows the deduction of interest incurred by the issuer of a debt instrument. The amount of interest deemed to have been incurred under section 24J(2) is determined by the accrual method, not necessarily the amount of interest as defined. The accrual amount is defined as the yield-to-maturity multiplied by the adjusted initial amount of the instrument.

5.5. Commentary

5.5.1. The judgment emphasised that the definition of interest under section 24J is crucial for determining whether an instrument exists for the purposes of section 24J(2). The upfront fees were deemed part of the cost of borrowing and thus deductible.

5.5.2. The definition of interest under section 24J serves to identify whether an instrument exists, which is a prerequisite for applying section 24J(2). The judgment clarified that

the upfront fees, being part of the borrowing cost, should be included in the yield-to-maturity calculation and deducted over the loan term.

6. Legislative Intent and Practical Application

- 6.1. Following on from the provisions discussed above as well as the judicial approach, it is clear that the primary objective of the definition of "interest" under Section 24J is to determine whether a financial instrument qualifies as an "instrument" for the purposes of section 24J(2). In this context, the term "interest" serves as a threshold criterion for the application of the provisions under section 24J.
- 6.2. It is important to note that not all amounts payable under a loan agreement must necessarily meet the definition of interest. Rather, as long as at least one of the amounts payable qualifies as interest, the agreement will be regarded as involving an instrument. This enables the provisions of section 24J(2) to apply, ensuring that the treatment of interest under the section is triggered.
- 6.3. The Explanatory Memorandum, 1995 (EM of 1995), when section 24J was introduced, underlines the rationale presented in this submission. It emphasises that the accrual amount represents the total interest determined after considering all relevant points in section 24J. This holistic approach ensures that all finance charges related to the instrument are included, providing a clear and consistent method for calculating interest.
- 6.4. Furthermore, the judgment emphasised that the definition of interest under section 24J is crucial for determining whether an instrument exists for the purposes of section 24J(2). The upfront fees were deemed part of the cost of borrowing and thus deductible. The definition of interest under section 24J serves to identify whether an instrument exists, which is a prerequisite for applying section 24J(2). The judgment clarified that the upfront fees, being part of the borrowing cost, should be included in the yield-to-maturity calculation and deducted over the loan term.

7. Conclusion

- 7.1. We respectfully submit that the current draft interpretation note may not fully capture the legislative intent and practical application of Section 24J.
- 7.2. We recommend that SARS consider our analysis and revise the interpretation to ensure that all finance charges payable under the terms of an instrument are included in the interest calculation. As opposed to seeking to treat finance charges separately. This approach will provide clarity and consistency in the application of Section 24J, aligning with the legislative intent and practical realities of financial transactions.

We appreciate the opportunity to provide our comments and are available for further discussion if needed.

End.