Tax treatment of costs to raise funding

Various tax complexities exist in relation to fees incurred when raising capital, whether in the form of debt or equity. In this article, I consider a recent tax court case that deals with the deductibility of costs related to raising debt. I also highlight some broader tax considerations.

There are many costs to raising funding for a business, whether debt or equity capital. These include raising fees, initiation fees, facility fees and charges relating to structuring the transaction, to mention a few. In this article, I consider a recent case that dealt with the tax deductibility of upfront debt raising fees. I also highlight some of the broader tax considerations concerning these fees.

Taxpayer A v C:SARS (IT25042)

The taxpayer's business was to invest in and manage properties. It incurred raising fees, debt origination fees and structuring fees during its 2016 tax year in connection with a loan to facilitate the redevelopment of an investment property.

The taxpayer deducted the upfront fees in terms of section 24J of the Income Tax Act, which deals with interest. SARS disallowed the deduction. It seems as if the basis for the disallowance changed during the matter. The initial indication in the case is that the taxpayer did not provide sufficient or relevant information. The focus, however, changed to a more factual question regarding the nature of the upfront fees being distinguishable from the interest. Since the costs arose upfront and did not depend on the duration of the loan, SARS contended they were unlike interest. They were, therefore, not interest for purposes of section 24J.

The definition of interest was amended with effect from 19 January 2017. Before the amendment, interest was defined to include, as far as relevant here, "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 phrase 'similar finance charges' replaced 'related finance charges' in 2017. It appears that counsel for SARS argued that the amendment confirmed what was always the law. The court, however, interpreted the amendment as narrowing the concept of interest. The change did not apply retrospectively. This was despite the taxpayer only filing its 2016 return after the promulgation of the amendments.

The court concluded that the fees were closely connected to obtaining the loan and represented related finance charges. The costs were deductible in terms of section 24J, despite possibly being capital in nature. Unlike section 11(a), section 24J does not require one to consider whether expenditure is of a capital nature.

Broader considerations

One can glean some insight into the position post the amendment from the judgment. The court's focus on the effective date of the amendment and the views in paragraph 32 suggest the amended definition of interest is narrower than before. The court did, however, not indicate what they considered as similar finance charges to interest.

The deductibility of at least some costs of raising debt funding that previously qualified for deduction under section 24J now hinges on section 11*(a)*. (Incidentally, this provision also determines the deductibility of costs to raise equity funding). It requires, among other things, that expenditure must not be of a capital nature. The courts employ some common tests to determine if expenditure is of a capital nature. They often assess whether the expenditure relates more closely to a taxpayer's operations or income-earning structure.

Raising fees also pose difficult VAT questions. ITC 1744, A tax court case from the early 2000s, suggests that taxpayers may not deduct input tax in respect of these costs. The more recent SCA case of *Consol Glass (Pty) Ltd v C:SARS* may, however, provide grounds to argue for an input tax deduction in some instances.

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