REPUBLIC OF SOUTH AFRICA

IN THE TAX COURT OF SOUTH AFRICA
HELD AT BLOEMFONTEIN

CASE NO: IT 25042

(1)	REPORTABLE: YES / NO
(2)	OF INTEREST TO OTHER JUDGES: YES / NO
(3)	REVISED.
…………………….. SIGNATURE	**14 July 2022** DATE

In the matter between:

TAXPAYER A Appellant

and

THE COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE Respondent

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J U D G M E N T

MOLITSOANE, J:

[1] This appeal is concerned with the deductibility by the appellant of the finance charges under section 24J of the Income Tax Act, 58 of 1962(the ITA). The finance charges in question are comprised of the raising fees, the debt origination fees as well as the structuring fees for the 2016 tax period. Associated with the determination of the deductibility of the finance charges is the determination of the validity of the 50% understatement penalty imposed by the respondent under Chapter 16 of the Tax Administration Act,28 of 2011(TAA). The issue in respect of the deductibility of certain legal fees in the same period was abandoned.

[2] The appellant is Taxpayer A, a company incorporated in terms of the company laws of the Republic of South Africa, with its registered office in Bloemfontein.

[3] The respondent is the Commissioner for the South African Revenue Service with its Head Office at Lehae la SARS, Nieuw Muckleneuk, Pretoria.

[4] The appellant filed its income tax return on 30 January 2018. On 19 March 2018 the respondent requested additional information, inter alia, the breakdown of the expenses in respect of legal fees in the amount of R1 431 116.00 and finance charges in the amount of R19 515 690.00 claimed in the return, reflecting the date they were incurred, the amount incurred as well as the nature of the expense. The appellant provided the requested information.

[5] On 17 May 2018 the respondent raised additional assessment in respect of the 2016-year period against the appellant in terms of section 92 of the TAA. The following adjustment in the calculation of the appellant's taxable income was made:

2016

Year of assessment	Provisions of the Act	Brief description of the adjustment	Adjustment amount(R)	USP
2016	Section 102(1)(*b*) of the TTA, section 11(*a*) of the Income Tax Act 58 of 1962 (the ITA)	Finance charges	R19 500 000	2 730 000

2016	Section 102(1)(*b*), section 11(*c*) of the Income Tax 58 of 1962 (the ITA)	Legal fees	R1 413 114	200 355.96

[6] The respondent gave as its reason for the additional adjustment that the expenses were disallowed on the basis that the appellant provided “no or insufficient or relevant material” to support the deduction claimed for finance charges (which comprised of raising fees, debt origination fee and structuring fee) and legal fees. For the purposes of this judgment “finance charges” mean the collective of raising fees, debt origination fees and structuring fees and will hereinafter conveniently be referred to as “upfront fees”.

[7] The respondent further imposed an understatement penalty of 50% attributed to what it called an incorrect statement in a return and failure to take reasonable care in completing the return.

[8] On 24 May 2018 the appellant objected to the additional assessment. The objection was partially disallowed and the adjustment in respect of the legal fees was reduced. It is the contention of the appellant that because of the “small quantum” in respect of the legal fees the appeal thereof is no longer pursued as indicated above and will play no role in these proceedings. Aggrieved by the decision of the respondent, the appellant filed a notice of appeal. The essence of the grounds of appeal is succinctly as set out in the issues to be determined below.

[9] The issues for determination in this appeal are as follows:

a) Whether the appellant should be allowed deductions for finance charges as contemplated in section 24J of the ITA and if so,

b) Whether the understatement penalty was correctly levied in terms of sections 222 and 223 of the TAA.

[10] The appellant led the evidence of Mr Z. His evidence substantially resonates with the common cause facts. At all material times hereto the appellant conducted the business of property investment and property management. The appellant leased property for the purpose of earning rental income and property management income.

[11] During the 2016 year of assessment the appellant entered into loan agreements with Propsky. Propsky and RMB in terms of which funds were borrowed by the appellant for the purposes of facilitating property development and investment. It is the case for the appellants that in this regard it incurred finance charges.

[12] On 17 May 2016 the appellant entered into a loan agreement with Propsky the purpose of which was to fund certain professional costs and expenses plus interest thereon associated with the Taxpayer A Mall Redevelopment. The Taxpayer A Redevelopment Mall was a property redevelopment project undertaken with a view to earning rental income. The Propsky loan was to enable the appellant to pay professional fees on the redevelopment project.

[13] On 18 May 2016 through debiting of the appellant's loan account with Propsky an amount of R4 000 000.00 was paid by appellant to Propsky as a structuring and execution fee. A further amount of R3 000 000 was similarly paid on 2 August 2016 to Propsky in terms of the Bridging Loan agreement read with the definition of "Structuring and Execution fee".

[14] During December 2014 the appellant concluded a Second Amendment and Restated Facilities Agreement with RMB (the Second Restated Facilities Agreement). The purpose of the loan was to raise finance to fund the ABO Shares Consideration amount and the second Non-Refundable debt origination fee.

[15] It was a term of the agreement that the loan would bear interest during the term at prime rate on a day to day basis and shall be calculated on the actual number of days elapsed, for the purpose of calculation based on a year of 365 days. Interest would then be compounded on the first business day of each month during the term and compounded to the loan on such day.[1]

[16] The contention of the appellant is that the loan amount together with the upfront fees constituted the same total lending package. According to Mr Z the fees were directly connected to the loan and thus formed part and parcel of the total cost of borrowing. These fees, so the argument goes, were "no more than part of the cost to the appellant of obtaining capital for use by it." According to the appellant the fees were directly associated with the finance obtained.

[1] Trial bundle page 126 clause 5.1.

[17] On the other hand, the respondent contends that the parties to the agreements appreciated the difference between the fees which were payable upfront once the loans were advanced and the interest payable. It is submitted on behalf of the respondent that the fact that interest and fees were dealt with separately in the agreements fortify the notion that "interest" and "fees" were separate and could not be seen and taken as one and the same thing as contended by the appellant.

[18] The respondent further contends that if interest and fees were taken to be one and the same thing, they could not have been dealt with separately in the agreements and the appellant would not have been liable to pay VAT on the fees only, whereas there is no such provision in relation to interest.

[19] This court was urged to look in the manner the fees and interest were dealt with after the conclusion of the agreements. It is submitted that in both the RMB and Propsky agreements, invoices were issued to the appellant for payment of both the debt origination and structuring fees. It is submitted that seeing that fees were payable upfront and as a 'once off payment' and were not linked to the duration of the loan terms, they were unlike interest which was payable for the duration of the loan. For this reason, the respondent contends that the fees are not the same or related to interest.

[20] This court was also urged to have regard to the subsequent amendment of section 24J in determining the meaning and scope of the "related finance charges" as set out in the said section prior to the amendment. Much reliance was further placed on the Exploratory Memorandum in an attempt to show that the finance charges are not related to interest. I will deal with these contentions later in this judgment.

[21] Section 11(*a*) read with section 23(*g*) of the ITA provides a general deduction formula and serves as a guide to taxpayers to claim deductions. On the other hand, section 24J provides a specific deduction provision for interest expenditure incurred notwithstanding that the interest would, inter alia, ordinarily not be deductible under the general formula referred to above.

[22] Section 24J(2) allows for the deduction of interest as defined and provides as follows:

> "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 income."

[23] Section 24J(1) defines the "issuer" in relation to any instrument as:

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

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

On the other hand, "instrument" is defined in this section to mean:

"(*a*) Any interest bearing arrangement or debt;

(*b*) Any acquisition or disposal of any right to receive interest, as the case may be, in terms of any other interest bearing arrangement; or

(*c*) Any repurchase agreement or resale agreement which was—

(i) Issued or deemed to have been issued after 15 March 1995;

(ii) Issued on or before 15 March 1995 and transferred on or after 19 July 1995; or

(iii) In so far as it relates to the holder thereof, issued on or before 15 March 1995 and was unredeemed on 14 March 1996 (excluding any arrangement contemplated in subparagraphs (i) and (ii),

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

[24] The appellant has a contractual obligation to pay interest on the loans of Propsky and RMB. There can be no dispute that the appellant as the borrower in the loan agreements was the issuer. What this court is thus called upon to answer is whether the finance charges levied in respect of the loans of Propsky and RMB constituted interest for the purposes of section 24J.

[25] As a starting point it has to be borne in mind that the Taxation Laws Amendment Act, 15 of 2016 (the TLAA) which came into operation on 19 January 2017 brought an amendment to the definition of interest to allow a deduction of "similar finance charges". The period of assessment in this case is the year 2016. This is the period prior to the amendment. In this case this court is not concerned with the allowance of a deduction of "similar finance charges" as set out in section 24J after the amendment.

[26] Prior to the amendment section 24J defined interest 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."

[27] The appellant filed its 2016 income tax return after the commencement of Act 15 of 2016.That notwithstanding, the applicable period of assessment was prior to the commencement. The filing after the commencement has no bearing to the assessment in issue. Section 13(1) of the Interpretation Act 33 of 1957 provides that:

> "The expression 'commencement' when used in any law and with reference thereto, means the day on which that law comes or came into operation; and that day shall, subject to the provisions of section (2) and unless some other day is fixed or under the law for the coming into operation thereof, be the day when the law was first published in the Gazette as a law."

[28] Section 81 of the Constitution,1996 creates a presumption that unless the statute explicitly determines a commencement date, the Act in issue becomes of force upon promulgation.[2] *Loammi Wolff*[3] with reference to the German Constitution says the following:

> "Promulgation through publication of legislation is a prerequisite to ensure legal clarity and constitutionalism. The German Constitutional Court emphasised the importance of the public being properly informed about the content of new legislation and when that commences."

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2 Section 81 of the Constitution provides: "A Bill assented to a nd signed by the President becomes an Act of Parliament, must be published promptly, and takes effect when published or on a date determined in terms of the Act."

3 Revisiting section 81 of the Constitution; The commencement date of legislation (Legislative Power) Distinguished from Promulgation(Legislative Process) – an article in Southern African Public Law: November 2017.

The learned author further refers to the German Constitutional Court decision in which the following was said:

> "The publication of a statute is essential for law to become binding; it is a prerequisite for its enforceability. The promulgation of a statute implies that legal norms should be made public in a manner that persons affected by it could reliably inform themselves about the contents thereof…"

(Footnotes omitted)

Under our Constitution, parliament may specify the commencement date and if that has not been done, then the presumption kicks in.

[29] Section 11 of the Interpretation Act provides as follows:

> "**Repeal and substitution**
>
> "When a law repeals wholly or partially any former law and substitutes provisions for the law so repealed, the repealed law shall remain in force until the substituted provisions come into operation."

It is thus clear that the definition of interest during the period of the appellant 2016 assessment remained in force until the commencement of Act 15 of 2016.The respondent relies, *inter alia*, heavily on the Explanatory Memorandum to assert that the upfront fees do not constitute "related finance charges". This reliance is in my view misplaced for the reasons below.

[30] Our law recognises the presumption that the law is not intended to be retrospective unless a contrary intention appears in the legislation. In *Veldman v Director of Public Prosecutions*[4] the court said:

> "[26] Generally legislation is not to be interpreted to extinguish existing rights and obligations. This is so unless the statute provides otherwise or its language clearly shows such a meaning. That legislation will affect only future matters and not take away existing rights is basic to basic notions of fairness and justice which are integral to the rule of law, a foundational principle of our Constitution. Also central to the rule of law is the principle of legality which requires that law must be certain, clear and stable. Legislative enactments are intended to 'give fair warning of their effect and permit individuals to rely on their meaning until explicitly changed."

(See also *Du Toit v Minister of Safety and Security*[5] and the *Interpretation Act*[6].)

[4] 2007(3) SA 210(CC).
[5] 2009(1) SA 176(SCA); [2009] 1 All SA 322(SCA) para [10].
[6] Section 12.

[31] Act 15 of 2016 was assented to on 18 January 2017 and commenced on 19 January 2017. This was after the end of the appellant's 2016 year of assessment. There is no provision in the TLAA for the law to come into effect on any other date except 19 January 2017. In my view the TLAA is not applicable to the appellant's 2016 assessment. By interpreting 'related finance charges' in the same way as "similar finance charges" will offend the presumption against retrospectivity. There is nothing in the TLAA which comes close to requiring that the said statute be applied retrospectively. The Explanatory Memorandum does not assist the respondent. It therefore stands to reason that the 2017 amendment to section 24J in respect of the definition of 'interest' is irrelevant for the purposes of this appeal.

[32] The Explanatory Memorandum handed into evidence as exhibit B with specific reference to the substitution of the words "related" with "similar" so that the definition of interest will include "interest or similar finance charges" state as its reason for the amendment to clarify the policy position that this applies to finance charges of the same kind or nature. This memorandum came into being after the TLAA came into operation. It is disingenuous of the respondent to contend that the explanatory memorandum sought to confirm "what has always been the law"*.* In my view the memorandum seeks to explain the law post the amendment. Although we are not dealing with the concept of "similar finance charges", it does appear that the amendment may be geared towards narrowing the interpretation of this concept. This explanatory memorandum does not assist the respondent with reference to the 2016 assessment.

[33] This brings us to the issue of whether the upfront fees constitute "related finance charges". In *Commissioner for Inland Revenue v Genn & Co.(Pty) Ltd*[7] the tax payer sought an allowance of a deduction of expenditure on raising fees for the loans. The court dealt with the interpretation of the deduction of finance charges in terms of the now repealed section 11(B*b*) of the ITA. The repealed section provided that what was deductible was interest-including related finance charges. The court observed as follows:

> "It should I think be observed at the outset that, whatever might be the position on other facts, it is not possible in the present case to justify a difference in treatment between the interest on the loans and the commissions; the circumstances mentioned above show that in each case the commission together with the interest formed in effect in effect one consideration which the company had to pay for use of the money for the period of the loan. Although, therefore, the Commissioner allowed the deduction of the interest, as distinguished from the commission, the principles to be followed are on the present facts equally applicable to both."

[7] 1955(3) SA 293(AD) at 298F-H.

The Court went on further to say:[8]

> "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."

[34] In the case before us, the evidence in my view established that the upfront fees together with interest made up the cost of borrowing. The uncontested evidence is that should the upfront fees not have been paid, there could be no talk of any loan. It is for this reason that Mr Z contended that the upfront fees were inextricably linked with interest. Like in the case of *Genn*, there can be no reason to justify a difference in treatment between the interest on the loans and the upfront fees.

[35] The court in Commissioner, *South Africa Revenue Service v South African Custodial Services(Pty) Ltd*[9] *(SACS)* dealt with the question of whether what was described as an "introduction fee"; "financial advisory fee"; "margin fee"; "commitment fee" and "initial fee" to the lenders constituted "related finance charges" under the now repealed section 11(*b*A), which allowed a deduction of "any interest" (including related finance charges) which was not otherwise allowable as a deduction under the Income Tax Act 58 of 1962.

[36] The court found that the taxpayer could validly deduct all the fees on the basis that they were "related finance charges" and were closely connected to the obtaining of the loan. The court said:

> "[49] The interest that SACS has incurred is, in my view, deductible in terms of section 11(*b*A): 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 section 11(*b*A): 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. I am also of the view that the various fees are deductible in terms of section 11(*b*A): 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."

[37] The manner in which the upfront fees and interest were dealt with in SACS did not bar the court in concluding that the said fees constituted "related finance charges". The contention by the respondent that upfront fees were not linked to the duration of the loans and the appellant was not liable to pay VAT on interest cannot be the basis to hold that the upfront fees are not related

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[8] At page 299F-H.

[9] 2012(1) SA 522(SCA).

to finance charges. In any case interest is exempt in terms of the Value Added Tax Act 89 of 1991.[10] The fact that they were dealt with separately from interest in the loan agreements cannot on that basis alone be a reason to treat them differently. The issue is whether they are, as finance charges, related to interest, which we find they are.

[38] The respondent further contends that the fees were not deductible because they were of a capital nature. The deduction in this case is sought under section 24J and not section 11(*a*). Section 24J permits a taxpayer to make a deduction of the interest incurred from carrying on any trade, if that amount is incurred in the production of income. I agree with Counsel for the appellant in the Heads of Argument that "section 24J constitutes a stand-alone deduction provision in relation to interest as defined". A deduction in terms of section 24J must not be conflated with a claim for deduction under section 11(*a*). There might be some overlap but they are different.

[39] In terms of section 24J(2) interest is deductible whether or not the interest is seen as capital in nature. For interest to be deductible in terms of this section, it must have been incurred (1) in the production of income and (2) as part and parcel of a trade. The requirement that an amount sought to be deducted be of a capital nature is part of the deductibility test in terms of section 11(*a*) and not of section 24J.

[40] The appellant bears the onus to prove that the amount sought to be deducted was incurred in the production of income. The expenditure is regarded as being incurred in the production of income if same is closely related to the act which produces the said income. *Port Elizabeth Electric Tramway Co Ltd v CIR*[11] puts it this way:

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

[41] The upfront fees used to finance the Taxpayer A Mall Redevelopment project were incurred with the specific intent of earning rental from additional retail space. As alluded to above, the appellant conducted business of property investment and management which includes rental of property with the specific aim of earning income. This in my view is common cause.

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[10] See section 2 read with section 12 of the Value Added Tax Act 89 of 1991.
[11] 8 SATC 13 at 16.

[42] The expenditure incurred which is the subject of this dispute was directly related to the development means of earning income. This much is conceded by the respondent in the pleaded case and the following is said:[12]

> "There is no connection, alternatively direct connection between the finance charges and the appellant's income producing operations. **To the contrary, the finance charges are closely connected to the appellant's income earning structure.**"

(My emphasis)

[43] This concession by the respondent is correct and sound. The expenditure was incurred in the production of income. The respondent also accepts this as indicated above. This brings to end any notion that upfront fees were not incurred in the production of income.

[44] The appellant disposed of the Taxpayer A Mall by selling it to APF in exchange for shares. This was done in order to enable it to follow its rights and protect its income stream. APF is a listed REIT. By disposing its shares as it did the appellant exchanged its direct rental income to indirect rental income in that the income received in the form of dividends from the REIT are taxable in the hands of the shareholders[13]. The income therefore expended to obtain a revenue stream in the form of dividends from a REIT, qualifies as money spent in the production of income.

[45] At this stage, it is perhaps prudent to deal with an application brought by the respondent in terms of rule 52(7) to amend the Statement of Grounds of Assessment. This application was heard, for convenience, simultaneously with the trial as its adjudication is inextricably bound with the merits. This was also the view of the parties. Prior to the hearing of this matter the respondent approached the appellant with a view to request the appellant to consent to certain proposed amendments in its rule 31 statement as contemplated in rule 35(1).

[46] The appellant had no objection and narrow consented to the proposed amendments save to the amendment to paragraph 33 of the rule 31 statement as well as the insertion of the words "for the purposes of trade and" in paragraph 55 of the said statement. The application for the amendment therefore only fell to be dealt with by this court in respect of these narrow disputed points.

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[12] Rule 31 Statement para [44].

[13] See section 1 definition of 'income' read with sections 1(k)(1) of the ITA.

[47] The objection was aimed at the insertion of the words in paragraphs 33 and 55 as set out below:

> "33. These charges were furthermore not incurred from [carrying on a trade and] in the production of income. On this basis also, they do not qualify for deduction in terms of section 11(*a*) of the ITA [and are also prohibited in terms of section 23(*f*) and (*g*) of the ITA.]
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> 55. There was simply no basis for the appellant to contend that the deductions made were not of a capital nature [or that they were incurred for purposes of trade and in the production of income], having regard to clear documentary evidence which shows that these charges are closely related to the acquisition and development of the appellant's capital assets."

[48] One of the important considerations in an application for an amendment is prejudice against the other party. In view of the finding, we make, that the introduction of disputed words in the rule 31 statement would amount to a novation, we are of the view that such amendment would be prejudicial to the appellant and would accordingly not be allowed. We will thus only allow amendment to the rule 31 statement save for the proposed amendments in paragraphs 33 and 55 of the said statement.

[49] The term "trade" is widely defined in section 1 of the ITA and includes "every profession, trade, business, employment, calling, occupation, or venture, including the letting of property…". The respondent argues, albeit belatedly, that the related finance charges were not incurred for the purpose of the trade of the appellant. The problem with this argument is that the respondent did not raise as a basis that the disallowance was grounded on the fact that the fees were not incurred for the purposes of the Appellant's trade. Conscious of the plight the respondent noted in its case, it sought an amendment and thus sought to introduce this new ground of assessment. The new ground is raised about four years after the assessment. The new ground raised, flies in the face of rule 31(3) which provides that:

> "SARS may not include in the statement a ground that constitute a novation of the whole of the factual or legal basis of the disputed assessment, or which requires the issue of a revised assessment."

The reason for the adjustment was clearly set out in the Notification of Adjustment to Assessment dated 17 May 2017. It was said that the "expenses were disallowed on the basis that no or insufficient relevant material was provided". Raising this new additional ground in the rule 31 statement amounts to a novation and cannot be allowed hence the refusal to allow the amendment. We find that the respondent is entitled to a deduction in terms of section 24J. In view of this finding, the adjudication of the issue of the understatement penalty falls away.

[50] In respect of the costs we cannot find that the opposition of the Commissioner was frivolous and/or vexatious as contemplated in section 83(17) of the ITA. We exercise our discretion in not awarding costs for the successful party in the appeal and also in the application to amend. We accordingly make the following order:

ORDER

1. The appeal is upheld and the matter is remitted to the Commissioner to enable him to make a new assessment for the 2016 tax year in accordance with this judgment.
2. There is no order as to costs.

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P. E. MOLITSOANE, J

I concur.

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J. LIEBENBERG

I concur.

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B. MATHIBELA

CORAM:	**MOLITSOANE, J (sitting with assessors)**
JUDGMENT BY:	**MOLITSOANE, J**
HEARD ON:	**14 AND 15 FEBRUARY 2022**
DELIVERED ON:	**14 JULY 2022**