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This write-up, seeks to provide guidance on what qualifies as financial cost for the purposes of Section 16 of Act 896.

Per Section 9 of the Income Tax Act, 2015 (Act 896), all expenses which are wholly, exclusively and necessarily incurred in the generation of income from business or investment are deductible in determining the chargeable income from the business or investment. This is a general rule which is subject to any specific rule provided in the Act.

Financial cost in most cases, qualify as an expenditure that has been wholly, exclusively and necessarily incurred in the generation of income.

A person incurs financial cost when that person incurs losses with respect to a financial instrument with the exception of interest. However, Section 16 of Act 896 places a limitation on how much of financial cost other than interest can be deducted in calculating the chargeable income of a person from an investment or a business.

Rules in Respect of Deduction of Financial Cost

- Financial cost does not include interest.
- The quantum of financial cost that can be allowed for tax deduction in the year in which it is incurred is limited to the sum of financial gain and fifty percent (50%) of chargeable income from the business or investment without the financial cost or gain.
- Financial cost that has been disallowed for tax deduction can be carried forward for the following five (5) years of assessment.
- Financial costs that are carried forward shall be used in the order in which they were incurred

Section 25 of Act 896 places emphasis on the deductibility of losses associated with financial instruments in determining a person's chargeable income from a business or investment. This loss includes situations where the loss results from the application of fair value accounting and whether the loss has been derived, incurred, realised or of capital or revenue nature. Thus, to the extent that a loss (example, exchange loss) on a financial instrument is established in line with Generally Accepted Accounting Principles (GAAP), it is deemed tax deductible.

In addition to the above, Section 131(3) of Act 896, specifies that a person incurs a financial cost when that person incurs losses with respect to a financial instrument.

What then is a financial instrument?

Section 131 of Act 896 defines a financial instrument to mean:

- a debt claim or debt obligation
- a derivative instrument
- a foreign currency instrument
- any other instrument prescribed by regulations or in the absence of regulations treated as a financial instrument by Generally Accepted Accounting Principles (GAAP).

It does not, however, include a membership interest in an entity (example shares in a Company) unless specified in the Regulation.



The Act further defines "debt claim" or "debt obligation" as:

- "Debt claim" means a right to receive a payment under a debt obligation.
- "Debt obligation" means an obligation to make a payment to another person that is denominated in money and is in the nature of accounts payable and the obligations arising under deposits, debentures, stocks, shares, treasury bills, promissory notes, bills of exchange and bonds.

Derivative instrument and foreign currency instrument have been defined by the Act to take their meaning from GAAP in the absence of any other definition in the Act or its Regulations.

Based on the above, the question now is, what constitutes financial cost for the purposes of Section 16 of Act 896?

Losses incurred on the following constitute financial cost:

- debt claim (example, receivables)
- debt obligations (example, account payables, loans)
- obligations arising from deposits, debentures, stocks, shares, treasury bills, promissory notes, bills of exchange and bonds
- derivative instruments
- foreign currency instruments

The losses that fall under the above, therefore, include foreign exchange losses and fair value losses to the extent that they are included in the statement of comprehensive income.

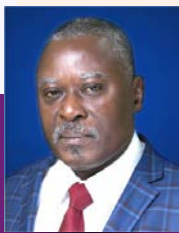
Is there a need to subject exchange losses incurred on related party loans to the financial cost restriction test after testing these exchange losses under thin capitalisation rules?

Foreign exchange losses incurred on related party debts are also subject to thin capitalisation rules (Section 33 of Act 896). The thin capitalisation rules and financial cost restriction rules are not mutually exclusive. On one hand, thin capitalisation restricts the amount of foreign exchange loss incurred on related party debts that is allowable for tax deduction based on the debt to equity ratio of 3:1. Financial cost restriction rules, on the other hand, seek to limit the amount of the allowable foreign exchange losses that can be deducted for tax purposes in a year of assessment. In such cases, first test the foreign exchange losses incurred on related party debts under thin capitalisation to determine the quantum allowable for tax deduction. After, subject this allowable portion to the financial cost test to ascertain how much of the foreign exchange losses is allowable in the current year then, carry forward the excess, if any, up to the next five (5) years.

Conclusion

It should be noted that Section 16 which places limitation on financial cost is a specific rule and therefore, takes precedence over the general rule under Section 9 and Section 25 of Act 896. As such, Section 16 does not disallow financial cost entirely as an expense but only restricts the amount of financial cost that should be allowed as a deduction in the year in which the financial cost was incurred.

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