BIZCOMMUNITY

Don't use your commercial property loan like an overdraft

By Preggie Pillay

31 May 2021

In the current economic environment, businesses are keen to reduce debt by paying down their commercial loans. While this is a facility that banks offer their clients, and there are valid reasons to pay off a commercial property loan early, many clients unwittingly do so for the wrong reasons and to their own detriment.


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There are certain situations when it can hurt more than help. Users of such loans – typically unlisted small and medium-sized corporates – are often not aware of the financial implications of early repayment, followed by redrawing the capital, especially the tax consequences. Commercial property loans are quite different from revolving credit facilities, such as personal mortgage bonds, which can be run down early and then borrowed against as cash flow requires.

There are a number of potential consequences of early repayment, followed by redrawing the capital:

Creditworthiness

For each loan application, the bank re-assesses the creditworthiness of the client, and this may vary from time to time. There are costs involved in this process. But more importantly, the client may run the risk of having a loan declined if their financial position has deteriorated. One of the unintended consequences is that it may affect a client's credit history, whereas they may have incorrectly assumed that paying off a loan would help. For many new businesses, establishing a credit history is a big challenge. Having secured a loan, continuing to make on-time, scheduled payments on that loan does more than anything else to build a credit history.

Tax deductibility

Clients may lose the tax deductibility of interest payments if the loan is prepaid and then later drawn down for reasons that the fiscus deems are not tax deductible. For the interest charge on a commercial property loan to be tax deductible, it must be incurred in the 'production of income'.

Once an amount has been prepaid and later withdrawn, that withdrawal may be deemed to have a different purpose. This new purpose will determine whether or not the interest charge is tax deductible and the client will have to keep meticulous records to prove that it was used for the purpose of generating income.

The more often the capital is repaid and withdrawn, time after time, the more arduous it gets from an administrative point of view to prove your intention every time. It muddies the water. Many borrowers are not aware of this – especially as SARS may ask questions many years later. If you do not have adequate proof that the capital was used for productive purposes, the interest will not be deductible.

Even if the new purpose can be demonstrated as being tax deductible, it is usually better to keep matters simple. An alternative option might be to keep loans ring-fenced to a specific asset and to rather put cash saved up throughout the year into a deposit account which can subsequently be used instead of the loan withdrawal. In this illustration, there would be no risk of change in the tax status of interest payments, as the original purpose stands.

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It may be that a client that has too much cash at the moment may not be looking sufficiently far ahead. Even if they have available cash to comfortably pay off a chunk of loan, they should think ahead to anticipate possible unintended expenses and consequences. Using your extra money to pay off a loan turns a liquid asset (cash) into an illiquid asset — meaning you can't use that money for any other purpose.

For example, companies accumulating free cash during the year pay it into their property loan and then withdraw it later when they need the cash, for instance to pay a shareholder dividend. They would thereafter unwittingly lose the tax deductibility of the interest payments.

This can be 'unwitting' in that they are used to doing this in their personal lives with their home loan as, in that instance, there are no tax consequences. However, there are tax implications with commercial property loans.

Timing

A commercial property loan, as a fixed-term contract, was never designed to be used as a rolling facility. The property risk assessment and client credit assessment take time and a client wishing to use it for instance to make an advance payment for imports, may find the funds cannot be made available on the day they need it. There are other products better suited to working-capital purposes.

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