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A CRITICAL ANALYSIS OF SECTION 19 AND PARAGRAPH 12A OF THE EIGHTH SCHEDULE OF THE INCOME TAX ACT FOR DEBT TRANSACTIONS

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ABSTRACT

The Income Tax Act 58 of 1962 was amended, with effect from 1 January 2013, by the introduction of a set of structured debt relief rules (also referred to as the debt relief provisions). The rules were stipulated in section 19 and paragraph 12A of the Eighth Schedule of the Income Tax Act. These rules have been amended several times since they came into effect on 1 January 2013. Section 19 and paragraph 12A of the Eighth Schedule of the Income Tax Act regulate the situation where a debt is cancelled, waived, forgiven or discharged for no consideration (or for a consideration which is less than the amount of the debt). The rules were intended to assist distressed debtors by simplifying the debt reduction process without creating further tax liabilities. Since the introduction of section 19 and paragraph 12A of the Eighth Schedule, there have been many issues raised in the media around the application and interpretation of various aspects of the legislation. This has resulted in numerous amendments. The purpose of this study is to analyse the legislation from its inception to establish whether (despite the numerous amendments) there are any unintended consequences in the legislation applicable to the 2020 tax year, in order to suggest possible solutions. The study revealed flaws and unintended consequences of the exclusions to the debt relief rules which relate to donations tax, estate duty and liquidated companies. Appropriate recommendations have been suggested to solve these problems. The study identified issues with the concepts of '*market value'* and *'effective interest'* in the context of debt to share conversions and recommended, among other things, that interpretation notes be provided to solve the problems. In addition, the study discussed the loophole which exists in section 19(6A) and paragraph 12A(4) of the Eighth Schedule. This loophole has resulted in the application of the debt relief rules not triggering any income tax in instances where assets are sold in the same tax year in which a debt benefit arises. Finally, the study discussed the implications and consequences of the retrospective application of the 2019 amendment to section 19(6A) and paragraph 12A(4) of the Eighth Schedule of the Income Tax Act and recommended that these amendments only apply to transactions which were concluded from 1 January 2019.

Key words: debt relief rules, debt relief provisions, financially distressed, insolvent, cancelled, waived, forgiven, discharged, no consideration, market value, effective interest, debt claim, unintended consequences, exclusions, implication.

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1. CHAPTER ONE - INTRODUCTION

1.1 INTRODUCTION

Debt relief, in its various forms, takes place when, among other things, a company is financially distressed, insolvent or must be placed under business rescue (South African Revenue Service 2016:3).

Prior to 1 January 2013, when a debt owing by a taxpayer was cancelled, waived, forgiven or discharged for no consideration (or for consideration that was less than the amount of the debt), the financial advantage obtained by the distressed debtor was eroded because of the various taxes levied at that stage upon the debtor (South African Revenue Service 2016:3-4) (National Treasury, 2012:29). The then-tax system served as a hindrance to rehabilitating companies experiencing financial hardships and, as a result, inhibited the growth of the South African economy (National Treasury, 2012:47).

With effect from 1 January 2013, the Income Tax Act 58 of 1962 ('the Act') was amended with a set of structured debt relief rules (Gers & Marais, 2018). The debt relief rules were specified in section 19 of the Act ('section 19') and paragraph 12A of the Eighth Schedule of the Act ('paragraph 12A') (Gers & Marais, 2018). References to section numbers are to the Act, and references to paragraph numbers are to the Eighth Schedule of the Act, unless stated otherwise. Section 19 and paragraph 12A regulate the situation where a debt is cancelled, waived, forgiven or discharged for no consideration (or for consideration which is less than the amount of the debt) (South African Revenue Service, 2016: 3-4). Section 19 generally applies to debts incurred for purposes of funding expenditure on revenue account, while paragraph 12A generally applies to debts incurred for purposes of funding expenditure on capital account (PwC 2017-b:1).

The debt relief rules were intended to assist distressed debtors by simplifying the debt reduction process without creating further tax liabilities (ENSafrica, 2014) (National Treasury, 2012:44). In addition, the intention of the rules was to ensure, among other things, that the incurral of an immediate tax liability only arose as a final resort (National Treasury, 2012:53). Since the introduction of section 19 and paragraph 12A, there have been many issues raised around the application and the interpretation of various aspects of the legislation. This has resulted in section 19 and paragraph 12A being amended several times (Taxation Laws Amendment Act, 2018: s 36(1)(*i*), s 77(1)(*h*)) (Income Tax Act 58 of 1962: para 12A(4)).

What follows in the body of this research report is a critical analysis of the debt relief rules

which applied before 2013. The intention of the legislature behind the introduction of the debt relief rules which applied with effect from 1 January 2013 will be examined. Thereafter the 2013 debt relief rules, the exclusions to the rules and the various amendments will be discussed. This will be followed by an analysis of section 19 (attached as Appendix 1), the exclusions to section 19 (attached as Appendix 2), paragraph 12A (attached as Appendix 3), and the exclusions to paragraph 12A (attached as Appendix 4). This will be done in order to establish whether the legislation applicable to the 2020 tax year is achieving its intended purpose, with a particular focus on any unintended consequences. It is submitted that a consequence is unintended if the effects of the legislation are not consistent with its purpose or objective. A consequence will also be considered unintended if the legislation creates a loophole which can be exploited by taxpayers. Finally, there will be a critical analysis which includes suggestions of whether interpretation notes and/or further amendments are required to the Act in order to address any weaknesses highlighted in the body of the research report.

1.2 RESEARCH QUESTIONS

This research aims to determine whether the debt relief rules are achieving its intended purpose or whether they have unintended consequences, which can inevitably have an impact on the South African economy.

The research sub-questions are as follows:

1. What was the purpose of the introduction of the debt relief legislation?
2. Why has the debt relief legislation been amended several times since its inception?
3. Have the debt relief amendments achieved the intended purpose?
4. Are there any unintended consequences of the amendments for debtors, creditors, and the South African Revenue Service (SARS)?
5. Are further amendments required to the debt relief legislation or should additional interpretation notes be issued as guidance?

1.3 RESEARCH METHODOLOGY

The research method adopted is of a qualitative, interpretive nature, and is based on a detailed interpretation and analysis of, among other things, literature and case law.

An extensive literature review and analysis was undertaken which included the following sources:

- Books
- Cases
- Electronic databases
- Electronic resources (internet)
- Journals
- Magazine articles
- Publications
- Statutes

1.4 CHAPTER OUTLINE

The chapters in this research report will be arranged as follows:

Chapter One: Introduction

The introduction will outline the background of the topic. It will state the research problem and sub- problems, research methodology and chapter outline.

Chapter Two: Purpose and amendments to debt relief rules

This chapter will discuss the purpose and intention of section 19 and paragraph 12A and the various amendments made.

Chapter Three: Consequences of exclusions

This chapter will critically discuss the unintended consequences of the following 3 exclusions to the debt relief rules, namely, the estate duty exclusion, the donations tax exclusion and the exclusions related to liquidated and terminated companies. It will provide conclusions and recommendations in relation to each.

Chapter Four: Consequences of debt to share conversions

This chapter will critically analyse the unintended consequences of the debt relief rules as they relate to debt to share conversions. It will also draw conclusions and make practical recommendations.

Chapter Five: Consequences of sale of assets

This chapter will analyse the unintended consequences of the debt relief rules when there is a sale of an asset in the same tax year in which a debt benefit occurs. It will also draw

conclusions and provide clear and practical recommendations.

Chapter Six: Retrospective application of debt relief rules

This chapter will discuss the implications and constitutionality of the retrospective application of the debt relief rules and will provide recommendations to alleviate the unintended consequences.

Chapter Seven: Conclusion

This chapter deals with the overall conclusions of the study and provides holistic recommendations based on the findings of the study.

2. CHAPTER TWO – PURPOSE AND AMENDMENTS TO DEBT RELIEF RULES

2.1 DEBT RELIEF RULES WHICH APPLIED PRIOR TO 1 JANUARY 2013

Prior to 1 January 2013, there were numerous provisions throughout the Act which dealt with the tax implications when a debt was reduced or cancelled (South African Revenue Service 2018:159). A brief summary of certain of the provisions applicable prior to 1 January 2013 follows:

Paragraph 2(*h*) of the Seventh Schedule

Paragraph 2(*h*) of the Seventh Schedule of the Act deems a taxable benefit to arise if an employer settles a debt owed by an employee and does not require it to be reimbursed (Presidency, 2012: para 2(*h*) of the Seventh Schedule to the Income Tax Act).

Paragraph (3)(*b*)(ii)

In terms of paragraph 3(*b*)(ii) a capital gain would instantaneously be incurred if expenditure which formed part of an asset's base cost was subsequently recouped by a taxpayer (The Presidency, 2012: para (3)(*b*)(ii)).

Paragraph 12(5)

Paragraph 12(5), which was subject to certain exclusions, deemed a debtor to have disposed of an asset if the debt owed was reduced or written off for a lesser amount than the outstanding amount due (The Presidency, 2012: para 12(5)).

Paragraph 20(3)(*b*)

Paragraph 20(3)(*b*) deals with instances which require the base cost of an asset to be reduced (The Presidency, 2012: para 20(3)(*b*)). In terms of this paragraph, the base cost of an asset had to be decreased if a debt owed by a debtor, used to acquire an asset, was reduced or written off for a lesser amount than the outstanding amount due (South African Revenue Service 2018:49).

Section 8(4)(*m*)

In terms of section 8(4)(*m*), a taxpayer was deemed to have recouped or recovered amounts in respect of debts owed by that person which were reduced or written off for a lesser amount than the outstanding amount due (The Presidency, 2012: s 8(4)(*m*)).

Section 20(1)(*a*)(ii)

Section 20(1)(*a*) applied when taxpayers had balances of assessed losses available from prior tax years. In terms of paragraph (ii) of the proviso to section 20(1)(*a*), if a debt owed by a debtor was reduced or written off for a lesser amount than the outstanding amount, such benefit had to be applied by the debtor to reduce the balance of assessed losses (The Presidency, 2012: s 20(1)(*a*)(ii)).

Section 54

Section 54 is the charging section for the levying of donations tax (The Presidency, 2012: s 54).

2.2 PURPOSE OF THE DEBT RELIEF RULES

Prior to 1 January 2013, when a debt owing by a taxpayer was cancelled, waived, forgiven or discharged for no consideration (or for consideration which was less than the amount of the debt), the financial advantage obtained by the distressed debtor was eroded because of the various taxes which were levied upon the debtor (South African Revenue Service, 2016: 3-4) (National Treasury, 2012:29). As a result, the tax system served as a hindrance to rehabilitating companies which were experiencing financial hardships and inhibited the growth of the South African economy (National Treasury, 2012:47).

The Act was revamped by the promulgation of a set of structured debt relief rules (Gers & Marais, 2018). The debt relief rules were promulgated in section 19 and paragraph 12A, in accordance with the Taxation Laws Amendment Act 2012 (s 36(1), s 108(1)) These rules were effective from 1 January 2013 (Gers & Marais, 2018). The debt relief rules were implemented

in reaction to the international financial crisis which was causing financial distress for many companies (ENSafrica, 2014). These debt relief rules were deemed essential in order to strengthen the South African economy by providing relief to the vast number of distressed debtors facing financial hardships (ENSafrica, 2014) (National Treasury, 2012:44).

The rules set out in a structured manner the tax consequences when debt relief was provided by a creditor to a debtor in distress (Gers & Marais, 2018). The rules were intended to assist distressed debtors by simplifying the debt reduction process without creating further tax liabilities (ENSafrica, 2014) (National Treasury, 2012:44). The promulgation of these structured rules was intended to centralised, in two main locations (namely section 19 and paragraph 12A), the numerous provisions which previously existed throughout the Act (PwC, 2013: 27). The rules were intentionally structured to levy tax on debt relief transactions in a manner most advantageous for distressed debtors (National Treasury, 2012: pp 49-53). These rules were intended to (as far as possible) not instantly trigger tax liabilities for distressed debtors granted debt relief (National Treasury, 2012: pp 49-53). The intention was to delay the incurral of tax until such a time, for example, when an asset (which was acquired using the reduced debt) was sold (National Treasury, 2012: pp 49-53). In essence, the debt relief rules were formulated to ensure that the incurral of an instantaneous tax liability only materialised as a final resort (National Treasury, 2012:53).

2.3 2012 AMENDMENTS TO THE DEBT RELIEF RULES

In accordance with the Taxation Laws Amendment Act 2012, the following changes were incorporated into the Act. Unless otherwise stated, these changes applied with effect from 1 January 2013. (Taxation Laws Amendment Act, 2012: s 36(1), s 36(2), s 108(1), s 108(2)).

Introduction of section 19 and paragraph 12A

Effective 1 January 2013, section 19 and paragraph 12A were introduced (Taxation Laws Amendment Act, 2012: s 36(1), s 36(2), s 108(1), s 108(2)). These provisions dealt with the tax consequences when a debt was reduced or cancelled for a lesser amount than the total consideration due (Taxation Laws Amendment Act, 2012: s 36(1), s 36(2), s 108(1), s 108(2)). Section 19 and paragraph 12A centralised the numerous provisions which previously existed throughout the Act into these two main locations (PwC, 2013: 27).

In terms of section 19 and paragraph 12A, the relevant tax consequences were determined based on how the debt finance (which was subsequently written off or reduced) had been used by the taxpayer (National Treasury, 2012:48). For example, the normal revenue rules,

as contained in section 19, generally applied to debts which had financed expenses or allowances and were deductible for tax purposes (National Treasury, 2012:48). The capital gains tax rules, as contained in paragraph 12A, generally applied where the debt funding had been utilised to acquire assets or expenditure in respect of which the taxpayer could not claim a tax deduction or allowance (National Treasury, 2012:48). The debt relief rules in section 19 and paragraph 12A specified the sequence (or order) of the tax consequences which materialised when a debt owed by a person was written off or reduced for a lesser amount than the outstanding amount due (Gers & Marais, 2018) (National Treasury, 2012: pp 48-53). Accordingly, where there was previously uncertainty regarding the sequence in how transactions should be dealt with, section 19 and paragraph 12A provided clearer guidance. (National Treasury, 2012: pp 46-53)

Paragraph 12(5) replaced by paragraph 12A

In order to consolidate the numerous provisions throughout the Act, paragraph 12(5) which deemed a disposal to take place when an amount owed by a debtor was either reduced or cancelled was removed and replaced by paragraph 12A. (The Presidency, 2012: para 12(5)) (Taxation Laws Amendment Act, 2012: s 107(1)(*c*), s 108(1)) (PwC, 2013: 27)

Section 8(4)(*m*) was deleted

Section 8(4)(*m*) was deleted with effect from 1 January 2012 (Taxation Laws Amendment Act, 2012: s 9(1)(*c*), s 9(2)). Section 8(4)(*m*) was the relevant section which triggered a recoupment when debts owed by taxpayers were reduced or written off (The Presidency, 2012: s 8(4)(*m*)). When deleted, the recoupment provision of section 8(4)(m) was incorporated into section 19 in order to combine the various provisions which previously existed into a central point (The Presidency, 2013: s 19(6)) (PwC, 2013: 27).

Section 20(1)(*a*)(ii) was deleted

Section 20(1)(*a*)(ii) which required that a debtors' balance of assessed losses be reduced by the value of a debt benefit was removed from the Act (The Presidency, 2012: s 20(1)(*a*)(ii)) (Taxation Laws Amendment Act, 2012: s 37(1)).

Paragraph (3)(*b*)(ii) was amended

In terms of paragraph 3(*b*)(ii) a capital gain would instantaneously arise when expenditure which formed part of an asset's base cost was subsequently recouped by the taxpayer (The Presidency, 2012: para 3(*b*)(ii)). Paragraph 3(*b*)(ii) was amended to no longer automatically

trigger an instantaneous capital gain in respect of debt claims owed by a taxpayer if such debts were subsequently reduced (The Presidency, 2013: para 3(*b*)(ii)).

2.4 DEBT RELIEF RULES APPLICABLE AS FROM 1 JANUARY 2013

The 2012 amendments brought about section 19 and paragraph 12A with effect from 1 January 2013. Section 19 and paragraph 12A specified the sequence in which transactions should be accounted for. For example, in terms of section 19 and paragraph 12A, if a transaction was subject to estate duty, the Estate Duty Act 45 of 1955 ('Estate Duty Act') took precedence. The transaction would be subjected to tax in terms of the Estate Duty Act and not the debt relief provisions in the Income Tax Act. Section 19 and paragraph 12A resulted in transactions being accounted for in a similar sequence as before 1 January 2013. The difference was that where there was previously uncertainty regarding the sequence in how transactions should be dealt with, section 19 and paragraph 12A provided clearer guidance. (National Treasury, 2012: pp 46-53)

Ordering rules as contained in section 19 and paragraph 12A

In terms of section 19 and paragraph 12A, the sequence in which transactions were accounted for as from 1 January 2013 was as follows:

1. **Donations Tax, Estate Duty or Employee Benefits (Fringe Benefits)**
   The first step when accounting for the tax implications of a transaction in terms of section 19 and paragraph 12A was to consider whether the transaction was liable for either donations tax, estate duty or was taxed in terms of the Seventh Schedule of the Act as an employee benefit. If the debt which was decreased constituted a donation, the transaction was liable for donations tax. If the debt was decreased in terms of a person's last will and testament, the transaction was liable for estate duty. If the decreased debt stemmed from an employer - employee relationship, the transaction was taxed in terms of the Seventh Schedule to the Act as a taxable employee benefit. (National Treasury, 2012: pp 48-49) (The Presidency, 2013: s 19(8), para 12A(6))

   It was only transactions which were not subject to donations tax, estate duty or were not taxed as employee benefits which were then, based on the way in which the debt funding had been utilised, taxed as either normal revenue (in accordance with the normal revenue rules of section 19) or taxed in terms of the capital gains tax regime

(in accordance with the capital gains tax rules of paragraph 12A) (National Treasury, 2012: pp 48-49) (The Presidency, 2013: s 19(8), para 12A(6)).

Difference between the ordering rules which applied from 1 January 2013 and the preceding rules

The introduction of section 19 and paragraph 12A (with effect from 1 January 2013) did not change the sequence in which transactions which were subject to donations tax, estate duty, or were taxed as employee benefits were previously accounted for (National Treasury, 2012:48).

2. **Normal revenue rules**

   a. **Eliminate the residual cost price of trading stock on hand**

      The normal revenue rules were relevant if the debt was used to finance expenses which were tax deductible or expenses in respect of which tax allowances were granted. For example, if a taxpayer had trading stock which was debt funded and still on hand (at the time of the debt reduction) any amount of the debt which had been reduced or cancelled would first of all be applied against the residual cost price of the stock. (National Treasury, 2012: 48-53)

   b. **Taxable recoupment incurred**

      If trading stock which was debt funded did not have a residual cost price or if the trading stock had already been sold at the time of the debt reduction, any amount of the debt which was reduced or cancelled would result in a taxable recoupment (National Treasury, 2012: 48-53).

      Difference between the ordering rules which applied from 1 January 2013 and the preceding rules

      The introduction of section 19 and paragraph 12A changed the sequence of how debt transactions which funded allowance assets not sold were previously accounted for (National Treasury, 2012: 46-53). Prior to 1 January 2013, the normal revenue rules took precedence over the capital gains tax rules (National Treasury, 2012: 46-53). This meant that the normal revenue rules would first and foremost be applied, and the capital gains tax rules would only take effect thereafter (National Treasury, 2012: 46-53). As a result, the capital gains tax rules only applied to debts which were reduced and had not been taxed in terms

of the normal revenue rules (National Treasury, 2012: 46-53). For that reason, prior to 1 January 2013, any debt reduced or cancelled which was used to acquire assets or fund expenses in respect of which tax allowances or deductions were granted would first result in taxable recoupments (National Treasury, 2012: 46-53). This resulted in tax being immediately incurred (National Treasury, 2012:49). It was only after that, that the reduced debt could be applied against an asset's base cost to decrease the balance thereof (National Treasury, 2012: 46-53). According to PKF, companies at the time were subjected to tax at a rate of 28% and the effective capital gains tax rate for companies was 18.6% (66.6% x 28%) (PKF, 2013). In addition to the tax being immediately incurred, more tax (as taxable recoupments were taxed at a rate of 28%) would have been incurred than if the debt had first been applied against the asset's base cost (National Treasury, 2012: 46-53) (PKF, 2013). If the reduced debt had first been applied against the assets base cost, a larger taxable capital gain would have resulted which would be taxed at an effective rate of only 18.6% (66.6% x 28%) (PKF, 2013).

3. Capital gains tax rules

a. Eliminate the base cost

The application of the capital gains tax rules depended on whether the debt funded asset, at the time of the debt reduction, was either still owned by the debtor or had been sold (National Treasury, 2012: 46-53). If the asset was still owned, any amount of debts cancelled or reduced were first and foremost applied against an asset's base cost to decrease its cost(National Treasury, 2012: 46-53). Once the base cost had been fully depleted, a taxable recoupment would, in terms of section 19, be incurred if there was a further amount of debt which had not been applied against the asset's base cost (National Treasury, 2012: 48-53).

Difference between the ordering rules which applied from 1 January 2013 and the preceding rules

As previously discussed, prior to 1 January 2013, any debts reduced or cancelled which were used to acquire assets or fund expenses in respect of which tax allowances or deductions were granted would result in taxable recoupments before a base cost reduction could be applied (National Treasury, 2012: 46-47).

b. Eliminate an assessed loss balance

A decrease in an assessed loss balance occurred if the debt which was reduced had been applied to acquire assets sold at the time of the debt reduction. This rule also applied if the debt funded asset did not have any remaining base cost against which the debt reduction could be applied. (National Treasury, 2012:50)

Difference between the ordering rules which applied from 1 January 2013 and the preceding rules

The introduction of section 19 and paragraph 12A did not amend the sequence or order in which these transactions were previously accounted for prior to 1 January 2013 (National Treasury, 2012: 46-47).

c. No further capital gains tax consequences

In terms of the capital gains tax rules that applied as from 1 January 2013, there were no additional capital gains tax implications when a debt funded asset had already been sold at the time the debt was reduced or written off (National Treasury, 2012:50).

Difference between the ordering rules which applied from 1 January 2013 and the preceding rules

Prior to 1 January 2013, an instantaneous capital gain would result in respect of debts which were reduced or cancelled where the debt funded asset had already been sold at the time of the debt reduction (National Treasury, 2012: 46-47).

Illustrative example:

The following illustrative example shows the income tax implications of the sequence of the debt relief rules which applied both before 1 January 2013 and from 1 January 2013.

XYZ (Pty) Ltd has a tax year which ends on the last day of December. XYZ (Pty) Ltd does not have a balance of assessed losses. On 1 January 2013 XYZ (Pty) Ltd obtained a loan of R1 250 000 from ABC Bank. On 1 January 2013, XYZ (Pty) Ltd used the loan to purchase a borehole drilling machine for a total cost of R1 250 000. The drilling machine was brought into use in XYZ (Pty) Ltd's trade on the same day (1 January 2013). In terms of Interpretation Note 47 (Issue 4), drilling machines are written off over a period of 5 years. As a result of XYZ (Pty) Ltd's inability to repay the loan, ABC Bank discharged the unpaid debt

of R500 000 which was due to it on 31 December 2014. The base cost of the drilling machine on 31 December 2014 amounted to R750 000. (Adapted from: Stiglingh, Koekemoer, van Heerden, Wilcocks & van der Zwan, 2020: 610 -611)

Income tax implications based on the sequence of the debt relief rules which applied <u>BEFORE 1 January 2013</u>

At the time when the R500 000 debt was discharged, XYZ (Pty) Ltd had claimed capital allowances in terms of section 11(*e*) of the Act amounting to R500 000 (Adapted from: Stiglingh et al., 2020: 610- 611). In terms of the then section 8(4)(*m*) read with section 8(4)(*a*) of the Act, a taxable recoupment amounting to R500 000 should have resulted (The Presidency, 2012: s 8(4)(*m*), s 8(4)(*a*)). According to PKF, companies at the time were subject to tax at a rate of 28% and the capital gains tax inclusion rate for companies amounted to 66.6% (PKF, 2013). For that reason, the R500 000 recoupment would have been taxed at 28% (PKF, 2013). XYZ (Pty) Ltd would, as a result, in terms of the debt relief rules which applied before 1 January 2013 instantaneously incurred tax of R140 000 (R500 000 x 28%) because of the R500 000 debt which was discharged (The Presidency, 2012: s 8(4)(*m*), s 8(4)(*a*)).

Income tax implications based on the sequence of the debt relief rules which applied <u>FROM 1 January 2013</u>

The base cost of R750 000 would have been reduced by the R500 000 debt benefit to R250 000 (Adapted from: Stiglingh et al., 2020: 610-611) (National Treasury, 2012: 48-53). The entire R500 000 debt benefit would have been applied against the base cost to reduce it to R250 000 (R750 000 – R500 000) (Adapted from: Stiglingh et al., 2020: 610-611) (National Treasury, 2012: 48-53). In terms of section 19(7), as a result of XYZ (Pty) Ltd receiving the R500 000 debt benefit, the amount of allowances which XYZ (Pty) Ltd could claim <u>**after the debt benefit was granted**</u> would have been capped at R250 000 (The Presidency, 2013: s 19(7)). The amount of R250 000 is calculated by taking the assets cost of R1 250 000 and subtracting the sum of the R500 000 debt waived and the R500 000 allowances which had already been claimed by XYZ (Pty) Ltd (before the debt benefit was granted) (Stiglingh et al., 2020:453) (The Presidency, 2013: s 19(7)). It is submitted that in the absence of section 19(7), XYZ (Pty) Ltd would have been entitled to claim allowances of R750 000 <u>**after the debt benefit was granted**</u> and not R250 000. It is, therefore, the writer's view that in the absence of section 19(7), the tax incurred (in terms of the debt relief rules) would be reduced.

XYZ (Pty) Ltd would be entitled to claim total allowances amounting to R1 250 0000 in spite of the fact that a R500 000 debt benefit had been applied to reduce the assets cost. It is submitted that, as the debt benefit of R500 000 was applied to reduce the assets cost of R1 250 000, the total allowances available to XYZ (Pty) Ltd should not exceed R750 000 (R1 250 000 – R500 000). Section 19(7) in effect ensures that this is achieved by taking into account the debt benefit of R500 000 when determining the amount of the allowances which XYZ (Pty) Ltd can claim after the debt benefit was granted.

In terms of the debt relief rules which applied from 1 January 2013, an instant tax liability would not have been incurred when the debt was discharged (as was the case before 1 January 2013) (National Treasury, 2012:50). The incurral of tax in terms of the debt relief rules which applied as from 1 January 2013 was not immediate and would have been deferred until the borehole drilling machine was ultimately sold (if ever) (National Treasury, 2012: 50-53).

Analysis of the illustrative example results

It is evident that changing the sequence in which transactions were accounted for was positive for financially distressed taxpayers (National Treasury, 2012: 46-53). This change (which led to the base cost of an asset being reduced before a taxable recoupment was incurred) resulted in both the deferral of the tax liability and a lesser amount of tax being incurred (National Treasury, 2012: 46-53). In terms of the debt relief rules which applied from 1 January 2013, no tax liability was instantaneously incurred but the tax liability was, instead, deferred until the debt funded asset was ultimately disposed of (if ever). (National Treasury, 2012:49) The debt relief provisions which applied from 1 January 2013 resulted in tax being incurred (on the R500 000 unpaid debt that was discharged) at a reduced effective rate of 18.6% (28% x 66.6%), instead of (as was the case before 1 January 2013) at a rate of 28% (National Treasury, 2012: 46-53) (PKF, 2013).

2.5 2017 AMENDMENTS TO SECTION 19 AND PARAGRAPH 12A

Concession or compromise definition introduced

In 2017, amendments were made to section 19 and paragraph 12A which included defining the notion of what constituted a '*concession or compromise*' (Taxation Laws Amendment Act, 2017: s 32(1), s 70(1)). These amendments were effective from 1 January 2018 (Taxation Laws Amendment Act, 2017: s 32(2), s 70(2)). The implication of this amendment was that the scope of section 19 and paragraph 12A was significantly expanded not merely to trigger the incurral of tax in terms of the debt relief provisions for debt reductions or cancellations, but

also to trigger tax in terms of these provisions each time a '*concession or compromise*' occurred (Chong, 2017).

In terms of the '*concession or compromise*' definition, a '*concession or compromise*' occurred, firstly, when an amendment was made to any terms or conditions of a debt obligation. A '*concession or compromise*' was also deemed to take place when an existing debt obligation was replaced or exchanged with a new one (i.e. debt swaps or substitution). In addition, the '*concession or compromise*' definition encompassed the conversion of liabilities or debts due by taxpayers into shares (i.e. debt to share conversions). (Taxation Laws Amendment Act, 2017: s 32(1), s 70(1))

As the term '*concession or compromise*' was defined to include any change made to the terms or conditions of a debt, this amendment significantly broadened the scope to which the debt relief provisions of section 19 and paragraph 12A applied (Taxation Laws Amendment Act, 2017: s 32(1), s 70(1)). Accordingly, tax (in terms of the debt relief provisions) was triggered each time a '*concession or compromise*' occurred (National Treasury, 2017:29) (Chong, 2017). The 2017 amendment, as a result, created an unintended consequence of triggering an instantaneous tax liability for a debtor each time a debt was restructured (through, for example, the modification of an interest rate, or the postponement of a debt repayment date), despite there being legitimate business or economic reasons to do so (Chong, 2017) (Harrison & Gaetsewe, 2019). As a result, an unintended consequence of this amendment was that valid business transactions which were not entered into for the purpose of evading tax were undermined (Chong, 2017) (Harrison & Gaetsewe, 2019).

Further unintended tax consequences of this amendment were also identified in cases where debt funding was sourced by a taxpayer from an independent party, such as a financial institution (bank). When debt funding is sourced from a bank, it is often considered normal business practice for the bank (as a prerequisite to granting the funding) to call for the prospective borrower to subordinate all existing loans with connected parties. As a result of the 2017 amendment, tax consequences were triggered, undermining legitimate business transactions, as the subordination of a loan would have constituted a '*concession or compromise*' as the terms and conditions of the original loan would have been altered. (National Treasury, 2018:12)

Further unintended tax consequences of the 2017 amendment which triggered tax (in terms of the debt relief provisions) each time a concession or compromise occurred which negatively impacted legitimate business transactions which did not cause a tax leakage to the fiscus were identified in instances when temporary bridging loan finance was substituted by long-term debt (National Treasury, 2018:12).

2.6 2018 AMENDMENTS TO SECTION 19 AND PARAGRAPH 12A

Concession or compromise definition amended

In 2018, further amendments were made to the debt relief provisions in section 19 and paragraph 12A (Harrison & Gaetsewe, 2019) (Haupt, 2019:338). The changes which were effective from 1 January 2018 included amending the definition of '*concession or compromise*' merely to include realisation events such as the '*cancellation, waiver or extinguishment*' of a debt (Taxation Laws Amendment Act, 2018: s 36(1), s 36(2)). These changes were promulgated only to trigger tax (in terms of the debt relief provisions) for a debtor if the debtor had been released from an obligation because of a debt being '*cancelled, waived, or extinguished*' by the creditor (Harrison & Gaetsewe, 2019) (Haupt, 2019:338). This change was well received by taxpayers (Harrison & Gaetsewe, 2019). The amended definition eliminated the unintended consequence which undermined valid debt restructuring transactions because of tax being incurred when for example an interest rate was modified or a debt repayment date postponed (Chong, 2017) (Harrison & Gaetsewe, 2019).

Section 19(6A) and paragraph 12A(4) introduced

Paragraph 12A(4) and section 19(6A) were introduced to close a loophole which resulted in taxpayers not incurring tax in terms of the debt relief rules when debt funded assets were sold before a debt benefit was granted (Gronewald & Van Rooyen, 2019: 68-71). Section 19(6A) was introduced with effect from 1 January 2019 and has an impact on tax years which start on or after this effective date. This section applies to all capital assets which are debt funded and were disposed in a tax year which precedes the tax year in which the debt was forgiven. In terms of this section, additional tax (in the form of a taxable recoupment) will be incurred if the tax paid when an asset was disposed is lower than the tax which would have been paid had the debt been forgiven in the same tax year the asset was disposed. (Income Tax Act 58 of 1962: s 19(6A), para 12A(4)) (Taxation Laws Amendment Act, 2018: s 36(1)(*i*), s 77(1)(*g*))

Paragraph 12A(4) was introduced with effect from 1 January 2019 and has an impact on tax years which start on or after this effective date (Income Tax Act 58 of 1962: para 12A(4)). Paragraph 12A(4) applies to all assets which are debt funded and are disposed in a tax year which precedes the tax year in which the debt was forgiven. In terms of this paragraph, an additional capital gain will be incurred if the capital gain which arose when the asset was disposed is lower than the capital gain which would have arisen had the debt been forgiven in the same tax year in which the asset was disposed. (Income Tax Act 58 of 1962: para 12A(4)) (Taxation Laws Amendment Act, 2018: s 77(1)(*g*))

2.7 EXCLUSIONS TO THE DEBT RELIEF PROVISIONS

Initial exclusions which apply to both section 19 and paragraph 12A

Section 19 generally applies to debts incurred for purposes of funding expenditure on revenue account, while paragraph 12A generally applies to debts incurred for purposes of funding expenditure on capital account (PwC, 2017-b:1). Initially, when section 19 and paragraph 12A were introduced (with effect from 1 January 2013) they contained certain exclusions from the taxing provisions of the debt reduction rules (The Presidency, 2013: s 19(8), para 12A(6)). In terms of these initial exclusions, there were 3 identical exclusions in section 19 and paragraph 12A, and a further 2 exclusions in paragraph 12A which were not replicated in section 19 (The Presidency, 2013: s 19(8), para 12A(6)). An example of an identical exclusion found both in section 19 and paragraph 12A is the so-called donations tax exclusion (The Presidency, 2013: s 19(8)(*b*), para 12A(6)(*b*)). As this exclusion was contained in section 19 and also replicated in paragraph 12A, any transaction which constituted a donation and fell either within the ordinary revenue rules (of section 19) or the capital gains tax regime (of paragraph 12A) would not be taxed in terms of the debt reduction rules (The Presidency, 2013: s 19(8)(*b*), para 12A(6)(*b*)).

The 3 exclusions detailed below were contained in both section 19 and paragraph 12A. As a result, when the requirements of these exclusions were met, neither of the taxing provisions of section 19 or paragraph 12A was triggered. (The Presidency, 2013: s 19(8), para 12A(6))

The first exclusion (‘the estate duty exclusion from the debt relief provisions’) applied to transactions which were accounted for in terms of the Estate Duty Act (The Presidency, 2013: s 19(8)(*a*), para 12A(6)(*a*)). This exclusion applied when a debt claim that a deceased estate had against an inheritor (of the estate) was decreased by the estate (The Presidency, 2013: s 19(8)(*a*), para 12A(6)(*a*)). The estate duty exclusion from the debt relief provisions only

applied to debt claims of deceased estates which constituted its property in terms of the Estate Duty Act (The Presidency, 2013: s 19(8)(*a*) para 12A(6)(*a*)).

The second exclusion ('the donations tax exclusion from the debt relief provisions') applied to transactions which were dealt with in terms of the donations tax provisions contained in sections 54 to 64 of the Act (The Presidency, 2013: s 19(8)(*b*), para 12A(6)(*b*)) (The Presidency, 2013: ss 54 -64).This exclusion applied if the decreased debt claim was either classified as a donation due to the donation definition being met, or if the donation definition was not met but the decreased debt claim was deemed (or considered) to be a donation in terms of section 58 (The Presidency, 2013: s 19(8)(*b*), s 55(1), s 58(1), para 12A(6)(*b*)).

The third exclusion applied to transactions which constituted taxable employee benefits in terms of the Seventh Schedule of the Act (The Presidency, 2013: s 19(8)(*c*), para 12A(6)(*b*)). The third exclusion applied when an employer settled any amounts that were due by an employee to an independent party (The Presidency, 2013: s 19(8)(*c*), para 12A(6)(*b*)). This exclusion only applied if the employee did not have to reimburse the employer for the amount paid on their behalf (The Presidency, 2013: s 19(8)(*c*), para 12A(6)(*b*)).

Initial exclusions which apply only to paragraph 12A

In addition to the mentioned exclusions, paragraph 12A contained 2 more exclusions which were not replicated in section 19 (The Presidency, 2013: s 19(8), para 12A(6)). These exclusions were contained in paragraph 12A(6)(d) and paragraph 12A(6)(e). The implication of these exclusions was that transactions which met the requirements of the exclusions were not subject to the taxing provisions of paragraph 12A (The Presidency, 2013: para 12A).

In terms of paragraph 12A(6)(*d*), debt transactions which occurred between group companies were excluded from the taxing provisions of paragraph 12A if the debt was granted by one company in the group to another and was subsequently written off or reduced (The Presidency, 2013: para 12A(6)(*d*)).

In terms of paragraph 12A(6)(*e*) when a company had an obligation to repay a debt, to a related (or connected) person, the debt relief provisions contained in paragraph 12A were not applicable if the debt was reduced in expectation of the impending liquidation (or actual liquidation), or as a result of any process followed to end the company's legal existence (The Presidency, 2013: para 12A(6)(*e*)). The exclusion did not apply if the debtor company had not implemented the necessary processes to liquidate or end the company's existence within 36

months, commencing from the date on which the debt was reduced (The Presidency, 2013: para 12A(6)(*e*)). The implication of the paragraph 12A(6)(*e*) exclusion was that a company in the process of being liquidated or terminated would not incur any additional tax (in terms of the capital gains tax regime), which required among other things that an asset's base cost be decreased by the debt benefit in respect of debts which were reduced to fund capital assets (The Presidency, 2013: para 12A(6)).

Exclusions applicable to the 2020 tax year which apply to both section 19 and paragraph 12A

The exclusions to section 19 have been attached as Appendix 2, and the exclusions to paragraph 12A have been attached as Appendix 4. These exclusions are applicable to the 2020 tax year.

The estate duty exclusion (as discussed under the initial exclusions) from the debt relief provisions remains in the legislation applicable to the 2020 tax year (Income Tax Act 58 of 1962: s 19(8)(*a*), para 12A(6)(*a*)). The donations tax exclusion (as discussed under the initial exclusions) from the debt relief provisions remains in the legislation applicable to the 2020 tax year (Income Tax Act 58 of 1962: s 19(8)(*b*), para 12A(6)(*b*)). A further requirement has been added to this exclusion: it is mandatory for donations tax to be paid in respect of the debt reduction. (Income Tax Act 58 of 1962: s 19(8)(*b*), para 12A(6)(*b*)). The exclusion which relates to taxable employee benefits (as discussed under the initial exclusions) remains in the legislation applicable to the 2020 tax year (Income Tax Act 58 of 1962: s 19(8)(*c*), para 12A(6)(*c*)).

In addition to the estate duty and donations tax exclusion from the debt relief provisions and the exclusion which relates to taxable employee benefits: section 19 and paragraph 12A also contain the 3 identical exclusions detailed below (Income Tax Act 58 of 1962: s 19(8), para 12A(6)).

Debt transactions between group companies are excluded from the taxing provisions of both section 19 and paragraph 12A if the group company which received the benefit of the write- off did not conduct business (i.e. trade) for a two year period (the year that the debt benefit was obtained and the year before that) (Income Tax Act 58 of 1962: s19(8)(*d*), para 12A(6)(*d*)).

Debt transactions between group companies are excluded from the taxing provisions of both section 19 and paragraph 12A if the group company which was liable to pay the debt extinguished the debt by means of a share issue (Income Tax Act 58 of 1962: s 19(8)(*e*),

para 12A(6)(*f*)). These exclusions would apply if for example a debtor issued its shares to a creditor in order to settle a debt owed. In essence the debtor's debt liability would be substituted for equity (Stiglingh et al., 2020:448).

When a debt liability is discharged as a result of a debtor issuing its shares to a creditor, the capital portion of the debt liability (and not the interest) is excluded from the taxing provisions of section 19 and paragraph 12A (Income Tax Act 58 of 1962: s 19(8)(*f*), para 12A(6)(*g*)).

Exclusion applicable to the 2020 tax year which apply only to paragraph 12A

The exclusions to paragraph 12A have been attached as Appendix 4. These exclusions are valid for the 2020 tax year.

The exclusion (as discussed under the initial exclusions) from the paragraph 12A debt relief provisions which apply to companies which received debt benefits and are in the process of having their legal existence terminated remains in the legislation applicable to the 2020 tax year (Income Tax Act 58 of 1962: para 12A(6)(*e*)).

Intention of the legislation

The debt relief provisions as contained in section 19 and paragraph 12A were legislated with the specific intention of assisting financially distressed debtors (National Treasury, 2012:44) (Nel & Herron, 2016:517). These provisions were intended to reduce the tax incurred by such taxpayers when a debt owed by them was written off or reduced (National Treasury, 2012:44) (Nel & Herron, 2016:517). In essence, the fundamental intention of the debt relief provisions was to preserve, and not to diminish, the economic advantage derived by financially distressed debtors when a debt owed by them was written off or reduced (National Treasury, 2012:44) (Nel & Herron, 2016:517). The legislation had numerous unintended consequences which were addressed in subsequent amendments to the legislation. The question remains whether the legislation is achieving its intended purpose and whether the amendments have rectified the defects in the legislation. What follows in the next chapters is a critical analysis of the possible defects/unintended consequences of the legislation which applies to the 2020 tax year.

3. CHAPTER THREE – CONSEQUENCES OF EXCLUSIONS

3.1 ESTATE DUTY EXCLUSION

[Section 19(8)(a) and paragraph 12A(6)(a)]

In terms of the estate duty exclusions from the debt relief provisions, the debt relief provisions are not triggered when the debt claim of a deceased estate is reduced (or written off) in favour of an inheritor of the estate (Income Tax Act 58 of 1962: s 19(8)(a), para 12A(6)(*a*)). In terms of these requirements, the payment of estate duty is not mandatory for the exclusions to apply (South African Revenue Service, 2016:44). This creates a loophole which may result in the non-taxation of certain transactions (Duvenage, 2019). In terms of section 4A of the Estate Duty Act, a deceased estate will only be liable for the payment of estate duty if the net value of the estate is more than R3 500 0000 (Stiglingh et al., 2020:977). It is evident that estate duty will not be payable, if for example, a deceased estate with a net value of R2 500 0000 waives a R500 000 debt claim owed by an inheritor (Adapted from Duvenage, 2019). In addition, due to the estate duty exclusions from the debt relief provisions, there will not be any tax incurred as a result of the R500 000 debt waiver (Income Tax Act 58 of 1962: s 19(8)(*a*), para 12A(6)(*a*)). There will be no tax liability in terms of the Estate Duty Act and the debt relief provisions (Estate Duty Act 45 of 1955: s 4A) (Income Tax Act 58 of 1962: s 19(8)(*a*), para 12A(6)(*a*)).

Conclusion

The payment of estate duty is not mandatory for the exclusions from the debt relief provisions to apply (Income Tax Act 58 of 1962, s 19(8)(a), para 12A(6)(*a*)). It is submitted that these exclusions are not adequate to prevent the non-taxation of debt as estate duty will not be paid, nor will tax be incurred in terms of the debt relief provisions in certain instances when a debt is reduced by a deceased estate in favour of an inheritor.

Recommendation

In terms of the Explanatory Memorandum, the purpose of the exclusions from the debt relief provisions was for certain transactions to not be taxed (in terms of the debt relief rules) when other provisions of the Act applied (National Treasury, 2018: 19-20) (National Treasury, 2012: 49-50). It is submitted that the exclusions from the debt relief provisions were intended to avoid the double taxation of transactions. In terms of the Explanatory Memorandum, it was mentioned that the donations tax exclusion from the debt reduction provisions was changed to rectify an unanticipated consequence where both donations tax and tax in terms of the debt relief provisions were not incurred by taxpayers (National Treasury, 2018: 19-20). In other

words, the donations tax exclusions from the debt reduction provisions were amended to close a loophole which resulted in the non-taxation of certain transactions (National Treasury, 2018: 19-20). It is submitted that the intention of the legislature in terms of the estate duty exclusions in section 19(8)(*a*) and paragraph 12A(6)(*a*) will not be to prevent a transaction from being taxed (i.e. the non-taxation of a transaction) but to rather avoid double taxing. If the legislature wishes to close the loophole which could result in transactions not being taxed, it is recommended that both section 19(8)(*a*) and paragraph 12A(6)(*a*) be amended to include the phrase '*<u>and estate duty is payable on the amount of the debt reduced</u>*', as indicated below:

> '*This section must not apply to a debt benefit in respect of any debt owed by a person—*
>
> *(a)* *that is an heir or legatee of a deceased estate, to the extent that—*
>
> *(i)* *the debt is owed to that deceased estate;*
>
> *(ii)* *the debt is reduced by the deceased estate; and*
>
> (iii) *the amount by which the debt is reduced by the deceased estate forms part of the property of the deceased estate for the purposes of the Estate Duty Act:* ***<u>and</u>***
>
> ***<u>estate duty is payable on the amount of the debt reduced</u>***'

3.2 DONATIONS TAX EXCLUSION
[Section 19(8)(*b*) and paragraph 12A(6)(*b*)]

In terms of the donations tax exclusions from the debt relief provisions, property which has been disposed of either by way of a donation or deemed donation, in respect of which donations tax is payable, is not subject to the debt relief provisions (Income Tax Act 58 of 1962: s 19(8)(*b*), para 12A(6)(*b*)). Accordingly, depending upon the total amount of assets donated, such disposals are subject to either 20% or 25% donations tax (Income Tax Act 58 of 1962: s 64(1)(*a*)). Donations tax is less than corporate tax which is levied at a rate of 28% (Income Tax Act 58 of 1962: Tax Rates 2019/2020, Schedule 1).

In terms of the donations tax provisions which are contained in section 59 of the Act, the donor (i.e. the creditor who wrote off the debt), and not the financially distressed debtor (i.e. the donee), will be liable for the payment of donations tax (Income Tax Act 58 of 1962: s 59). The financially distressed debtor only becomes 'jointly and severally' liable for the payment of donations tax if the donor fails to pay the donations tax by the last day of month after the month when the donation was made (Income Tax Act 58 of 1962: s 59, s 60). It is submitted that the application of the donations tax exclusions from the debt relief provisions is beneficial for

financially distressed taxpayers, as the creditor (i.e. the donor) and not the financially distressed debtor (i.e. the donee) bear the tax burden. Accordingly, it is submitted that the economic benefit derived by financially distressed debtors remains intact (and is not reduced as no tax is incurred in terms of the debt relief rules) when the donations tax exclusions from the debt relief provisions apply. This is illustrated in the following example.

Assume for the purpose of this example that the loan which was written off **was deemed a donation in terms of section 58 of the Act**. In addition, assume that the deemed donation was not specifically exempt from donations tax and that the donor timeously paid the donations tax.

Company A (not a money lender) granted a R1 million loan to Company B. Company B ('the financially distressed debtor') was unable to repay R500 000 of the loan. As the financially distressed debtor could not afford to repay the loan, Company A ('the donor') wrote off the outstanding amount of R500 000. The donor, and not the financially distressed debtor would be liable for the payment of R100 000 donations tax (R500 000 x 20%) (Income Tax Act 58 of 1962: s 59, s 64). The financially distressed debtor would, as a result of the donations tax exclusions from the debt relief provisions not incur any tax in terms of the debt relief rules (Income Tax Act 58 of 1962: s 19(8)(*b*), para 12A(6)(*b*)). For that reason, the R500 000 economic benefit derived by the financially distressed debtor from the debt write-off will be maintained and not eroded by the payment of tax.

Application of the donations tax exclusion

The correct and appropriate application of the donations tax exclusions from the debt relief provisions depends upon whether the debt reduction constitutes a donation or deemed donation (Kolitz & Mitchell, 2017). A taxpayer should be able to determine, with certainty, whether a transaction is a donation or is deemed to be one (Nel & Herron, 2016:518) (Kolitz & Mitchell, 2017). This is because of such transactions being specifically carved out from the taxing provisions of the debt reduction rules in terms of these exclusions (Nel & Herron, 2016:518) (Kolitz & Mitchell, 2017).

Does the transaction constitute a donation?

The term '*donation*' is defined in section 55 of the Act as '*property*' which has been disposed of in a gratuitous manner (Income Tax Act 58 of 1962: s 55). The definition of donation also incorporates waivers which are gratuitous, as well as rights which have been renunciated (Income Tax Act 58 of 1962: s 55). According to the South African Revenue Service, in order

for property to be disposed of in a gratuitous manner, the person who disposed of the property must not expect to receive anything in return. This implies, as interpreted by the courts, that the motive for the donation must be driven by '*sheer liberality or disinterested benevolence*' (*CIR v Estate Hulett*, 1990:11).

The 'donation' definition makes reference to '*property*' (Income Tax Act 58 of 1962: s 55). The term '*property*' is defined in section 55 of the Act as property which is moveable or fixed (immovable). The property definition also encompasses intangible (incorporeal) property, as well as tangible (corporal) property. (Income Tax Act 58 of 1962: s 55)

A debt which has been written off or reduced by a creditor is a right relinquished by the creditor and is considered as an intangible asset (or incorporeal property). As a result, a debt written off is '*property*' as defined. The relinquishment of a right constitutes a disposal event. For that reason, a debt written off constitutes '*property which has been 'disposed*'. (Nel & Herron, 2016:521)

A debt which has been written off or reduced, only constitutes a donation if the disposal was gratuitous. A debt which has been written off or reduced by a creditor because of a debtor's inability to repay cannot be seen as driven by pure generosity or goodwill and is as a result not considered gratuitous and not a donation. (Stiglingh et al., 2020:946). As a debt written- off due to a debtor's inability to pay is not a donation, a taxpayer would still need to consider whether such a transaction constitutes a deemed donation (Stiglingh et al., 2020:945).

Does the transaction constitute a deemed donation?

In terms of section 58 of the Act, a disposal will be classified as a deemed donation if in the opinion of the Commissioner the transaction was settled for an insufficient amount or consideration (Nel & Herron, 2016:521). During this study a comprehensive list of specific factors which the Commissioner applies when determining whether a consideration is sufficient or not could not be found.

A disposal is deemed a donation when the transaction is cleared or settled for an amount that the Commissioner considers insufficient (Income Tax Act 58 of 1962: s 58(1)). It may be assumed, based on general business practice, that a consideration will be deemed insufficient if it were below market value. This is not the case, as it cannot be automatically assumed that a consideration which is not at fair market value will be deemed insufficient by the Commissioner (Kolitz & Mitchell, 2017).

In terms of Interpretation Note 91, Reduction of Debt (21 October 2016) when assessing the adequacy of consideration for a transaction, the specific circumstances which caused the transaction must be taken into account (South African Revenue Service, 2016:48). The intention of the legislature for introducing estate duty must be considered (South African Revenue Service, 2016:48).

If the purpose of the transaction was to pay less estate duty, the consideration in all likelihood is going to be considered inadequate and a deemed donation by the Commissioner (South African Revenue Service, 2016:48). According to Interpretation Note 91, it can be deduced that if the estate of the donor does not diminish, the Commissioner will regard the consideration to be insufficient and not a deemed donation (South African Revenue Service, 2016:48). It is submitted that a deemed donation may arise when a debt is written off by a creditor (that is a natural person) because of a debtor's inability to pay. In these circumstances, the waived debt may be construed by the Commissioner to be an insufficient consideration, as the estate of the donor (the creditor) may be reduced by the value of the debt relinquished by the creditor (South African Revenue Service, 2016:48). If the debt reduction occurs between companies, as a result of a debtor not being able to pay, it may be argued that as the debtor could not afford to settle the full amount of the debt, any amount paid (if any) should be considered sufficient and the transaction should not be deemed a donation (Kolitz & Mitchell, 2017). It is submitted that a counter argument may be that in such instances, as the full consideration was not paid, the actual amount paid should be considered inadequate and the transaction deemed a donation. If the debt reduction occurs between companies and the debt was written off over a disagreement of contract terms, it is submitted, that unless a court or other forum determines an amount to be paid, it may be argued that as the full amount (as stipulated in the contract)was not settled, the actual amount paid is considered insufficient and deemed a donation. It is further submitted that a counter argument in such cases may be that as there was a dispute which resulted in the debtor not settling the full contract amount, any amount paid should be regarded as sufficient as the amount paid will represent the portion of the contract amount upon which both parties agree.

Conclusion

There seems to be uncertainty about when debt reduction transactions are deemed to be donations by the Commissioner (Nel & Herron, 2016: 517-518). This is because of the subjectivity of the term '*inadequate consideration*', coupled with the lack of comprehensive guidance about this term's meaning (Nel & Herron, 2016: 517-518). It is submitted that uncertainty increases the risk of inappropriate application of the tax legislation by taxpayers (either intentionally or unintentionally) as taxpayers may not classify debt reduction

transactions which should be classified as deemed donations as such. Financially distressed taxpayers may therefore incorrectly pay tax on these transactions which in essence will erode the economic benefit intended for these taxpayers when a debt is reduced or written off. It is submitted that the payment of tax in such instances may increase the financial burden of distressed taxpayers which could negatively impact these taxpayers' prospects of financial recovery.

Recommendation

In order to remedy the uncertainty created by the subjectivity of the term '*inadequate consideratio*n' when determining whether a transaction constitutes a deemed donation, it is recommended that a comprehensive list of specific factors which detail when the Commissioner considers a consideration to be inadequate be provided through the issuance of an Interpretation Note.

As discussed above, where a donor fails to pay donations tax, the financially distressed debtor who is the donee becomes '*jointly and severally liable*' (Income Tax Act 58 of 1962: s 59). This means that a financially distressed debtor may be equally liable for the payment of donations tax should a donor waive a debt and not pay the donations tax (Income Tax Act 58 of 1962: s 59). This does not appear to be in line with the intention of the legislature which was to reduce the tax incurred and, in this way, preserve the economic benefit obtained by financially distressed taxpayers when a debt owed by them was written off or reduced. It is proposed that, in order to achieve its purpose, the legislature should consider excluding the joint and several liability of debtors in situations where the debtor is financially distressed (as defined in section 128(*f*) of the Companies Act 71 of 2008) or insolvent.

3.3 EXCLUSIONS FOR LIQUIDATED AND TERMINATED COMPANIES [Paragraph 12A(6)(*e*)]

In terms of the paragraph 12A(6)(*e*) exclusion, a debt claim which is reduced as a result of any process undertaken to end a company's legal existence will not trigger the debt relief provisions of paragraph 12A (Income Tax Act 58 of 1962: para 12A(6)(*e*)). This exclusion applies where the debtor and creditor are connected persons (Income Tax Act 58 of 1962: para 12A(6)(*e*)).

This exclusion has not been replicated in section 19 which could have negative normal tax implications, as entities may have to pay tax on certain transactions (Duvenage, 2019).

Financially distressed entities which are insolvent may incur additional tax liabilities in terms of section 19 (in the form of taxable recoupments) as a result of having debts reduced which financed operating expenditure (Income Tax Act 58 of 1962: s 19(5)).

Conclusion

It is submitted that by not replicating the exclusion in section 19, the process to deregister or liquidate financially distressed entities which are insolvent and no longer trading may be delayed because these financially stagnant entities will not be able to pay the outstanding tax. In addition, the paragraph 12A(6)(e) exclusion appears to be too narrow in that it only applies to debt transactions between the debtor companies and **connected persons**. Section 1 of the Act defines the term 'connected person' (Income Tax Act 58 of 1962: s 1). In accordance with this definition certain shareholding requirements have to be met before a company can be regarded as a connected person in relation to another company (Income Tax Act 58 of 1962: s 1). The connected person definition defines two companies as connected if one of the companies owns more than half of the shares in the other company (Income Tax Act 58 of 1962: s 1). For example, in accordance with the definition of a connected person, Company A (the creditor) will not be regarded as a connected person in relation to Company B (the liquidated debtor), if Company A owns 50% of the shares in Company B (Income Tax Act 58 of 1962: s 1).

Recommendation

Presumably the intention of the legislature was not to create any further tax liabilities for insolvent financially distressed companies which received debt write-offs if their legal existence had ended or was coming to an end. If the legislature wishes to correct this it is recommended that the paragraph 12A(6)(*e*) exclusion be replicated in section 19 (Duvenage, 2019). This will avoid triggering further income tax liabilities which SARS will not be able to recover.

In addition, in order not to delay the legitimate process of terminating any company (and not merely connected companies) which are not liquid and insolvent, it is recommended that these exclusions be extended to apply not only to connected persons, but also when debt relief is provided between taxpayers which are not liquid and insolvent who are independent of each other. This submission is made as a company which is not liquid and insolvent will not be able to pay tax debts which have arisen as a result of a debt write-off. It is the writer's opinion that this could ultimately delay the legitimate process of terminating such entities existence. It is recommended that the paragraph 12A(6)(e) exclusion be amended by removing all references to the term '*connected person*' as detailed below.

Paragraph 12A(6)(e)

This paragraph must not apply to a debt benefit in respect of any debt owed by a person-

(e) 'that is a company, where—

(i) that debt is reduced in the course, or in anticipation, of the liquidation, winding up, deregistration or final termination of the existence of that company; ~~and~~

(ii) ~~the person to whom the debt is owed is a connected person in relation to that company~~,

to the extent that debt benefit in respect of that debt does not, at the time that the debt benefit arises, exceed the amount of expenditure contemplated in paragraph 20 incurred in respect of that debt by the connected person: Provided that this subitem must not apply—

(a) if—

~~(i)~~ the debt was reduced as part of any transaction, operation or scheme entered into to avoid any tax imposed by this Act; ~~and~~

(ii) ~~that company became a connected person in relation to the person to whom the debt is owed after the debt (or any debt issued in substitution of that debt) arose;~~ or

(b) if that company—

(i) has not, within 36 months of the date on which the debt is reduced or such further period as the Commissioner may allow, taken the steps contemplated in section 41(4) to liquidate, wind up, deregister or finally terminate its existence;

(ii) has at any stage withdrawn any step taken to liquidate, wind up, deregister or finally terminate its corporate existence; or

(iii) does anything to invalidate any step contemplated in subparagraph (A), with the result that the company is or will not be liquidated, wound up, deregistered or finally terminate its existence;'

4. CHAPTER FOUR – CONSEQUENCES OF DEBT TO SHARES CONVERSIONS

In accordance with the debt relief provisions applicable to the 2020 tax year, tax implications arise when a debtor settles an outstanding debt due by issuing its shares to the creditor. The tax implications which emerge from these transactions are based on the amount of the '*debt benefit*' derived by the debtor as a result of the debtor converting its debt liability into shares. The '*debt benefit*' calculation is defined in section 19 and paragraph 12A. In essence, in terms of this calculation, a debt benefit arises when the amount of the outstanding debt owed by the debtor (which was subsequently converted into shares) is greater than the market value of the debtor's shares which were issued to the debt holder (i.e. the creditor). (Income Tax Act 58 of 1962: s 19, para 12A).

What follows is a critical analysis of the debt benefit calculation as this calculation is fundamental to determining the tax implications of the debt relief provisions. In terms of this calculation, the amount of a debt benefit is, among other things, affected by whether the debt holder (i.e. the creditor) previously owned shares in the debtor (or not), as well as the market value of those shares (Income Tax Act 58 of 1962: s 19(1), para 12A(1)).

Debt benefit calculation: *When a debt holder converts its debt claim into shares and the debt holder* prior to the concession or compromise *held an 'effective interest' in the shares of the debtor*

A debt benefit will result if the face value of the debt holder's claim before the concession or compromise is more than the difference between the market value of the effective interest of shares held by the debt holder before and after the concession or compromise (Income Tax Act 58 of 1962: s 19(1), para 12A(1)).

Debt benefit calculation: *When a debt holder converts its debt claim into shares and the debt holder prior to the concession or compromise did not hold an 'effective interest' in the shares of the debtor*

A debt benefit will result if the face value of the debt claim held by the debt holder before the concession or compromise is more than the market value of the shares obtained from the conversion (Income Tax Act 58 of 1962: s 19(1), para 12A(1)).

Market value must be determined to calculate the debt benefit

When a debt is converted into shares, the debt benefit calculation requires that the market value of the shares (at various points in time depending on whether the debt holder held an

effective interest in the debtor or not) be determined (Income Tax Act 58 of 1962: s 19(1), para 12A(1)).

Valuation methods to determine the market value of shares

The market value of shares can be determined by applying various valuation methods. The most frequently used methods in South Africa are the discounted cash flow method, the market multiple method and the net assets method. (PwC, 2017-a:18)

Discounted cash flow method

The discounted cash flow method requires an estimation of future cashflows (PwC, 2017-a:18). According to the Johannesburg Stock Exchange website (n.d.-a), the estimated future cash flows are discounted to the present value using the weighted average cost of capital (WACC) in order to establish the value of the shares.

Determining an accurate estimate of the weighted average cost of equity which is required to calculate the WACC is challenging. This is because of the high level of subjectivity involved in this calculation (PwC, 2017-a:19).

Market multiple method

In terms of the market multiple method, the market value of shares is determined by comparing the company in question to similar companies which are listed on the stock exchange and industry transactions (PwC, 2017-a:18). In addition, when determining the market value of shares, historical share transactions are taken into consideration by applying a valuation multiple (PwC, 2017-a:18).

According to the Corporate Finance Institute (n.d.-b) one of the major challenges of correctly applying this method (which can negatively impact on the accuracy of the valuation) is identifying companies which are similar and genuinely comparable to the company in question.

Net asset method

The market value of shares using the net asset method is calculated by determining the market value of each and every asset and liability on the company's Statement of Financial Position (PwC, 2017-a: 18-19). The net asset value, which is used to determine the market value per share, is calculated by subtracting the market value of the total assets from the market of the total liabilities (PwC, 2017-a: 18-19).

According to Equivista (n.d.-c), a drawback of this method is that the market value of a company can far exceed the value of all the assets recorded on the companies' Statement of Financial Position. For example, according to the South African Market Insights website (2019) technology companies such as listed MTN in 2019 were trading at a rate which was 2.48 times its stated net asset value. According to Equivista (n.d.-c), this may be a result of certain assets such as a company's long-standing relationship with reliable suppliers, efficient business processes and the uniqueness of a company's merchandise and services not being recorded on the Statement of Financial Position. Equivista (n.d.-c) also notes that placing a value on these types of assets can prove to be challenging.

General – Market Value

According to the Johannesburg Stock Exchange website (n.d.-a), all valuation methods are based on assumptions, such as assumptions about future earnings and discount rates. These methods, according to the Johannesburg Stock Exchange website (n.d.-a), are as a result flawed as there is a risk that the inputted data used in the valuation are incorrect. According to the Corporate Finance Institute website (n.d.-b), the process of valuing shares is a difficult and complex one, as estimating the value of a share involves a '*combination of both art and science*'.

In essence, a debt benefit arises when the amount of an outstanding debt owed by a debtor (which was subsequently converted into shares) exceeds the market value of the debtor's shares which were issued to the creditor (Income Tax Act 58 of 1962: s 19, para 12A). The amount of tax incurred in terms of the debt relief provisions is based on the amount of the debt benefit (Income Tax Act 58 of 1962: s 19, para 12A). The lower the market value of an entity's shares, the greater the debt benefit and so the amount of tax incurred in terms of the debt relief provisions (Income Tax Act 58 of 1962: s 19, para 12A). It is submitted that the debt benefit calculation when a debt is converted into shares may result in an unintended consequence of eroding the financial benefit obtained by insolvent financially distressed companies to a greater extent than for solvent financially distressed companies. The market value of an insolvent entity will be lower than that of a solvent financially distressed entity as the value of the liabilities of an insolvent entity exceeds the value of its assets. Because of the low market value of these entities a greater amount of tax (in terms of the debt relief provisions) than that of a solvent entity will be incurred.

Effective interest

When debt is converted into shares, the debt benefit calculation requires that the '*effective interest*' of shares held by the creditor be taken into consideration (Income Tax Act 58 of 1962: s 19(1), para 12A(1)).

This leads to the question of whether the term '*effective interest*' merely includes direct and indirect interests in the debtor's ordinary shares, or whether the term also encompasses interests in preference shares or hybrid equity instruments. The absence of a definition of the term '*effective interest*' in the Act has created uncertainty in the tax community (National Treasury & South African Revenue Service, Response Documents 2018:15). This is evidenced by the recommendation which was submitted according to the Final Response Document on Taxation Laws Amendment Bill 2018 to have the term '*effective interest*' defined (National Treasury & South African Revenue Service, Response Documents 2018:15).

Does the conversion from debt to shares include preference shares or hybrid equity instruments?

Section 19 and paragraph 12A refer to a conversion from debt to '*shares*' (Income Tax Act 58 of 1962: s 19(1), para 12A(1)). This leads to the question whether the conversion from debt to shares is limited only to equity shares (ordinary shares) or whether it includes the conversion into hybrid equity instruments or preference shares.

The Act defines in section 1 a **'***share***'** as:

'*in relation to any company, any unit into which the proprietary interest in that company is divided'* (Income Tax Act 58 of 1962: s 1*)*

The Act also defines *in section 1 'equity share'* as:

'any share in a company, ***excluding any share that,*** *neither as respects dividends nor as respects* ***returns of capital****, carries any right to participate beyond a specified amount in a distribution*' (Income Tax Act 58 of 1962: s 1*)*

A share will be deemed a hybrid equity instrument if the issuer is obliged to redeem the share, or if the holder has an option to redeem the share within three years (Mazansky, 2019). A share is also deemed a hybrid equity instrument if the issuer is obliged to distribute an '*amount constituting a* ***return of the issue price of the share****, in whole or in part'* or if the holder can

exercise an option to receive an amount which constitutes a return of the issue price, in whole or in part (Mazansky, 2019). Since a hybrid equity instrument has a return on the issue price, i.e. a return on capital, it cannot be classified as an '*equity share'* which by definition excludes a return on capital. Accordingly, by implication, if a hybrid equity instrument is not an '*equity share*' it is a 'share' as defined in section 1 of the Act. Consequently, the conversion from debt to shares referenced in section 19 and paragraph 12A is not limited to equity shares (i.e. ordinary shares) but includes hybrid equity instruments or preference shares.

Conclusion

The debt benefit which must be calculated each time a debt claim is converted into shares requires that the market value of shares (in certain instances at various points in time) be determined (Income Tax Act 58 of 1962: s 19(1), para 12A(1)). According to the Corporate Finance Institute website (n.d.-b) the process of valuing shares is a difficult and complex one. For that reason, it can be costly and difficult for financially distressed taxpayers to determine accurately the market value of shares each time a debt claim is converted into shares.

In addition, there is uncertainty regarding the meaning of the term '*effective interest*' (National Treasury & South African Revenue Service, Response Documents 2018:15). This term has not been defined and is fundamental to the debt benefit calculation (National Treasury & South African Revenue Service, Response Documents 2018:15) (Income Tax Act 58 of 1962: s 19(1), para 12A(1)).

When converting '*debt to shares*' the holder of the debt could either convert the debt into ordinary shares or into a hybrid equity instrument (where the holder of the debt receives a return on capital). In instances where the holder of a debt choses to convert the debt into a hybrid equity instrument, the uncertainty of market valuation methodology and the application of '*effective interest*' when calculating a debt benefit is compounded further. This is as a result of the complex nature of hybrid equity instruments.

It is evident that the debt benefit calculation in respect of debt claims which are converted into shares is not practical. This calculation is complex and difficult to accurately determine. It is for these reasons that taxpayers may, whether intentionally or unintentionally, incorrectly account for tax in terms of the debt relief provisions when debt benefits arise as a result of debts being converted into shares.

Recommendation

The legislature must provide detailed guidance, by way of an interpretation note, about how market value and effective interest are to be determined in the various cases.

Alternatively, the legislature may consider international best practice in order to find a solution. For example, according to the Norton Rose Fulbright website (2020) in the United Kingdom there are detailed prescriptive rules which govern debt to equity swaps. In the United Kingdom corporate borrowers have access to an exemption which releases the debtor from corporate tax when debt is converted into equity (Black, 2020). In the United Kingdom, debt to equity swaps may also only be for ordinary shares and not preference shares or hybrid equity instruments. According to the Norton Rose Fulbright website (2020), in the Netherlands debt to equity conversions are tax neutral and the issue of shares is done at a nominal value, rather than market value.

5. CHAPTER FIVE – CONSEQUENCES OF THE SALE OF ASSETS

The debt relief rules contain a number of provisions which detail the tax implications which emerge when a taxpayer receives a debt benefit. When determining the tax implications of a debt benefit, taxpayers need to ascertain which of the debt relief provisions are relevant and should be applied. The relevant debt relief provisions which should be applied to establish the tax implications of a debt benefit depend on, among other things, whether or not the debt funded asset was still owned or whether it had been sold at the time the debt benefit was received by the debtor. (Gronewald & Van Rooyen, 2019: 68-71)

Below is a critical analysis of the different debt relief provisions, the different situations to which these provisions relate, as well as, the tax consequences which emerge.

Case 1: Asset sold in a tax year which preceded the tax year in which the debt benefit occurred
[Section 19(6A) and paragraph 12A(4)]

Paragraph 12A(4) and section 19(6A) **explicitly cater for the case when an asset was sold in a tax year which preceded the tax year in which the debt benefit occurred** (Income Tax Act 58 of 1962: s 19(6A), para 12A(4)). These provisions were effective from 1 January 2019 (Income Tax Act 58 of 1962: s 19(6A), para 12A(4)). Paragraph 12A(4) and section 19(6A) were introduced as an anti-avoidance measure to close a loophole which existed where taxpayers could dispose of debt funded assets before a debt benefit was granted

without triggering any tax consequences in terms of the debt relief provisions (Gronewald & Van Rooyen, 2019: 68-71).

In terms of these provisions, a taxpayer will incur additional tax which is calculated as the difference between the tax which would have been incurred had the asset been sold in the same tax year in which the debt was written off and the actual amount of tax incurred when the asset was sold. (Income Tax Act 58 of 1962: s 19(6A)) (Taxation Laws Amendment Act, 2018: s 36(1)(*i*))

Case 2: Asset not sold in a tax year preceding the tax year in which the debt benefit occurred
[Section 19(6) and paragraph 12A(3)]

Paragraph 12A(3) and section 19(6) **<u>explicitly cater</u> for the case when an asset was not sold in a tax year which preceded the tax year in which the debt benefit occurred** (Income Tax Act 58 of 1962: s 19(6), para 12A(3)). An example of when these debt relief provisions apply is in instances where an asset which was financed by debt which was subsequently waived is still owned by the taxpayer when the debt was waived (Gronewald & Van Rooyen, 2019: 68-71).

The tax implications of section 19(6) and paragraph 12A(3) are firstly to apply the debt benefit against the assets base cost in this way decreasing the balance. Subsequent to that, should any other amount of the debt benefit remain (after the base cost had been fully written off) this would be considered a recovery or recoupment of allowances previously granted. The recoupment is restricted to allowances previously claimed by the taxpayer. (Income Tax Act 58 of 1962: s 19(6), para 12A(3)) (Gronewald & Van Rooyen, 2019: 68-71)

Case 3: Asset sold during the same tax year in which the debt benefit occurred

The debt relief provisions which apply when an asset is sold during the same tax year in which a debt benefit occurred is determined through a process of elimination of section 19(6A), paragraph 12A(4), section 19(6) and paragraph 12A(3) as there are **<u>no specific debt relief provisions which explicitly cater for such cases</u>** (Gronewald & Van Rooyen, 2019: 68-71). A taxpayer would need to consider which of the mentioned provisions (as detailed in case 1 and 2) apply (Gronewald & Van Rooyen, 2019: 68-71). When an asset is sold during the same tax year in which the debt benefit occurred, the provisions of paragraph 12A(3) and section 19(6) are deemed relevant (through the process of elimination) as the asset would not have

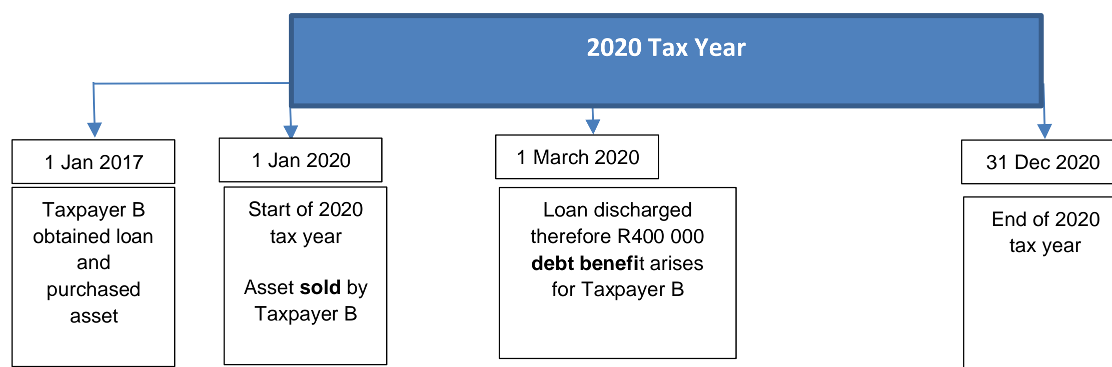
been sold in a tax year which preceded the tax year in which the debt benefit arose (Gronewald & Van Rooyen, 2019: 68-71). Accordingly, section 19(6A) and paragraph 12A(4) could not apply.

The example below illustrates the income tax implications of the debt relief provisions when an <u>asset is sold during the same tax year in which the debt benefit arose</u>.

Assume that Taxpayer B has a tax year which ends on the last day of December. On 1 January 2017, Taxpayer B obtained a loan of R1 250 000 from Taxpayer C. Taxpayer B used the loan to purchase medical equipment on 1 January 2017 for a total cost of R1 250 000. The medical equipment was brought into use in Taxpayer B's trade on the same day (1 January 2017). In terms of Interpretation Note 47 (Issue 4), medical equipment is written off over a period of 5 years. On 1 January 2020, Taxpayer B sold the medical equipment for R1 400 000 to an independent third party. When the medical equipment was sold, Taxpayer B had claimed capital allowances amounting to R750 000.

Taxpayer B used the funds received from the sale to pay staff salaries. Taxpayer B was financially distressed and was unable to repay Taxpayer C. The balance owning to Taxpayer C was R400 000. As a result of Taxpayer B's inability to repay the loan, on 1 March 2020, Taxpayer C discharged the remaining unpaid debt of R400 00 which was due to it. (Illustrative example adapted from: Gronewald & Van Rooyen, 2019: 68-71)

Timeline of events: Asset sold during the same tax year in which the debt benefit arose



The income tax implications of paragraph 12A(3) and section 19(6) are as follows:

A recovery of capital allowances granted (in terms of section 8(4)(*a*)) amounting to R750 000, as well as a capital gain upon the sale of the medical equipment amounting to R150 000

[proceeds (R650 000) less base cost (R500 000)] should be accounted for. Proceeds of R650 000 are calculated as R 1 400 000 (amount received in respect of the sale) less R750 000 (recovery of allowances claimed) and base cost as R 1 250 000 (purchase price) less R750 000 (capital allowances claimed). (Adapted from: Gronewald & Van Rooyen, 2019: 68-71)

In accordance with paragraph 12A(3), as the medical equipment had already been sold when the debt benefit occurred, the debt benefit could not be applied against the base cost to reduce the balance. As the base cost was not reduced by the debt benefit, a higher base cost resulted. For that reason, a **capital gain** of only **R150 000** was incurred by Taxpayer B. In addition, the debt benefit did not result in any further taxable recoupments as all of the previous capital allowances which were claimed by Taxpayer B had been recovered when the asset was sold. (Adapted from: Gronewald & Van Rooyen , 2019: 68-71)

Conclusion

The relevant provisions (applicable to the 2020 tax year) which apply when an asset is **sold in the same tax year** in which a debt benefit arises is section 19(6) and paragraph 12A(3) (Gronewald & Van Rooyen, 2019: 68-71). These provisions apply as the prerequisites of these provisions are met (Gronewald & Van Rooyen, 2019: 68-71). The prerequisites require that an asset should **not** have been **sold in a tax year which preceded the tax year in which the debt benefit occurred** (Income Tax Act 58 of 1962: s 19(6), para 12A(3)). This is the case when assets are sold in the same tax year as the debt benefit (Gronewald & Van Rooyen, 2019: 68-71).

Based on the application of these provisions, it is evident that a loophole exists in the legislation. The application of section 19(6) and paragraph 12A(3) does not result in taxpayers incurring any additional tax in respect of debt benefits received when debt benefits are obtained in the same tax year as the asset was sold. (Gronewald & Van Rooyen, 2019: 68-71)

Recommendation

Paragraph 12A(4) and section 19(6A) explicitly cater for the scenario when an asset was sold in a tax year which preceded the tax year in which the debt benefit occurred (Income Tax Act 58 of 1962: s 19(6A), para 12A(4)). The prerequisites of these provisions are, therefore, not met when an asset is sold in the same tax year in which a debt benefit occurs (Gronewald &

Van Rooyen, 2019: 68-71). The relevant provisions (applicable to the 2020 tax year) in these instances are section 19(6) and paragraph 12A(3) (Gronewald & Van Rooyen, 2019: 68-71). These provisions apply as the prerequisites which require that an asset should not have been sold in a tax year that preceded the tax year in which the debt benefit occurred are met (Gronewald & Van Rooyen, 2019: 68-71).

If the legislature wishes to remedy the loophole caused by the application of section 19(6) and paragraph 12A(3) when an asset is sold in the same tax year in which a debt benefit occurs, it is recommended that section 19(6A) and paragraph 12A(4) be amended. Section 19(6A) and paragraph 12A(4) should be amended to be relevant to all instances in which debt funded assets are sold prior to the debt benefit being granted, and not merely to debt funded assets sold in a tax year which preceded the tax year in which the debt benefit occurred. (Gronewald & Van Rooyen, 2019: 68-71)

Should the legislature implement this recommendation, the income tax effects of the illustrative example would be as follows:

The R400 000 debt benefit would be applied to reduce the base cost of the asset. This would lower the base cost from R500 000 (as referred to above) to R100 000. The base cost of R100 000 is calculated as R1 250 000 (purchase price) less R750 000 (capital allowances) less R400 000 (debt benefit). When the asset is sold, the recovery of capital allowances is R750 000. This amounts to all the capital allowances claimed until the date of sale. The R650 000 proceeds used to calculate the capital gain is calculated as R1 400 000 (amount received in respect of the sale) less R750 000 (recovery of allowances). A capital gain of R550 000 [proceeds (R650 000) less base cost (R100 000)] will be incurred. (Adapted from: Gronewald & Van Rooyen, 2019: 68-71)

Summary of the income tax implications based on the legislation applicable to the 2020 tax year and the proposed recommendation:

Description	Income tax implications based on the proposed recommendation of amending section 19(6A) and paragraph 12A(4)	Income tax implications based on the legislation applicable to the 2020 tax year [section 19(6) and paragraph 12A(3)]	Difference
Recoupment	R750 000	R750 000	Nil
Capital gain	R550 000	R150 000	R400 000

(Adapted from: Gronewald & Van Rooyen, 2019: 68-71)

Based on the results of the illustrative example, it is evident that if the legislature implements the proposed recommendation, a larger capital gain of R550 000 (as opposed to a capital gain of only R150 000) will be incurred by the taxpayer (Adapted from: Gronewald & Van Rooyen, 2019: 68-71). This additional R400 000 capital gain will be triggered as a direct result of the taxpayer receiving the debt benefit. Should the legislature not implement the proposed recommendation, the loophole which exists in the legislation applicable to the 2020 tax year will not be closed. No additional tax will be incurred by taxpayers (in terms of the debt relief provisions) when debt benefits are received during the same tax year in which the related debt funded assets are sold (Gronewald & Van Rooyen, 2019: 68-71).

6. CHAPTER SIX – RETROSPECTIVE APPLICATION OF DEBT RELIEF RULES

Section 19(6A) and paragraph 12A(4) were introduced with effect from 1 January 2019 and apply to tax years which start on or after the effective date. In terms of these provisions, a taxpayer will incur additional tax when a debt is reduced in a tax year subsequent to the tax year in which the related debt funded asset was sold. The additional tax is calculated as the difference between the tax which would have been incurred had the asset been sold in the same tax year in which the debt was reduced and the actual amount of tax incurred when the asset was sold. (Income Tax Act 58 of 1962: s 19 (6A)) (Taxation Laws Amendment Act, 2018: s 36(1)(*i*)). In terms of the Explanatory Memorandum, these provisions were introduced to close a loophole which resulted in no tax being incurred in terms of the debt relief rules when debt funded assets were sold before a debt benefit was granted (National Treasury, 2018:20).

The following illustrative example shows the tax implications of the provisions:

Assume that XYZ (Pty) Ltd has a tax year which ends on the last day of December. Also assume that in terms of Interpretation Note 47 (Issue 4), drilling machines are written off over a period of 4 years.

On 1 January 2017 XYZ (Pty) Ltd obtained a loan of R1 250 000 from ABC Bank. On 1 January 2017, XYZ (Pty) Ltd used the loan to purchase a borehole drilling machine for a total cost of R1 250 000. The drilling machine was brought into use in XYZ (Pty) Ltd's trade on the same day (1 January 2017). On 31 December 2018 XYZ (Pty) Ltd sold the drilling machine for R1 000 000 to an independent third party. XYZ (Pty) Ltd used the funds received from the sale to pay staff salaries. XYZ (Pty) Ltd was financially distressed and was unable to repay ABC Bank. As a result of XYZ (Pty) Ltd's inability to repay the loan, ABC Bank discharged the unpaid debt of R 1 100 000 which was due to it on 30 June 2019. (Adapted from: Stiglingh et al., 2020: 610-611)

2018 tax year

Original recoupment of R375 000 and capital gain of nil

A recovery (recoupment) of capital allowances previously granted amounting to R375 000 should be accounted for. The recoupment of R375 000 is calculated as R1 000 000 (amount received in respect of the sale) less R625 000 (tax value which is calculated as the original cost of the asset R1 250 000 less the allowances granted R625 000). No capital gain upon the sale of the drilling machine is incurred [proceeds (R625 000) less base cost (R625 000)]. The proceeds are calculated as R 1 000 000 (amount received in respect of the sale) less R375 000 (recovery/recoupment of allowances) and the base cost as R 1 250 000 (purchase price) less R625 000 (capital allowances). (Adapted from: Stiglingh et al., 2020: 610-611)

Tax implications in respect of the debt benefit

The debt benefit of R 1 100 000 arose on 30 June 2019 which is after 31 December 2018, the date on which the drilling machine was sold. (Adapted from: Stiglingh et al., 2020: 610-611) The income tax which would have been incurred had the debt been forgiven (i.e. the debt benefit of R1 100 000 arisen) in the same tax year that the drilling machine was sold is as follows:

Recalculated recoupment of R475 000

The base cost of R625 000 would be fully eliminated to nil as a result of applying R625 000 of the R1 100 000 debt benefit against this cost. The R475 000 excess portion of the debt benefit which was not applied to eliminate the base cost would be recognised as a recoupment. (Adapted from: Stiglingh et al., 2020: 610-611)

Recalculated capital gain of R1 000 000

A capital gain of R1 000 000 would have been incurred had the debt benefit arisen in the same tax year in which the drilling machine was disposed. The R1 000 000 capital gain is calculated as proceeds (R1 000 000) less base cost (Rnil). (Adapted from: Stiglingh et al., 2020: 610-611)

The proceeds of R1 000 000 are the amount received in respect of the sale. The recalculated recoupment of R475 000 which was incurred as a result of the debt benefit which was not applied to decrease the base cost is not taken into account when determining the proceeds as this amount had already been included as a recoupment in accordance with section 19(6)). The base cost of nil is calculated as the base cost of R625 000 when the asset was sold less R625 000 of the debt benefit applied against this cost. (Adapted from: Stiglingh et al., 2020: 610-611) (Income Tax Act 58 of 1962: s 8(4)(a))

Additional tax to be accounted for in terms of section 19(6A) and paragraph 12A(4)

The additional tax (in the form of a taxable recoupment) to be accounted for in terms of section 19(6A) amounts to R100 000. This amount is calculated as the recalculated recoupment of R475 000 less the original recoupment of R375 000 (Adapted from: Stiglingh et al., 2020: 610-611).The additional capital gain incurred by the taxpayer in terms of paragraph 12A(4) amounts to R1 000 000. This amount is calculated as the recalculated capital gain on disposal of R1 000 000 less the original capital gain of Rnil (Adapted from: Stiglingh et al., 2020: 610-611).

The example above provides an illustration of the effect of section 19(6A) and paragraph 12A(4). These provisions result in additional tax being levied on taxpayers in respect of assets sold before 1 January 2019, the effective implementation date of the legislation. As was illustrated, XYZ (Pty) Ltd would incur additional tax even though the capital asset was sold on 31 December 2018, before the effective implementation date of 1 January 2019. It is evident that the implementation of section 19(6A) and paragraph 12A(4) with effect from 1 January 2019 applies retrospectively.

Is the retrospective change strong or weak?

The impact which a retrospective change in legislation has on taxpayers varies and can be classified as either '*strong*' or '*weak*'. The classification of retrospective changes is dependent on how transactions which had already taken place before the provisions were passed as laws are impacted. Accordingly, a retrospective change will be weak if only future tax implications of transactions which had already taken place are impacted. A retrospective change will be strong if the change not only impacts future transactions but also impacts transactions which occurred before the legislation was passed as a law (or came into effect). (Brink & Brincker, 2017: 1-2)

With regard to the illustrative example, the application of section 19(6A) and paragraph 12A(4) resulted in XYZ (Pty) Ltd incurring additional tax even though the capital asset had been disposed of on 31 December 2018, which was prior to 1 January 2019, the effective implementation date of the provisions (Income Tax Act 58 of 1962: s 19(6A), para 12A(4)). It is submitted that section 19(6A) and paragraph 12A(4) have strong retrospective effects as these provisions not only impact transactions which occurred after 1 January 2019, the effective implementation date of the legislation, but also have an impact on transactions which occurred before 1 January 2019.

Is the strong retrospective change constitutional?

The constitutionality of a strong retrospective change was considered in *Pienaar Brothers (Pty) Ltd v Commissioner for the South African Revenue and Another*, case no 87760/2014 (the *Pienaar Brothers'* case). In March 2007, Serurubele Trading 15 (Pty) Ltd (the taxpayer) concluded an amalgamation transaction and purchased all of Pienaar Brothers (Pty) Ltd (Pienaar Brothers) assets (*Pienaar Brothers (Pty) Ltd v Commissioner for the South African Revenue and Another* (2014), case no 87760/2014: 8). The taxpayer then issued shares to Pienaar Brothers as part of the acquisition price (*Pienaar Brothers (Pty) Ltd v Commissioner for the South African Revenue and Another* (2014), case no 87760/2014: 8). On 3 May 2007, the taxpayer allocated R29 500 000 of its share premium account to the equity holders (*Pienaar Brothers (Pty) Ltd v Commissioner for the South African Revenue and Another* (2014), case no 87760/2014: 9). On 3 May 2007, when the taxpayer allocated the amount of R29 500 000, no secondary tax on companies (STC) was incurred because of an exemption contained in section 44(9) of the Act ('STC exemption') (Brink & Brincker, 2017: 2-3). On 21 February 2007, a public statement in the form of a press release was made by the Commissioner stating the STC exemption would be repealed as from 21 February 2007 (*Pienaar Brothers (Pty) Ltd v Commissioner for the South African Revenue and Another* (2014), case no 87760/2014: 15). The reason for exemption being repealed was to close a

loophole which was being abused by taxpayers (*Pienaar Brothers (Pty) Ltd v Commissioner for the South African Revenue and Another* (2014), case no 87760/2014: 25). The 2007 Taxation Laws Amendment Act which made the STC exemption no longer applicable (as from 21 February 2007) was effected by official promulgation on 8 August 2007 (*Pienaar Brothers (Pty) Ltd v Commissioner for the South African Revenue and Another* (2014), case no 87760/2014 48-49). The taxpayer's point of contention was that the repealing of the STC exemption had a retrospective impact and should not have affected the distribution which made on 3 May 2007(Brink & Brincker, 2017:4). The taxpayer submitted that the Taxation Laws Amendment Act promulgated on 8 August 2007 which stated that the exemption no longer applied as from 21 February 2007 was not lawful in terms of the Constitution. (Brink & Brincker, 2017:4)

The court held that a strong retrospective change which meets the Constitutional principles of rationality and reasonableness are permitted and lawful in terms of the Constitution (Brink & Brincker, 2017:7). In terms of these principles, strong retrospective changes are required to be logical and well-reasoned (Brink & Brincker, 2017: 7-8). The court held that determining the lawfulness of any retrospective change should be done on a case specific basis and should take into consideration the relevant facts and prevailing conditions (Brink & Brincker, 2017:10). The prevailing conditions which led to the introduction of the debt relief rules was a sluggish South African economy (National Treasury, 2012:44). For that reason, the main objective for introducing the debt relief rules was to help the sluggish South African economy by providing relief to the vast number of distressed debtors facing financial hardships (ENSafrica, 2014) (National Treasury, 2012:44). Section 19(6A) and paragraph 12A(4) were introduced, with effect from 1 January 2019**,** with an intention of rectifying an unintended consequence of the debt relief rules which resulted in no tax being incurred (in terms of the debt relief rules) when debt funded assets were sold before debt benefits were granted (National Treasury, 2018:20). As shown above, these provisions not only affected transactions which occurred from 1 January 2019 (the effective implementation date) but also affected transactions which occurred before 1 January 2019. In light of the overarching objective of the debt relief rules, it is submitted that it is not reasonable nor logical to levy additional tax on financially distressed taxpayers (which they in all probability cannot afford to pay) in respect of transactions which occurred prior to the legislations effective date. Furthermore, it is submitted that the legislature's reason for retrospectively implementing these provisions, which was to close a loophole that was causing losses to the fiscus, does not justify levying additional tax on financially distressed taxpayers in respect of transactions which occurred before the legislations effective date.

Conclusion

It is submitted that the reasons for retrospectively implementing the legislation is not rational nor reasonable and is not considered constitutionally valid.

Recommendation

A principle of a good tax system is that there should be certainty (Stiglingh et al., 2020:7). In terms of this principle, when a tax must be paid, as well as the amount of tax which needs to paid must be known (Stiglingh et al., 2020:7). It is evident that tax laws should be clearly drafted so that taxpayers know and are aware of the amount of tax which will be incurred when a transaction is undertaken (Eiselen & Van Zyl, 2016:7). Legislation should be certain in order to allow taxpayers to (without fraudulent intent) plan legally their affairs in order to pay the least amount of tax possible (Eiselen & Van Zyl, 2016:7). It has been argued that in order to maintain a good tax system, if a piece of legislation presents a loophole which results in losses to the fiscus, such loophole should be closed through the passing of a prospective and not retrospective amendment (Eiselen & Van Zyl, 2016:6). In order to maintain a good tax system which does not adversely affect financially distressed debtors, it is recommended that section 19(6A) and paragraph 12A(4) be amended to impact only transactions which occurred after (and not before) the effective implementation date of 1 January 2019.

7. CHAPTER SEVEN – CONCLUSION

The effective date of originally introducing section 19 and paragraph 12A was 1 January 2013 and 8 years after its inception (which included multiple amendments), there are still numerous problems with these provisions. This research report reviewed the debt relief provisions set out in section 19 and paragraph 12A and has made recommendations about how the legislation applicable to the 2020 tax year can be amended in order to remove its flaws. If implemented some of these amendments will provide more relief to the taxpayer and others will merely implement the intention of the legislature as well as close any loopholes created by poor drafting.

Because of the national lockdown and Covid 19 pandemic, it is common knowledge that many businesses are financially distressed. It is the writer’s view that the debt relief rules applicable to the 2020 tax year (even with the implementation of the recommendations in this research report) are inadequate to assist debtors during this crisis as the debt relief provisions are not

very lenient towards debtors and tend to focus on deferring tax rather than actually providing relief.

A future study can be conducted to look at international trends on debt relief, with a particular focus on legislation which seeks to assist in combating the effects of the global Covid 19 pandemic. The future study can include a comparative analysis with the taxation laws of the United Kingdom. In the United Kingdom corporate borrowers have access to an exemption which releases the debtor from corporate tax where debt relief is granted in certain circumstances (Mortimer & Swanson 2020). The exemption applies if '*it can be reasonably assumed that, but for the release and surrounding arrangements, there would be a material risk of the borrower being unable to pay its debts within the next 12 months'* (Mortimer & Swanson 2020). The exemption is very wide and includes circumstances where the debtor has insufficient cash to pay their debts or where its balance sheet is insolvent (Mortimer & Swanson 2020). Most notably the exemption does not require the debtor to be insolvent, under administration or necessarily on the verge of a formal insolvency or similar proceedings (Mortimer & Swanson 2020). It is the writer's view that the South African debt relief rules are not nearly as robust and the legislature may want to consider implementing similar provisions to the United Kingdom in light of the global pandemic to see how the South African debt relief rules can be amended to be more accommodating to taxpayers.

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Appendix 1

Section 19 of the Income Tax Act

19. Concession or compromise in respect of a debt

(1) For the purposes of this section –

'allowance asset' means a capital asset in respect of which a deduction or allowance is allowable in terms of this Act for purposes other than the determination of any capital gain or capital loss;

'capital asset' means an asset as defined in paragraph 1 of the Eighth Schedule that is not trading stock;

'concession or compromise' means any arrangement in terms of which—

(a) a debt is —

(i) cancelled or waived; or

(ii) extinguished by –

(aa) redemption of the claim in respect of that debt by the person owing that debt or by any person that is a connected person in relation to that person; or

(bb) merger by reason of the acquisition by the person owing that debt of the claim in respect of that debt, otherwise than as the result or by reason of the implementation of an arrangement described in paragraph (b);

(b) a debt owed by a company is settled, directly or indirectly —

(i) by being converted to or exchanged for shares in that company; or

(ii) by applying the proceeds from shares issued by that company;

'debt' means any amount that is owed by a person in respect of -

(a) expenditure incurred by that person; or

(b) a loan, advance or credit that was used, directly or indirectly, to fund any expenditure incurred by that person, but does not include a tax debt as defined in section 1 of the Tax Administration Act;

debt benefit', in respect of a debt owed by a person to another person, means –

(a) in the case of an arrangement described in paragraph (a)(i) of the definition of 'concession or compromise', the amount cancelled or waived;

(b) in the case of the extinction of that debt by means of an arrangement described in paragraph (a)(ii) of the definition of 'concession or compromise', the amount by which the face value of the claim in respect of that debt held by the person to whom the debt is owed prior to the entering into of that arrangement exceeds the expenditure incurred in respect of—

(i) the redemption of that debt; or

(ii) the acquisition of the claim in respect of that debt;

(c) in the case of the settling of that debt by means of an arrangement described in paragraph (b) of the definition of 'concession or compromise', where the person who acquired shares in a company in terms of that arrangement did not hold an effective interest in the shares of that company prior to the entering into of that arrangement, the amount by which the face value of the claim held in respect of that debt prior to the entering into of that arrangement exceeds the market value of the shares acquired by reason or as a result of the implementation of that arrangement; or

(d) in the case of the settling of that debt by means of an arrangement described in paragraph (b) of the definition of 'concession or compromise', where the person who acquired shares in a company in terms of that arrangement held an effective interest in the shares of that company prior to the entering into of that arrangement, the amount by which the face value of the claim held in respect of that debt prior to the entering into of that arrangement exceeds the amount by which the market value of any effective interest held by that person in the shares of that company immediately after the implementation of that arrangement exceeds, solely as a result of the implementation of that arrangement, the market value of the effective interest held by that person in the shares of that company immediately prior to the entering into of that arrangement;

'group of companies' means a group of companies as defined in section 41.

'market value', in relation to shares acquired or held by reason or as a result of implementing a concession or compromise in respect of a debt, means the market value of those shares immediately after the implementation of that concession or compromise.

(2) Subject to subsection (8), this section applies where—

(a) a debt benefit in respect of a debt owed by a person arises in respect of a year of assessment by reason or as a result of a concession or compromise in respect of that debt during that year of assessment; and

(b) the amount of that debt is owed by that person in respect of or was used by that person to fund, directly or indirectly, any expenditure in respect of which a deduction or allowance was granted in terms of this Act.

(3) Where—

(a) a debt benefit arises in respect of a debt owed by a person as contemplated in subsection (2); and

(b) the amount of that debt is owed in respect of or was used as contemplated in paragraph (b) of that subsection to fund expenditure incurred in respect of trading stock that is held and not disposed of by that person at the time the debt benefit arises,

the debt benefit in respect of that debt must, to the extent that an amount is taken into account by that person in respect of that trading stock in terms of section 11(a) or 22(1) or (2) for the year of assessment in which the debt benefit arises, be applied to reduce the amount so taken into account in respect of that trading stock.

(4) Where—

(a) a debt benefit arises in respect of a debt owed by a person as contemplated in subsection (2);

(b) the amount of that debt is owed in respect of or was used as contemplated in paragraph (b) of that subsection to fund expenditure incurred in respect of trading stock that is held and not disposed of by that person at the time the debt benefit arises,

(c) subsection (3) has been applied to reduce an amount taken into account by that person in respect of trading stock as contemplated in that subsection to the full extent of that amount so taken into account,

the debt benefit in respect of that debt, less any amount of that debt benefit that has been applied to reduce an amount as contemplated in subsection (3) must, to the extent that a deduction or allowance was granted in terms of this Act to that person in respect of that expenditure, be deemed, for the purposes of section 8(4)(a), to be an amount that has been recovered or recouped by that person for the year of assessment in which the debt benefit arises.

(5) Where—

(a) a debt benefit arises in respect of a debt owed by a person as contemplated in subsection (2); and

(b) the amount of that debt is owed in respect of or was used as contemplated in paragraph (b) of that subsection to fund any expenditure other than expenditure incurred—

(i) in respect of trading stock that is held and not disposed of by that person at the time the debt benefit arises; or

(ii) in respect of an allowance asset,

the debt benefit in respect of that debt must, to the extent that a deduction or allowance was granted in terms of this Act to that person in respect of that expenditure, be deemed, for the purposes of section 8(4)(a), to be an amount that has been recovered or recouped by that person for the year of assessment in which the debt benefit arises.

(6) Where—

(a) a debt benefit arises in respect of a debt owed by a person as contemplated in subsection (2); and

(b) the amount of that debt is owed in respect of or was used as contemplated in paragraph (b) of that subsection to fund expenditure incurred in respect of an allowance asset that was not disposed of in a year of assessment prior to that in which that debt benefit arises,

the debt benefit in respect of that debt must, to the extent that—

(i) a deduction or allowance was granted in terms of this Act to that person in respect of that expenditure; and

(ii) the debt benefit has not been applied as contemplated in paragraph 12A of the Eighth Schedule to reduce the amount of expenditure as contemplated in paragraph 20 of that Schedule in respect of that allowance asset,

be deemed, for the purposes of section 8(4)(a), to be an amount that has been recovered or recouped by that person for the year of assessment in which the debt benefit arises.

(6A) Where—

(a) a debt benefit arises during any year of assessment in respect of a debt owed by a person as contemplated in subsection (2); and

(b) the amount of that debt is owed in respect of or was used as contemplated in paragraph (b) of that subsection to fund expenditure incurred in respect of an allowance asset that was disposed of in a year of assessment prior to that in which that debt benefit arises,

that person must, if the amount determined in respect of that disposal as a recovery or recoupment of a deduction or allowance is less than the amount that would have been so determined had that debt benefit been taken into account in the year of assessment in which the disposal occurred, treat the amount of that difference as an amount recovered or recouped for purposes of section 8(4)(a) in the year of assessment in which that debt benefit arises.

(7) Where a debt benefit arises in respect of a debt owed by a person that was used to fund expenditure incurred in respect of an allowance asset, the aggregate amount of the deductions and allowances allowable to that person in respect of that allowance asset may not exceed an amount equal to the aggregate of the expenditure incurred in the acquisition of that allowance asset, reduced by an amount equal to the sum of—

(a) the debt benefit in respect of that debt; and

(b) the aggregate amount of all deductions and allowances previously allowed to that person in respect of that allowance asset.

Appendix 2

Exclusions to section 19 of the Income Tax Act

(8) This section must not apply to a debt benefit in respect of any debt owed by a person—

(a) that is an heir or legatee of a deceased estate, to the extent that—

(i) the debt is owed to that deceased estate;

(ii) the debt is reduced by the deceased estate; and

(iii) the amount by which the debt is reduced by the deceased estate forms part of the property of the deceased estate for the purposes of the Estate Duty Act;

(b) to the extent that the debt is reduced by way of—

(i) a donation as defined in section 55(1); or

(ii) any transaction to which section 58 applies,

in respect of which donations tax is payable; or

(c) to an employer of that person, to the extent that the debt is reduced in the circumstances contemplated in paragraph 2(h) of the Seventh Schedule;

(d) to another person where the person that owes that debt is a company if—

(i) that company owes that debt to a company that forms part of the same group of companies as that company; and

(ii) that company has not carried on any trade,

during the year of assessment in which that debt benefit arises as well as during the immediately preceding year of assessment: Provided that this paragraph must not apply in respect of any debt—

(aa) incurred, directly or indirectly by that company to fund expenditure incurred in respect of any asset that was subsequently disposed of by that company by way of an asset-for- share, intra-group or amalgamation transaction or a liquidation distribution in respect of which the provisions of section 42, 44, 45 or 47, as the case may be, applied; or

(bb) incurred or assumed by that company in order to settle, take over, refinance or renew, directly or indirectly, any debt incurred by—

(A) any other company that forms part of the same group of companies; or

(B) any company that is a controlled foreign company in relation to any company that forms part of the same group of companies;

(e) to another person where the person that owes that debt is a company that—

(i) owes that debt to a company that forms part of the same group of companies as thatcompany; and

(ii) reduces or settles that debt, directly or indirectly, by means of shares issued by that company:

Provided that this paragraph must not apply in respect of any debt that was incurred or assumed by that company in order to settle, take over, refinance or renew, directly or indirectly, any debt incurred by another company which—

(aa) did not form part of that same group of companies at the time that that other company incurred that debt; or

(bb) does not form part of that same group of companies at the time that that company reduces or settles that debt, directly or indirectly, by means of shares issued by that company; or

(f) to the extent that the debt so owed—

(i) is settled by means of an arrangement described in paragraph (b) of the definition of 'concession or compromise'; and

(ii) does not consist of or represent an amount owed by that person in respect of any interest incurred by that person during any year of assessment.

Appendix 3

Paragraph 12A of the Eighth Schedule to the Income Tax Act

12A. Concession or compromise in respect of a debt

(1) For the purposes of this paragraph—

'allowance asset' ……….

'capital asset' means an asset that is not trading stock;

'concession or compromise' means any arrangement in terms of which—

(a) a debt is —

(i) cancelled or waived; or

(ii) extinguished by—

(aa) redemption of the claim in respect of that debt by the person owing that debt or by any person that is a connected person in relation to that person; or

(bb) merger by reason of the acquisition, by the person owing that debt, of the claim in respect of that debt,

otherwise than as the result or by reason of the implementation of an arrangement described in paragraph (b);

(b) a debt owed by a company to a person is settled, directly or indirectly —

(i) by being converted to or exchanged for shares in that company; or

(ii) by applying the proceeds from shares issued by that company;

'debt' means any amount that is owed by a person in respect of —

(a) expenditure incurred by that person; or

(b) a loan, advance or credit that was used, directly or indirectly, to fund any expenditure incurred by that person,

but does not include a tax debt as defined in section 1 of the Tax Administration Act;

'debt benefit', in respect of a debt owed by a person to another person, means –

(a) in the case of an arrangement described in paragraph (a)(i) of the definition of 'concession or compromise', the amount cancelled or waived;

(b) in the case of the extinction of that debt by means of an arrangement described in paragraph (a)(ii) of the definition of 'concession or compromise', the amount by which the face value of the claim in respect of that debt held by the person to whom the debt is owed prior to the entering into of that arrangement exceeds the expenditure incurred in respect of—

(i) the redemption of that debt; or

(ii) the acquisition of the claim in respect of that debt;

(c) in the case of the settling of that debt by means of an arrangement described in paragraph (b) of the definition of 'concession or compromise', where the person who acquired shares in a company in terms of that arrangement held no effective interest in the shares of that company prior to the entering into of that arrangement, the amount by which the face value of the claim held in respect of that debt prior to the entering into of that arrangement exceeds the market value of the shares acquired by reason or as a result of the implementation of that arrangement; or

(d) in the case of the settling of that debt by means of an arrangement described in paragraph (b) of the definition of 'concession or compromise', where the person who acquired shares in a company in terms of that arrangement held an effective interest in the shares of that company prior to the entering into of that arrangement, the amount by which the face value of the claim held in respect of that debt prior to the entering into of that arrangement exceeds the amount by which the market value of the effective interest held by that person in the shares of that company immediately after the implementation of that arrangement exceeds, solely as a result of the implementation of that arrangement, the market value of the effective interest held by that person in the shares of that company immediately prior to the entering into of that arrangement;

'group of companies' means a group of companies as defined in section 41.

'market value', in relation to shares acquired or held by reason or as a result of implementing a concession or compromise in respect of a debt, means the market value of those shares immediately after the implementation of that concession or compromise.

(2) Subject to subparagraph (6), this paragraph applies where—

(a) a debt benefit in respect of a debt owed by a person arises in respect of a year of assessment by reason or as a result of a concession or compromise in respect of that debt during that year of assessment; and

(b) the amount of that debt is owed by that person in respect of or was used by that person to fund, directly or indirectly, any expenditure, other than expenditure in respect of trading stock in respect of which a deduction or allowance was granted in terms of this Act.

(3) Where—

(a) a debt benefit arises in respect of a debt owed by a person as contemplated in subparagraph (2); and

(b) the amount of that debt is owed in respect of or was used as contemplated in item (b) of that subparagraph to fund expenditure incurred in respect of an asset that was not disposed of by that person in a year of assessment prior to that in which that debt benefit arises,

the amount of expenditure so incurred in respect of that asset must, for the purposes of paragraph 20, be reduced by the debt benefit in respect of that debt.

(4) Where—

(a) a debt benefit arises in respect of a debt owed by a person as contemplated in subparagraph (2); and

(b) the amount of that debt is owed in respect of or was used as contemplated in item (b) of that subparagraph to fund expenditure incurred in respect of an asset that was disposed of in a year of assessment prior to that in which that debt benefit arises, that person must if the amount determined in respect of that disposal as—

(i) a capital gain; or

(ii) a capital loss,

differs from the amount that would have been determined, whether as a capital gain or as a capital loss, in respect of that disposal had that debt benefit been taken into account in the year of the disposal of that asset, treat that absolute difference as a capital gain to be taken into account in respect of the year of assessment in which the debt benefit arises: Provided that in taking that debt benefit into account in respect of the year of disposal of that asset that person must take into account the extent to which the expenditure in respect of that asset has been reduced by any other debt benefit taken into account, in terms of this subparagraph, in respect of that disposal.

(5) Where subparagraph (3) or (4) applies in respect of a debt that was used to fund expenditure in respect of a pre-valuation date asset of a person, for the purposes of determining the date of acquisition of that asset and the expenditure incurred in respect of that asset, that person must be treated as having—

(a) disposed of that asset at a time immediately before that debt benefit arose as contemplated in subparagraph (3)(a) or (4)(a), as the case may be, for an amount equal to the market value of that asset at that time; and

(b) immediately reacquired that asset at that time at an expenditure equal to that market value—

(i) less any capital gain, and

(ii) increased by any capital loss,

that would have been determined had the asset been disposed of at market value at that time, which expenditure must be treated as an amount of expenditure actually incurred at that time for the purposes of paragraph 20(1)(a).

Appendix 4

Exclusions to paragraph 12A of the Eighth Schedule to the Income Tax Act

(6) This paragraph must not apply to a debt benefit in respect of any debt owed by a person—

(a) that is an heir or legatee of a deceased estate, to the extent that—

(i) the debt is owed to that deceased estate;

(ii) the debt is reduced by the deceased estate; and

(iii) the amount by which the debt is reduced by the deceased estate forms part of the property of the deceased estate for the purposes of the Estate Duty Act;

(b) to the extent that the debt is reduced by way of—

(i) donation as defined in section 55(1); or

(ii) any transaction to which section 58 applies,

in respect of which donations tax is payable

(c) to an employer of that person, to the extent that the debt is reduced in the circumstances contemplated in paragraph 2(h) of the Seventh Schedule;

(d) to another person where the person that owes that debt is a company, if—

(i) that company owes that debt to a company that forms part of the same group of companies as that company; and

(ii) that company has not carried on any trade,

during the year of assessment during which that debt benefit arises and the immediately preceding year of assessment: Provided that this subitem must not apply in respect of any debt—

(aa) incurred, directly or indirectly, by that company to fund expenditure incurred in respect of any asset that was subsequently disposed of by that company by way of an asset-for- share, intra-group or amalgamation transaction or a liquidation distribution in respect of which the provisions of section 42, 44, 45 or 47, as the case may be, applied; or

(bb) incurred or assumed by that company in order to settle, take over, refinance or renew, directly or indirectly, any debt incurred by—

(A) any other company that forms part of the same group of companies; or

(B) any company that is a controlled foreign company in relation to any company that forms part of the same group of companies;

(e) that is a company, where—

(i) that debt is reduced in the course, or in anticipation, of the liquidation, winding up, deregistration or final termination of the existence of that company; and

(ii) the person to whom the debt is owed is a connected person in relation to that company,

to the extent that debt benefit in respect of that debt does not, at the time that the debt benefit arises, exceed the amount of expenditure contemplated in paragraph 20 incurred in respect of that debt by the connected person: Provided that this subitem must not apply—

(a) if—

(i) the debt was reduced as part of any transaction, operation or scheme entered into to avoid any tax imposed by this Act; and

(ii) that company became a connected person in relation to the person to whom the debt is owed after the debt (or any debt issued in substitution of that debt) arose; or

(b) if that company—

(i) has not, within 36 months of the date on which the debt is reduced or such further period as the Commissioner may allow, taken the steps contemplated in section 41(4) to liquidate, wind up, deregister or finally terminate its existence;

(ii) has at any stage withdrawn any step taken to liquidate, wind up, deregister or finally terminate its corporate existence; or

(iii) does anything to invalidate any step contemplated in subparagraph (A), with the result that the company is or will not be liquidated, wound up, deregistered or finally terminate its existence;

(f) to another person where the person that owes that debt is a company that—

(i) owes that debt to a company that forms part of the same group of companies as that company; and

(ii) reduces or settles that debt, directly or indirectly, by means of shares issued by that company:

Provided that this subitem must not apply in respect of any debt that was incurred or assumed by that company in order to settle, take over, refinance or renew, directly or indirectly, any debt incurred by another company which—

(aa) did not form part of that same group of companies at the time that that other company incurred that debt; or

(bb) does not form part of that same group of companies at the time that company reduces or settles that debt, directly or indirectly, by means of shares issued by that company; or

(g) to the extent that the debt so owed—

(i) is settled by means of an arrangement described in paragraph (b) of the definition of 'concession or compromise'; and

(j) does not consist of or represent an amount owed by that person in respect of any interest incurred by that person during any year of assessment.