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Debt reduction: new legislation, new challenges

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SCHOOL OF ACCOUNTANCY

University of the Witwatersrand, Johannesburg

캢A research report submitted to the Faculty of Commerce, Law and Management in

A research report submitted to the Faculty of Commerce, Law and Management in partial fulfilment of the requirements for the degree of Master of Commerce

DEBT REDUCTION: NEW LEGISLATION, NEW CHALLENGES

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Date	26 February 2015



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ABSTRACT

The debt reduction provisions contained in s 19 and para 12A of the Eighth Schedule to the Income Tax Act 58 of 1962 seek to reverse the tax benefits claimed or enjoyed by debtors in relation to debt which has been forgiven, wholly or in part. In most cases, the application of these provisions should not lead to any difficulty. Nevertheless, some scenarios are not adequately provided for by the legislation, including debt reduction in favour of debtors carrying on mining operations, as well as partial debt reductions. Furthermore, the applicability of some of the exemptions to these provisions is unclear. Despite recent amendments to these provisions, which will apply to years of assessment commencing on or after 1 January 2013, the legislature has not addressed these issues.

Key words: allowance assets; base cost; capital assets; capital gains tax; debt forgiveness; debt reduction; debt waiver; deemed donation; donation; donations tax; exemption; group of companies; operating expenditure; mining capital expenditure; tracing of expenditure; trading stock.

DECLARATION

I declare that this research report is my own unaided work. It is submitted in partial fulfilment of the requirements for the degree of Master of Commerce (specialising in Taxation) at the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination at any other institution.



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Jané van Reenen

Date: 31 July 2015

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1. INTRODUCTION

The Taxation Laws Amendment Act 22 of 2012 deleted proviso (*ii*) to s 20(1)(*a*) and s 8(4)(*m*) of the Income Tax Act 58 of 1962 ('the Act') and para 12(5) of the Eighth Schedule to the Act, which provisions regulated the tax consequences of debt forgiveness. These provisions were replaced by s 19 and para 12A of the Eighth Schedule to the Act, which provisions came into effect on 1 January 2013.[1] The Taxation Laws Amendment Act 31 of 2013 made minor amendments to the text of these new provisions,[2] and the Taxation Laws Amendment Act 43 of 2014 made further minor amendments.[3] These amendments have not materially altered the application of the provisions. The amendments apply to years of assessment commencing on or after 1 January 2013,[4] with the result that the original wording in the Taxation Laws Amendment Act 2012 will never apply.

As these provisions only became effective on 1 January 2013, there have been no reported cases on these provisions to date.

1.1 Application of s 19 and para 12A

Section 19(2) and para 12A(2) determine that these provisions apply in situations where a debt has been reduced, and the amount of the reduction exceeds the consideration given for the reduction.[5]

Where a qualifying debt reduction has occurred, the provisions seek to reverse the tax benefits enjoyed by a debtor in relation to expenditure funded by debt which has been waived, reduced or forgiven, wholly or in part. This reversal occurs, as the debtor has not actually incurred the portion of the expenditure that is reduced, which forms the basis of the deduction or allowance claimed. The *Explanatory Memorandum on the Taxation Laws*

[1] Sections 36(2) and 108(2) of the Taxation Laws Amendment Act 22 of 2012.

[2] Sections 53(1) and 127(1).

[3] Sections 30 and 82.

[4] Sections 53(2) and 127(2) of the Taxation Laws Amendment Act 31 of 2013.

[5] Debt reduction in the context of s 19 and para 12A is often referred to as 'debt waiver' or 'debt forgiveness'.

Amendment Bill, 2012 ('the *2012 Explanatory Memorandum*') indicates that the reason for the amended debt reduction provisions is to accommodate '[d]ebtors in distress seeking relief', especially taking into consideration the recent global financial crisis.[6] Business rescue as provided for in Chapter 6 of the Companies Act 71 of 2008 often entails debt reduction.[7]

It was conceded in the *2012 Explanatory Memorandum* that:

> 'the tax system unfortunately acts as an added impediment to the recovery of companies and other parties in financial distress. In particular, the potential tax imposed upon parties receiving the benefit of debt relief effectively undermines the economic benefit of the relief.'[8]

It was therefore specifically recognised in the *2012 Explanatory Memorandum* that the tax imposed upon taxpayers receiving the benefit of relief from debt in the form of debt reduction effectively undermined the economic benefit of the relief.[9]

1.2 Scope and limitations of the research

1.2.1 Statement of the research problem

As discussed in Chapter 4, the new debt reduction provisions have led to considerable uncertainty. As a result, the main research question is: what are certain of the problems experienced with regard to the recent amendments to the debt reduction provisions?

The research will seek to answer this question by critically examining the application, exemptions and complexities of the debt reduction provisions contained in s 19 and para 12A, with specific emphasis on the circumstances where these provisions will not apply, as well as certain circumstances where the application of these provisions is problematic. Furthermore, the research will briefly compare this new regime to the previous debt

[6] The *2012 Explanatory Memorandum*, p 43.

[7] Seccombe, D 'Proposed tax amendments will assist business rescue' (2013) *TaxTalk* Jan/Feb p40.

[8] The *2012 Explanatory Memorandum*, p 44.

[9] *Draft SARS Capital Gains Tax Guide*, p 125.

reduction regime contained in proviso (*ii*) to s 20(1)(*a*), s 8(4)(*m*) and para 12(5), to determine whether the purpose of the amendments is achieved.

The research problem will be approached from the perspective of commercial trade expenditure, thus not examining debt reductions for non-commercial reasons. Other considerations such as (i) the effect of debt reduction on taxes other than normal tax, and (ii) company law, fall beyond the scope of this research.

1.2.2 The Research Sub-questions

1.2.2.1 Research sub-question 1

What is meant by debt reduction and how do such reductions arise?

1.2.2.2 Research sub-question 2

How do the new debt reduction provisions function, and how does this relate to the purpose of these provisions as explained in the *2012 Explanatory Memorandum*? Furthermore, which transactions are exempt from the new debt reduction provisions?

1.2.2.3 Research sub-question 3

In which circumstances is the application of the new debt reduction provisions problematic?

1.3 Research methodology

A qualitative research methodology was adopted to conduct this research study. A literature review comprising the analysis of legislation, case law, academic articles, legal text books and legal reference works was conducted.

2. THE NEW DEBT REDUCTION PROVISIONS: S 19 AND PARA 12A

The so-called new debt reduction provisions contained in s 19 and para 12A came into effect on 1 January 2013. Paragraph 12A regulates the capital gains tax consequences of debt reduction and s 19 regulates the normal tax consequences. These provisions were subsequently amended by the Taxation Laws Amendment Act 2013[10] and the Taxation Laws Amendment Act 2014.[11] The amendments apply to years of assessment commencing on or after 1 January 2013, with the result that the original wording will not apply to any qualifying debt reductions.

As these provisions are relatively new, there is not a wealth of authority on the subject. The South African Revenue Service ('SARS') recently published the updated *Draft Comprehensive Guide to Capital Gains Tax, Issue 5* ('*Draft SARS Capital Gains Tax Guide*'), which addresses the new debt reduction provisions.[12] It must be noted that guides issued by SARS are not 'official publications' as defined in s 1 of the Tax Administration Act 28 of 2011. Accordingly, these guides do not create practice generally prevailing under s 5 of the Tax Administration Act 2011. These documents do, however, provide guidance as to how SARS will typically deal with certain matters.[13]

This chapter critically examines the new debt reduction provisions to lay the foundation for identifying flaws and lacunae in the legislation. This chapter furthermore compares the previous provisions to the new provisions in the light of the purpose and objectives of the new provisions. To place the amendments and the reasons for the amendments in context, the debt reduction provisions prior to the 2012 amendments are briefly discussed.

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[10] Sections 53(1) and 127(1).

[11] Sections 30 and 82.

[12] Reference will also be made to *South African Revenue Service Comprehensive Guide to Capital Gains Tax, Issue 4* ('*SARS Capital Gains Tax Guide*'), which guide addresses the previous debt reduction regime.

[13] *Draft SARS Capital Gains Tax Guide*, p i.

2.1 Debt reduction prior to the 2012 amendments

Prior to 2013, the tax consequences attendant upon the reduction of debt were regulated by proviso (*ii*) to s 20(1)(*a*), s 8(4)(*m*) and para 12(5). These sections were deleted by the Taxation Laws Amendment Act 2012.[14]

2.1.1 Proviso (*ii*) to s 20(1)(*a*)

Section 20(1)(*a*) applied only in circumstances where the debtor in respect of a reduced debt was in an assessed loss position. The debtor's balance of assessed loss was reduced where a liability owed by a debtor to a creditor was reduced or extinguished, in circumstances where the amount so reduced was used to fund expenditure in respect of which a deduction was claimed in terms of s 11.

This section only applied in the event that the debt that was reduced arose in the ordinary course of the debtor's trade.[15]

2.1.2 Section 8(4)(*m*)

Section 8(4)(*m*) was subject to the provisions of s 20, and therefore this section applied only in circumstances where the debtor had no balance of assessed loss.

Section 8(4)(*m*) provided that where the debtor was relieved from a debt and the debtor was also relieved from making payment of any expenditure actually incurred and such expenditure was not yet paid but allowed as a deduction, then the debtor was deemed to have recovered or recouped an amount equal to the amount of the obligation from which the debtor was relieved or partially relieved. This section, however, only applied to amounts that were allowed as deductions against the income of the relevant debtor.

[14] Sections 9(1)(*c*), 37(1) and 107(1)(*c*).

[15] Strauss B 'Waving goodbye to waiving of debts' *De Rebus* 2003 Vol 66(422): 57-58.

Section 8(4)(*m*) was inserted in 1997[16] in response to the argument that no recoupment arose for the purposes of s 8(4)(*a*) in the case of a debt reduction,[17] despite the decisions in ITC 1634[18] and ITC 1704[19] confirming that s 8(4)(*a*) applied in these circumstances.[20]

The provisions of s 8(4)(*m*) typically applied where a company provided services to another company on loan account, in circumstances where the company incurring the expenditure claimed the expenditure as a tax deduction, and the company providing the service subsequently reduced the loan. At the time when the loan was reduced, the expenditure would not have been paid, and accordingly, the provisions of s 8(4)(*m*) may have been applicable.

As a debtor could not deduct any capital repayments in respect of a loan from its taxable income, as it is of a capital nature, this section did not apply to the reduction of the loan capital. The interest due on the loan was, however, depending on the purpose of the loan, deductible by that debtor in terms of s 11(*a*). Therefore, s 8(4)(*m*) likely applied to the reduced interest portion of a loan. This gave rise to a taxable recoupment in the hands of that debtor.

Section 8(4)(*m*) did not apply in the case of the cession of book debts, as the debtor was not relieved from making payment, but was simply obliged to make payment to a substituted creditor.[21] Unlike para 12(5), it was not specifically required in s 8(4)(*m*) that the debtor was released from payment by the creditor.[22]

In contrast to s 19, there were no exemptions from the ss 20(1)(*a*) and 8(4)(*m*) regime. Furthermore, there appeared to be no bar to the economic double taxation that would have

[16] Section 6(1)(*b*) of the Income Tax Act 28 of 1997.

[17] Olivier, L 'Reduction or discharge of debts: the hidden dangers' *Stellenbosch Law Review* 2006 2 302, 303.

[18] 60 SATC 235.

[19] 63 SATC 285.

[20] Olivier, L 'Reduction or discharge of debts: the hidden dangers' *Stellenbosch Law Review* 2006 2 302, 303.

[21] Olivier, L 'Reduction or discharge of debts: the hidden dangers' *Stellenbosch Law Review* 2006 2 302, 303.

[22] Olivier, L 'Reduction or discharge of debts: the hidden dangers' *Stellenbosch Law Review* 2006 2 302, 303.

taken place in the case of a debt reduction as a result of a donation.[23] It was, however, SARS practice to treat such a release from payment as a recoupment only.[24]

2.1.3 Paragraph 12(5)(*a*)

Paragraph 12(5) contained the capital gains tax provisions relating to the reduction or discharge of a debt owed by a person to a creditor, and deemed these transactions to have been a disposal for capital gains tax purposes in the hands of the debtor.

Paragraph 12(5)(*a*) provided that where debt owed by a debtor was reduced or discharged by the creditor for no consideration or for consideration less than the face value of the debt, then the reduction or discharge of the debt was treated as a deemed disposal in the hands of the debtor with a base cost[25] of zero and proceeds equal to the amount of the debt reduced or discharged.[26] Effectively, the debtor was subject to capital gains tax on the amount of the debt being reduced. This provision only dealt with the debtor, and not with the creditor in respect of a debt. Normal capital gains tax principles thus applied to any capital loss suffered by the creditor.[27]

According to the *SARS Capital Gains Tax Guide*, the purpose of para 12(5) was twofold, namely:

> 'that a debtor who [was] relieved of the obligation to pay any portion of the amount owing [would have been] subject to CGT on a capital gain equal to the amount discharged';[28]

---

[23] In this context, 'donation' refers to the release from payment by reason of pure liberality or generosity. See *Welch's Estate v Commissioner, South African Revenue Service* 2005 (4) SA 173 (SCA) and Olivier, L 'Reduction or discharge of debts: the hidden dangers' *Stellenbosch Law Review* 2006 2 302, 305.

[24] Olivier, L 'Reduction or discharge of debts: the hidden dangers' *Stellenbosch Law Review* 2006 2 302, 305.

[25] The base cost of an asset for capital gains tax purposes is determined with reference to para 20 of the Eighth Schedule. The base cost includes, inter alia, the cost of acquisition of the asset, less any deductions allowed for the purposes of determining taxable income.

[26] Paragraph 12(5)(*b*).

[27] *SARS Capital Gains Tax Guide,* p89.

[28] *SARS Capital Gains Tax Guide,* p 88.

and to provide for a matching of capital gains and losses, as

> '[i]n the absence of para 12(5), creditors would [have been] able to claim losses, while debtors would not [have been] taxed on the corresponding gains'.[29]

In the case of a debt reduction, the creditor was generally entitled to claim a loss for capital gains tax purposes. Where the debtor and creditor were, however, connected persons, the loss claimable by the creditor was limited by para 56 to the amount that was subject to normal tax or capital gains tax in the hands of the debtor.[30]

2.1.4 Exemptions from para 12(5)

2.1.4.1 Proviso (*aa*) to para 12(5)(*a*) – Other provisions of the Act apply

Paragraph 12(5)(*a*) contained residual rules, as in terms of proviso (*aa*) to para 12(5)(*a*), these provisions did not apply in circumstances where the debt reduction was taken into account for tax purposes in terms of para 3(*b*)(*ii*) of the Eighth Schedule; s 8(4)(*m*) or proviso (*ii*) to s 20(1)(*a*); para 2(*h*) of the Seventh Schedule; or para 20(3) of the Eighth Schedule.

The purpose of this exemption was to prevent double taxation.[31]

2.1.4.2 Proviso (*bb*) to para 12(5)(*a*) - Group of companies

Paragraph 12(5)(*a*) did not apply where the debtor and creditor were members of the same group of companies as defined in s 41, unless the transaction was part of a scheme to avoid tax, and one of the following circumstances was present: (i) the debt, or any substituted debt, was acquired directly or indirectly from a person who is not a member of that group of companies; or (ii) that person or another person became members of that group of

[29] *SARS Capital Gains Tax Guide*, p 88.

[30] Strauss B 'Waving goodbye to waiving of debts' *De Rebus* 2003 Vol 66(422):57-58. Also see *SARS Capital Gains Tax Guide*, p 89.

[31] *SARS Capital Gains Tax Guide*, p 92. Also see *2012 Explanatory Memorandum*, p 43.

companies after that debt arose, or (iii) that person or another person became members of that group of companies after any substituted debt arose.

Section 41(1) defines 'group of companies' with reference to the 'group of companies' definition in s 1. This definition will be discussed in Chapter 3.

2.1.4.3 Proviso (*cc*) to para 12(5)(*a*) - Debt reduction in anticipation of liquidation, winding up or deregistration

Lastly, para 12(5)(*a*) did not apply where the debtor was a company which was a connected person in relation to the creditor and that reduction or discharge was made in the course or in anticipation of the liquidation, winding up, deregistration or final termination of the corporate existence of that company.[32]

This exemption applied to the extent that the amount of the reduction or discharge did not exceed the amount of the creditor's base cost expenditure for the purposes of para 20 in respect of the debt at the time of the reduction or discharge.[33] In addition, this exemption did not apply if the debtor became a connected person in relation to that creditor after the debt (or any substituted debt) arose,[34] and these transactions were part of a scheme to avoid any tax.[35]

In circumstances where the debtor company (i) failed to take the necessary steps to liquidate, wind up or deregister the company within six months of the debt reduction, or (ii) withdrew such steps, or (iii) did anything to invalidate such steps, then the exemption no

[32] Proviso (*cc*) to para 12(5)(*a*).

[33] Proviso (*cc*) to para 12(5)(*a*).

[34] Proviso (*cc*)(*A*) to para 12(5)(*a*).

[35] Proviso (*cc*)(*B*) to para 12(5)(*a*).

longer applied, and a capital gain may have been triggered.[36] The debtor and creditor would have been held jointly and severally liable for the resultant tax liability.[37]

2.2 Reasons for the amended debt reduction provisions

Debt reductions typically occur in the case of insolvency and business rescue.[38] According to the *2012 Explanatory Memorandum*, the amendments to the debt reduction provisions were made to accommodate debtors in financial distress.[39] It was conceded that:

> 'the tax system unfortunately acts as an added impediment to the recovery of companies and other parties in financial distress. In particular, the potential tax imposed upon parties receiving the benefit of debt relief effectively undermines the economic benefit of the relief'.[40]

It was therefore specifically recognised that the tax imposed upon taxpayers receiving the benefit of relief from debt in the form of debt reduction effectively undermined the economic benefit of the relief.[41] One of the aims of the new rules is therefore to prevent the double taxation that may occur as a result of the application of more than one of the following taxes in the case of a debt reduction: (i) estate duty; (ii) donations tax; (iii) income tax on a fringe benefit received by an employee; (iv) income tax on income; or (v) capital gains tax.[42]

The order of application of the old provisions was firstly that the debtor's balance of assessed loss was reduced in terms of s 20(1)(*a*), secondly that a recoupment was triggered in terms of s 8(4)(*m*), and finally that a deemed disposal for capital gains tax purposes was

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[36] Paragraph 12(5)(*c*) and Olivier, L 'Reduction or discharge of debts: the hidden dangers' *Stellenbosch Law Review* 2006 2 302, 309.

[37] Paragraph 12(5)(*d*) and Olivier, L 'Reduction or discharge of debts: the hidden dangers' *Stellenbosch Law Review* 2006 2 302, 310.

[38] *Draft SARS Capital Gains Tax Guide,* p 125.

[39] *2012 Explanatory Memorandum,* p 43.

[40] *2012 Explanatory Memorandum,* p 43.

[41] *Draft SARS Capital Gains Tax Guide,* p 125.

[42] *Draft SARS Capital Gains Tax Guide,* p 126.

triggered in terms of para 12(5)(*a*) in the year of assessment during which the debt reduction occurred. In an effort to achieve the objective to accommodate debtors in financial distress, the order of application of the new provisions, particularly to allowance assets, was changed to firstly reduce the base cost of the allowance asset in terms of para 12A(3), and then to trigger a recoupment of the balance of the reduction amount after the base cost has been extinguished in terms of s 19(6). The result is that the immediate tax liability resulting from the debt reduction is reduced and the future capital gains tax liability is increased. Furthermore, the capital gains tax liability is not triggered immediately upon the reduction, but only triggered upon a future disposal by the debtor of the relevant asset. Additional exemptions to the debt reduction provisions, such as the donations tax exemption in s 19(8)(*b*) and para 12A(6)(*b*), were also introduced with the aim of preventing double taxation.

The efficacy of the new debt reduction provisions is measured by way of a comparative calculation in 2.7 below against the objective to accommodate debtors in financial distress by reducing the immediate tax liability arising from the debt reduction.

2.3 Key concepts in s 19 and para 12A

Both s 19 and para 12A apply where a debt that is owed by a person is reduced by any amount and the amount of the reduction exceeds the consideration given for the reduction.[43] Section 19 applies in circumstances where the relevant debt was used, directly or indirectly, to fund deductible expenditure.[44] Paragraph 12A applies in circumstances where the relevant debt was used, directly or indirectly, to fund any expenditure, other than expenditure in respect of which a deduction or allowance was granted in terms of the Act, or to fund any expenditure incurred in respect of an allowance asset.[45]

[43] Section 19(2) and para 12A(2).

[44] Section 19(2).

[45] Paragraph 12A(2).

The key concepts that stem from s 19 and para 12A are discussed below. Where necessary, these concepts will be contrasted to the corresponding concepts in the previous debt reduction provisions. Reference will also be made to the *SARS Capital Gains Tax Guide* and the *Draft SARS Capital Gains Tax Guide* in respect of these key concepts.

2.3.1 Allowance asset

'Allowance asset' is defined in s 19 (1) and para 12A(1) as:

> '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' is in turn defined in s 19(1) and para 12A(1) as 'an asset that is not trading stock'.[46] For the purposes of the Eighth Schedule, and therefore for para 12A, an 'asset' is defined so as to include:

> '(*a*) property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum; and
>
> (*b*) a right or interest of whatever nature to or in such property'.[47]

2.3.2 Debt that is owed

The term 'debt' is not defined in the Act. Therefore, the ordinary dictionary meaning must be given to this word. The *Concise Oxford English Dictionary* defines the word as 'money owed or due'.[48]

Section 19(1) and para 12A(1) specifically provide that these provisions do not apply to tax debts as defined in s 1 of the Tax Administration Act 28 of 2011, being

> '[a]n amount of tax due or payable in terms of a tax Act is a tax debt due to SARS for the benefit of the National Revenue Fund'.[49]

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[46] The definition of 'capital asset' in s 19(1) refers specifically to the definition of 'asset' in para 1.

[47] Paragraph 1.

[48] Soanes, C. & Stevenson, A. (eds) (2004) *Concise Oxford English Dictionary*, p 369.

Davis, Olivier and Urquhart indicate that the debtor must have an unconditional liability to pay or transfer an amount to the creditor.[50] Paragraph 12(5)(*a*) applied where there was a 'debt owed', which would have been present where the debtor had an unconditional liability to pay an amount, which included debts which have not yet become due and payable, but excluded redeemable preference shares in terms of the decision in *CIR v Datakor Engineering* (*Pty*) *Ltd.*[51] The provisions of s 19 and para 12A therefore would also not apply if preference shares are redeemed at a discount, as preference shares are not regarded as debt.[52] Section 19 and para 12A apply to unpaid interest incurred on outstanding amounts, which would have been calculated in accordance with s 24J.[53]

2.3.3 Reduced by an amount

The tax consequences of the application of s 19 and para 12A are set out with reference to the 'reduction amount'. This term is defined in s 19(1) and para 12A(1) as:

> 'in relation to a debt owed by a person, … any amount by which that debt is reduced less any amount applied by that person as consideration for that reduction'.

As is clear from the wording of this definition, only the amount of consideration for the debt reduction that was applied by the *debtor* will be taken into account in determining the reduction amount, and not consideration applied by another person, for example, a connected person in relation to the debtor.[54]

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[49] Section 169(1) of the Tax Administration Act.

[50] *South African Income Tax: Legislation and Commentary* Chapter II The Taxes (ss 5 – 64C), Part I Normal Tax (ss 5 – 37H) s 19.

[51] *CIR v Datakor Engineering* (*Pty*) *Ltd 1998 (4) SA 1060 (SCA); 60 SATC 501* at 510. Also see *SARS Capital Gains Tax Guide*, p 88.

[52] De Koker AP and Williams RC *Silke on South African Income Tax* (online edition) §24.34C.

[53] Clegg D and Stretch R 'Income Tax in South Africa' §24.11.9.

[54] *South African Income Tax: Legislation and Commentary* Chapter II The Taxes (ss 5 – 64C), Part I Normal Tax (ss 5 – 37H) s 19.

In *CIR v Datakor Engineering (Pty) Ltd*,[55] a debt capitalisation took place, whereby creditors abandoned their claims against Datakor in exchange for preference shares in the company. The court held that this constituted a compromise.[56] Visser submits that this decision is still relevant in the context of the new debt reduction provisions, as the abandonment of claims in the *Datakor* case would amount to a qualifying debt reduction under s 19 and para 12A.[57] In the *Datakor* case, the debt was substituted for redeemable preference shares, the redemption of which cannot be enforced as debt can be enforced.[58] Visser furthermore explains that the issue of the preference shares dilutes the former creditor's rights, and that a valuator may consequently value the preference shares' rights (representing the consideration for the reduction in the company's debt) lower than the face value of the debt so reduced.[59] The result is that a reduction amount as defined in s 19(1) and para 12A(1) arises.

Visser's view is confirmed by the *Draft SARS Capital Gains Tax Guide*.[60] The *Draft SARS Capital Gains Tax Guide* indicates that a loan capitalisation will result in a debt reduction, but only to the extent that the market value of the shares issued as part of the capitalisation is less than the face value of the debt.[61]

The facts to which SARS' Binding Private Ruling number 173 apply, are that a shareholder loan was capitalised, i.e. the shareholder subscribed for additional shares in the company,

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[55] 1998 (4) SA 1060 (SCA).

[56] At para 11.

[57] Visser B (2014) 'Datakor case is still alive for new debt reduction rules' available at http://www.gt.co.za/publications/2014/07/e-taxline-the-winds-of-change-affecting-tax-pla.... Accessed on 2014/09/22.

[58] Visser B (2014) 'Datakor case is still alive for new debt reduction rules' available at http://www.gt.co.za/publications/2014/07/e-taxline-the-winds-of-change-affecting-tax-pla.... Accessed on 2014/09/22.

[59] Visser B (2014) 'Datakor case is still alive for new debt reduction rules' available at http://www.gt.co.za/publications/2014/07/e-taxline-the-winds-of-change-affecting-tax-pla.... Accessed on 2014/09/22.

[60] *Draft SARS Capital Gains Tax Guide*, p 128.

[61] *Draft SARS Capital Gains Tax Guide*, p 128.

and the company used the proceeds from this subscription to settle the shareholder loan. The question which arose in this regard was whether the issue of shares in settlement of a loan obligation resulted in the company factually discharging its loan obligation.[62] It was ruled that s 19 and para 12A do not apply to the transaction in question.[63] The ruling was made on the assumption that the subscription price and the loan repayment would be made by cash, and not by way of set-off.[64]

Paragraph 12(5)(*a*) applied where the debt was reduced 'by the creditor'. The paragraph did not apply if the debt reduction resulted from operation of law, but only where there was an act or omission by the creditor.[65] According to the *SARS Capital Gains Tax Guide*, if the creditor allowed the debt to prescribe in terms of the Prescription Act 68 of 1969 through the effluxion of time, then this would have been regarded as an omission by the creditor, and accordingly, para 12(5)(*a*) would have applied to that prescribed debt.[66] Olivier and Stein disagree with this interpretation.[67] As neither s 19, nor para 12A make reference to a reduction 'by the creditor', it is submitted that s 19 and para 12A will not only apply where the debt was reduced by the creditor, but also where the debt was reduced by operation of law. Unfortunately the *Draft SARS Capital Gains Tax Guide* does not address this particular point.

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[62] Louw, H 'Capitalisation of shareholder loans' available at http://www.cliffedekkerhofmeyr.com/export/sites/cdh/en/news/publications/2014/tax/downloads/Tax-Alert-4-July-2014.pdf. Accessed on 22 September 2014.

[63] Paragraph 6 of Binding Private Ruling number 173.

[64] Paragraph 5 of Binding Private Ruling number 173.

[65] *SARS Capital Gains Tax Guide*, p 92. Also see ITC 1387 (1984) 46 SATC 121 (T) and ITC 1448 (1988) 51 SATC 58 (C).

[66] *SARS Capital Gains Tax Guide*, p 92.

[67] Olivier, L 'Reduction or discharge of debts: the hidden dangers' *Stellenbosch Law Review* 2006 2 302, 309; Stein *Capital Gains Tax* 5.9 Reduction or discharge of a debt LexisNexis online. Also see ITC 1835 71 SATC 105 at 114.

2.3.4 Directly or indirectly

Section 19 and para 12A apply in respect of the reduction of debt that was used to directly or indirectly fund any expenditure in respect of which a deduction or allowance was granted. The word 'indirectly' broadens the scope of s 19 and para 12A. A sufficiently close connection must exist between the reduced debt and the expenditure incurred.[68]

Davis, Olivier and Urquhart indicate that the use of the word 'indirectly' means that the provisions cover transactions where the debtor owes the creditor an amount of money as consideration for goods or services supplied by the creditor to the debtor, being a direct funding transaction, and also transactions where the debtor owes the creditor an amount of money as a result of the creditor providing the debtor with a loan or other funding and the debtor applying such loan or other funding to cash settle a supplier of goods or services, being an indirect funding transaction.[69]

2.3.5 Expenditure in respect of which a deduction or allowance was granted

Section 19 applies to the reduction of debt used to fund expenditure in respect of which a deduction or allowance was *granted* in terms of the Income Tax Act, 1962.[70] Section 19 furthermore applies particularly to expenditure in respect of trading stock,[71] operating expenditure[72] and allowance assets.[73] Paragraph 12A in turn applies to the reduction of debt used to fund expenditure (i) other than expenditure in respect of which a deduction or

[68] *Draft SARS Capital Gains Tax Guide*, p 128.

[69] *South African Income Tax: Legislation and Commentary* Chapter II The Taxes (ss 5 – 64C), Part I Normal Tax (ss 5 – 37H) s 19. Also see the *Draft SARS Capital Gains Tax Guide* p 129.

[70] Section 19(2)(*a*).

[71] Section 19(3) and (4).

[72] Section 19(5).

[73] Section 19(6).

allowance was granted in terms of the Income Tax Act, 1962, and (ii) to expenditure incurred in respect of an allowance asset.[74]

In *C:SARS v Labat Africa Ltd*[75] the Supreme Court of Appeal indicated that the term 'expenditure' is not defined in the Act, and that its ordinary meaning entails 'the action of spending funds; disbursement or consumption; and hence the amount of money spent'.

Section 19 only applies where a deduction or allowance *was granted* in terms of the Act in respect of the expenditure which was funded by the relevant debt. Therefore, should a deduction or allowance be allowable or claimable by the debtor, but the tax benefit of such deduction or allowance was not claimed by the debtor, then s 19 should not apply to that particular debt reduction. It is submitted that para 12A would apply in these circumstances, as para 12A(2) indicates that this paragraph applies to expenditure *other than* expenditure in respect of which a deduction or allowance was granted.

Geldenhuys and Tiedt submit that:

> 'One of the basic principles of statutory interpretation is that different words are used to convey different meanings. It is accordingly submitted that *granting* a deduction or allowance and merely *allowing* the deduction or allowance should bear different meanings. Based on the wording and purpose of section 19 of the Act, it appears that the granting of a deduction or allowance refers to a situation where the taxpayer has within that year of assessment *received* the tax benefit, which benefit must be reversed as a result of the waiver.'[76]

It therefore does not appear that s 19 applies to expenses that will become deductible in future, for example pre-trade expenditure in terms of s 11A.[77]

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[74] Paragraph 12A(1).

[75] 2013 (2) SA 33 (SCA), 74 SATC 1 at 6.

[76] Geldenhuys BS and Tiedt T 'Quo Vadis … when Mining Companies Receive a Reduction or Cancellation of Debt?' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 1 21, 26.

[77] *South African Income Tax: Legislation and Commentary* Chapter II The Taxes (ss 5 – 64C), Part I Normal Tax (ss 5 – 37H) s 19.

Both s 19 and para 12A apply to the reduction of debt used to fund expenditure incurred in respect of an allowance asset.[78] The term 'allowance asset' is defined in both s 19(1) and para 12A(1) as

> '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'.

Section 19, however, will only apply to debt used to fund expenditure in respect of allowance assets to the extent that a deduction or allowance has already been *granted* in respect of that allowance asset,[79] whereas para 12A will apply, irrespective of whether or not any deductions or allowances have been *granted* in respect of that allowance asset.[80]

2.3.6 Consideration

The term 'consideration' is not defined for the purposes of the Act. In respect of para 12(5)(*a*), Olivier submits that this term should bear a similar meaning as that of 'proceeds' for capital gains tax purposes,[81] being the amount received or accrued in respect of a disposal.[82] It was held in *Ogus v SIR*[83] that the term 'consideration' refers to 'quid pro quo given under a reciprocal obligation'.[84] According to the *Draft SARS Capital Gains Tax Guide*, the words 'amount' and 'consideration' refer to true consideration, being the market value of the consideration applied in respect of the debt reduction.[85]

It is therefore clear that consideration need not be in a monetary form. This view is confirmed in the *2012 Explanatory Memorandum*, which indicates that debt may also be

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[78] Section 19(6) and (7) and para 12A(3).

[79] Proviso (*i*) to s 19(6).

[80] Paragraph 12A(2).

[81] Olivier, L 'Reduction or discharge of debts: the hidden dangers' *Stellenbosch Law Review* 2006 2 302, 307.

[82] Paragraph 35(1) of the Eighth Schedule.

[83] 1987 (3) SA 67 (T) at 109. The case is also reported under 40 SATC 100.

[84] *SARS Capital Gains Tax Guide*, p 90.

[85] *Draft SARS Capital Gains Tax Guide*, p 127.

reduced in exchange for consideration in the form of services rendered or the transfer of a capital asset.[86]

It is a well-known principle from *C:SARS v Labat*[87] that the issue of shares does not constitute expenditure incurred, as it does not diminish a company's assets.[88] It was, however, held in *Lace Proprietary Mines Ltd v CIR*[89] that the consideration received for the sale of mineral rights was the market value of shares issued by the purchasing company. It is therefore submitted that the issue of shares will constitute consideration for the purposes of s 19 and para 12A.

2.4 Section 19

As mentioned in 2.3 above, s 19 applies where debt that is owed by a person and that was used, directly or indirectly, to fund deductible expenditure, is reduced by any amount and the amount of the reduction exceeds the consideration given for the reduction.[90]

The exemptions to the application of s 19 as contained in s 19(8) are discussed in Chapter 3 below.

2.4.1 Result of the application of s 19

2.4.1.1 Section 19(3) and (4) – Trading stock

Where a debt is reduced, and the amount of the debt was used to fund expenditure in respect of trading stock that is held and not disposed of, the amount of the reduction must

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[86] *2012 Explanatory Memorandum*, p 43.

[87] 2011 ZASCA 157; 74 SATC 1.

[88] Louw, H 'Capitalisation of shareholder loans' available at http://www.cliffedekkerhofmeyr.com/export/sites/cdh/en/news/publications/2014/tax/downloads/Tax-Alert-4-July-2014.pdf. Accessed on 22 September 2014.

[89] 1938 AD 267, 9 SATC 349 at 356.

[90] Section 19(2).

either reduce the value of the trading stock, or be recouped to income (or a combination thereof).[91]

In terms of s 19(3), where a qualifying debt reduction occurred, and the amount of that debt was used to fund expenditure incurred in respect of trading stock that is held and not disposed of by that person at the time of the reduction of the debt, then the reduction amount 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 ss 11(*a*) or 22(1) or (2) for the year of assessment in which the debt is so reduced, be applied to reduce the amount so taken into account in respect of that trading stock. Section 19(3) therefore reduces the quantum of the tax deduction claimable upon disposal of trading stock.[92]

The meaning of held and not disposed of in the context of s 19 is uncertain.[93] According to De Koker and Williams, trading stock is held and not disposed of if the taxpayer has dominium in it, and therefore when he is the owner of it.[94]

Furthermore, in terms of s 19(4), where s 19(3) has been applied to reduce the amount taken into account in respect of that trading stock in terms of ss 11(*a*) or 22(1) or (2) to zero, then the excess of the reduction amount in respect of that debt must, to the extent that a deduction or allowance was granted in terms of the Act to that person in respect of that expenditure, be deemed for the purposes of s 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 is

[91] Sections 19(3) and (4).

[92] Rudnicki M and Bird N 'The Debt-Waiver Rules and their Exemptions' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 4 52, 54.

[93] De Koker AP and Williams RC *Silke on South African Income Tax* (online edition) §4.64.

[94] De Koker AP and Williams RC *Silke on South African Income Tax* (online edition) §8.111. If the debtor has disposed of the trading stock by the time of the debt reduction, then the expenditure incurred in respect of the trading stock will be dealt with by s 19(5).

reduced. This scenario may arise where the debtor has in a previous year of assessment adjusted the value to be taken into account for purposes of s 22 (1) for obsolete stock.[95]

The original wording of sections 19(3) and (4) in the Taxation Laws Amendment Act 2012 referred to expenditure incurred 'in the acquisition of trading stock'.[96] This phrase was replaced by the Taxation Laws Amendment Act 2013 by the phrase 'in respect of trading stock'.[97] According to the *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2013* (the *'2013 Explanatory Memorandum'*), the reason for the amendment was to extend the application of this subsection to any expenditure incurred in respect of trading stock, and not merely the acquisition of trading stock.[98]

2.4.1.2 Section 19(5) – Operating expenditure

In terms of s 19(5), where a qualifying debt reduction occurred, and the amount of that debt was utilised to fund expenditure other than in relation to trading stock held and not disposed of or allowance assets, then the reduction amount in respect of that debt must, to the extent that a deduction or allowance was granted in terms of the Act to that person in respect of that expenditure, be deemed for the purposes of s 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 is reduced.

This category of expenditure can most accurately be described as operating expenditure, which may include salaries, rental, utilities, legal fees, consulting fees and interest.[99]

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[95] *South African Income Tax: Legislation and Commentary* Chapter II The Taxes (ss 5 – 64C), Part I Normal Tax (ss 5 – 37H) s 19.

[96] Section 36 of the Taxation Laws Amendment Act 22 of 2012.

[97] Section 53 of the Taxation Laws Amendment Act 31 of 2013.

[98] *2013 Explanatory memorandum*, p 112.

[99] *2012 Explanatory Memorandum*, p 48. Also see *South African Income Tax: Legislation and Commentary* Chapter II The Taxes (ss 5 – 64C), Part I Normal Tax (ss 5 – 37H) s 19.

2.4.1.3 Section 19(6) and (7) – Allowance assets

Sections 19 (6) and (7) deal with the tax treatment of qualifying debt reductions in the case of debt used to fund expenditure in respect of allowance assets. 'Allowance asset' is defined in s 19(1) as

> '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' is in turn defined in s 19(1) as

> 'an asset as defined in paragraph 1 of the Eighth Schedule that is not trading stock'.

Paragraph 1 of the Eighth Schedule defines 'asset' as

> '(*a*) property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum; and
>
> (*b*) a right or interest of whatever nature to or in such property'.[100]

Where a qualifying debt reduction occurred, and the amount of the debt was used in respect of an allowance asset, the reduction amount must (to the extent that a deduction or allowance was granted in respect of the expenditure relating to the debt, and to the extent that para 12A has not been applied in respect of that allowance asset to reduce the base cost to zero)[101] be deemed for the purposes of s 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 is reduced.[102]

Where the debt reduction occurred in respect of expenditure used in the acquisition, creation or improvement of an allowance asset, s 19(7) limits the aggregate amount of the deductions and allowances allowable to that person in respect of that allowance asset to 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 the reduction amount in respect of that debt and the aggregate amount of all deductions and allowances previously allowed

[100] Section 19(1) read with para 1 of the Eighth Schedule.

[101] Under the new provisions, the base cost is reduced before a recoupment is triggered.

[102] Section 19(6).

to that person in respect of that allowance asset. Essentially, s 19(7) resets the tax value on which deductions or allowances can be claimed following a debt reduction. According to Davis, Olivier and Urquhart, the purpose of s 19(7) is to allow deductions equal to the 'economic' cost of the allowance asset.[103]

The original wording of s 19(6) in the Taxation Laws Amendment Act 2012 referred to expenditure incurred 'in the acquisition, creation or improvement of an allowance asset'. This phrase was replaced by the Taxation Laws Amendment Act 2013 by the phrase 'in respect of an allowance asset'. The reason for the amendment in the wording is unclear from the *2013 Explanatory Memorandum*. It is submitted that a potential reason for amended wording, is that the phrase 'acquisition, creation or improvement' is more restrictive than the phrase 'in respect of', with the result that the amended wording leads to the application of s 19(6) to more scenarios than prior to the amendment.

2.5 Para 12A

Paragraph 12A regulates the capital gains tax consequences of the reduction of debt. Similarly to s 19, para 12A does not apply to tax debts.[104] The capital gains tax consequences of debt reduction are also set out with reference to a 'reduction amount', being

> 'any amount by which that debt is reduced less any amount applied by that person as consideration for that reduction.'[105]

As mentioned in 2.3 above, para 12A(2) provides that this paragraph applies where a debt that is owed by a person is reduced by any amount, and the amount of the reduction exceeds the consideration given for the reduction, in circumstances where the relevant debt was used, directly or indirectly, to fund any expenditure, other than expenditure in respect

[103] *South African Income Tax: Legislation and Commentary* Chapter II The Taxes (ss 5 – 64C), Part I Normal Tax (ss 5 – 37H) s 19.

[104] Paragraph 12A(1).

[105] Paragraph 12A(1).

of which a deduction or allowance was granted in terms of the Act, or to fund any expenditure incurred in respect of an allowance asset.

Paragraph 12A(3) provides that where the relevant debt was used to fund expenditure incurred in respect of an asset that is held by that person at the time of the reduction of the debt, the base cost of the asset must be reduced by the reduction amount.

In addition, para 12A(4) applies where a debt is reduced, and that debt was used to fund expenditure incurred in the acquisition, creation or improvement of an asset (other than an allowance asset), irrespective of whether the asset is held or not at the time of the reduction. In such instance, para 12A(4) applies to reduce a person's assessed capital loss by the amount of the debt reduction, less the portion of the reduction amount that has already reduced the base cost of the asset to nil, as contemplated in para 12A(3).

Should an *asset (other than an allowance asset)* no longer be held by the debtor at the time of the debt reduction, para 12A(3) will not apply, and the only capital gains tax consequence for that debtor will be the reduction of the assessed capital loss in terms of para 12A(4). Furthermore, to the extent that an *allowance asset* is no longer held by the debtor at the time of the debt reduction, neither the provisions of para 12A(3), nor para 12A(4) will apply to that debt reduction in respect of the allowance asset. The result is that only s 19(6) will apply to a reduction of debt used to fund an allowance asset no longer held by the debtor.

According to the *Draft SARS Capital Gains Tax Guide*, in an effort to prevent double taxation, para 12A(4) does not apply where the asset was acquired directly from the creditor, where the asset was disposed of during that year of assessment, and where the debt is reduced after the disposal, during that year of assessment.[106] Should this be the case, then para 20(3)(*b*) will apply to reduce the base cost of the asset, and any excess will result in a reduction in the debtor's capital loss.[107]

[106] *Draft SARS Capital Gains Tax Guide,* p 129.

[107] *Draft SARS Capital Gains Tax Guide,* p 129.

Where the assets are no longer held at the time of the debt reduction, the assessed capital loss or the base cost of the asset may be reduced by either para 12A(4) or para 20(3)(*b*).[108]

The wording of para 12A(4) was amended by the Taxation Laws Amendment Act 2013 to refer to expenditure incurred 'in respect of an asset'.[109] The Taxation Laws Amendment Act 2014, however, changed the wording back to 'the acquisition, creation or improvement of an asset'.[110] The *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2014* simply indicates that the purpose of the amendment is to reflect the correct position of the words.[111] It is submitted that the amendment reduces the circumstances to which para 12A(4) would apply.

Paragraph 12A(5) applies to pre-valuation date assets, being assets acquired prior to 1 October 2001. Para 12A(5) determines that in the case of pre-valuation date assets, the debtor is treated as having disposed of the asset immediately before the debt reduction for an amount equal to the market value of that asset at that time,[112] and immediately reacquired that asset at that same time for expenditure equal to the market value of the asset, adjusted for any capital gain or capital loss that would have been determined had that asset been disposed of at that time for proceeds equal to the market value thereof.[113] The result is that pre-valuation date assets are converted to a post-valuation date asset.[114]

The exemptions to the application of para 12A as contained in para 12A (6) and (7) are discussed in Chapter 3 below.

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[108] *Draft SARS Capital Gains Tax Guide,* p 129.

[109] Section 127(1)(*d*).

[110] Section 82(1)(*b*).

[111] At page 88.

[112] Paragraph 12A(5)(*a*).

[113] Paragraph 12A(5)(*b*).

[114] *Draft SARS Capital Gains Tax Guide,* p 126.

2.6 Summary of the debt reduction provisions

The provisions of s 19 and para 12A as discussed in 2.4 and 2.5 above can be summarised as follows:

The purpose of the expenditure	**Section 19**	**Paragraph 12A**
Trading stock held and not disposed of	Section 19(3) - Reduce the amount taken into account in terms of s 11(*a*) or 22(1) or (2).	N/A
	Section 19(4) – Recoup the balance of the reduction amount in terms of s 8(4)(*a*) to the extent that the amount taken into account in terms of s 11(*a*) or 22(1) or (2) has been reduced to zero in terms of s 19(3), and to the extent that a deduction or allowance has been granted in respect of that expenditure.	
Other expenditure (operating expenditure)	Section 19(5) – Recoup the reduction amount in terms of s 8(4)(*a*) to the extent that a deduction or allowance was granted in respect of that expenditure.	N/A

Allowance assets held	Section 19(6) – Recoup the reduction amount in terms of s 8(4)(*a*) to the extent that the base cost of the asset has not been reduced to zero in terms of para 12A(3) and to the extent that a deduction or allowance was granted.	Paragraph 12A(3) – Reduce the base cost of the asset with the reduction amount.
	Section 19(7) - The aggregate amount of the deductions and allowances allowable in respect of the allowance asset is limited to 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 the reduction amount in respect of that debt and the aggregate amount of all deductions and allowances previously allowed to that person in respect of that allowance asset.	
Allowance assets not held	Section 19(6) – Recoup the reduction amount in terms of s 8(4)(a) to the extent that a deduction or allowance was granted.	N/A

Capital assets held (other than allowance assets)	N/A	Paragraph 12A(3) – Reduce the base cost of the asset with the reduction amount.
		Paragraph 12A(4) – Reduce the assessed capital loss with the balance of the reduction amount to the extent that the base cost of the asset has been reduced to zero in terms of para 12A(3).
Capital assets not held (other than allowance assets)	N/A	Paragraph 12A(4) – Reduce the assessed capital loss with the reduction amount.

2.7 Comparative calculation

As discussed in 2.2 above, the order of application of the old provisions was firstly that the debtor's balance of assessed loss was reduced in terms of proviso (ii) to s 20(1)(*a*), secondly that a recoupment was triggered in terms of s 8(4)(*m*), and finally that a deemed disposal for capital gains tax purposes was triggered in terms of para 12(5)(*a*). Under the new regime, para 12A is applied first to reduce the base cost of the allowance asset, and thereafter, to the extent that the entire reduction amount has not been applied to reduce the base cost of the allowance asset, the residue will lead to taxable income in terms of s 19(6).[115] As a result, the corporate taxpayer's immediate tax liability is reduced, and a larger capital gain will be triggered upon the future disposal of the allowance asset, which

[115] *2012 Explanatory Memorandum*, p 45.

gain is taxed at 18,84%,[116] as opposed to an immediate gross income inclusion, which is taxed at 28%.

The *2012 Explanatory Memorandum* provides an illustrative example of the application of the new provisions:[117]

> 'Facts: Company Y borrows R3,5 million. Company Y applies all of the borrowed funds to acquire a plant. Company Y depreciates the plant by R3 million, leaving R500 000 of base cost (R3,5 million less the R3 million of depreciation). The lender subsequently cancels R3 million of the debt.
>
> Result: The R3 million of the cancelled debt will initially be applied towards the capital portion (reducing the base cost of the plant to [sic] R500 000 to zero)[118]. The remaining R2,5 million will be viewed as having been applied against the previously depreciated portion (resulting in ordinary revenue of R2 million [sic]).'

It is respectfully submitted that the *2012 Explanatory Memorandum* is incorrect. The total reduction amount is R3 million. R500 000 is applied to reduce the base cost of the plant. The residue of R2,5 million must be recouped to income, resulting in taxable income of R2,5 million, as opposed to R2 million.

If the previous debt reduction regime is applied to the example above, in circumstances where the debtor is not in an assessed loss position, it will result in higher taxable income, and thus a higher tax liability in the year of assessment during which the debt reduction occurs. The R3 million of the cancelled debt will initially be applied towards the previously depreciated portion in terms of s 8(4)(*m*), resulting in taxable income of R3 million. As the entire reduction amount has already been taken into account, the residual provisions of para 12(5) will not be taken into account to reduce the base cost of the depreciable asset.

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[116] The capital gains tax inclusion rate is determined in terms of para 10. In terms of item (*c*) a corporate taxpayer's taxable capital gain is 66.6%. When 66.6% of the capital gain is subjected to normal tax at 28%, the result is that capital gains tax of 18.84% is ultimately payable upon a capital gain made by the corporate taxpayer.

[117] *2012 Explanatory Memorandum*, p 45-46.

[118] It is submitted that this should have read 'from R500 000 to zero'.

The new debt reduction provisions clearly provide relief to the debtor in the example above. Under the previous provisions, the debtor would have suffered a tax cost of R840 000,[119] whereas under the new provisions, the debtor will suffer a tax cost of only R700 000.[120] Even though the debtor will realise an increased capital gain on the eventual disposal of the plant, the immediate financial impact results in a saving of R140 000. This is not a large saving, but it will nevertheless assist a debtor in financial distress.

2.8 Conclusion

The previous debt reduction provisions contained in proviso (*ii*) to s 20(1)(*a*), s 8(4)(*m*) and para 12(5) functioned on a similar recoupment and reduction in cost basis to the new debt reduction provisions contained in s 19 and para 12A. The various recoupment and cost reduction mechanisms are, however, applied in a different order in terms of s 19 and para 12A.

In terms of the new debt reduction provisions in s 19 and para 12A, the tax consequences of debt reduction is determined with reference to the purpose for which the reduced debt was used. As such, s 19 and para 12A differentiates between the tax consequences in the case of debt used to fund trading stock, operating expenditure, allowance assets and capital assets other than allowance assets.

The objectives of the new debt reduction provisions in s 19 and para 12A are to accommodate debtors in financial distress by reducing the immediate tax liability arising from the debt reduction and by preventing double taxation.[121] The comparative calculation performed in 2.7 above illustrates that the objective of s 19 and para 12A to reduce the immediate tax liability is met, as the application of s 19 and para 12A lead to an immediate saving of R140 000 for the debtor, as well as the postponement of the realisation of a

[119] R3 000 000 taxed at a rate of 28%.

[120] R2 500 000 taxed at a rate of 28%.

[121] *Draft SARS Capital Gains Tax Guide*, p 126 and the *2012 Explanatory Memorandum*, p 43.

capital gain in the hands of that debtor. This will certainly aid a taxpayer in financial distress.

3. EXEMPTIONS

Section 19(8) and para 12A(6) set out various circumstances in which the new debt reduction provisions will not apply. Both s 19 and para 12A will not apply in the following circumstances: (i) where the debtor is an heir or legatee of a deceased estate and the debt is owed to that estate, and the debt forms part of the property of the deceased estate for the purposes of the Estate Duty Act 45 of 1955,[122] (ii) where the debt is reduced by way of donation or deemed donation,[123] and (iii) where the debtor owes the debt to his employer, to the extent that the debt is reduced as contemplated in para 2(*h*) of the Seventh Schedule.[124] In addition to the exemptions mentioned above, para 12A will also not apply in the following circumstances: (i) where the debtor and creditor form part of the same group of companies as defined in section 41,[125] and (ii) where the debtor is a company and the debt reduction occurs in the course of the liquidation, winding up, deregistration or final termination of the existence of that company.[126]

As mentioned in Chapter 2, there were no exemptions from the ss 20(1)(*a*) and 8(4)(*m*) regime. Paragraph 12(5)(*a*) did not apply in the following circumstances: (i) the amount of the debt reduction constituted a capital gain in terms of proviso (*ii*) to para 3(*b*),[127] (ii) the amount of the debt reduction has been taken into account in terms of s 8(4)(*m*) or proviso (*ii*) to s 20(1)(*a*), para 2(*h*) of the Seventh Schedule or para 20(3),[128] (iii) the debtor and creditor formed part of the same group of companies,[129] and (iv) the debt reduction took place in the course of liquidation or deregistration of a company.[130] Of these exemptions to para 12(5)(*a*), the exemptions relating to para 2(*h*) of the Seventh Schedule, groups of

[122] Section 19(8)(*a*) and para 12A(6)(*a*).

[123] Section 19(8)(*b*) and para 12A(6)(*b*).

[124] Section 19(8)(*c*) and para 12A(6)(*c*).

[125] Paragraph 12A(6)(*d*).

[126] Paragraph 12A(6)(*e*).

[127] Proviso (*aa*)(A) to para 12(5)(*a*).

[128] Proviso (*aa*)(B) to para 12(5)(*a*).

[129] Proviso (*bb*) to para 12(5)(*a*).

[130] Proviso (*cc*) to para 12(5)(*a*).

companies and the liquidation or deregistration of companies have been included in para 12A(6).[131] These two exemptions have not been extended to s 19(8). The significance of this exclusion from s 19(8) is discussed in 3.2 and 3.3 below. The exemptions relating to donations tax and estate duty were not present in para 12(5)(*a*), and was introduced to both para 12A(6) and s 19(8).[132]

This chapter critically analyses certain of the exemptions to the new debt reduction provisions and identifies instances where the application of these exemptions is unclear. This chapter only considers debt reductions in commercial contexts, and accordingly, this chapter addresses only the exemptions relating to the reduction of debt which (i) constitutes a donation or a deemed donation,[133] (ii) the reduction of debt between companies forming part of the same group of companies,[134] and (iii) the reduction of debt in the course of the liquidation or deregistration of a company.[135]

3.1 Donations or deemed donations

Both s 19(8)(*b*) and para 12A(6)(*b*) provide that the respective provisions of s 19 and para 12A will not apply:

> '(*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'.[136]

Should the debt reduction be subject to donations tax, the debtor will not suffer recoupments or reductions in cost in terms or s 19 or para 12A, and the creditor will be taxed at 20% on the reduction amount. Should this exemption apply, many taxpayers would be able to reduce debt without the debtor suffering recoupments or reductions in cost in

[131] See paras 12A(6)(*d*) and (*e*).

[132] Sections 36(1) and 108(1) of the Taxation Laws Amendment Act, 2012.

[133] Section 19(8)(*b*) and para 12A(6)(*b*).

[134] Paragraph 12A(6)(*d*).

[135] Paragraph 12A(6)(*e*).

[136] Section 58 refers to transactions that are deemed to be donations.

terms of s 19 or para 12A, and without the creditor being subject to donations tax by virtue of the many exemptions contained in s 56. Especially in a commercial context, donations may be exempt by virtue of the fact that the donor is a public company,[137] or the donee is a South African tax resident and the donor and donee form part of the same group of companies.[138] The *Draft SARS Capital Gains Tax Guide* acknowledges that it is not required for the transaction to be subject to donations tax for this particular exemption to apply.[139]

3.1.1 The meaning of 'donation'

The term 'donation' is defined in s 55(1) as

> '…any gratuitous disposal of property including any gratuitous waiver or renunciation of a right'.

The expression 'gratuitous disposal' for the purposes of donations tax has been considered by the Appellate Division in *Welch's Estate v Commissioner, South African Revenue Service*.[140] The court concluded that it was not the intention of the legislature to alter the common law meaning of the term 'donation' by way of the insertion of the definition in s 55.[141] Clegg and Stretch also submit that

> 'there does not seem to be a difference between the essential characteristics of a donation at common law and those of a donation under the Income Tax Act, and there is no doubt that every donation at common law would be one governed by the Income Tax Act.'[142]

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[137] Section 56(1)(*n*).

[138] Section 56(1)(*r*).

[139] *Draft SARS Capital Gains Tax Guide,* p 132.

[140] 2005 (4) SA 173 (SCA). This was an appeal from the decision of the Cape Provincial Division, reported as *Commissioner, South African Revenue Service v Welch's Estate* 2003 (1)(SA 257 (C).

[141] *Welch* at para 35. The court commented at paras 26 and 27 that Meyerowitz came to the contrary conclusion, relying on the decision in *Commissioner for Inland Revenue v Estate Hulett* 1990 (2) 786 (A) at 797H-J. Marais JA criticises Meyerowitz' view, attributing the incorrect view to a misinterpretation of the *Hulett* case.

[142] Clegg D and Stretch R 'Income Tax in South Africa' §29.2.2. Last updated March 2014.

The essential characteristics of this common law definition are the elements of 'pure liberality' and 'disinterested benevolence'.[143] In this regard, Marais JA referred to the definition of 'gratuitous' in the *Shorter Oxford English Dictionary*,[144] and found that the word in the context of donations tax meant 'without obligation', 'for no return', or 'without any quid pro quo being given or expected'. The court concluded that these meanings are indicative of the existence of pure liberality or disinterested benevolence.[145] Finally, the court stated that should a view be followed that the meaning of 'donation' in s 55 is ambiguous, the provision must be interpreted contra fiscum.[146]

It is clear from the Supreme Court of Appeal's decision in *Welch* that the common law elements of liberality and generosity must be present for the purposes of a s 55 donation. In a commercial context, a debt typically arises based on agreement, and the reduction of a debt does not typically occur out of the benevolence of the creditor.[147] Commercial debt reductions are more likely to be based on commercial drivers, such as economic circumstances preventing the debtor from settling the debt, the need to establish liquidity or solvency in the debtor entity, or the need to improve the debtor entity's balance sheet.[148] Rudnicki and Bird submit that just as a donation will not arise based on the inability of a

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[143] *Welch* at para 30. The common law concept of 'donation' was described by the Appellate Division in *Ovenstone v Secretary for Inland Revenue* 1980 (2) SA 721 (A) at 736H as a disposition of property 'gratuitously out of liberality or generosity'. Also see *Avis v Verseput* 1943 AD 331 at 345, 377 and ITC 1545 54 SATC 464.

[144] *Welch* at para 31.

[145] *Welch* at para 32.

[146] *Welch* at para 35.

[147] Rudnicki M and Bird N 'The Debt-Waiver Rules and their Exemptions' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 4 52, 58.

[148] KPMG 'Debt Waivers: Reduction/Cancellation of Debt' SAIT. Available at http://www.thesait.org.za/news/136102/Opinion-Debt-Waivers-ReductionCancellation-of-debt-.htm. Accessed on 21 November 2014.

debtor to settle a debt due to insolvency or due to liquidity constraints, it is unlikely that debt reduction in most corporate scenarios would fall within the ambit of donations tax.[149]

Although it may be argued that to the extent that a debt reduction is 'without obligation', 'for no return' or 'without any quid pro quo being given' to the creditor reducing the debt, such reduction will be a donation, it remains doubtful that the common law elements are present in the case of a commercial transaction. Furthermore, where a creditor reduces a debt owed by its wholly owned subsidiary, it is doubtful that a donation as envisaged in s 55(1) is present, as a set off may occur between the reduction of the debt and the increase in the value of the shares in the subsidiary.[150]

3.1.2 The meaning of 'deemed donation'

Section 58(1) defines a 'deemed donation' as the disposal of property

> 'for a consideration which, in the opinion of the Commissioner, is not an adequate consideration…'.

Meyerowitz indicated that it appears to have been the intention of the legislature that the intention to donate must also be present in the case of a deemed donation, although unfortunately, the wording of s 58(1) does not seem to reflect this intention.[151] For this reason, Meyerowitz concludes that animus donandi is not a requirement for a donation under s 58(1),[152] which conclusion was confirmed by the court in the *Welch* case, albeit obiter.[153]

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[149] Rudnicki M and Bird N 'The Debt-Waiver Rules and their Exemptions' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 4 52, 59.

[150] KPMG 'Debt Waivers: Reduction/Cancellation of Debt' SAIT. Available at http://www.thesait.org.za/news/136102/Opinion-Debt-Waivers-ReductionCancellation-of-debt-.htm. Accessed on 21 November 2014.

[151] Meyerowitz D *Meyerowitz on Income Tax* (2007/2008) para 31.5.

[152] Meyerowitz D *Meyerowitz on Income Tax* (2007/2008) para 31.5.

[153] *Welch* at para 34.

The term 'adequate consideration' is not defined in the Act. As it is a presumption in statutory interpretation that different words are used to convey different meanings,[154] it is submitted that the legislature did not intend that this term should bear the same meaning as 'value', which term is also used in s 58(1). The *Draft SARS Capital Gains Tax Guide* confirms that SARS takes the view that 'adequate consideration' and 'fair market value' do not necessarily bear the same meaning.[155] Furthermore, what one person considers to be adequate consideration for a particular disposal, may not constitute adequate consideration in the opinion of another person.

Rudnicki and Bird submit that in considering the adequacy of consideration, the test must not be purely objective.[156] They explain that the consideration must be considered in light of all the circumstances surrounding the transaction, and particularly, the circumstances prevailing between the parties to the debt reduction.[157] Marais JA in the *Welch* case added that the consideration should not be illusory or insubstantial.[158]

According to Olivier, SARS should not be successful in imposing donations tax in terms of s 58(1) upon the shareholders or creditors of an insolvent company in circumstances where the company's loan accounts are capitalised. The reason is that the loan account, which is a worthless asset, is exchanged for another worthless asset, being the shares in the insolvent company. The result is that the loan account is not disposed of for less than its market value.[159] The *Draft SARS Capital Gains Tax Guide* explains that when the sole shareholder of a company partially reduces a shareholder's loan account, or where loans between wholly owned group companies are partially reduced, the shareholder's estate will not

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[154] Du Plessis LM 'Statute law and interpretation' in WA Joubert *LAWSA* 25(1) (2005) para 347.

[155] *Draft SARS Capital Gains Tax Guide,* p 133.

[156] Rudnicki M and Bird N 'The Debt-Waiver Rules and their Exemptions' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 4 52, 61.

[157] Rudnicki M and Bird N 'The Debt-Waiver Rules and their Exemptions' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 4 52, 61.

[158] *Welch* at para 47.

[159] Olivier, L 'Reduction or discharge of debts: the hidden dangers' *Stellenbosch Law Review* 2006 2 302, 310. Also see De Koker AP and Williams RC *Silke on South African Income Tax* (Online edition) §23.1.

necessarily be impoverished, as the value of the shares would increase with a corresponding amount. As a result, SARS is unlikely to view the consideration as being inadequate for the purposes of s 58(1).[160]

The difficulty with deemed donations is that following the letter of the law may lead to absurd consequences. Rudnicki and Bird use the example of a motor dealership selling a vehicle at a discount. They submit that SARS is unlikely to treat the transaction as a deemed donation for the purposes of s 58(1), as it is clearly a transaction motivated by commercial reasons, despite the fact that the purchaser of the vehicle may have paid inadequate consideration for the vehicle.[161]

Rudnicki and Bird submit that it is unlikely that a debt reduction in a corporate context will be treated as a deemed donation for the purposes of s 58(1).[162] They explain that as the provisions of s 19 and para 12A were introduced specifically to impose tax on debt reduction transactions, it is unlikely that SARS would exercise the discretion to impose donations tax on a debt reduction transaction in a corporate context, as one of the exemptions from donations tax as set out in s 56 may result in the debt reduction not being subject to s 19, para 12A or donations tax.[163]

3.2 Debt reduction within a group of companies

Intragroup debt often arises where one company advances a loan to another group company, or where one company sells goods or renders services to another group company, and the consideration for these goods or services remains outstanding on loan account.

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[160] *Draft SARS Capital Gains Tax Guide*, p 133-134.

[161] Rudnicki M and Bird N 'The Debt-Waiver Rules and their Exemptions' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 4 52, 60.

[162] Rudnicki M and Bird N 'The Debt-Waiver Rules and their Exemptions' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 4 52, 60.

[163] Rudnicki M and Bird N 'The Debt-Waiver Rules and their Exemptions' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 4 52, 60.

Paragraph 12A(6)(*d*) provides that the debt reduction provisions in para 12A do not apply to a debt owed by one company to another, where those companies form part of the same group of companies as defined in s 41. This exemption will, however, not apply where the debt reduction in question forms part of any transaction, operation or scheme entered into to avoid any tax imposed by the Act and –

> '(*i*) that debt (or any debt issued in substitution for that debt) was acquired directly or indirectly from a person who does not form part of that group of companies; or
>
> (*ii*) that company or that other company became part of that group of companies after that debt (or any debt issued in substitution for that debt) arose'.[164]

The term 'group of companies' is defined in s 1. The s 41 definition is, however, narrower that the s 1 definition. Section 41 requires 70% direct or indirect shareholding between companies, and companies that are not South African tax residents are excluded from this definition. The *Draft SARS Capital Gains Tax Guide* indicates that this exemption will only apply when both companies are 'fully within the tax system'.[165] The *Draft SARS Capital Gains Tax Guide* explains that this means that a reduction in base cost under para 12A(3) or a reduction in assessed capital loss under para 12A(4) must be matched by a capital loss on disposal of the debt for a creditor under para 56(1).[166]

From a capital gains tax perspective, debt reduction may give rise to a capital loss in the hands of the creditor,[167] which capital loss must be disregarded in terms of para 56(1) in circumstances where the debt is owed to a connected person.[168] A capital loss resulting from the debt reduction in favour of a connected person may still arise in the hands of the

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[164] Paragraph 12A(6)(*d*).

[165] *Draft SARS Capital Gains Tax Guide,* p 135.

[166] *Draft SARS Capital Gains Tax Guide,* p 135.

[167] Rudnicki M and Bird N 'The Debt-Waiver Rules and their Exemptions' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 4 52, 55.

[168] The term 'connected person' is defined in s 1.

creditor, in circumstances where the debt reduction resulted in either a reduction on the base cost of an asset, or in the reduction of any assessed capital loss of the debtor.[169]

Rudnicki and Bird submit that this results in tax consistency as between the debtor and creditor in the case of an intragroup debt reduction, as no capital gains tax implications arise in the hands of the debtor by virtue of the application of the para 12A(6)(*d*), and para 56 will prevent the creditor from claiming a capital loss.[170] In circumstances, however, where the para 12A(6)(*d*) exemption does not apply, the creditor should be entitled to claim a capital loss.[171]

The para 12A(6)(*d*) exemption is absent from s 19(8). Rudnicki and Bird submit that

> 'the likely reason for this is that section 19 will apply where a tax benefit or deduction has historically been granted to the debtor based on the purpose for which the loan was used, i e it may have been used to fund the acquisition of trading stock, other deductible expenditure (say in the form of salaries), or allowance assets on which capital allowances have been claimed. A "base cost" for [capital gains tax] purposes, however, does not trigger a tax benefit until the "disposal" of the related asset.'[172]

It is unclear exactly how Rudnicki and Bird's submission explains the absence of the group of companies exemption from s 19(8). A possible interpretation of their submission is that the legislature would be willing to be more lenient in respect of the capital gains tax consequences triggered by para 12A than in respect of the normal tax consequences triggered by s 19, as the tax effect of para 12A is effectively deferred until the disposal of the relevant asset, whereas the application of s 19 would lead to an immediate tax effect in the form of either a reduction in cost or a recoupment.

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[169] Rudnicki M and Bird N 'The Debt-Waiver Rules and their Exemptions' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 4 52, 55.

[170] Rudnicki M and Bird N 'The Debt-Waiver Rules and their Exemptions' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 4 52, 55.

[171] Rudnicki M and Bird N 'The Debt-Waiver Rules and their Exemptions' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 4 52, 55.

[172] Rudnicki M and Bird N 'The Debt-Waiver Rules and their Exemptions' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 4 52, 56.

As tax consequences may arise both in terms of s 19 and para 12A in the context of allowance assets, it is unclear how the para 12A(6)(*d*) exemption will apply to debt reduction in circumstances where the debt was used to fund allowance assets.[173] Rudnicki and Bird illustrate this uncertainty by way of an example.[174] Their example can be summarised as follows: A debtor receives a loan of R100 from a company forming part of the same group of companies as that debtor. The debtor uses the loan to fund the acquisition of a building. The debtor has claimed tax allowances of R40 in respect of the building. The debtor is only able to repay R30 of the loan, and the remaining R70 is subject to a debt reduction.

Rudnicki and Bird explain that in respect of allowance assets, para 12A(3) would firstly be applied to reduce the base cost of the asset with the reduction amount. As the para 12A(6)(*d*) exemption would apply in their example, no reduction in base cost will occur.[175] The next step is to apply s 19(6), which provides that a recoupment must take place to the extent that (i) a deduction or allowance was previously claimed, and (ii) para 12A has not been applied to reduce the base cost of the asset to zero. From this example, it is not clear whether the result of the application of s 19(6) is that the debtor will recoup (i) R10, being the R70 reduction amount reduced by R60, representing the reduction in base cost that would have taken place, had the debt reduction not been exempt from para 12A, or (ii) R40, being a recoupment of the allowances claimed by the debtor in respect of the building.[176]

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[173] Rudnicki M and Bird N 'The Debt-Waiver Rules and their Exemptions' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 4 52, 56.

[174] Rudnicki M and Bird N 'The Debt-Waiver Rules and their Exemptions' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 4 52, 56.

[175] Rudnicki M and Bird N 'The Debt-Waiver Rules and their Exemptions' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 4 52, 56.

[176] Rudnicki M and Bird N 'The Debt-Waiver Rules and their Exemptions' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 4 52, 57.

Rudnicki and Bird submit that the correct interpretation is that R40 must be recouped under s 19(6).[177] They point out, however, that this interpretation is inconsistent with the tax implications that would arise upon the disposal of an allowance asset.[178] This is illustrated by them with reference to the same example above, except that the asset is disposed of for R70, as opposed to a debt reduction having taken place. Should the debtor in this example have disposed of the asset for R70, a recoupment of only R10 would have arisen (the proceeds of the disposal less the base cost of the asset, which is calculated by deducting the R40 allowances previously claimed from the R100 cost of acquisition).[179]

It is clear from Rudnicki and Bird's reasoning, that the interaction of the para 12A(6)(*d*) exemption with s 19(6) does not accord with the purpose of the new debt reduction provisions, as explained in the *2012 Explanatory Memorandum* and the *Draft SARS Capital Gains Tax Guide*, which purpose is to accommodate debtors in financial distress by reducing the immediate tax liability arising from the debt reduction and by preventing double taxation.[180]

It is submitted that the same difficulties in respect of the application of s 19(6) will arise should the exemption in para 12A(6)(*e*) (discussed in 3.3 below) apply to a debt reduction in respect of allowance assets.

3.3 Debt reduction in the course of the liquidation of companies

Paragraph 12A(6)(*e*) provides that para 12A does not apply where the debtor is a company which is a connected person in relation to the creditor and that reduction or discharge was made in the course or in anticipation of the liquidation, winding up, deregistration or final termination of the corporate existence of that company. The term 'connected person' is

[177] Rudnicki M and Bird N 'The Debt-Waiver Rules and their Exemptions' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 4 52, 57.

[178] Rudnicki M and Bird N 'The Debt-Waiver Rules and their Exemptions' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 4 52, 57.

[179] Rudnicki M and Bird N 'The Debt-Waiver Rules and their Exemptions' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 4 52, 57.

[180] *Draft SARS Capital Gains Tax Guide*, p 126 and the *2012 Explanatory Memorandum*, p 43.

defined in s 1. For example, a debtor and creditor will be connected persons where the one party holds at least 50% of the shareholding in the other party.[181]

This exemption applies to the extent that the amount of the reduction or discharge does not exceed the amount of the creditor's base cost expenditure for the purposes of para 20 in respect of the debt at the time of the reduction or discharge.[182] In addition, this exemption does not apply if the debtor becomes a connected person in relation to that creditor after the debt (or any substituted debt) arose, and these transactions are part of a scheme to avoid any tax.[183]

In circumstances where the debtor company (i) fails to take the necessary steps to liquidate, wind up, deregister or finally terminate its existence within 36 months of the debt reduction, or (ii) when such steps have been taken, but have subsequently been withdrawn, or (iii) when that company does anything to invalidate any such steps taken,[184] then this exemption will no longer apply. Paragraph 12A(7) provides that any tax that becomes payable as a result of the application of proviso (*bb*) to para 12A(6)(*e*) must be recovered from the relevant company and the connected person, who must be jointly and severally liable for that tax.

Rudnicki and Bird submit that this exemption makes sound commercial sense in light of the purpose of the new debt reduction provisions, which is to accommodate debtors in financial distress by reducing the immediate tax liability arising from the debt reduction and by preventing double taxation.[185]

There is no uncertainty as to the circumstances when this exemption will apply. It is, however, unclear why this exemption was not also included in s 19(8). In this regard,

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[181] Paragraph (d) of the definition of connected person in s 1.

[182] Paragraph 12A(6)(*e*).

[183] Proviso (*aa*) to para 12A(6)(*e*).

[184] Proviso (*bb*) to para 12A(6)(*e*). The necessary steps are listed in s 41(4).

[185] Rudnicki M and Bird N 'The Debt-Waiver Rules and their Exemptions' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 4 52, 62. *Draft SARS Capital Gains Tax Guide,* p 126 and the *2012 Explanatory Memorandum*, p 43.

Rudnicki and Bird provide the same explanation for this omission from s 19(8) as the explanation offered by these authors for the omission of the group of companies exemption from s 19(8) in 3.2 above. They submit that where a debt reduction occurs in a capital context, the debtor would typically not have been granted any historical tax benefits in the form of a tax deduction.[186] They add that the ability of a connected party creditor to claim a capital loss is limited by para 56, which results in consistent tax treatment of the debtor and the creditor.[187]

Despite this potential reason for the omission of the exemption of debt reductions in the course of the liquidation of companies from s 19(8), Rudnicki and Bird submit that:

> 'it seems almost uneconomical to levy income tax on recoupments arising in terms of section 19 of the Act, where a debt waiver or reduction has occurred (which historically funded tax deductible expenditure), especially in the context of a debtor whose legal existence is being terminated.'[188]

It was proposed to the Standing Committee on Finance that a similar exemption be included in s 19.[189] Although the proposal was not rejected outright, no steps have been taken by National Treasury to extend this exemption to s 19.[190] As a result, the hope remains that s 19(8) will in the future be amended to include the exemption relating to debt reduction in the course of liquidation or deregistration of companies.

It is submitted that the same interpretational difficulties in respect of the application of s 19(6), as evidenced by Rudnicki and Bird's illustrative example set out in 3.2 above, will

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[186] Rudnicki M and Bird N 'The Debt-Waiver Rules and their Exemptions' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 4 52, 62.

[187] Rudnicki M and Bird N 'The Debt-Waiver Rules and their Exemptions' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 4 52, 62.

[188] Rudnicki M and Bird N 'The Debt-Waiver Rules and their Exemptions' Business Tax & Company Law Quarterly 2014 Vol 5 Issue 4 52, 62.

[189] Rudnicki and Bird make the same recommendation. Rudnicki M and Bird N 'The Debt-Waiver Rules and their Exemptions' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 4 52, 62.

[190] *Standing Committee on Finance (SCOF): Report-Back Hearings, Response Document from National Treasury and SARS, as presented to SCOF*, 13 November 2012, para 6.8.

arise in circumstances where the exemption in para 12A(6)(*e*) applies to a debt reduction in respect of allowance assets. Rudnicki and Bird identified that it is unclear in circumstances where the para 12A(6)(*e*) exemption applies, whether s 19(6) must be applied (i) as though a reduction in the base cost of the asset in terms of para 12A(3) has taken place, or (ii) whether s 19(6) must be applied as though no reduction in base cost has taken place due to the application of the exemption. They conclude that the correct interpretation is that s 19(6) must be applied as though no reduction in base cost has occurred, and they furthermore submit that this leads to a more onerous tax effect than the effect that would have been triggered had the debtor disposed of the allowance asset without a debt reduction having occurred.[191]

It is clear from Rudnicki and Bird's reasoning, that the interaction of the para 12A(6)(*e*) exemption with s 19(6) does not accord with the purpose of the new debt reduction provisions, as explained in the *2012 Explanatory Memorandum* and the *Draft SARS Capital Gains Tax Guide*, which purpose is to accommodate debtors in financial distress by reducing the immediate tax liability arising from the debt reduction and by preventing double taxation.[192]

3.4 Conclusion

There are five exemptions from para 12A[193] and three exemptions from s 19.[194] This chapter addresses only the exemptions relating to the reduction of debt which (i) constitutes a donation or a deemed donation,[195] (ii) the reduction of debt between companies forming

[191] Rudnicki M and Bird N 'The Debt-Waiver Rules and their Exemptions' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 4 52, 57.

[192] *Draft SARS Capital Gains Tax Guide*, p 126 and the *2012 Explanatory Memorandum*, p 43.

[193] Paragraph 12A(6).

[194] Section 19(8).

[195] Section 19(8)(*b*) and para 12A(6)(*b*).

part of the same group of companies,[196] and (iii) the reduction of debt in the course of the liquidation or deregistration of a company.[197]

The exemptions relating to debt reduction between companies forming part of the same group of companies and debt reduction in the course of the liquidation or deregistration of companies which were contained in the now repealed para 12(5)(*a*) have been included in para 12A(6). The donations tax exemptions in s 19(8)(*b*) and para 12A(6)(*b*) have been introduced for the first time by the Taxation Laws Amendment Act, 2012.[198]

Unfortunately, the application of the donations tax exemption, as well as the effect of the application of the group of companies and the liquidation of companies exemptions, have led to uncertainty.

In respect of the donations tax exemption in s 19(8)(*b*) and para 12A(6)(*b*), the uncertainty stems from the interpretation of the concepts 'donation' and 'deemed donation' in ss 55(1) and 58(1), respectively. It is concluded that a donation for the purposes of s 55(1) requires an element of gratuity. It is furthermore concluded that a deemed donation for the purposes of s 58(1) does not require an element of gratuity, and that regard must only be had to the adequacy of the consideration received for the debt reduction. It is submitted, firstly, that subjective factors, including the circumstances as between the parties to the debt reduction, must be taken into account in determining the adequacy of the considerations, and secondly, that it is unlikely that SARS will exercise the discretion to invoke the provisions of s 58 in the case of a debt reduction in a commercial context, as the exercise of this discretion may lead to the debt reduction transaction falling wholly outside of the tax net.

In respect of the group of companies exemption in para 12A(6)(*d*) and the exemption relating to debt reductions in the course of the liquidation or deregistration of companies in para 12A(6)(*e*), it is concluded that determining whether or not these exemptions apply, should not lead to any difficulty. Complexities, however, arise when the interaction of para

[196] Paragraph 12A(6)(*d*).

[197] Paragraph 12A(6)(*e*).

[198] Section 36(1) and s 108(1).

12A(3) and s 19(6) in the case of a debt reduction where the debt was used to fund expenditure in respect of allowance assets is considered. It is unclear whether para 19(6) should be applied as if a reduction in base cost had been effected in terms of para 12A(3), despite the fact that this has not occurred based on the application of the exemptions in para 12A(6)(*d*) and (*e*). It is submitted that s 19(6) should not be applied as though a reduction of the base cost of the allowance asset occurred in terms of para 12A(3) in these circumstances, despite the fact that the result is somewhat punitive, and gives rise to a greater recoupment in the hands of the debtor than in the case of a disposal of assets subject to recoupment.[199]

Finally, it is unclear why the para 12A(6)(*d*) and (*e*) exemptions are absent from s 19(8). It is submitted that the legislature should extend these particular exemptions to s 19(8).

[199] Rudnicki M and Bird N 'The Debt-Waiver Rules and their Exemptions' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 4 52, 62.

4. PROBLEMATIC APPLICATION OF THE NEW DEBT REDUCTION PROVISIONS

In most cases, the application of the new debt reduction provisions should be relatively straightforward. Nevertheless, there are circumstances where the application of these provisions is unclear. In addition to the complexities identified in Chapter 3 regarding the application of the donations tax, group of companies and liquidation of companies exemptions in paras 12A(6)(*b*), (*d*) and (*e*), as well as the exclusion of the group of companies and the liquidation of companies exemptions from s 19(8), the following problematic circumstances have been identified: (i) where a debt reduction takes place in favour of a debtor carrying on mining operations, (ii) where inadequate tracing of debt has taken place; and (iii) where a debt is partially reduced. These circumstances are discussed in this chapter.

This chapter seeks to establish the practical problems experienced with the application of the debt reduction provisions as they relate to the circumstances described in the paragraph above.

4.1 Debt reduction in favour of debtors carrying on mining operations

It appears that the introduction of the new debt reduction provisions did not contemplate the complexities associated with debt reduction in the context of debtors carrying on mining operations (‘mining taxpayers’) with unredeemed capital expenditure balances. As discussed below, the application of s 19 and para 12A in addition to s 15(*a*) and s 36 may lead to double taxation.

The taxation of farming operations is regulated by the First Schedule to the Act. As the capital expenditure regime in terms of para 12 of the First Schedule is similar to the capital expenditure regime in terms of ss 15 and 36 relating to mining operations, the question arises as to whether the application of the new debt reduction provisions will be equally challenging in the case of a debtor conducting farming operations. As a result of these similarities, it is expected that similar problems are likely to arise in the case of debt

reduction in favour of a debtor carrying on farming operations with a balance of unredeemed capital expenditure.[200]

Section 15(*a*) provides for a tax deduction of an amount to be ascertained under the provisions of s 36. Mining capital expenditure as defined in s 36(11) that is incurred in terms of s 36(7C) is deductible from income derived from a producing mine ('mining income') in terms of the provisions of ss 36(7E), (7F) and (7G). For the purposes of this research, only the provisions of s 36(7E), which sets a general cap on mining capital expenditure, will be considered.[201]

The definition of capital expenditure in s 36(11) includes, inter alia, expenditure on shaft sinking and mine equipment, and expenditure on development, general administration and management (including any interest and other charges on loans utilized for mining purposes) prior to the commencement of production or during any period of non-production.[202] The result is that mining capital expenditure is not only incurred to fund assets, but it may also include certain capitalised costs, such as staff salaries. It is submitted that assets included in mining capital expenditure would constitute allowance assets, as the term 'allowance asset' is defined in para 12A(1) as:

> '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'.

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[200] A detailed examination of the application of s 19 and para 12A to farming operations falls beyond the scope of this research.

[201] Section 36(7F) deals with the so-called capital expenditure per mine ring-fence, which imposes a restriction that provides that tax deductible capital expenditure in relation to any one mine cannot exceed the taxable income derived by the taxpayer from mining on that particular mine. Section 36(7G) applies in the event that a taxpayer has taxable income from mining after a tax deduction of whatever capital expenditure that may be allowable in terms of ss 36(7E) and (7F). Section 36(7G) is irrelevant for the purposes of this research, as the very existence of a balance of unredeemed capital expenditure means that there was no taxable income from mining left after applying the provisions of s 36(7E).

[202] Section 36(11)(*a*) and (*b*). A mine is considered to be productive when drilling, blasting and the hauling of ore for the purposes of beneficiation occurs. See Geldenhuys BS and Tiedt T 'Quo Vadis … when Mining Companies Receive a Reduction or Cancellation of Debt?' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 1 21, 24.

A period of non-production as envisaged in s 36(11)(*b*) arguably exists when a mine is on care and maintenance. When a mine is on care and maintenance, it is temporarily closed down due to unfavourable economic conditions, with the aim to re-open once conditions are favourable again. During this non-productive period the mine must be maintained so as to be in a position to start mining again once conditions are favourable.[203] During such a period, it is likely that all expenditure incurred by the mine would be treated in accordance with s 36.[204]

Section 36(7E) provides that the tax deduction of the

> 'aggregate of the amounts of capital expenditure determined ... in respect of any year of assessment in relation to any mine or mines shall not exceed the taxable income ... derived by the taxpayer from mining.'

This subsection also provides that

> 'any amount by which the said aggregate would ... have exceeded such taxable income as so determined, shall be *carried forward* and be deemed to be an amount of capital expenditure incurred during the next succeeding year of assessment in respect of the mine or mines to which such capital expenditure relates' (emphasis added).

This means that the excess that is not tax deductible as a result of the provisions of s 36(7E) in the next tax year must again be carried forward, and will again be deemed to be an amount of capital expenditure incurred during the next succeeding year of assessment on the mine concerned. It is therefore by virtue of s 36(7E) that a mining taxpayer builds up a balance of unredeemed capital expenditure.

As discussed in 2.4 above, the provisions of s 19(3) to (6) apply where a debt that was reduced

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[203] Van Blerck MC *Mining Tax in South Africa* Second Edition 7-22.

[204] Geldenhuys BS and Tiedt T 'Quo Vadis … when Mining Companies Receive a Reduction or Cancellation of Debt?' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 1 21, 24.

> 'was used, directly or indirectly, to fund any expenditure in respect of which a deduction or allowance was *granted* in terms of this Act'[205] (emphasis added).

Geldenhuys and Tiedt state that:

> 'One of the basic principles of statutory interpretation is that different words are used to convey different meanings. It is accordingly submitted that *granting* a deduction or allowance and merely *allowing* the deduction or allowance should bear different meanings. Based on the wording and purpose of section 19 of the Act, it appears that the granting of a deduction or allowance refers to a situation where the taxpayer has within that year of assessment *received* the tax benefit, which benefit must be reversed as a result of the waiver.
>
> Accordingly, until such time as Capex[206] is accessed, it cannot be said that a deduction or allowance is *granted*.'[207]

Section 15 read together with s 36 *allows* the deduction of capital expenditure which is calculated in accordance with s 36 from taxable mining income during the year of assessment in which it was incurred, but limited to the various caps set out in ss 36(7E), (7F) and (7G).[208] Accordingly, until such time as the capital expenditure is accessed (i.e. set-off against mining income when the tax benefit is enjoyed by the taxpayer), it cannot be said that a deduction or allowance is *granted*. Therefore, on this alone, the provisions of ss 19(3) to (6) should not be applicable to the reduction of debts owed by mining taxpayers with a balance of unredeemed capital expenditure, as no deduction or allowance has actually been *granted* to that mining taxpayer in terms of s 15 read with s 36 (provided that the amount of the debt reduction does not exceed the amount of the balance of unredeemed capital expenditure), and thus no tax benefit (in the form of set-off against mining income) has been provided to that mining taxpayer.

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[205] Section 19(2).

[206] 'Capex' in this context refers to mining capital expenditure.

[207] Geldenhuys BS and Tiedt T 'Quo Vadis … when Mining Companies Receive a Reduction or Cancellation of Debt?' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 1 21, 26.

[208] Geldenhuys BS and Tiedt T 'Quo Vadis … when Mining Companies Receive a Reduction or Cancellation of Debt?' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 1 21, 25.

In essence, unredeemed capital expenditure is an amount of capital expenditure that is *allowed* as a deduction, but the deduction has not yet been *granted* for tax purposes in any particular tax year under the provisions of s 36(7E).[209]

Paragraph 12A(3) provides for the reduction in base cost of the relevant asset. The base cost of assets (including mining assets) is typically determined in terms of the provisions of para 20. In light, however, of the mechanism provided for in ss 15 and 36, it is unnecessary to individually track the cost of capital assets acquired, because the capital cost is pooled in terms of capital expenditure incurred and/or unredeemed capital expenditure carried forward and set-off against mining income in its entirety as and when mining income is generated. Therefore, as mining taxpayers do not typically keep track of the base cost of individual assets acquired by way of capital expenditure, it is impractical to expect mining taxpayers to reduce the base cost of these assets as envisaged in para 12A(3).

In addition, para (*j*) of the gross income definition in s 1 essentially provides for the recoupment of any amount received in respect of the disposal of an asset, the cost of which was included in capital expenditure for the purposes of a deduction under s 15(*a*), in the event that the proceeds in respect of the disposal of an asset exceeds the unredeemed capital expenditure balance.[210] In light of how the capital expenditure regime for mining taxpayers operates practically in terms of the provisions of the Act, it is impractical that the reduction in base cost as envisaged in terms of para 12A(3) be applied in the case of debt reductions in favour of mining taxpayers, where an unredeemed capital expenditure balance exists. Based on the submission that assets falling under mining capital expenditure are allowance assets, the provisions of para 12A(4) should not apply to these assets.

For purposes of s 36, 'expenditure' is defined as:

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[209] Geldenhuys BS and Tiedt T 'Quo Vadis … when Mining Companies Receive a Reduction or Cancellation of Debt?' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 1 21, 26.

[210] Geldenhuys BS and Tiedt T 'Quo Vadis … when Mining Companies Receive a Reduction or Cancellation of Debt?' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 1 21, 28.

> 'net expenditure after taking into account any rebates or returns from expenditure, regardless of when such last-mentioned expenditure was incurred'.[211]

In circumstances where a mining taxpayer incurred debt to fund capital expenditure as defined in s 36(11), and the debt has subsequently been reduced, then it is submitted that the balance of unredeemed capital expenditure must be adjusted by the amount so reduced, as this would constitute a 'rebate or return from expenditure' as envisaged in the definition of 'expenditure' in s 36(11), as discussed in the next paragraph.

It is submitted that the words 'rebate or return from expenditure' clearly contemplates a reduction of debt or a compromise with a creditor. The *Concise Oxford English Dictionary* includes under the definition of rebate 'a deduction or discount on a sum of money due'.[212]

Davis, Olivier and Urquhart state the following with regard to what is contemplated by a 'rebate or return from expenditure':[213]

> 'The concept of a rebate from expenditure, meaning a reduction in the amount of that expenditure, is clear. The linked concept of a return from expenditure is not. The word "return" in this type of context generally refers to a return on investment, as a percentage figure related to an amount or amounts invested. Here the reference is to expenditure, not investment, and the meaning must be similar to that of rebate. It is considered that a return from expenditure means an actual return of expenditure laid out, for whatever reason, whilst a rebate from that expenditure means a decrease in the amount of the expenditure originally incurred, without any return of funds.'

Based on Davis, Olivier and Urquhart's explanation above of the meaning of 'rebate or return from expenditure' in the definition of 'expenditure' in s 36(11), the reduction of debt in favour of a mining taxpayer with a balance of unredeemed capital expenditure should result in an adjustment to the capital expenditure balance, as the reduction effectively constitutes a rebate from the capital expenditure incurred, without any return of funds.

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[211] Section 36(11).

[212] Soanes, C. & Stevenson, A. (eds) (2004) *Concise Oxford English Dictionary*, p 1198.

[213] *South African Income Tax: Legislation and Commentary* Chapter II The Taxes (ss 5 – 64C), Part I Normal Tax (ss 5 – 37H) s 36.

A reduction in the unredeemed capital expenditure balance, in addition to a recoupment to income as envisaged in s 19(6), will result in a double taxation event in the hands of the debtor, as the same amount will reduce the unredeemed capital expenditure balance and be recouped to income. It is submitted that this is inconsistent with the purpose of the legislation, which is to accommodate debtors in financial distress by preventing double taxation.[214]

As discussed in 2.4.1.3 above, s 19(7) essentially resets the tax value on which deductions or allowances can be claimed following a debt reduction. In the context of mining taxpayers, by reducing the unredeemed capital expenditure balance by the full amount of the debt reduction, this ensures that the mining allowances provided in ss 15 and 36 can never be claimed in respect of expenditure, where the debt that funded such expenditure is subsequently reduced. To the extent that the amount of the debt reduction exceeds the amount of the balance of unredeemed capital expenditure, the mining taxpayer will have claimed an allowance in respect of a portion of the reduction amount, and therefore, the allowances so claimed will be recouped under the provisions of s 19(6).

Finally, to the extent that it may be argued that the new debt reduction provisions should nevertheless be applied to a debt reduction in the context of a mining taxpayer, it is submitted that the principle of statutory interpretation, generalia specialibus non derogant, dictates that where a general and a specific provision in an act are at odds, the specific provision must prevail. It is submitted that the provisions of ss 15 and 36 more specifically apply to mining taxpayers than those of s 19 and para 12A, and accordingly, the provisions of ss 15 and 36 must prevail in the case of a debt reduction involving a mining taxpayer, with the result that the debtor's balance of unredeemed capital expenditure will be reduced under para (*j*) of the gross income definition in s 1.

SARS' Binding Private Ruling 182 supports the conclusion above that the balance of unredeemed capital expenditure must be reduced in the case of a debt reduction where the debt was used to fund mining capital expenditure. The ruling was issued in November

[214] *Draft SARS Capital Gains Tax Guide*, p 126 and the *2012 Explanatory Memorandum*, p 43.

2014, and dealt with a debt reduction in favour of a mining company with a balance of unredeemed capital expenditure. The parent company of the mining company wished to dispose of its shareholding in the mining company to a purchaser. It was a condition of the sale and purchase agreement that certain of the mining company's debts be reduced. On the particular facts of the matter, the majority of the development expenditure in respect of the company's mine which was financed through loan funding still remained to be claimed as a deduction under s 15(*a*) read with s 36.

SARS ruled that the mining company must reduce its balance of unredeemed capital expenditure as contemplated in s 36(7E) with the reduction amount for purposes of claiming allowances under s 15(*a*) read with s 36, and to the extent that the loans reduced funded an allowance asset or a capital asset as defined in para 12A, the base cost of that asset must be reduced by the reduction amount as defined in para 12A.[215] It is unclear from the wording of the ruling whether (i) both the balance of unredeemed capital expenditure and the base cost of the capital assets and allowance assets must be reduced with the reduction amount, or (ii) whether para 12A must be applied to reduce the base cost of the capital assets and allowance assets, and the balance of unredeemed capital expenditure must be reduced only to the extent that the debt was used to fund expenditure other than in respect of capital assets or allowance assets.

Davis, Olivier and Urquhart submit that it is interesting to note that the provisions of s 8(4)(*a*) do not, inter alia, apply to the recoupment of allowances granted in terms of s 15 (dealing with mining operations) nor do they appear to apply to allowances granted in terms of para 12 of the First Schedule (dealing with farming operations).[216]

4.2 Tracing of debt and expenditure and partial debt reduction

As discussed in Chapter 2, the tax consequences of debt reduction under s 19 and para 12A are based on the purpose of the expenditure which the reduced debt was used to fund. For

[215] Binding Private Ruling 182, para 6.

[216] *South African Income Tax: Legislation and Commentary* Chapter II The Taxes (ss 5 – 64C), Part I Normal Tax (ss 5 – 37H) s 19.

example, if the debt that was reduced was used to fund allowance assets, the base cost of these assets would firstly be reduced in terms of para 12A(3), and then the balance of the reduction amount will be recouped in terms of s 19(6). It is conceivable that situations may arise where the debtor has not kept accurate track of the link between the debt and expenditure, or where this link is difficult to establish due to the fact that the debt was acquired a number of years ago and subsequent staff changes have led to the loss of this information.[217]

The issue of tracing is also relevant in the case where a debt is only partially reduced, and that debt was used to fund multiple types of expenditure addressed in the debt reduction provisions. A lacuna exists in that the legislation does not provide a method of allocation in these circumstances.[218] It may be difficult, if not impossible, for a debtor to link the part of the debt that was reduced to specific expenditure in circumstances where the debt funding was deposited in the debtor's bank account. In these situations, it is unclear from the legislation whether the debtor may choose an allocation of the reduction amount to certain expenditure. Should such an allocation be allowed, debtors will likely allocate the reduction amount first to allowance assets or other capital assets with high base costs.[219] The reason for this is that this allocation will lead to a lower immediate tax liability, based on the order of application of s 19 and para 12A, which will result firstly in the reduction of the high base cost of these assets before any recoupments are triggered.[220]

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[217] Musviba N 'Debt restructuring – practical considerations'. Available at http://sataxguide.co.za/debt-restructuring-practical-considerations/. Accessed on 22 September 2014.

[218] KPMG 'Debt Waivers: Reduction/Cancellation of Debt' SAIT. Available at http://www.thesait.org.za/news/136102/Opinion-Debt-Waivers-ReductionCancellation-of-debt-.htm. Accessed on 21 November 2014.

[219] KPMG 'Debt Waivers: Reduction/Cancellation of Debt' SAIT. Available at http://www.thesait.org.za/news/136102/Opinion-Debt-Waivers-ReductionCancellation-of-debt-.htm. Accessed on 21 November 2014.

[220] See the discussion in 2.2 above.

This issue was raised in the *Standing Committee on Finance (SCOF): Report-Back Hearings, Response Document from National Treasury and SARS* where a comment was made that tracing is often difficult to perform where the

> 'debt is used for aggregate purposes (e.g. credit lines, working capital facilities, general banking facilities, rolling credit facilities).'[221]

The Committee dismissed this argument and responded that the previous debt reduction provisions also required tracing, and that tracing will always be required in the light of the distinction between capital and ordinary revenue.[222]

As a result of inadequate tracing and partial debt reductions, many taxpayers may have to resort to applying to SARS for rulings in terms of chapter 7 of the Tax Administration Act 28 of 2011 to gain clarity as to the application of s 19 and para 12A to that taxpayer's particular circumstances. This may be a costly and time consuming exercise.

4.3 Conclusion

As discussed in this chapter, the application of the new debt reduction provisions becomes problematic in certain circumstances. The problematic circumstances identified in this chapter are in addition to the complexities identified in Chapter 3 regarding the application of the donations tax,[223] group of companies[224] and liquidation of companies[225] exemptions, as well as the exclusion of the group of companies and liquidation of companies exemptions from s 19(8).

In the case of debt reduction in favour of mining taxpayers with a balance of unredeemed capital expenditure, the application of the new debt reduction provisions in s 19 and para

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[221] *Standing Committee on Finance (SCOF): Report-Back Hearings, Response Document from National Treasury and SARS, as presented to SCOF*, 13 November 2012, para 6.8.

[222] *Standing Committee on Finance (SCOF): Report-Back Hearings, Response Document from National Treasury and SARS, as presented to SCOF*, 13 November 2012, para 6.8.

[223] Section 19(8)(*b*) and para 12A(6)(*b*).

[224] Para 12A(6)(*d*).

[225] Para 12A(6)(*e*).

12A in addition to s 15(*a*) read with s 36 would lead to double taxation. SARS recently provided some guidance in the form of Binding Private Ruling 182, by confirming that the debtor should reduce its balance of unredeemed capital expenditure.[226] SARS furthermore ruled that in the case of capital assets or allowance assets, the base cost of the assets must also be reduced.[227] The wording of the ruling, however, does lead to difficulty in interpreting the effect of the ruling, as it is unclear whether (i) both the balance of unredeemed capital expenditure and the base cost of the capital assets and allowance assets must be reduced with the reduction amount, or (ii) whether para 12A must be applied to reduce the base cost of the capital assets and allowance assets, and the balance of unredeemed capital expenditure must be reduced only to the extent that the debt was used to fund expenditure other than in respect of capital assets or allowance assets.

Based on the similar tax treatment of capital expenditure for both mining and farming taxpayers, it is submitted that should a farming taxpayer apply to SARS for a ruling in respect of a debt reduction, SARS will likely come to the same conclusion as in Binding Private Ruling 182 in respect of the application of the new debt reduction provisions in s 19 and para 12A.

As the tax consequences of the new debt reduction provisions in s 19 and para 12A are based on the purpose for which the reduced debt was applied, debtors who have not kept accurate track of the expenditure that their debt was used to fund, will be unable to determine the tax consequences of a debt reduction. It is also unclear in the case of a partial debt reduction whether the debtor may choose to allocate the reduction amount to certain expenditure.

[226] Binding Private Ruling 182, para 6.

[227] Binding Private Ruling 182, para 6.

5. CONCLUSION

The main purpose of this research is to identify the problems experienced in relation to the recent amendments to the debt reduction provisions in s 19 and para 12A in the context of commercial trade expenditure. To identify these problems, the research examined the application, exemptions and complexities of the debt reduction provisions.

Upon conducting a comparative calculation between the previous debt reduction provisions (contained in proviso (*ii*) to s 20(1)(*a*), s 8(4)(*m*) and para 12(5)) to the new debt reduction provisions (contained in s 19 and para 12A) in 2.7 above, the research concluded that the purpose of amending the debt reduction provisions, which is to accommodate debtors in financial distress by reducing the immediate tax liability arising from the debt reduction,[228] was in fact achieved, as the new debt reduction provisions in s 19 and para 12A lead to a lower immediate tax liability, coupled with a greater capital gain upon the future disposal of the asset, than under the previous debt reduction provisions in proviso (*ii*) to s 20(1)(*a*), s 8(4)(*m*) and para 12(5).

In respect of the exemptions to s 19 and para 12A considered in Chapter 3, uncertainty exists regarding the application of the donations tax exemption in s 19(8)(*b*) and para 12A(6)(*b*), as well as regarding the effect of the application of the group of companies and the liquidation of companies exemptions in para 12A(6)(*d*) and (*e*), respectively. It is furthermore unclear why the exemptions relating to debt reduction between companies forming part of the same group of companies and debt reduction in the course of liquidation or deregistration of a company only apply to para 12A, and not to s 19.

It is concluded in 3.1 above that it is unlikely that the donations tax exemption in s 19(8)(*b*) and para 12A(6)(*b*) will apply in the case of a debt reduction in a commercial context. The reasons for this conclusion are that (i) a true donation requires the element of gratuity as decided in the *Welch* case,[229] which element is absent in the case of most commercially driven transactions, and (ii) the provisions of s 19 and para 12A were introduced

[228] *Draft SARS Capital Gains Tax Guide*, p 126 and the *2012 Explanatory Memorandum*, p 43.

[229] 2005 (4) SA 173 (SCA); 66 SATC 303. Refer to the discussion in 3.1 above.

specifically to impose tax on debt reduction transactions, and therefore it is unlikely that SARS would exercise the discretion to impose donations tax on a debt reduction transaction in a corporate context as a deemed donation in terms of s 58, in circumstances where one of the exemptions from donations tax as set out in s 56 may result in the debt reduction not being subject to s 19, para 12A or donations tax.[230]

Difficulty was also identified in 3.2 and 3.3 above regarding the application of the recouping provisions of s 19(6) in circumstances where either the group of companies exemption in para 12A(6)(*d*) or the liquidation of companies exemption in para 12A(6)(*e*) apply to a debt reduction where that debt was used to fund expenditure in respect of allowance assets. It was concluded that where either of these exemptions apply, s 19(6) should not be applied as though a reduction of the base cost of the allowance asset has occurred in terms of para 12A(3). This conclusion may result in somewhat punitive tax consequences for the debtor, and gives rise to a greater recoupment in the hands of the debtor than in the case of a disposal of assets subject to recoupment.[231]

In Chapter 4, the research identified certain instances where the application of the new debt reduction provisions is problematic. These instances include debt reductions in favour of mining taxpayers with a balance of unredeemed capital expenditure and instances where taxpayers have not kept accurate track of the expenditure that their debt was used to fund, or where partial debt reductions have taken place.

It is submitted in 4.1 above that s 19 and para 12A should not apply to a debt reduction where that debt was used to fund mining capital expenditure, and the reduction amount does not exceed the debtor's balance of unredeemed capital expenditure. The reason for the submission is that the application of s 19 and para 12A may lead to double taxation in light of the recouping provisions in section 36 and s 15(*a*). Although an analysis of the application of s 19 and para 12A to farming capital expenditure falls beyond the scope of

[230] Rudnicki M and Bird N 'The Debt-Waiver Rules and their Exemptions' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 4 52, 60.

[231] Rudnicki M and Bird N 'The Debt-Waiver Rules and their Exemptions' *Business Tax & Company Law Quarterly* 2014 Vol 5 Issue 4 52, 62.

this research, it is submitted that a similar approach should be followed to debt reduction where that debt was used to fund farming capital expenditure.

Despite SARS having given a measure of confirmation of the submission made in the paragraph above in Binding Private Ruling 182, it is nevertheless recommended that the legislature amend the provisions of s 19 and para 12A so as to give a clear indication of the effect of these provisions where the reduced debt was used to fund mining capital expenditure, as well as farming capital expenditure.

It is furthermore concluded in 4.2 above that as the tax consequences of the new debt reduction provisions in s 19 and para 12A are based on the purpose for which the reduced debt was applied, debtors who have not kept accurate track of the expenditure that their debt was used to fund, will be unable to determine the tax consequences of a debt reduction. It is also unclear in the case of a partial debt reduction whether the debtor may choose to allocate the reduction amount to certain expenditure. It is recommended that the legislature amend the provisions of s 19 and para 12A to perhaps provide a method of allocation of the reduction amount to the various categories of expenditure to which s 19 and para 12A apply.

As s 19 and para 12A are completely new provisions in the Act, difficulties are bound to arise. Unfortunately, there is not a wealth of authority on the subject, and no cases have been reported to date in relation to these provisions. Despite the amendments to s 19 and para 12A, which were effected by ss 53(1) and 127(1) of the Taxation Laws Amendment Act, 2013 and by ss 30 and 82 of the Taxation Laws Amendment Act, 2014, the issues identified by this research have not been adequately addressed. As a result, it is proposed that the legislature refine these provisions in line with the recommendations made in this report.

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