

A CRITICAL ANALYSIS OF THE TAX IMPLICATIONS OF DEBT REDUCTIONS

by

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ABSTRACT

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Recent legislative changes placed considerable emphasis on the provision of assistance to companies experiencing financial difficulties, as illustrated by, for instance, section 19 and paragraph 12A of the Eighth Schedule to the Income Tax Act. Where debt is reduced, these sections, as well as other sections in the Income Tax Act and the VAT Act, may become applicable. Misinterpretation of the legislation or failure to view it holistically can potentially increase a taxpayer's tax burdens (including potential penalties and interest) and may also affect the revenue due to government.

The main purpose of this study was to critically analyse the debt reduction provisions contained in the Income Tax Act and to consider how those provisions interact with other sections of the Income Tax Act as well as with the VAT Act. Practical difficulties and uncertainty with regard to the current legislation were considered and highlighted. The study contemplated the meaning of debt, how hybrid instruments are treated and potential reclassification between debt and equity by SARS. The study further considered what would constitute a debt reduction, how debt is reduced and how share capitalisations as repayment of debt are treated. The sections of the abovementioned Acts that impact on debt reductions were considered.

The findings of the study suggest that hybrid instruments create a form of mismatch when a debt reduction occurs that is not in line with the recommendations of the Davis Tax Committee. In certain instances a hybrid instrument reclassifies the interest or dividend component, but the classification for purposes of the debt reduction provisions may be different. When share capitalisations occur as settlement for outstanding debt, care should be taken to ensure that the debt is discharged in order to guarantee that the shares are taken as 'consideration' for purposes of the debt reduction provisions. This will avoid a potential tax liability on a larger amount. Taxpayers should align their processes and procedures to comply with the tracing burden placed on them by the debt reduction provisions. Clarification of the legislation is recommended on how the debt reduction provisions should be applied in a situation where a debt was used for a dual purpose and a partial debt reduction occurs. In the case of debt reductions, an additional tax burden can exist for a financially distressed taxpayer in terms of section 19 of the Income Tax Act and the relevant VAT legislation. It is recommended that the interaction between paragraph 20(3)(b) of the Eighth Schedule and the debt reduction provisions be clarified in the legislation. The study also considered an intragroup loan in terms of section 45 and the potential that exists for a creditor company to claim a capital loss in the case of a debt reduction.

Key words:

Debt

Debt reduction

Paragraph 12A

Reduction amount

Section 19

South Africa

Income Tax Act

OPSOMMING

'N KRITIESE ONTLEDING VAN DIE IMPLIKASIES VAN SKULDVERMINDERINGS

deur

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Onlangse veranderinge in wetgewing plaas meer klem op die verskaffing van hulp aan maatskappye wat finansiële probleme ondervind. Artikel 19 en paragraaf 12A van die Agtste Bylae tot die Inkomstebelastingwet is voorbeelde hiervan. Waar skuld verminder word, kan hierdie twee artikels in die wetgewing van toepassing wees, maar ander dele van die Inkomstebelastingwet en BTW-wet kan ook van toepassing wees. Waninterpretasie of nalating om die wetgewing holisties te beskou, kan tot 'n bykomende belastinglas (insluitende boetes en rente) op 'n belastingbetaler lei en kan ook die inkomste van die regering negatief beïnvloed.

Die hoofdoel van hierdie studie was om die skuldverminderingbepalings wat in die Inkomstebelastingwet vervat is en die wyse waarop hulle met ander wetgewing integreer krities te analiseer. Die praktiese probleme en onsekerheid wat ten opsigte van die bestaande wetgewing bestaan is oorweeg en uitgelig. Die studie ondersoek die betekenis van skuld, die hantering van hibriede instrumente en die moontlikheid dat SARS die instrument as skuld of ekwiteit kan herklassifiseer. Daar is ook ondersoek ingestel om te bepaal wat 'n skuldvermindering volgens die Inkomstebelastingwet is en hoe skuld verminder kan word, asook oor hoe die belastingwetgewing aandelekaptalisasies ter vergoeding van skuld hanteer. Die bogenoemde wetgewing wat moontlik op skuldvermindering van toepassing kan wees, is oorweeg.

Die bevindinge van die studie dui daarop dat hibriede instrumente 'n vorm van wanaanpassing skep wanneer 'n vermindering van die skuld plaasvind, wat nie met die aanbevelings van die Davis Belastingkomitee ooreenstem nie. In bepaalde gevalle herklassifiseer 'n hibriede instrument die rente- of dividendkomponent, maar klassifikasie vir die doel van die skuldverminderingbepalings kan verskil. Wanneer aandeelkapitalisasie ter vermindering van die skuld voorkom, moet daar verseker word dat die skuld afgelos is voordat 'n belastingbetaler in 'n posisie sal wees om die aandele se waarde van die skuldvermindering af te trek. Dit sal die potensiële heffing van belasting op 'n groter bedrag voorkom. Belastingbetalers moet hul prosesse en prosedures aanpas om te voldoen aan die opsporingslas ingevolge die skuldverminderingbepalings. Daar is aanbeveel dat die wetgewing verander moet word om groter duidelikheid te verskaf oor hoe 'n skuldvermindering hanteer moet word waar die skuld vir 'n tweeledige doel gebruik is en 'n gedeeltelike vermindering van die skuld plaasvind. Waar 'n vermindering van die skuld voorkom, kan artikel 19 van die Inkomstebelastingwet en die BTW-wetgewing 'n addisionele belastinglas op 'n belastingbetaler plaas. In dié verband moet die wetgewers oorweeg of enige verdere verligting aan belastingbetalers verskaf kan word. 'n Aanbeveling is gedoen dat die interaksie tussen paragraaf 20(3)(b) van die Agtste Bylae tot die Inkomstebelastingwet en die skuldverminderingbepalings uitgeklaar moet word. Die studie het ook oorweging geskenk aan 'n intra-groepplening, ingevolge artikel 45 van die Inkomstebelastingwet, en aan die moontlikheid dat 'n krediteurmaatskappy in die geval van 'n skuldvermindering 'n kapitale verlies te kan eis.

Sleutelwoorde:

Artikel 19

Paragraaf 12A

Skuld

Skuldvermindering

Verminderingsbedrag

Suid-Afrika

Inkomstebelastingwetgewing

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CHAPTER 1

INTRODUCTION

1.1 BACKGROUND

Section 19 of the Income Tax Act and paragraph 12A of the Eighth Schedule (also referred to in this document as the debt-reduction provisions) to the Income Tax Act (58/1962) (the Income Tax Act) came into effect on 1 January 2013. These sections were enacted to provide the large number of financially distressed taxpayers with some tax relief when they reduce their debt and to ensure that the tax system does not reverse the economic benefits created by debt reductions (National Treasury, 2012).

The Companies Act (71/2008) (the Companies Act) came into effect in May 2011 and enables companies to enter into a compromise with their creditors in terms of the business-rescue proceedings. The Tax Administration Act (28/2011) (Tax Admin Act) came into effect on 1 October 2012 and enables taxpayers to enter into an agreement with the South African Revenue Services (SARS) in order to compromise or write off tax debts. The enactment of these various laws shows that the South African government is serious about assisting and providing relief to financially distressed companies.

Although section 19 and paragraph 12A of the Eighth Schedule of the Income Tax Act deals specifically with debt reductions, section 24J (in the case of an interest-bearing instrument) and the donations tax provisions in terms of section 54 to 64 should also be considered (Dachs, 2014). Furthermore, a debt reduction may create consequences in terms of section 22(3) and 22(4) of the Value-added Tax Act (89/1991) (VAT Act) in cases where debtors have not paid their creditors within a period of 12 months (Kriel, 2014). A taxpayer should consider all the relevant sections of the legislation, including definitions.

The debt definition contained in the debt reduction provisions in the Income Tax Act is not exhaustive and simply excludes tax debt. Section 1 of the Income Tax Act contains the main definitions in the Income Tax Act, but does not define debt. This raises the question: Will a hybrid instrument that has elements of debt and equity be classified as debt or as

equity for purposes of the debt reduction provisions, and what will, for purposes of the debt reduction provisions, constitute a debt?

Compliance risk involves risk that exists in complying with one's tax obligations, which include the preparation and submission of the various tax returns. Compliance risk can be managed by ensuring that the latest tax legislation and practice is considered and applied (Elgood *et al.*, 2004). When taxpayers do not manage their compliance risk, they may be liable for late payment penalties, understatement penalties (which range from 0% to 200%), or interest in terms of the Tax Admin Act. The Tax Admin Act allows SARS very little discretion with regard to waiving penalties and interest levied. The voluntary disclosure programme provides relief for the understatement penalty only. Taxpayers should take the necessary steps to manage their compliance risk.

When managing their compliance risk, taxpayers must understand the interaction between the various laws that exist. It is essential to be aware of the practical difficulties that may arise from the applicable sections of the Income Tax Act and VAT Act, and to understand the uncertainty that exists regarding the interpretation of the existing legislation. If penalties and interest are imposed owing to the misinterpretation of legislation, or because parts of the legislation were interpreted in isolation, an additional financial burden can be placed on companies that are already experiencing financial difficulties. It is important to determine whether section 19 and paragraph 12A of the Eighth Schedule to the Income Tax Act, which governs debt reductions, actually provides definite relief, or whether some form of tax burden is still being placed on the taxpayer. Any additional tax burden may defeat the purpose of government's attempt to provide relief to companies experiencing financial difficulties.

According to the 2014 medium-term budget policy statement, it was estimated that the revenue-collection deficit would amount to R180 billion (Nene, 2014). While it is important for legislators to be informed about the debt-reduction provisions, it is equally important for them to be aware of the practical difficulties and potential loopholes that may exist. Ultimately the practical difficulties and potential loopholes will affect tax collection by SARS. Any uncertainty or practical difficulties that currently exist could be clarified by the amendment of the relevant legislation or through the issue of interpretation notes.

1.2 PROBLEM STATEMENT

The debt reduction provisions in the Income Tax Act are not the only sections that are likely to be affected by a debt reduction. Other parts of the Income Tax Act that may be affected by debt reductions are section 1, which contains the definitions; section 24J, which deals with interest-bearing instruments; the Eighth Schedule, which deals with capital gains tax; and the donation tax provisions in sections 54 to 64 of the Income Tax Act. In addition, sections 22(3) and 22(4) of the VAT Act should also be considered.

The many sections in the legislation that should be considered may create confusion when a person is interpreting the legislation. Misinterpretation of the legislation, or failure to take all the relevant aspects of the legislation into consideration when reducing debt, may inadvertently cause further financial distress. Such misinterpretation places a taxpayer at risk of incurring penalties, having to pay interest, and liability for the cost of disputing the matter with SARS. In the interest of both the taxpayers and SARS, compliance risk should be limited and managed. SARS may potentially lose revenue if the legislation is unclear or can be misinterpreted.

This study will therefore include a critical analysis of the implications and potential consequences of debt reductions in an attempt to determine where potential misinterpretation may occur, and to identify other legislation that may become applicable. The study will look at practical considerations and will determine what can be considered as debt for the purposes of the debt-reduction provisions in the Income Tax Act. The study will attempt to highlight any areas of uncertainty with regard to how taxpayers and legislators interpret the existing legislation.

1.3 PURPOSE STATEMENT

To date, no court decisions have been made in South Africa with regard to the most recently enacted debt-reduction provisions in the Income Tax Act. This study will be an important contribution to the relevant literature as it represents the first research that offers

a detailed consideration of the interaction between the debt-reduction provisions and other provisions in the Income Tax Act and the VAT Act. The study will further contribute to the literature as it will specifically address and define debt and a debt reduction for the purposes of the debt-reduction provisions in the Income Tax Act. The study will assist tax practitioners and tax governing bodies to identify the practical difficulties and assist with providing a holistic view of the possible implications of a debt reduction. Furthermore, the study will provide legislators with an indication of where practical difficulties may exist for tax practitioners and taxpayers, and will highlight where changes should be considered.

The main purpose of the study is to critically analyse the debt reduction provisions of the Income Tax Act and their interaction between other sections of the Income Tax Act and the VAT Act, and to discuss the practical difficulties presented by, and uncertainty within the legislation, which leads to misinterpretation and confusion.

1.4 RESEARCH OBJECTIVES

The study will be guided by the following research objectives:

- *To determine, through critical analysis, what constitutes a debt and a debt reduction in terms of the debt reduction provisions of the Income Tax Act, taking into consideration the definition currently enacted.*
- *To discuss practical considerations for both the taxpayers and the legislators where clarification is required in terms of the existing Income Tax Act.*
- *To explore the interaction between the debt reduction provisions and other relevant sections in the Income Tax Act, as well as the applicable sections in the VAT Act.*

1.5 LIMITATIONS AND ASSUMPTIONS

The following limitations will guide this study:

- Since legislation is amended frequently, only South African legislation that was enacted up to the 2014 Taxation Laws Amendment Act will be considered for the purposes of this study.

- The study will consider only the implications for South African companies that are tax residents for purposes of the Income Tax Act. Individual taxpayers and estates will not be considered.
- The study will consider no legislation apart from the Tax Act and the VAT Act.
- The recommendations made in this study considered and highlighted only the potential relief for a taxpayer experiencing financial difficulties and did not consider the possible impact of such relief on national tax revenues.

1.6 KEY TERMS AND ABBREVIATIONS

1.6.1 Definition of key terms

The following key terms will be used in this study:

Base cost: This is the cost that can be deducted from any proceeds when determining a capital gain or capital loss in terms of the Eighth Schedule to the Income Tax Act. Base cost is specifically addressed in paragraph 20 of the Eighth Schedule to the Income Tax Act.

Debt reduction provisions: The legislation contained in section 19 and paragraph 12A of the Eighth Schedule to the Income Tax Act.

Capital items/expenses: An item or expense that will be classified as capital in nature in terms of the gross income definition, or an item or expense that falls within the Eighth Schedule to the Income Tax Act.

Company/ies: Refers to a company as defined in the Companies Act (71/2008), or to a close corporation.

Credited institution: An institution that is recognised for providing tax and legal consulting services.

Input tax: An amount that can be claimed from SARS against output tax and as defined in section 1, read together with section 7(1)(a) of the VAT Act.

Gross income: Gross income as defined in section 1 of the Income Tax Act.

Intragroup transaction: An intragroup transaction undertaken in terms of section 45 of the Income Tax Act.

Output tax: An amount payable to SARS for the supply of goods or services as defined in section 1, read together with section 17 of the VAT Act.

Recoupment: Where a deduction or allowance was claimed and a portion of such deduction or allowance was recovered. Recoupments are dealt with in section 8 of the Income Tax Act.

Revenue item/expense: An item or expense that is not capital in nature in terms of the gross income definition in sections 1 or section 11(a) of the Income Tax Act and that does not fall within the ambit of the Eighth Schedule to the Income Tax Act.

Taxpayer: A person (this can be an individual, a juristic person or a trust) who is liable to pay tax in South Africa.

1.6.2 List of abbreviations and acronyms

Table 1 contains the abbreviations and acronyms used in this study.

Table 1: Abbreviations and acronyms used in this document

Abbreviation	Meaning
BPR	Binding private ruling
Companies Act	Companies Act (71/2008)
GAAR	General anti-avoidance provisions
Income Tax Act	Income Tax Act (58/1962)
OECD	Organisation for Economic Co-Operation and Development

PWC	PriceWaterhouseCoopers
SARS	South African Revenue Services
Tax Admin Act	Tax Administration Act (28/2011)
VAT	Value-added tax
VAT Act	Value-added Tax Act (89/1991)
USA	United States of America

1.7 RESEARCH METHODOLOGY

A search was conducted on the University's online journal databases and electronic websites to determine whether any research has been conducted on the tax implications of debt reductions. No research could be found that attempted to critically analyse the implications of reducing or waiving debt in terms of the recently enacted legislation and how this interacts with other sections in the Income Tax Act, or to highlight the practical considerations and difficulties that may exist.

During the literature search, a number of studies were found on the now repealed sections 20(1)(a)(i) of the Income Tax Act and paragraph 12(5) to the Eighth Schedule of the Income Tax Act, in which certain aspects of the debt reduction provisions were considered. A large number of articles published by consulting firms (credited institutions) are available on their websites. A study was discovered that considered the settlement of debt by way of a share issue, and whether it constituted a debt reduction for purposes of section 19 and paragraph 12A of the Income Tax Act (Claassen, 2013).

A critical literature review empowers the researcher, through existing literature, to answer the research problem and enables him/her to consider the conclusions and issues addressed in the literature by confronting any contentious issues (Sekaran & Bougie, 2013). A literature review can provide a summary of the existing literature on a topic of interest and will provide the researcher with an understanding of problems previously considered, as well as topics being currently debated in the specific research field (Mouton, 2001).

A critical literature review process will be used in this study and the researcher will rely on the legislation, case law, journals, books, dissertations, theses and articles to address the

research objectives. To ensure that the quality of the study is not affected, the researcher will rely only on articles written and published by credited institutions.

1.8 STRUCTURE OF THE MINI-DISSERTATION

The study will be structured as follows:

1.8.1 Chapter 1 Introduction

Chapter 1 provides the background for the study and sets out the research objectives. The importance of the study and the benefits it offers will be discussed. This will be followed by an explanation of the limitations and assumptions and a discussion of the research methodology. The chapter will conclude with a summary of the different chapters.

1.8.2 Chapter 2 Defining ‘debt’ in South Africa

In Chapter 2, consideration will be given to what actually constitutes debt for purposes of the debt reduction provisions of the Income Tax Act, specifically in view of the classification of hybrid instruments and the potential reclassification between debt and equity in practice.

1.8.3 Chapter 3 Defining the ‘reduction amount’ in South Africa

Chapter 3 will consider what constitutes a ‘reduction amount’ in terms of the debt reduction provisions. Specific attention will be paid to the reduction of debt by issuing shares (including preference shares).

1.8.4 Chapter 4 Interpreting the debt reduction provisions in the Income Tax Act

Chapter 4 provides an understanding of section 19 and paragraph 12A of the Eighth Schedule to the Income Tax Act and explains when these sections will not be applicable. It

focuses in particular on the practical difficulties and considerations regarding the existing legislation.

1.8.5 Chapter 5 Other relevant legislation

In Chapter 5, other legislation that may be applicable when debt is reduced will be evaluated and the interaction between such other legislation and the debt reduction provisions in the Income Tax Act will be considered.

1.8.6 Chapter 6 Conclusion

Chapter 6 will summarise the contents of the study and the findings and conclusions will be discussed. Suggestions will also be made regarding possible future research.

CHAPTER 2

DEFINING 'DEBT' IN SOUTH AFRICA

2.1 INTRODUCTION

The debt reduction provisions in the Income Tax Act define debt for the purposes of section 19 and paragraph 12A of the Eighth Schedule to the Income Tax Act. This definition simply states that debt excludes tax debt as defined in section 1 of the Tax Admin Act. However, section 1 of the Income Tax Act contains no such definition, therefore no clarity is provided about what will constitute debt for purposes of the debt reduction provisions.

In this chapter an attempt is made to determine what constitutes debt. Specific consideration will be given to the classification of hybrid instruments and potential reclassifications.

2.2 THE WRITTEN WORD

2.2.1 Ordinary meaning

A modern approach to interpreting tax law considers the purpose of the legislation in the context of the provision in the legislation, whereas a traditional approach to interpreting tax law considers the literal meaning of the words and the intention of the legislature when they chose to use specific words (Van Schalkwyk & Geldenhuys, 2009). Considering only the literal meaning of a word without considering the intention or purpose of the legislation could result in the interpretation being unconstitutional (Goldswain, 2008). A strictly literal interpretation could, however, be useful in practice if it is not in conflict with the intention or purpose of the legislation (Goldswain, 2008). Groome *et al.* (2013:17) states that 'only where the text is ambiguous or unclear, or if a strict literal meaning will be absurd, the literal meaning of the words may be departed from'. If a word or term is defined neither in

section 1 of the Income Tax Act, nor in the Interpretation Act, one should assume it to have the meaning usually attached to it, as provided in a dictionary (Haupt, 2014).

The text in which the term debt is used in section 19 and paragraph 12A of the Eighth Schedule to the Income Tax Act is not unclear or ambiguous and the legislation simply states that debt excludes a tax debt as defined in the Tax Admin Act. A literal interpretation will not result in any illogical results and the ordinary literal meaning can therefore be considered.

Debt is defined as ‘that which is owed or due; anything (as money, goods or service) which one person is under obligation to pay or to render to another ...’ (Oxford English Dictionary, nd). The Collins English dictionary defines debt as ‘something that is owed, such as money, goods or services. An obligation to pay or perform something; liability ...’ (Collins English Dictionary, nd), and according to the Merriam-Webster encyclopaedia it is ‘an amount of money that you owe to a person, bank, company etc., the state of owing money to someone or something ...’ (Merriam-Webster, nd).

The definitions provided by the dictionaries are very similar and it can be accepted that the term debt, used in a literal sense, can be defined as an obligation to another person, and that such obligation can include an actual payment in money or an obligation to deliver goods or services to another person.

2.2.2 Legislation

The debt reduction provisions to the Income Tax Act define debt and simply exclude ‘tax debt as defined in section 1’ of the Tax Admin Act (Section 19 and paragraph 12A of the Eighth Schedule). This definition applies only to the debt reduction provisions and not to any other section of the Income Tax Act. There is no clear definition of exactly what will constitute debt and one should consider the possibility of obtaining clarity in this regard in other sections in the Income Tax Act.

Section 1 does contain some definitions that are used when interpreting the legislation, but does not include a definition for the term debt. Any statement of the financial position of a

company (balance sheet) includes assets, liabilities and equity; therefore debt can be classified only as either equity or a liability. The Income Tax Act does contain definitions for the terms equity share and share, which may potentially assist us in determining what will constitute a debt. The definition for an equity share provided in section 1 excludes shares that are not allowed to participate in respect of dividends or capital by more than a specified amount. Section 1 further defines a share as 'any unit into which the proprietary interest in that company is divided'.

Although debt is not explicitly defined in section 1 of the Income Tax Act, the definition of a share can be useful when establishing the meaning of debt. Debt will therefore not include any form of interest that the owners of a company hold in the assets of that company.

2.2.3 Case law in South Africa

One should consider any court cases that might assist with the interpretation of debt and exactly what it entails.

In the case of *Joint Liquidators of Glen Anil Development Corporation Ltd (IN LIQUIDATION) v Hill Samuel (SA) Ltd*, 1963 (1) ALL SA 105 (A), it was held that debt is a definite obligation to pay an amount, regardless of whether such payment occurs now or at a later stage, but that a conditional liability cannot be considered debt as it is not certain that it will in fact become a debt in future (De Koker & Williams, 2014). Even though the dispute in this court case was not a tax dispute, it still provides a reliable explanation of what constitutes debt.

In the tax case of *Burman v CIR*, 1991 (1) SA 533 (A) (53 SATC 63), a taxpayer advanced loans to property companies with minimal share capital. The dispute was about whether the loss on the loan account was deductible for income tax purposes or not. Judge Goldstone held that, irrespective of the intention of the taxpayer, a loan contract existed between the taxpayer and its shareholder, as the taxpayer contractually became entitled to receive repayment for the loans. However, Judge Nicholas (dissenting) held that in the case of small private companies a shareholder's loan is, in an economic sense, similar to its capital contribution and no different from the shares.

In the case of *CIR v Datakor Engineering (Pty) Ltd*, 1998 (4) ALL SA 414 (A) (60 SATC 223) a compromise was entered into with the taxpayer's creditors and part of the compromise involved issuing redeemable preference shares. The court held that a company's creditors represent an enforceable obligation and that all the assets of the company can be used to settle such a liability. This differs from a share or preference share, which can be redeemed only out of profits or a fresh share issue and therefore different to the creditors' claims. The court held that a creditor's claim had been substituted for a share and that a redeemable preference share will therefore be classified as equity and not as a debt.

The above court cases suggest that in order to exist, debt requires an unconditional obligation (*Joint Liquidators of Glen Anil Development Corporation Ltd (IN LIQUIDATION) v Hill Samuel (SA) Ltd*). Where a taxpayer has a legal obligation to deliver or pay something, this represents a debt obligation. However, it can be argued that in an owner-managed entity the shareholders' loans can in fact represent equity and not debt (*Burman v CIR*). The capitalisation of loans through the issuing of shares will constitute a compromise between the parties (*CIR v Datakor Engineering (Pty) Ltd*). Brincker (2011) confirms the principle that the capitalisation of a loan through the issuing of shares will also constitute a compromise. If an item can be classified as either debt or equity, tax-planning opportunities exist for taxpayers since debt is normally tax deductible.

In the case of *CIR v Conhage (Pty) Ltd (formerly known as Tyco)*, 1999 (4) SA 1149 (SCA) (61 SATC 391), the taxpayer entered into a sale and leaseback agreement and the Commissioner held that the sole or main purpose of the sale and leaseback was to obtain a tax benefit. Judge J.A. Hefer, giving judgement in the Supreme Court of Appeal, held that a person can arrange his/her affairs to reduce a tax liability within the bounds of the general anti-avoidance rules (GAAR) and the applicable legislation.

The case law suggests that a person can, within the bounds of the provisions of the GAAR, arrange his/her tax affairs in a tax-efficient manner.

2.2.4 Preliminary conclusion

If one considers the ordinary literal meaning of the term debt, as well as legislation and case law in South Africa, it can be concluded that an item can only be classified as debt if an unconditional obligation exists to settle or repay the amount agreed upon. The obligation does not necessarily involve only money, but could include any form of goods or services. Debt differs from shares in the sense that where a debt exists, the company's creditors have access to all of the company's assets in case of a default, whereas a share can only be paid or redeemed from profits. For the purposes of the Income Tax Act, redeemable preference shares are classified as equity. The dividends may however, in certain instances, be classified as interest (section 8E and section 8EA).

The case law suggests that taxpayers can plan and arrange their affairs to obtain some form of tax benefit, provided that it is in line with the legislation and the GAAR provisions in the Income Tax Act.

2.3 PRACTICAL APPLICATION

2.3.1 Substance over form and simulation

The substance over form doctrine implies that the court does not consider the actual form in which the transaction is undertaken, but considers the substance of the transaction (Spamer, 2013). The economic substance doctrine implies that even though a transaction may have taken place, there is no real change in the economic position of a taxpayer except for the reduction in taxes. The substance over form and economic substance over form doctrines are common law principles where the substance of a transaction is considered where no economic substance or commercial rationale exists other than to reduce a tax liability (Fraser, 2011).

In the South African context, two of the leading court cases that dealt with simulated transactions where substance over form was considered, will now be discussed.

In the Supreme Court of appeal case of *Commissioner SARS v NWK Ltd*, 2011 (2) SA 67(SCA) (73 SATC 55), the taxpayer entered into a loan of R50 million with a well-known bank and added features to the loan that resulted in it being reflected as R96 415 776. This enabled the taxpayer to claim a tax deduction on a much higher value. However, since the transaction lacked commercial rationale, the court treated it as a simulated transaction and looked at the substance. Even though the parties intended to take the steps provided for in the agreements, the court held that one should test the commercial sense of a transaction to determine its real substance. If the purpose is to evade tax, it will constitute a simulated transaction.

In the more recent Supreme Court of Appeal case *Commissioner SARS v Bosch*, (394/2013)[2014] ZASCA 171 (19 November 2014), the taxpayers were parties to a share incentive scheme with their employer. The share options granted provided for an exercise period of 21 days, but the actual shares were only delivered and paid for in two tranches over four years. SARS contended that the contracts between the employer and employees were simulated. The court held that a simulated transaction involves a form of dishonesty and that where a real intention (without any dishonesty) exists, it cannot constitute a simulated transaction. The court specifically referred to the case of *Commissioner SARS v NWK Ltd* when it explained that simulation requires some form of dishonesty. The judge held that there is nothing wrong with tax avoidance and that taxpayers may arrange their affairs to minimise the tax payable by them. The court indicated that SARS could at any time amend the legislation if it disapproves of the tax avoidance scheme.

The courts will ignore the form of the transaction and consider its substance where no commercial substance or rationale exists for the transaction. The main indicator of a simulated transaction is where the transaction does not represent the true intention of the parties and where a dishonest intention or agreement exists in some form.

2.3.2 Potential reclassifications

The GAAR provisions are contained in sections 80A to 80L of the Income Tax Act. An arrangement will fall within the GAAR provisions if it is an 'impermissible tax avoidance arrangement' as defined, if the 'sole or main purpose' of the arrangement was to obtain a

'tax benefit', and if the transaction contains some tainted element. Broadly speaking, section 80B gives SARS the right to ignore the legal form of the arrangement and to tax the transaction based on its substance, which includes the potential re-characterisation of the arrangement. Section 80H indicates that SARS can apply the GAAR provisions to any step or part of any arrangement.

One of the tainted elements that is considered in section 80A(a)(ii) relates to when a transaction 'lacks commercial substance', and section 80C lists the elements that may cause a 'lack of commercial substance'. One such element is where the substance differs from its legal form (section 80C(2)(a)). The tainted element when a transaction 'lacks commercial substance', as mentioned in section 80A(a)(ii), and the substance-over-form element mentioned in section 80C(2)(a) do not require an intention to mislead on the part of the taxpayer, which differentiates it from the common law principle that requires the presence of some form of misrepresentation (Cassidy, 2012).

The deductibility of interest affects financing decisions and where an interest deduction results in a reduction in the effective tax rate that applies to a taxpayer, a preference exists for debt financing. Companies that have substantial losses or a tax rate of zero are less likely to use debt as a method of financing (Mackie-Mason, 1990). In the South African context, interest is also deductible for tax purposes, which may affect the choice between debt and equity financing. In terms of debt reduction provisions, the risk may be substantially lower to SARS on account of the fact that a company may prefer debt financing (as the interest is deductible). Where debt financing is chosen, it will automatically be classified as debt and will fall within the ambit of the debt reduction provisions. Even if a taxpayer prefers debt financing, a possibility of reclassification may still exist.

Taking into consideration the GAAR provisions in the Income Tax Act, it would appear that SARS has the ability to potentially re-characterise an instrument as either debt or equity, which may affect the applicability of the debt reduction provisions. Such a reclassification may occur if the taxpayer entered into a transaction in respect of which no other commercial rationale existed and the 'sole or main purpose' was to obtain a tax benefit.

The GAAR provisions allow SARS to reclassify the instrument even if no form of dishonesty had occurred.

2.3.3 Foreign court decisions on reclassifications

No South African case law could be found on the classification and potential reclassification of debt. The judges considered whether the loss on a loan account was deductible in the case of *Burman v CIR*, but did not specifically consider the reclassification of the debt. South African courts often consider judgements made in other countries in cases relating to specific matters that have not yet been dealt with by a South African court. In the United States of America (USA), the substance over form doctrine, is also applied and, like in South Africa, no 'defined set of standards' exist to differentiate between debt and equity (*Pepsico Puerto Rico Inc and Pepsico Inc other affiliates v CIR*, (TC Memo 2012 - 269)). In the USA, the tax court dealt with three cases in 2012, where the difference between debt and equity had to be considered.

In the case of *Pepsico Puerto Rico Inc and Pepsico Inc other affiliates v CIR*, the court had to consider whether the advance agreements that formed part of a restructuring of the group constituted debt or equity. The court held that even though in the Netherlands the advance agreements were treated as equity, they were treated as debt in the USA. The court considered the substance of the instrument over its form and acknowledged that the substance of the instrument is used to classify an instrument for tax purposes. The court further held that considering only the substance and not looking at the obligations created by the instrument will produce an incorrect result. To ultimately determine the classification of the instrument, the court therefore also considered debt versus equity factors to determine the intent of the taxpayer, and whether there was agreement between the intent and the economic reality of the transaction. The court acknowledged that transactions are often structured with a view to obtaining a tax benefit and that such structuring may not result in the disallowance of the tax effects.

In the case of *NA General Partnership & Subsidiaries, Iberdrola Renewables Holdings Inc. & Subsidiaries v CIR*, (TC Memo 2012 - 172), an advance was made between group companies and the lender did not initially pay all the interest. The non-payment may have

suggested that it was not a definite liability, but since subsequent payments were made, the court concluded that the instrument was a debt instrument. The revenue authority held that the interest deduction should not be allowed as it was not an actual loan, but rather a capital contribution. The court followed a similar approach in dealing with the *Pepsico Puerto Rico Inc and Pepsico Inc other affiliates v CIR* case.

In the case of *Hewlett-Packard Company and consolidated Subsidiaries v CIR*, (TC Memo 2012 - 135), the court concluded that an investment in a subsidiary should be treated as debt for tax purposes in the USA, and disallowed a capital loss claimed by Hewlett Packard. The issues in dispute related to the classification between debt and equity, whether the transaction would be classified as a sham transaction if considered in accordance with the economic substance doctrine, and whether the foreign investment company should be considered as a conduit entity in terms of the step-transaction doctrine. The court held that it only needed to consider the first matter in dispute and considered the characteristic of debt versus equity to conclude that the investment should be treated as a loan and not as equity. The court focused mainly on the factors listed below.

The following represents a summary of some of the factors the courts considered in the three listed court cases, to determine whether the instrument should be treated as debt or equity:

- The names and labels given to the instrument.
- Whether a fixed obligation to pay existed, which could be determined by looking at the existence of a maturity date. An unconditional obligation to pay indicates that an item is a debt instrument.
- The source of the funds. Where repayment is dependent on the earnings of the entity it is treated as equity, whereas if the payments are due, even if no earnings are made, it is classified as a loan.
- Whether the debtor has a right to enforce any repayment. Such right would suggest a debt instrument.
- Whether the person advancing funds took part in the management of the business. If they participated in the management it may indicate an equity instrument.

- The status of the instrument compared with other payable instruments may indicate whether it is a debt or equity. Where the instrument ranks for payment after the other normal creditors it may indicate an investor relationship and therefore an equity instrument.
- The intent of the parties indicates whether the instrument is treated as equity or debt.
- The proportion of debt to equity. If the debt is in line with the proportion of equity it may indicate an equity instrument.
- Whether the entity is thinly capitalised – look specifically at the debt to equity ratio.
- The ability of the company to obtain funding from outside sources.
- Consider what the funds were used for. If their use was related to capital acquisitions, it may indicate equity.
- Whether the creditor is actually repaying the loan.

In the Netherlands the distinction between debt and equity is based on the ‘civil law’ classification. A ‘participation loan’ exists where the income is dependent on profit margins, the loan is subordinated and there are no repayment terms or repayment terms are in excess of 50 years. Where a loan is classified as a ‘participation loan’, the interest component is treated as if it were a dividend and not deductible for tax purposes (Van Gelder & Niels, 2013). In the Netherlands, as in South Africa, no set of rules or definitions exists to assist with the classification of instruments as either debt or equity instruments.

In the case *Dutch Supreme Court of Appeal, 7 February 2014 No 12/03540*, discussed by Van Gelder and Niels (2013), the decision was similar to that of the USA court. In this case preference share dividends received from an Australian company were classified by the court as equity in the Netherlands, even though the preference shares were classified as debt in Australia. Ignoring the classification in Australia, the court considered only the civil law classification in the Netherlands and dismissed the fact that the law had been abused and that the instrument should be reclassified.

The court cases suggest that substance over form plays a role in determining the debt or equity classification, but taxpayers may still arrange their affairs so as to obtain some form of tax advantage. Courts in the USA rely on a number of factors to determine whether the

transaction should be classified as a debt or equity and focus mainly on the intention of the taxpayer. Where a foreign jurisdiction is impacted or affected, the courts appear to pay very little heed to the classification in the other jurisdiction and focus only on the classification in the country where the dispute arose.

2.3.4 Hybrid instruments

A hybrid instrument is an instrument that contains elements of both debt and equity. Legislation can be used to reclassify a hybrid instrument for tax purposes, but such a reclassification may create potential opportunities for taxpayers locally and in the international tax arena to exploit the different tax treatments. If, for example, an entity is in an assessed loss position, it would prefer to treat the interest as a dividend in the hands of the company paying the interest, and to treat it as a dividend in the hands of the entity who receives the interest where that entity potentially qualifies for a dividend tax exemption (Brincker, 2011). Hybrid instruments that should be considered are dealt with in sections 8E to 8FA of the Income Tax Act.

Hybrid equity instruments are dealt with in section 8E of the Income Tax Act. When an item is classified as a 'hybrid equity instrument', any dividend received is deemed to be income in the hands of the recipient (Section 8E(2)), but such dividend is not reclassified in the hands of the issuer. In certain instances section 8EA will reclassify preference shares, as well as third-party backed shares. The dividend will be reclassified as income in the hands of the person receiving the income, but the instrument will still be treated as a dividend in the hands of the issuer (Section 8EA(2)). Section 8F and 8FA deals with hybrid debt instruments and any interest incurred by the issuer is deemed to be a dividend in specie (paragraph 2), while any interest received by the holder is a deemed dividend in specie received (paragraph 3).

When an instrument is classified as a 'hybrid equity instrument', it is only the dividend received by the holder that is being reclassified for tax purposes. The dividend declared by the issuer will remain a dividend and, where applicable, will be subject to dividend tax. Note that the reclassification occurs only for purposes of sections 8E, 8EA and 8F, and that the instrument will not be reclassified as either a debt or an equity instrument for the

purposes of any other sections of the Income Tax Act. The normal classification will still apply for purposes of section 19 and paragraph 12A of the Eighth schedule.

The Explanatory Memorandum to the Taxation Law Amendment Bill of 2013 states that it is accepted that when classifying an item as debt or equity, one should consider the legal form. This provides taxpayers with some freedom with regard to their classification of the instrument and creates a potential risk for treasury. The explanatory memorandum further highlights taxpayers' general preference for classification as debt so as to obtain an interest deduction (National Treasury, 2013). The Organisation for Economic Co-operation and Development (OECD) has done a considerable amount of work on hybrid instruments in recent years and it is worth considering its views.

The OECD considered the impact of 'hybrid mismatch arrangements' as part of its profit-shifting and base-erosion project. The report highlights some recommendations to countries in terms of their domestic legislation in respect of hybrids. The recommendations made in the report focus mainly on the risk created in an international and cross-border arena, but it is useful for South Africa to consider these recommendations in order to protect its tax base. The recommendations include the denial of a deduction unless it was included in the income of the other jurisdiction. Where the other jurisdiction does not neutralise a mismatch, the OECD recommends an 'offensive rule', which will reclassify the income as normal income. In the case of a 'double deduction', the report recommends a 'defensive rule' that denies the deduction in the payer's country. The OECD recommends that hybrid rules should not disrupt the domestic law. The report contains no reference to whether the hybrid rules should be used to reclassify the instrument as either debt or equity for purposes of the other sections in domestic law. The OECD recommendations focus mainly on the deduction and income components to resolve the hybrid mismatch, and not on the classification of instruments as debt or equity (OECD, 2014). Locally the Davis Tax Committee also considered the impact of hybrid instruments in South Africa.

The Davis Tax Committee issued an interim report on the 'hybrid mismatch arrangements'. The report highlights the risks created by sections 8E, 8EA, 8F and 8FA of the Income Tax Act, in accordance with which taxpayers can structure their affairs in a way that makes it possible to avoid these provisions. The report highlights the fact that the complexity of

these provisions can result in interpretation issues and uncertainty, with SARS spending more time enforcing the legislation while the taxpayers spend more time avoiding it. The report also points out that while the existing legislation does attempt to look at the substance over form principle, it does not consider whether a real mismatch exists where one person obtains a deduction without a corresponding income in the hands of the other party. The report suggests simpler rules that focus on principles rather than on specific transactions, and considering the treatment in the foreign jurisdiction to prevent potential abuse (Davis Tax Committee, nd).

2.3.5 Preliminary conclusions

The substance over form and simulation doctrine in the South African content appears to require some form of dishonesty before the form of the transaction will be ignored and the substance of the transaction be considered. This differs from the GAAR provisions in the Income Tax Act, which do not require a form of dishonesty, but simply require the taxpayer to conduct a transaction the 'sole or main purpose' of which is to obtain a tax benefit. Where valid commercial reasons, other than obtaining a tax benefit, exist for a transaction, it is unlikely that a reclassification by SARS between debt and equity will occur. The decisions and considerations in the court cases in the USA and Netherlands, which were discussed earlier, reflect a similar view.

The South African legislation dealing with hybrid instruments reclassifies mainly the dividend or interest component. The classification of the instrument as either debt or equity will not be affected by sections 8E, 8EA or 8F of the Income Tax Act when the debt reduction provisions are applied. However, the Davis Tax Committee suggested that hybrid rules should only exist where a real mismatch occurs, in other words, when one party obtains a deduction and the other party does not include such amount in their income.

2.4 COMPARISON BETWEEN THE WRITTEN WORD AND PRACTICE

Although debt is not clearly defined in the Income Tax Act, the literal meaning of the word and case law can be used to construct its meaning. Debt exists where a person or

company has an unconditional obligation to pay an amount and where the creditors have a right to that person or company's assets in case of non-payment. However, this creates opportunities for the parties involved to structure transactions and to create obligations that do not reflect their true intention.

The case law in South Africa indicates that when a taxpayer structures a transaction to obtain any tax benefit, the substance will be considered only where a form of dishonesty exists on the part of the taxpayer. Taxpayers have the freedom to plan their tax affairs and pay the minimum amount of tax allowed by the legislation. The GAAR provisions in the Income Tax Act do not require a form of dishonesty, but simply require the taxpayer to receive a 'tax benefit', and that the main reason for structuring a transaction in a specific way must be to obtain such a benefit. Where a transaction's legal substance differs from or is inconsistent with its legal form it is, according to the GAAR provisions, an indication that the transaction lacks 'commercial substance'. If one considers the court cases in the USA and the Netherlands that were discussed earlier, it appears that a similar view exists in the international arena. The existing legislation dealing with hybrid instruments focuses on the substance of the transaction and attempts to reclassify the interest or dividend component of the instrument in certain instances.

In certain instances a hybrid instrument may not be subject to the debt reduction provisions. If, for example, one considers a redeemable preference share where the issuer has an obligation to redeem the share within three years, or the holder has the option to redeem it within three years, it will constitute a 'hybrid equity instrument' (Dachs & Du Plessis, 2012). If the instrument is classified as a 'hybrid equity instrument', section 8E(2) of the Income Tax Act reclassifies the dividend received by the holder as income, but does not reclassify the instrument as a debt instrument. Considering the case *CIR v Datakor Engineering (Pty) Ltd*, a preference share cannot be classified as debt and will therefore not fall within the ambit of section 19 and paragraph 12A of the Eighth Schedule to the Income Tax Act. A 'hybrid debt instrument' is treated differently and the interest in the hands of the issuer and holder is reclassified.

Where the instrument is a 'hybrid debt instrument', section 8F(2) reclassifies the interest in the hands of the holder and issuer as a dividend in specie, but if the company enters into a

debt reduction, the instrument will still be considered as debt for purposes of the debt reduction provisions. The issuer will therefore not be able to claim the interest as a deduction and likewise the holder will be subject to dividend tax where no dividend tax exemption exists. However, where such debt is reduced the company will be subject to the debt reduction provisions. Similar legislation as that discussed in section 2.3.3 exists in the Netherlands in respect of 'participation loans'. The existing legislation dealing with hybrid instruments creates a form of mismatch in respect of the debt reduction provisions. The OECD and The Davis Tax Committee did a great deal of research on the treatment of hybrid instruments.

The OECD recommendations do not suggest or include hybrid rules in domestic law to reclassify the instrument as either debt or equity. Like the existing legislation in South Africa, the OECD recommendations focus on the reclassification of the dividend or interest. The Davis Tax Committee pointed out that in the South African context hybrid rules should be implemented where a form of mismatch exists, and simpler principles should be applied rather than detailed complex rules.

2.5 FINAL CONCLUSION

Taxpayers can arrange their affairs in a way that will ensure tax-efficient functioning and operation. However, where the transaction involves dishonestly, or the taxpayer obtains a 'tax benefit' with the 'sole or main purpose' of the transaction being to obtain such a benefit, an instrument may potentially be reclassified as either debt or equity.

The researcher is of the opinion that, in respect of hybrid instruments, some form of double taxation and arbitrage may potentially exist in the context of section 19 and paragraph 12A of the Eighth Schedule to the Income Tax Act. This opinion is based on the fact that the existing legislation reclassifies only the dividend or interest component and therefore effectively treats the instrument as if it were debt or equity. However, for purposes of the debt reduction provisions a different classification may exist. In case of a 'hybrid debt instrument' a taxpayer will lose the interest deduction and, in addition, be subject to the debt reduction provisions. In the case of a 'hybrid equity instrument' such as certain types of redeemable preference shares the dividend will be treated as interest income in the

hands of the holder, but the issuer will not be subject to the debt reduction provisions. The Davis Tax Committee further points out that the legislation dealing with hybrids should focus on where a mismatch exists. The existing legislation may potentially create a form of mismatch in terms of section 19 and paragraph 12A of the Eighth Schedule to the Income Tax Act.

CHAPTER 3

DEFINING THE 'REDUCTION AMOUNT' IN SOUTH AFRICA

3.1 INTRODUCTION

The debt reduction provisions contained in section 19 and paragraph 12A of the Eighth Schedule to the Income Tax Act, define a 'reduction amount', which will be addressed in this chapter. The debt reduction provisions will only become applicable in terms of paragraph 2(b) of section 19 and paragraph 12A of the Eighth Schedule to the Income Tax Act where debt is reduced and the amount of the reduction exceeds any consideration applied. The reduction amount will effectively be the value on which the tax consequences of the debt reduction provisions will be calculated.

In Chapter 2 the discussion focused on what constitutes debt for purposes of the debt reduction provisions. In this chapter the meaning of a 'reduction amount' will be explored.

3.2 THE WRITTEN WORD

A 'reduction amount' is defined in section 19 and paragraph 12A of the Eighth Schedule as follows: 'in relation to a *debt* owed by a person, means *any amount* by which that debt is *reduced less any amount applied* by that person as *consideration* for that reduction' (own emphasis).

The study will now explore the meaning of the words used in the definition of a 'reduction amount' by considering their ordinary meanings, and their meanings when used in legislation and case law.

3.2.1 Ordinary meaning

The ordinary meaning of the words 'amount', 'reduced' and 'consideration' will be analysed.

Amount means: 'the sum total to which anything mounts up or reaches: in quantity, in number ...' (Oxford English Dictionary, nd). The Collins English dictionary (nd) defines an amount as '... the total of two or more quantities; sum; the full value, effect, or significance of something ...'. The Merriam-Webster encyclopaedia (nd) defines amount as '... to reach a total: add up ...'. Based on these definitions, one could define an amount as: the total to which something adds up or amounts to.

Reduced means 'diminished in size, number, quantity or amount; lessened' (Oxford English Dictionary, nd). The Collins English dictionary (nd) defines reduced as 'brought down in price; ... to make or become smaller in size, to impoverish. The Merriam-Webster Encyclopaedia (nd) defines reduced as 'to make (something) smaller in size, amount, number etc. ...'. Based on these definitions, one could define the term reduced as: to have become smaller, to have been diminished, to have been brought down or to have become impoverished.

Consideration means 'something given in payment; a reward, remuneration; compensation, equivalent' (Oxford English Dictionary, nd). The Collins English dictionary (nd) defines consideration as '... payment for a service; recompense; fee ...; the promise, object, etc. given by one party to persuade another to enter into a contract'. The Merriam-Webster Encyclopaedia (nd) defines consideration as 'recompense; payment; the inducement to a contract or other legal transaction; specifically: an act or forbearance or the promise thereof done or given by one party in return for the act or promise of another ...'. Consideration can therefore be defined as compensation, payment or something similar given by one party to another in terms of a contract or agreement between the parties.

Based on the ordinary meaning of the words used in the definition of a 'reduction amount', one can interpret it as: the total amount in rand by which the debt becomes smaller or is diminished or lessened, less any form of payment, compensation or similar applied to reduce the amount by which the debt becomes smaller or diminished or lessened.

Based on the discussion in section 2.2.1, when interpreting legislation, one can rely on the ordinary meaning of the words used in instances where it does not result in a conclusion that differs from the intention or purpose of the legislation. One can also not rely on the literal meaning if it would result in an absurd or unclear meaning. The purpose or intention of the debt reduction provisions is to provide for taxing rules where a debt reduction or cancellation occurs 'for less than the full consideration' (National Treasury, 2012). The literal meaning appears to be in line with the intention and purpose of the legislation and does not result in a misinterpretation of the legislation.

3.2.2 Legislation

Section 1 of the Income Tax Act or paragraph 1 of the Eighth Schedule to the Income Tax Act does not contain definitions for the words 'amount', 'consideration' or 'reduced'. The researcher could not find any definitions for 'amount' or 'reduced' in any of the other sections of the Income Tax Act either.

In terms of the Eighth Schedule a capital gain will exist where the proceeds received from the disposal of an asset exceed its base cost, and it can be interpreted that 'consideration' has a similar meaning to 'proceeds' (Olivier, 2006). Proceeds are defined in terms of paragraph 1, read together with paragraph 35 of the Eighth schedule. Proceeds are defined as '... the amount received or accrued to, or which is treated as having been received by, or accrued to or in favour of, that person in respect of that disposal, ...'. Based on the definition of 'proceeds', one can interpret 'consideration' to mean any amount received or accrued in respect of a disposal.

According to the definition for the term 'consideration' provided in section 1 of the Companies Act it can, broadly speaking, refer to anything to which value can be attached that is given to another person in exchange for something else of value and includes (but is not limited to) money, property and other forms of consideration such as barter transactions. Section 1 of the VAT Act also defines 'consideration' and includes money or any other form of payment. Section 8C of the Income Tax Act, which deals with the taxation and vesting of equity instruments, defines 'consideration' as '...any amount given

or to be given (otherwise than in the form of services rendered or to be rendered or anything done, to be done or not to be done) ...’.

Taking into account the definitions provided in the abovementioned legislation, the word ‘consideration’ can be interpreted as meaning the amount of payment, whether in the form of money or another form, that is due to another person as payment for goods disposed of or services rendered, and can include a barter transaction.

Although the legislation does not contain definitions for the words ‘reduced’ or ‘amount’, it does provide useful guidance regarding the meaning of the word ‘consideration’. Case law will now be contemplated to determine the meaning of the words considered above and to assist in comparing this to the written word.

3.2.3 Case Law in South Africa

In the case of *CIR v Datakor Engineering (Pty) Ltd*, 1998 (4) ALL SA 414 (A) (60 SATC 223), a compromise reached with the taxpayer’s creditors consisted, in part, of issuing redeemable preference shares. The dispute related to section 20(1)(a)(ii), which has been repealed. The repealed section had the effect that the balance of an assessed loss would be reduced by the amount of any benefit obtained by a taxpayer. The benefit that was obtained was the liability being extinguished or reduced as a result of the compromise with the taxpayer’s creditors. It was held that an ‘amount’ needed to be ‘an amount ascertainable in money terms’. The court concluded that the replacement of a creditor with preference shares resulted in a compromise through which a benefit is obtained by the taxpayer. The repealed section 20(1)(a)(ii) did not consider whether the benefit was ‘affected or reduced by other factors’ and was therefore irrelevant. The court referred to the case of *CIR v Butcher Bros (Pty) Ltd*, 1945 AD 301 (13 SATC 21) and concluded that the special court had erroneously placed the obligation to prove the amount or value of the compromise on SARS. The court did not express an opinion on whether the value of the benefit received had been affected by the creation of a preference share liability, or on its associated cost due to the taxpayers not including this matter in their objection.

In the case of *WH Lategan v Commissioner for Inland Revenue*, 1926 CPD 203 (2 SATC 16), it was held that the word 'amount' has a wide meaning and includes not only money, but anything 'corporeal or incorporeal' with an ascertainable money value. The principle in the *WH Lategan* case was confirmed in *CIR v People's Stores (Walvis Bay) (Pty) Ltd*, 1990 (2) SA 353 (A) (52 SATC 9), where it was held that debtors to which the taxpayer was entitled had an ascertainable money value and constituted an 'amount'.

A similar view held in the court case *CIR v Butcher Bros (Pty) Ltd*. 1945 AS 301 (13 SATC 21), in which the dispute was about whether the buildings erected by a lessee without any compensation would constitute a premium in the hands of the lessor in the year the building was erected. The court held that the word 'amount' means having an ascertainable money value and held that the Commissioner bears the burden of proof that an 'amount' was received or accrued to that person.

In *Commissioner SARS v Brummeria Renaissance (Pty) Ltd*, 2007 (6) SA 601 (SCA) (69 SATC 205), the taxpayer received interest-free loans to build retirement villages and the recipients received life-long occupancy of the retirement units. It was held that the taxpayer received a right that was capable of being valued and therefore an 'amount' was established and the fact that they could not convert the right into cash was irrelevant. In this case the court held that the decision of *Stander v CIR* was incorrect and that a taxpayer should not be required to be able to convert an amount into money to give it an ascertainable money value.

In *Stander v CIR*, 1997 (3) SA 617 (C) (59 SATC 212), a prize was awarded by a franchise dealer to a taxpayer who was not employed by that franchise dealer, with the result that there was no employee–employer relationship. It was held that the prize awarded to the taxpayer had no monetary value as the taxpayer could not convert the prize into cash.

According to the case law discussed an 'amount' must have a determinable value in monetary terms and will constitute an 'amount' even if it cannot be converted to or exchanged for money. An 'amount' could even include a right, provided that such a right can be valued in monetary terms. The settlement of a liability by issuing shares would constitute a concession and therefore a reduction in the debt.

In the case of *Commissioner SARS v Labat Africa Ltd*, 2013 (2) SA 33 (SCA) (74 SATC 1), the taxpayer acquired a trademark and as consideration for the trademark issued its own shares. The matter in dispute was whether the issuing of the shares constituted 'expenditure actually incurred' for purposes of section 11(gA) of the Income Tax Act. The court considered three English court decisions where the meaning of 'consideration' had been contemplated and did not contend that the issuing of shares constituted a consideration. However, the court held that the issuing of a company's own shares will not constitute 'expenditure actually incurred' for purposes of section 11(gA) of the Income Tax Act (Legwaila, 2013). The settlement of a liability through the issuing of shares would therefore constitute 'consideration' for the settlement of a liability (Claassen, 2013). The court held that one cannot set off shares against a liability. The court acknowledged that had a set price been agreed on for the shares, and had the proceeds from the shares been applied against the purchase price, the answer may have led to a deductible expense and that it would have been 'actually incurred'.

In *Lace Proprietary Mines Ltd v CIR*, 1938 AD 267 (9 SATC 349), the taxpayer acquired mining rights and the agreement provided for the consideration of R250 000, to be settled by issuing 1 000 000 shares of five cents each. The court concluded that the value of the consideration is the market value of the 1 000 000 shares and not R250 000, as the taxpayer could not demand the cash but was only entitled to the shares, which reflected the true intention of the parties.

In the case of *Barnett v Commissioner of Taxes*, 1959 (2) SA 713 (FC) (22 SATC 326), it was held that consideration includes a reciprocal undertaking and therefore does not necessarily require the transfer of money or property.

The case law suggests that the issuing of shares will constitute a consideration and that a consideration may also include a reciprocal undertaking. Where the intention is that the issuing of shares will constitute the consideration (and cash cannot be demanded), the market value will be used to determine the value of the consideration. Where an asset is disposed of for a cash consideration and the proceeds are used to subscribe for shares,

SARS in practice accepts the cash as being the actual consideration (De Koker & Williams, 2014).

3.2.4 Preliminary conclusion

By considering the ordinary meaning, legislation and case law one can derive the following meaning for the words used to define a 'reduction amount'. An 'amount' is the total to which something amounts and should have a determinable monetary value (even though it need not be possible to convert it to money) and includes corporeal or incorporeal items and even a right. 'Consideration' can be defined as the compensation or payment received or accrued to one party of a contract from another, in the form of money or in another form, for the disposal of something or the rendering of goods or services. It specifically includes the issuing of shares and reciprocal undertakings as 'consideration'. Where shares are issued as consideration and no cash can be demanded, the market value of the shares issued should be used to determine the amount of consideration. De Koker & Williams (2014) confirm the view that where the asset is disposed of for cash, the cash amount will constitute a 'consideration', and that SARS applies this in practice. The term 'reduced' indicates that something has become smaller, has been diminished in size or has become impoverished and specifically includes a compromise or transaction where debt is settled by the issuing of shares.

The 'reduction amount', as defined in the debt reduction provisions, can therefore be interpreted as the total number of rand (or having a determinable value in rand) by which the amount of debt that is owed becomes smaller, or is diminished, or the creditor is impoverished minus any form of compensation or payment (received or accrued) applied by the debtor against such a reduction. Such compensation can be in the form of money or another form and may include the issuing of shares.

3.3 PRACTICAL APPLICATION

3.3.1 Methods of reducing debt

For a reduction to exist, the creditor must give up the right to claim full or partial repayment of the debt by either 'reducing or extinguishing' the amount of the debt. No consequences can exist until such time as the creditor reduces the debt. A decision by a creditor to give up the right to the repayment of a debt is called a waiver and in case of a bilateral contractual act such waiver will only become binding once it has been accepted by the debtor, except in the case of a unilateral contract, when it will become binding when communicated to the debtor (De Koker & Williams, 2014).

Debt can be terminated through performance by the debtor and creditor (Huisamer, 2010). Such termination will fall within the ambit of the debt reduction provisions only where the consideration applied is less than the face value of the debt. Debt can also be reduced in terms of a release agreement between the debtor and creditor (Huisamer, 2010). The debt reduction provisions in the Income Tax Act will only become applicable where the amount of the reduction in debt exceeds any form of consideration applied.

A novation agreement exists where one obligation is terminated and a new obligation is created, but the parties involved remain the same. Where a new third party substitutes one of the existing parties to the agreement it is called a delegation. A delegation can only be valid if all parties agree to the agreement. A delegation is in effect a 'discharge of the original debt' (Huisamer, 2010). Novation is, however, not regarded as a form of payment (Christie & Bradfield, 2011). The debt reduction provisions will only become applicable if the debt is reduced in any way by the novation agreement entered into.

Debt can be cancelled by a compromise between the parties, but a valid compromise requires some form of dispute between the parties (Huisamer, 2010). In terms of common law a creditor should agree to a compromise for it to be binding on that particular creditor. In instances where the majority of the creditors agree to a compromise, those who do not agree to the compromise can still proceed with legal action against the company. The Companies Act can bind a creditor to a compromise even if that creditor does not agree to the compromise (Van Zuylen & Stein, 2009). The compromise will fall within the ambit of the debt reduction provisions where the amount of the compromise is in excess of any consideration applied.

Set-off is a common law principle established in South Africa and occurs when two persons have debt due to one another and set-off constitutes a form of payment (*Siltek Holdings (Pty) Ltd trading as Workgroup v Business Connexion Solutions (Pty) Ltd*, (081/2008) [2008] ZASCA 136). Where set-off occurs, the debt is cancelled as if a payment was made (*Schierhout v Union Government (Minister of Justice)*, 1926 AD 286 in Huisamer, 2010). Where set-off takes place in respect of an identical amount, such debt is cancelled in its entirety, whereas if there is a difference between the amounts owed by the parties the smallest debt will be cancelled and the bigger value will be reduced by the smaller amount of debt (Christie & Bradfield, 2011). Set-off can be applied only if the 'type and nature' of the debts involved are identical and the debt is liquid (Claassen, 2013).

If one considers the *Commissioner SARS v Labat Africa Ltd* case, set-off was not possible as *Labat* had an obligation to issue shares to acquire the trade mark and the other party had an obligation to pay an amount of cash which resulted in the debt not being identical. If the shares had been issued for a cash consideration and the trade mark had been sold for a cash consideration, the decision may have been different and the expenditure incurred may have been deductible. This was clearly highlighted in the judgement. The issuing of shares prior to them being fully paid for is prohibited by the Companies Act. However, this can be overcome by relying on section 40(5) of the Companies Act, which enables the issuing of shares before the exchange of cash, which can be held in trust by a third party until the payment is made (Claassen, 2013).

Debt can also be extinguished by merger, where the debt is in effect consolidated and the debtor and the creditor become the same person (Huisamer, 2010). SARS holds the view that debt extinguished by merger will constitute a debt reduction. SARS provides an example of a company that issued debentures and repurchased such debentures at a time that the market value reduced, in which case the reduction in the market value constituted a debt reduction for purposes of the debt reduction provisions (SARS, 2014b).

A debt can also be terminated in terms of the Prescription Act (68/1969) (Huisamer, 2010). SARS holds the view that the reduction of debt due to prescription will constitute a debt reduction (SARS, 2014b). No consideration will be applied in the case of a prescription of

debt and the full amount of the prescription will constitute a 'reduction amount' for purposes of the debt reduction provisions in the Income Tax Act.

A cession involves the replacement of an existing creditor with a new creditor while the debtor remains the same person (Huisamer, 2010). A creditor will not be released from its obligations where a cession occurs and a cession does not result in any amendments in respect of the terms of the agreement (Olivier, 2006). The debt reduction provisions in the Income Tax Act will therefore not become applicable as no form of reduction is created by a cession.

Various methods therefore exist that will result in a debt reduction. A 'reduction amount' will exist where the debt is reduced (considering the above methods) and the 'consideration' that was given by the debtor company is less than the value of the debt reduction. Some other practical issues will now be considered.

3.3.2 'Consideration' by issuing shares

During July 2014, SARS issued Binding Private Ruling number 173 (BPR 173) which specifically considered the capitalisation of a foreign shareholder's loan through a new share issue. The foreign shareholder would subscribe to shares in cash and the South African applicant would use the proceeds from the share subscription to repay the loan to the foreign shareholder. BPR 173 was issued on the condition that the share subscription and loan repayment occur in cash, and SARS confirmed that the debt reduction provisions in the Income Tax Act would not be applicable in these circumstances (SARS, 2014a). In BPR 173 SARS did not consider the settlement by way of set-off, but confirmed that the debt reduction provisions in the Income Tax Act may potentially not be applicable, where capitalisation of shareholder loans takes place (Louw, 2014).

SARS also issued BPR 124 in October 2012 (SARS, 2012). In this BPR application, the taxpayer wished to capitalise its shareholder loans to improve the solvency and liquidity of the business. The taxpayer was concerned that the capitalisation would result in a compromise. SARS ruled that the now repealed paragraph 12(5) of the Eighth Schedule to the Income Tax Act and section 20(1)(a) would not be applicable if the share subscription

and settlement occurred on a cash basis (SARS, 2012). An interesting observation regarding BPRs 173 and 124 is that SARS placed a condition on the BPR which stipulated that the share subscription and loan repayment should occur on a cash basis.

In the case of *Commissioner SARS v Labat Africa Ltd*, it was highlighted that the issuing of shares by the *Labat* Company to acquire a trade mark constituted 'consideration'. Considering the facts in *CIR v Datakor Engineering (Pty) Ltd*, it would appear that the capitalisation of a shareholder's loan will result in a reduction of that debt. It may, however, be argued that the debtor has not discharged the loan obligation through the issuing of shares (Brincker, 2011). The wording in the debt reduction provisions in the Income Tax Act requires the 'consideration' to be 'applied' against the debt in order for the issuing of shares to reduce the amount of the debt reduction (Visser, 2014). In instances where the debt has not been legally discharged, it can be argued that the 'consideration' for the issuing of the share is not 'applied' against the debt reduction.

The obligation can be discharged by way of set-off, where the share subscription price will be set-off against the outstanding loan obligation, but it is important to ensure that both the obligations are payable (Brincker, 2011). To be able to use set-off and discharge the obligation, the debts should be identical and due (Claassen, 2013). As highlighted in section 3.2.3, in *Lace Proprietary Mines Ltd v CIR* the court held that the market value of shares issued would constitute the consideration received. The market value of the shares would be used where no cash could be demanded by the issuer of the shares and the true intention of the parties was to settle the obligation through the issuing of shares. Once the loan obligation has been discharged and the 'consideration' is 'applied' against the value of the debt reduction, the market value of the shares (or where cash can be demanded, the cash consideration) can be used to reduce the value of the debt reduction. A cash consideration is therefore not required, but set-off can be used as an alternative to discharge the obligation and it is important that the requirements of the Companies Act be considered. This corresponds with the view held by Claassen (2013). This issue is considered in the draft Comprehensive Guide to Capital Gains Tax and will need to be addressed (SARS, 2014b).

In the draft Comprehensive Guide to Capital Gains Tax, SARS states that a debt reduction will occur when the debt of a company is converted into equity, but only to the extent that the market value of the shares that were issued is less than the face value of the debt (SARS, 2014b). The guide does not clearly indicate whether the liability should be discharged before the market value of the shares can be used to reduce the value of the debt reduction. Set-off can only apply where the shares are issued and there is a cash obligation on the person obtaining the shares. In the case of *Lace Proprietary Mines Ltd v CIR*, the court held that the true consideration was the market value of the shares, since cash could not have been demanded and the true intention of the parties should have been considered. Where the true intention of a cash 'consideration' exists, it can still be argued that the market value is not the correct value to be used. De Koker and Williams (2014) holds a similar view. Section 24BA of the Income Tax Act (see section 3.3.3) may, however, become applicable and deem the transaction to occur at market value. The researcher recommends that the matter be clarified in the draft guide.

3.3.3 Asset exchange for shares or debt

Following the *Labat* case, a number of recent legislative changes have been made that govern the issuing of shares and debt to acquire an asset.

Section 40CA of the Income Tax Act, which came into effect on 1 January 2013, deems a company to have incurred an amount of expenditure equal to the market value where shares are issued in return for an asset or equal to the market value of the debt where debt is assumed in return for an asset. Section 40C deems the expenditure incurred to be zero where a share distribution or issue is undertaken for no consideration. Section 24BA of the Income Tax Act was also inserted to regulate certain mismatches that may occur where transactions do not take place at arm's length.

Section 24BA came into effect on 1 January 2013 and attempts to ensure that where assets are acquired in return for shares (and the transaction is not at arm's length), any mismatches in the market value between the asset acquired and the shares issued are dealt with. Broadly speaking, according to this section, it will be deemed that a capital gain exists in the hands of the person issuing the share if prior to the transaction the market

value of the asset exceeded the market value of the shares after the transaction. Where the person who acquires the share holds the share as a capital asset, the excess of the market value of the asset over the shares will reduce the base cost of the share, and where the asset is trading stock it will reduce the cost of the stock. Where the market value of the shares, after the transaction, exceeds the market value of the asset before the transaction, the difference is treated as a dividend in specie. The section contains a number of exclusions that will not be discussed in detail.

Based on the above legislative changes it would appear that the legislator accepts the fact that the issuing of shares in exchange for debt or assets constitutes a 'consideration' and also 'expenditure actually incurred'. Unless transactions occur at market value, section 24BA of the Income Tax Act will, in certain instances, treat the transaction as if it occurred at arm's length. These legislative changes were made subsequent to the decision in the *Commissioner SARS v Labat Africa Ltd* case.

Since sections 24BA and 40CA will, in certain instances, deem transactions to have occurred at market value, and the issue of shares will constitute 'expenditure' which was 'actually incurred', it would be worthwhile for the legislator to consider amending section 19 and paragraph 12A of the Eighth Schedule to the Income Tax Act. These amendments will align this treatment with other sections in the Income Tax Act that consider the market value in cases where shares are issued or debt assumed in return for assets. The amendments could potentially include that the market value of shares issued or debt assumed be deemed to be 'consideration' 'applied' against the debt reduction.

3.3.4 Foreign jurisdictions

The treatment of share capitalisations and debt reductions in other jurisdictions will also be considered.

Where a share capitalisation occurs in Austria, the actual face value of the liability will constitute the amount at which the shares are issued. The difference between the market value of the shares issued and the face value of the liability will create the tax consequences unless the difference between the market value and the face value of the

liability is still fully recoverable, in which instance no tax consequences will arise. In case of an actual debt waiver, tax consequences will only arise where the value of the repayment is less than the face value of the debt (Günther & Sedlaczek, 2012).

In the Netherlands, the corporate law requires that a nominal amount be paid for the shares where a share capitalisation occurs. However, the payment can be set off against the debt, but the value of the debt should at least be equal to the value that is to be paid for the shares. The shares can be issued at a lower nominal value than the debt, provided the value of the debt is at least equal to the value paid for the shares. A debt waiver will result in a capital gains tax event, but an exemption exists where the debt is not 'realistically collectable' or 'the creditor actively (expressly) waives' the amount of the debt (Van Kasteren & Van der Pol, 2012).

Where a share capitalisation occurs in the USA and the market value of the shares being issued is less than the face value of the debt, tax consequences may arise (Scarborough & Caracristi, 2012).

The treatment in foreign jurisdictions is very similar to the treatment of a debt waiver and share capitalisation in South Africa. Corporate law in the Netherlands also requires the shares to be paid before they can be issued; therefore a cash liability has to be created for the share subscription, which can thereafter be set-off against the amount of the debt but, interestingly, does not require the value to be at market value. The result will be the same in South Africa if the asset is sold for cash and the proceeds are used to subscribe for shares (De Koker & Williams, 2014). Similarly, Austria also requires the debt to be discharged before a tax consequence can arise. The Netherlands appears to have a more lenient exemption where an amount is not collectable.

3.3.5 Preliminary conclusion

Various methods can be used to cancel or reduce debt. The important consideration in this regard is that, where a debt is cancelled or reduced, the value of the 'consideration' that is 'applied' against the value of the debt reduction should exceed the value of the debt reduction. If it does not exceed the value of the debt reduction, a 'reduction amount' exists

and the debt reduction provisions should be considered. Furthermore, the debt obligation should be discharged in a legal sense to enable a taxpayer to claim any 'consideration' against the value of the debt reduction. Where the debt is not discharged, it may be difficult to substantiate the application of the 'consideration' as a reduction against the value of the debt reduction (Brincker, 2011). Discharging a debt can occur by way of set-off or a cash settlement, but set-off can only be applied where the debts are similar. Set-off cannot occur where an obligation to issue shares and a loan obligation exists, as the debts are not similar. Where the obligation is a cash obligation to subscribe for shares and a cash loan obligation, set-off can be applied (Claassen, 2013).

3.4 COMPARISON BETWEEN THE WRITTEN WORD AND PRACTICE

Several court cases were found in which the dispute related to a tax matter and could be used to assist in clarifying the court's interpretation of both an 'amount' and 'consideration'. The researcher was unable to find any court cases with a tax-related dispute where the exact meaning of the word 'reduction' was clarified in any other way than that a loan settled by the issuing of shares would constitute a compromise and therefore a reduction. The debt reduction provisions in the Income Tax Act will be applicable only where debt is reduced and the 'amount' of the debt reduction is less than any 'consideration' applied. In order to determine what constitutes a 'reduction', reference is made to contract law, with specific consideration of how debt is reduced or cancelled.

The debt reduction provisions can be applied only where the creditor actually reduced the liability. Where a bilateral contract exists, the debt reduction will only be binding on the debtor once it has been accepted by the debtor (De Koker & Williams, 2014).

The word 'amount' has a wide meaning and includes not only money, but also any form of corporeal or incorporeal property with an ascertainable monetary value. The issuing of shares as settlement of a debt will constitute a debt reduction. The case law suggests that where shares are issued, cash cannot be demanded and it is the intention of the parties to settle the obligation by issuing shares, the market value of the shares will constitute the 'consideration'. In Austria and the USA tax consequences will arise where the market value of the shares is less than the face value of the debt.

In the case of a share capitalisation, the loan obligation by the debtor should be discharged before a taxpayer can deduct the value of the shares issued from the amount of the debt reduction as 'consideration' (Brincker, 2011). In Austria and the Netherlands a similar view exists and the issuing of shares does not legally discharge the existing loan obligation.

BPR 173 and BPR 124 issued by SARS with regard to situations where a share subscription and subsequent settlement of the shareholders loan existed, required the share issue and debt repayment to be in the form of a cash transaction, but set-off was not considered or allowed as an alternative in BPR 173 and BPR 124. It is not clear whether SARS merely highlighted the assumptions and conditions based on the BPR 173 and BPR 124 application submitted, or whether they do not in fact accept that set-off could be used as an alternative method.

3.5 FINAL CONCLUSION

The debt reduction provisions in the Income Tax Act will be applied only where debt is reduced and the amount of the consideration that is applied by the debtor against such debt reduction is less than the face value of the debt reduction.

The issuing of shares to settle a liability can be undertaken by way of a cash settlement or by way of set-off where an obligation is placed on the issuer to repay the loan in cash and the subscriber of the shares is given an obligation to subscribe for the shares in cash. Once the two liabilities exist, it is possible to set-off the liabilities against one another. Where the liability is discharged by way of set-off, the debt reduction provisions will be applicable only where the value of the shares is less than the face value of the debt. This is due to the fact that the issuing of shares will constitute a 'consideration' and can be used to reduce the value of the 'reduction amount' if it is 'applied' against the value of the reduction. Where the liability is settled in cash, such cash consideration should be deducted from the value of the debt reduction before the debt reduction provisions are applied. A debt reduction will furthermore only exist once the creditor has reduced the debt, and in the case of a bilateral contract the debtor should have accepted the debt

reduction before the debt reduction provisions in the Income Tax Act may become applicable (De Koker & Williams, 2014).

A recommendation is that the legislature should consider amending the debt reduction provisions in the Income Tax Act to deem the value of debt assumed or shares issued in return for acquiring an asset to constitute a 'consideration' that is 'applied' against the amount of the debt reduction, and that the value of such 'consideration' be the market value. Such a change will align the debt reduction provisions to the recently enacted legislation that governs where shares or debt are issued or assumed in return for an asset. The recent legislative changes ensure that the transactions occur at market value, and that where shares are issued it is deemed an 'expense actually incurred'. A further recommendation is that the Draft Comprehensive Capital Gains Tax Guide be updated to reflect the discharging of a debt before the market value of a share issue (in case of a share capitalisation) can be used to reduce the amount of the debt reduction so as to avoid any uncertainty or misinterpretation by taxpayers.

CHAPTER 4

INTERPRETING THE DEBT REDUCTION PROVISIONS IN THE INCOME TAX ACT

4.1 INTRODUCTION

In Chapters 2 and 3, consideration was given to the two elements that are required before the debt reduction provisions contained in section 19 and paragraph 12A of the Eighth Schedule to the Income Tax Act can be applied. The first element requires a debt to exist in the hands of the debtor, while the second requires that the outstanding debt be reduced by more than the value of any 'consideration' 'applied' by the debtor against the debt reduction. Where debt is reduced and any 'consideration' that is 'applied' against such a debt reduction by the debtor is equal to or exceeds the value of the debt reduction, no consequences will arise and the debt reduction provisions will not be applied.

In this chapter the actual debt reduction provisions in the Income Tax Act will be discussed, as well as some of the practical difficulties that may exist within the existing legislation.

4.2 THE WRITTEN WORD

This section of the study will focus on the actual legislation enacted in section 19 and paragraph 12A of the Eighth Schedule.

4.2.1 Exclusions from the debt reduction provisions

Section 19(8) and paragraph 12A(6) of the Eighth Schedule states the instances in which the debt reduction provisions will not be applied. These exclusions will be applied even in instances where debt was reduced and the amount of the 'consideration' that was 'applied' is less than the amount of the debt reduction. The Income Tax Act contains ordering rules

that apply regardless of whether the proceeds of the debt were used to fund revenue or capital expenditure (National Treasury, 2012).

The ordering rules provide relief to a debtor where estate duty, donation tax or fringe benefit tax becomes applicable and effectively provides relief from double taxation. In a group environment and in the case of liquidation further relief is provided, but only if the debt proceeds were used to acquire capital items. The relief attempts to eliminate any loss in base cost or assessed losses for the debtor company (National Treasury, 2012).

The focus of the current research is on companies and excludes deceased or insolvent estates and fringe benefit tax on employees. The exclusions applicable to companies will be addressed in this section.

4.2.1.1 Donations

Section 19(8)(b) and paragraph 12A(6)(b) of the Eighth Schedule state that the debt reduction provisions will not be applied where the debt reduction also constitutes a donation as defined in sections 55(1) and 58 of the Income Tax Act. The legislation therefore attempts to avoid potential double taxation and it is important to consider what would constitute a donation and how donation tax is levied.

In terms of sections 54 to 64, donations tax will be levied at a rate of 20% on the value of the donation. Section 55 defines a donation as a 'gratuitous disposal of property including any gratuitous waiver or renunciation of a right'. A number of court cases will be considered in an attempt to clarify what constitutes a donation.

In the case of *Welch's Estate v Commissioner SARS*, 2004 2 All SA 586 (SCA) (66 SATC 303), it was held that a donation will only exist where the donation is motivated by pure kindness or generosity. Where a debtor's obligation to pay the outstanding debt is released as a result of kindness or generosity on part of the creditor, donations tax may be levied in terms of section 54. Where the creditor has another reason for not collecting the outstanding debt, for example that the cost of collection may exceed the benefit, no

'gratuitous' disposal will exist as the decision is not motivated by an act of kindness or generosity (Olivier, 2006).

In the case of *The Master v Thompson's Estate*, 1962 (2) SA 20 (FC) (24 SATC 157), it was held that to determine whether an amount qualifies as a donation, one should consider the 'motive and purpose' for entering into the transaction. Where a form of consideration exists, the transaction cannot constitute a donation. Based on this court case, and as discussed in Chapter 3, where a loan is capitalised in terms of a share capitalisation and some form of consideration exists that can be applied against the reduction of the loan, it cannot constitute a donation.

The case law suggests that a donation will only exist where the donation is made by the donor as a purely gratuitous disposal out of kindness and generosity, and the motive of the donor should play a role in the classification. Where any form of consideration is provided a donation cannot exist. The Income Tax Act contains an exemption on donations made between companies in certain instances.

Section 56(r) contains an exemption from donation tax in cases where the donation is made between two companies that form part of the 'same group of companies'.

Section 58 deems a donation to exist where inadequate consideration was given for property acquired. The donations tax shall be calculated on the value of the donation less any consideration applied. In the court case *Welch's Estate v Commissioner SARS*, 2004 2 All SA 586 (SCA) (66 SATC 303), it was held that section 58 does not require any form of generosity or kindness for the section to be applied, and that it will be applied where an inadequate consideration exists.

SARS holds that adequate consideration is not necessarily at market value and that the fact and circumstances of each case should be considered separately. SARS also indicated that, with regard to section 58, the purpose needed to be considered. The purpose of the section is to act as an anti-avoidance measure in respect of estate duty; therefore, if the donor is not impoverished in some way it cannot be said that inadequate consideration was given. SARS holds that where a shareholders loan is waived, section 58 may not become applicable as the shareholder is not impoverished. SARS indicates that

although the debt is no longer an asset in the hands of the shareholder, the value of the share in the company is also likely to increase due to the decrease in the amount of the debt (SARS, 2014b).

Where an entity already has a zero equity value and the debt reduction will not increase the value beyond zero, it is debatable whether the value of the debt reduction does in fact increase the value of the share. Donations tax will be applied where an act of kindness or generosity on the part of the creditor exists, but where inadequate consideration for property acquired was obtained, the Income Tax Act does not require a form of kindness or generosity to be applied. Where inadequate consideration was received, it appears that donations tax will be levied only where the creditor is impoverished.

4.2.1.2 Same 'group of companies'

Paragraph 12A(6)(d) of the Eighth Schedule indicates that the debt reduction provisions of paragraph 12A will not be applied where the debtor and creditor form part of the 'same group of companies' as defined in section 41. The paragraph clearly excludes debt acquired (directly or indirectly) from a person who does not belong to the 'same group of companies', or in cases where the debtor and creditor only became part of the 'same group of companies' after the debt had been created. The paragraph cannot be applied in respect of any substitution of debt listed. If a taxpayer therefore acquires a new group of companies with existing debt in the group, the exclusion cannot be applied in respect of that debt, unless they constituted a 'group of companies' before the acquisition.

In terms of section 1 of the Income Tax Act, a 'group of companies' requires a 'controlling group company' that directly or indirectly holds at least 70% of the equity shares in a 'controlled group company'. The 'controlling group company' should – either directly or together with another 'controlled group company' – hold a minimum of 70% of the equity shares in one or more 'controlled group company'. A 'group of companies' as defined in section 41, excludes a co-operative, an association, a foreign collective investment, a non-profit company or an entity whose income is exempt in terms of section 10, a public benefit organisation or any recreational clubs and a non-resident company that does not have its

place of effective management in South Africa (Stiglingh *et al.*, 2014). A partnership will not qualify for the exclusion as it is not a 'company' as defined in section 1.

The paragraph will only provide a form of relief if the debt proceeds are applied to acquire capital items. If a taxpayer incurs deductible expenditure or allowance assets, section 19 will still need to be applied.

4.2.1.3 Liquidation distribution

Paragraph 12A(6)(e) of the Eighth Schedule indicates that the debt reduction provisions will not be applied if the reduction takes place in the 'course, or in anticipation, of the liquidation, winding up, deregistration or final termination of the existence of that company; ...'. The relief is only available where the persons are 'connected persons' as defined in section 1 and to the extent that the 'reduction amount' does not exceed the base cost of the debt to the creditor. The relief is not available where the debt reduction forms part of any tax avoidance scheme or transaction and where the parties became connected after the debt arose or after any substitution of such debt (Paragraph 12A(e)(aa) of the Eighth Schedule).

Section 2.3.1 in Chapter 2 highlighted the fact that the case law on simulation indicates that taxpayers can arrange their affairs to obtain a tax benefit and can even go as far as tax avoidance. A simulated transaction can only exist where a dishonest intention exists. Tax avoidance will, however, prohibit the taxpayer from relying on the relief contained in paragraph 12A(6)(e), regardless of whether or not a dishonest intention exists on the part of the taxpayer.

A company that relies on the relief contained in paragraph 12A(6)(e) should take the steps required by section 41(4) to terminate the existence of the entity. The company should not withdraw or do anything to invalidate any steps taken to terminate its existence (Paragraph 12A(6)(e)(bb) of the Eighth Schedule).

As in the 'same group of companies' requirement, this paragraph (paragraph 12A(6)) will only provide a form of relief if the debt proceeds were applied to acquire capital items. If a

taxpayer incurred deductible expenditure or allowances, section 19 will still need to be applied.

4.2.2 Application of debt proceeds by the debtor

Section 19 and paragraph 12A of the Eighth Schedule requires a taxpayer to consider how the proceeds of the outstanding debt, that is being reduced, were applied in order to determine the tax consequences (National Treasury, 2012).

Where the debt was applied, directly or indirectly, in respect of deductible expenses, an expense on which an allowance was claimed or trading stock, section 19(2) will be applied if the amount of the reduction is higher than any consideration applied. Where the debt was applied directly or indirectly in respect of expenses other than deductible expenses and other than expenses on which an allowance was claimed (in other words, capital assets), paragraph 12A(2) of the Eighth Schedule will be applied if the amount of the reduction is higher than any consideration applied. Paragraph 12A(2)(ii) includes further allowance assets within its provisions.

This part of the study will determine the tax implications in terms of the Income Tax Act, considering the nature of the expenses for which the original debt proceeds were applied.

4.2.2.1 Trading stock

Section 19(3) determines the treatment in cases where the debt proceeds were applied in respect of trading stock that is still on hand. In case of a debt reduction, the trading stock still on hand will be reduced by the 'reduction amount'. Where a deduction was granted to a taxpayer and the 'reduction amount' is greater than the value of the stock on hand, section 19(4) deems the excess to be a recoupment in terms of section 8(4)(a).

Where the company does not have an assessed loss against which the recoupment can be set-off, the taxpayer may end up in a tax-paying position, which could create an additional burden on a taxpayer who is in financial distress.

In the 2014 budget review, Treasury highlighted that the debt reduction provisions in the Income Tax Act circumvent the benefits offered to companies entering into business rescue in terms of the Companies Act and often create a tax liability to the taxpayer. The 2014 budget review stated that the legislation would be amended in 2014 to provide relief to taxpayers (National Treasury, 2014a). The 2014 Taxation Laws Amendment Act contained changes to section 19 and paragraph 12A, but those changes merely amended the legislation to clarify certain elements of the debt reduction provisions (National Treasury, 2014b). The 2015 budget review made no mention of any proposed changes to the debt reduction provisions in respect of business rescue (National Treasury, 2015).

4.2.2.2 Deductible expenditure

Section 19(5) determines the tax treatment where the debt proceeds are applied towards tax-deductible expenses other than trading stock on hand and allowance assets. In terms of section 8(4)(a), a recoupment is deemed to exist to the extent that a deduction or allowance was previously granted to the taxpayer in terms of the Income Tax Act.

Where an assessed loss is not carried forward or is less than the 'reduction amount', the taxpayer may end up in a tax-paying position.

4.2.2.3 Allowance assets

An 'allowance asset' is defined in section 19 of the Income Tax Act and is in effect a capital asset on which a deduction or allowance can be claimed, but excludes any allowance or deduction granted when determining the capital gain or loss in the event of a disposal. A capital asset should be understood in terms of the broad definition of an 'asset' given in paragraph 1 of the Eighth Schedule. According to this definition, a capital asset includes any form of property, excluding currency (but including platinum or gold coins), and specifically includes a 'right or interest' in such property. An 'allowance asset' will therefore include assets on which capital allowances are granted. Examples include wear and tear allowances in section 11(e); building allowances in terms of sections 13, 13bis, 13ter, 13quat, 13quin, 13sex and 13sept; minor assets with a cost price below R7 000; and all other similar allowances provided for in the Income Tax Act.

In case of an 'allowance asset' that is still on hand at the time of the debt reduction, the 'reduction amount' is first used to reduce the base cost of the asset to zero and only thereafter will section 19(6) be applied (paragraph 12A(3) of the Eighth Schedule). Section 19(6) indicates that where proceeds from the debt were applied towards allowance assets, a recoupment in terms of section 8(4)(a) will arise to the extent that a deduction or allowance was claimed and paragraph 12A was not applied.

The legislation is not clear on what happens in a situation where, for example, a debt reduction occurred and the proceeds were originally used to acquire an allowance asset, with only a part debt reduction (De Koker & Williams, 2014). By way of example, assume that the original debt of R1 000 was used to fund an allowance asset, that a deduction of R300 was allowed for wear and tear, and that the debt was reduced by R100. The existing legislation is unclear as to whether the R100 reduction will be allocated to the capital asset or to the allowance (De Koker & Williams, 2014). This issue will be further explored in section 4.3 of this research.

Section 19(7) limits the amount of future allowances where a debt reduction exists in respect of the 'acquisition, creation or improvement' of an 'allowance asset'. The total allowance or deduction that can be claimed will be limited to the actual expenditure incurred by a taxpayer less any 'reduction amount' and less any deductions previously claimed.

In the case of an 'allowance asset', paragraph 12A will be applied only where the asset is still on hand at the time of the debt reduction. Where the debt proceeds were used to acquire an 'allowance asset' that is not on hand at the time of the debt reduction, a taxpayer should consider only section 19, and not paragraph 12A. Where an allowance or deduction was previously claimed by the taxpayer, this will result in a potential recoupment in terms of section 8(4)(a). Where the taxpayer does not have an assessed loss, it may end up in a tax-paying position.

4.2.2.4 Capital assets

Paragraph 12A(2) of the Eighth Schedule determines the treatment of a debt reduction where the debt was used to fund capital expenses, including any allowance assets. The base cost of the asset that is still on hand is reduced to zero, or by the 'reduction amount' if it is a lower amount (Paragraph 12A(3) of the Eighth Schedule). Paragraph 12A(4) of the Eighth Schedule determines the tax treatment where the debt was used to fund expenditure relating to the 'acquisition, creation or improvement of an asset', excluding an allowance asset, or where the asset is no longer held by the taxpayer at the time of the debt reduction. The paragraph indicates that the 'reduction amount' will reduce any assessed capital loss brought forward, to the extent that the 'reduction amount' exceeds the base cost that was reduced in terms of paragraph 12A(3).

The Income Tax Act ensures that assets acquired before 1 October 2001 (capital gains tax effective date) are considered and provides a special rule for the pre-valuation-date assets where the debt that funded their acquisition is reduced. Paragraph 12A(5) of the Eighth Schedule has the effect that a taxpayer is deemed to have disposed of the pre-valuation-date asset for its market value and to have immediately re-acquired the asset at its market value less any capital gain or plus any capital loss that would have been created had the asset been sold for that market value.

The legislation effectively limits the capital gains tax expense to a taxpayer in respect of capital assets other than allowance assets. The tax consequences in respect of capital assets still on hand are limited to the base cost of the asset and a reduction of any capital losses brought forward. No taxable capital gains are therefore created by the legislation. If capital assets have already been disposed of at the time of the debt reduction, the debt reduction will lead to a reduction in the capital loss brought forward, but will not lead to a taxable capital gain.

4.2.3 Preliminary conclusion

Where the debt proceeds were applied and an allowance or deduction was claimed by the taxpayer, section 19 will deem a recoupment to exist in terms of section 8(4)(a). The tax consequences are not limited to any assessed loss brought forward and taxpayers could end up in a tax-paying position even if they entered into the debt reduction because they

were in financial distress. In its 2014 Budget Review, the National Treasury indicated that a change in legislation would create relief when a taxpayer undertakes business rescue in terms of the Companies Act (National Treasury, 2014a). The changes made in terms of the 2014 Taxation Laws Amendment Act did not provide any relief to a company undertaking business rescue and it appears that no such change is anticipated for 2015. A recommendation is therefore made that the legislators amend the legislation to provide relief from the recoupments in section 19 in cases where an entity enters into business rescue and does not have an assessed loss in excess of the 'reduction amount'. The existing legislation will not place an obligation on a taxpayer in circumstances where the amount or the recoupment is less than the balance of assessed loss brought forward. The debt reduction provisions in paragraph 12A of the Eighth Schedule, which deals with capital items, do not appear to create an additional cash tax burden on financially distressed taxpayers.

Paragraph 12A of the Eighth Schedule, which limits the tax treatment in respect of capital items to the base cost in terms of assets still on hand and a reduction of the capital loss brought forward to a maximum amount of zero, appears not to create an additional tax burden on a taxpayer.

The relief provided in respect of debt reductions between the 'same group of companies' or as a result of liquidation or winding up is only applicable if the debt was used to acquire capital items. Section 19 will still be applied and a potential tax expense may be created in respect of expenses on which an allowance or deduction was claimed.

4.3 PRACTICAL CONSIDERATIONS

This section of the document will look at some practical considerations in terms of the existing debt reduction provisions in the Income Tax Act.

4.3.1 Debt proceeds used for dual purpose

As discussed in section 4.2, the existing legislation in the Income Tax Act requires a taxpayer to determine what the outstanding debt that is being reduced was used for in

order to determine the tax consequences in terms of the debt reduction provisions. The difficulty that may exist is that the debt proceeds may have been used for a dual purpose or, as highlighted by De Koker and Williams (2014), that a partial debt reduction may exist where the original debt proceeds were used for a dual purpose.

The existing debt reduction provisions in section 19 and paragraph 12A of the Eighth Schedule require a significant amount of tracing in order to determine what the debt proceeds were used for (National Treasury and SARS, 2012). This issue was considered in the response document from SARS and National Treasury to the Standing Committee on Finance in respect of the 2012 Taxation Laws Amendment Bill. The feedback from SARS and treasury was that they did not accept the comment that tracing may be difficult in certain instances and highlighted the fact that tracing will always be required, especially when differentiation between capital and revenue items is required (National Treasury and SARS, 2012). A number of South African court cases that considered expenses incurred for a dual purpose will now be discussed.

In the case of *Local Investment Co v Commissioner of Taxes*, 1958 (3) SA 34 (SR) (22 SATC 4), the dispute was around the deductibility of expenses incurred in earning exempt and taxable income. The court held that in instances where an accurate determination of expenses incurred to earn exempt income and taxable income was impossible, the expenses should be apportioned. The Commissioner may apply an apportionment method if the taxpayer cannot determine the allocation of the expense. The court further held that the apportionment should be 'fair and reasonable', and that no single rule for apportioning, that is applicable to all circumstances could exist or be created. The specific method that is applied when performing an apportionment calculation will depend on the facts and circumstances of that case. The courts will only override the apportionment calculation performed by the Commissioner if it is not 'fair and reasonable' (Louw & Paulsen, 2014).

In the case of *CIR v Nemojim (Pty) Ltd*, 1983 (4) SA 935 (A) (45 SATC 241), the taxpayer entered into a dividend-stripping scheme and received dividends as well as proceeds from the sale of shares. The court held that where the expense was incurred for a dual purpose, an apportionment should be made between the purposes for which the expense was incurred. In this particular case the court specifically provided a formula that should be

used and required that the total proceeds from the sale of shares, as well as from the dividend income, be used as the denominator in the formula.

In the more recent case of *Commissioner SARS v Mobile Telephone Networks Holdings (Pty) Ltd, 966/12 (76 SATC 205)*, the taxpayer received dividend and interest income and incurred training expenses and audit fees. The taxpayer claimed the deduction in respect of the audit fees based on the time spent by the auditors on auditing the various components of income. The court also held that one should apportion expenses incurred for a dual purpose. The audit fees were apportioned by the Commissioner based on the exempt income as a percentage of total exempt and taxable income. The Supreme Court held that a formula could not be used in the circumstances and allowed 10% of the audit fees, which it declared to be 'fair and reasonable' (Louw & Paulsen, 2014).

These three court cases clearly suggest that where an expense is incurred for a dual purpose and an accurate determination of the purpose cannot be made, the allocation of the expense between its various components should be apportioned. No uniform apportionment method exists and the apportionment method used will depend on the facts and circumstances of each case. The apportionment should be 'fair and reasonable' and a court will only override a decision by the Commissioner if this is not considered 'fair and reasonable'.

This suggests that where a taxpayer applied the debt proceeds for a dual purpose and cannot accurately determine the allocation, a 'fair and reasonable' apportionment should be made to determine the split. However, since section 102 of the Tax Admin Act places the burden of proof on the taxpayer, taxpayers should plan and properly document how the debt proceeds are applied.

Loans often exist between shareholders and companies and form part of the financing of a business (Arendse, 2013). The number of transactions that occur between group companies or shareholders can be substantial and could arise from funding between companies and shareholders (Dachs, 2014). Goods or services can also be provided between companies on loan account (Dachs, 2014). In situations where a large number of transactions occur, it may become difficult to prove what the outstanding debt was used for

and to determine the tax implications in terms of the debt reduction provisions. As previously highlighted, paragraph 12A provides some relief in a group company environment, but section 19 may still be applicable and create tax consequences in case of a debt reduction where no assessed loss is brought forward or the assessed loss is less than the value of the 'reduction amount'. Where a large number of transactions take place on loan account and payments are affected or set-off takes place, the question of how to allocate the outstanding debt arises.

The researcher recommends that a taxpayer prepare a group loan policy document or a loan agreement in which the terms and conditions of the shareholder loans and group company loans are documented to avoid any unnecessary disputes with SARS. The terms and conditions should include the allocation of payments and should also indicate to which part of the debt the allocations must be made first. If the terms and conditions of the agreement require that items on which an allowance or deduction was claimed be settled first, the taxpayer should consider the GAAR provisions in the Income Tax Act and ensure that commercial reasons (other than the main purpose of obtaining a tax benefit or avoiding the debt reduction provisions) do exist for such a condition. The GAAR provisions were considered in section 2.3.2. The researcher further recommends that reconciliations be prepared regularly to determine how the outstanding debt proceeds were applied to avoid any disputes with SARS. A taxpayer should also determine how the accounting software being used can assist with this process. If an accurate determination of the debt proceeds does not exist, a taxpayer may be required to apportion the debt proceeds in a way that may result in an additional tax expense to the taxpayer or even a loss to the revenue authority. Taxpayers can reduce their tax risk by ensuring that these loan accounts are analysed in detail and that they are able to, at any point, determine the tax consequences created by a debt reduction. In a 'group of companies' the risk is mainly in respect of expenses on which a deduction or allowance was claimed, or where the debt arose before the parties became a 'group of companies'. This is due to the fact that section 19 does not provide any relief to group companies and paragraph 12A excludes relief in instances where the debt arose before the parties became a 'group of companies'.

4.3.2 Sale of shares and debt

Another practical consideration may arise where a taxpayer acquires a business using a loan account and the loan proceeds are applied towards capital and deductible or allowance expenses. The taxpayer subsequently sells the shares in the company and the loan account, and the new purchaser is unable to repay the liability and the debt is reduced. The question that arises is whether the nature of the loan changed or remained the same when it was acquired by the third party (Napier, 2014). Another example that may be considered is where an entity enters into an amalgamation transaction (section 44), an asset-for-share transaction (section 42) or a liquidation distribution (section 47) and assumes certain liabilities (sections 42(8), 44(4) and 47(3A)) that meet the requirements of these sections. Sections 42, 44 and 47 enable a taxpayer to transfer assets at their tax value and the acquiring and selling entities are in effect treated as the same taxpayer for purposes of the Income Tax Act. These sections do not explicitly state that they deem the parties to the arrangement to be the same taxpayer in respect of the liabilities, for tax purposes (sections 42(8), 44(4) and 47(3A)).

Napier (2014) suggests that practically, where the loan obligation is simply assumed by the purchaser, it would appear that its nature would not change from what it was when the original taxpayer acquired the business on loan account. This is due to the purchaser not advancing a new loan, the proceeds of which could be used for a different purpose, to the debtor company (Napier, 2014). The legislation in section 19 and paragraph 12A clearly includes debt that was 'directly or indirectly' used to fund capital or revenue expenses. (Section 19(2)(a) and paragraph 12A(2)(a)). The substitution of a loan will therefore not change the nature of what the debt proceeds were applied for.

Similarly, as discussed in section 3.3.1, where debt is ceded the nature of the debt will not change in the hands of the debtor and the debt reduction provisions will remain the same as before the cession. Where the parties enter into a novation agreement or a delegation agreement, it would appear that even though a new obligation is created, the purpose for which the debt was used in the hands of the debtor (directly or indirectly) will not change (section 3.3.1). In case of set-off the obligation is in effect discharged, but where partial set-off occurs it would appear that the nature of the application of the debt proceeds will remain unchanged (section 3.3.1). A partial set-off may require some form of apportionment on the part of the debtor company.

A taxpayer should therefore carefully consider the implications that may be created by acquiring debt as part of a business or intragroup acquisition.

4.4 FINAL CONCLUSION

In order to apply the debt reduction provisions in section 19 and paragraph 12A of the Eighth Schedule, a taxpayer should first determine what the outstanding debt (the debt that is being reduced), was used for. The debt reduction provisions provide for a different treatment when the debt was used to acquire capital items or where a taxpayer acquired a deductible expense or an allowance asset.

In the case of a 'group of companies' and liquidation distributions, paragraph 12A will provide relief in certain instances where the debt was used to acquire capital items and the debt reduction provisions will not be applied in these instances. In respect of debt used by a company to acquire deductible expenditure or items on which allowances are granted, the debt reduction provisions in section 19 will apply, unless this constitutes a donation. If no assessed loss exists, or the assessed loss is insufficient, a tax paying position could arise.

A recommendation is that the legislator considers the purpose of business rescue and whether section 19 should provide relief to taxpayers entering into business rescue in terms of the Companies Act.

Where a taxpayer ends up in a situation where the debt proceeds were applied for a dual purpose, that taxpayer may need to apply an apportionment method to determine whether the debt was used to acquire capital or revenue expenditure. Based on the feedback from SARS and Treasury on the 2012 Taxation Laws Amendment Bill, the legislation will not be amended to reduce the tracing burden placed on a taxpayer (National Treasury and SARS, 2012). A recommendation is that the terms and conditions of all shareholders' loans and intergroup loan accounts be governed by a group policy or agreement. This will ensure that there is clarity on the method of payment allocations which will avoid any unnecessary disputes with SARS. A recommendation is that taxpayers analyse their loan

accounts at regular intervals to record the nature of what the outstanding debt represents in case of a debt reduction. The actual debt reduction provisions can also be amended to provide clarity and specific rules where a partial debt reduction took place and the debt was used to acquire capital items as well as items on which an allowance was claimed.

Where a business is acquired and part of the acquisition comprises of a loan, it appears that the nature of the debt in the hands of the debtor company will remain the same. The debt reduction provisions will always be applied if the debt was used 'directly or indirectly' to acquire any of the items listed in section 4.2.2. The debt reduction provisions should be carefully considered since tax consequences could arise where settlement of such debt does not take place.

CHAPTER 5

OTHER RELEVANT LEGISLATION

5.1 INTRODUCTION

The first four chapters of the study focused on the actual debt reduction provisions contained in section 19 and paragraph 12A of the Eighth Schedule to the Income Tax Act. In this chapter other applicable legislation in the Income Tax Act and the VAT Act will be considered with the focus on potential implications of debt reductions in terms of other sections of the Income Tax Act and the VAT Act.

5.2 INCOME TAX LEGISLATION

This section of the study will focus on the legislation in the Income Tax Act that apply where a debt reduction occurs.

5.2.1 Interest-bearing debt reduction

Section 24J applies to any 'instrument' (Groome *et al.*, 2013). An 'instrument' is defined in section 24J(1) and includes (in paragraph c) 'any interest-bearing arrangement or debt' (Groome *et al.*, 2013). The definition of 'debt' was discussed in Chapter 2 of this research.

Where a debt reduction relates to an interest-bearing debt, section 24J may need to be applied. However, section 24J(12) indicates that where the instrument is repayable on demand (the right to demand being held by the holder of the 'instrument') at any point during the year of assessment, section 24J will not apply. Section 24J(4)(a) deems an 'adjusted gain' on the transfer or the redemption of an 'instrument' to have accrued to the person during the year of assessment. Similarly, 24J(4)(b) deems an 'adjusted loss' relating to the transfer or redemption of an 'instrument' to have accrued to the person during the year of assessment. Section 24J(4) specifically deems an accrual to occur during the year of assessment, however the general capital versus revenue rules should

still be applied to determine if the loss or gain is of capital or revenue nature (Dachs, 2014).

In terms of section 24J(4), the profit or loss on the transfer or redemption is not deemed to be interest, but is merely considered to be a gain or a loss actually incurred during the year (Brincker, 2011). The income tax court case of *ITC 1578 (56 SATC 254)* dealt with a long-term insurance company which had made profits from the redemption and purchase of treasury and bank bills. The court held that a profit from the redemption is similar in character to that of interest. A decision by the tax court is not binding on other courts and there are some English court cases (for example *Lomax V Peter Dixon & Co*, 1943 2 AER 255 in Brincker, 2011) with a different view that suggest that discounts and premiums are not similar to interest and may in certain instances be capital in nature (Brincker, 2011). An interesting debate could arise if such a dispute had to proceed to the High Court or the Supreme Court of Appeal. If a company is a money-lender, the gain or loss will generally be in the form of revenue and, broadly speaking, if the company is not a money-lender, the losses will be capital in nature (Dachs, 2014). One example of a court case that supports the view that the loss or gain by a moneylender will be revenue in nature is the case of *Solaglass Finance Company (Pty) Ltd v CIR*, 1991 (2) SA 257 (A) (53 SATC 1).

Where the gain on redemption is revenue in nature, section 24J(4A)(b) deems the gain to be 'income' to the extent that it was not subject to section 19 (Dachs, 2014). Therefore, a taxpayer will only be subject to section 24J to the extent that section 19 did not create any taxable recoupments in terms of section 8(4)(a). The section therefore avoids any potential double taxation.

5.2.2 Capital gains tax

A capital gain may arise in a specific year of assessment where the proceeds from disposal exceeded the base cost (paragraph 3(a) of the Eighth Schedule). A capital gain can also arise in a subsequent year when additional proceeds are received, a recoupment is calculated or the recovery of base cost occurs (paragraph 3(b) of the Eighth Schedule) (Olivier, 2007). However, paragraph 3(b)(ii) specifically excludes a reduction or recoupment as a result of a debt reduction as a gain in a subsequent tax year. A

subsequent capital gain or loss, other than in paragraph 12A of the Eighth Schedule, can therefore not be created by a debt reduction.

Capital gains tax consequences will exist in the hands of the creditor where a debt reduction occurs and the debt represents an 'asset' to the creditor as defined in paragraph 1 of the Eighth Schedule. An 'asset' is broadly defined in paragraph 1 of the Eighth Schedule and includes a loan debtor. A disposal is also defined in paragraph 11 of the Eighth schedule and specifically includes the 'transfer or extinction of an asset'. Paragraph 11(b) specifically includes the 'forfeiture, termination, redemption, cancellation, surrender, discharge, relinquishment, release, waiver, renunciation, expiry or abandonment' as disposal events. A debt reduction will therefore give rise to a disposal of an asset in the hands of the creditor (Dachs, 2014).

Paragraph 38 of the Eighth Schedule deals with a situation where a disposal occurs as a result of a donation and where the consideration cannot be measured in monetary terms or where a transaction occurs between connected persons. The effect is that the disposal is recorded at market value. The person disposing of the asset is deemed to receive proceeds (equal to market value) and the person acquiring the asset is deemed to acquire a base cost (equal to market value). Paragraph 56 limits the capital loss in the hands of the creditor in certain instances.

Paragraph 56 indicates that the creditor will ignore any capital loss to the extent that the debt is owed by a connected person in relation to that creditor (Dachs, 2014). The creditor can claim the capital loss to the extent to which the amount is considered to have reduced the base cost or the capital loss brought forward in the hands of the debtor (paragraph 56(2)(a) to the Eighth Schedule) (Dachs, 2014). In terms of paragraph 56(2)(c) to the Eighth Schedule, the creditor can also claim a capital loss to the extent of the amount included in the debtors 'gross income' or 'income' (Dachs, 2014). Therefore, when a debt reduction exists between connected persons, the creditor can only claim a capital loss to the extent to which the debtor company reduced the base cost or capital loss in terms of paragraph 12A, or the amount that was included in its gross income as a result of section 19. The base cost of an asset acquired through debt may also be affected by a debt reduction in the hands of a debtor company.

Where the base cost of an asset is recovered or reduced, or paid by another person, paragraph 20(3)(b) of the Eighth Schedule will, in certain instances, reduce the base cost of the assets acquired. The base cost will be reduced unless a recoupment is created in terms of section 8(4)(a), or the balance of the trading stock is reduced in terms of section 19(3). Paragraph 20(3)(b) requires a link between the base cost expenditure and the recovery or reduction of the expense, whereas paragraph 12A applies where debt is reduced (Stiglingh *et al.*, 2014). Paragraph 12A will apply regardless of whether the debt was used directly or indirectly to fund capital expenses (SARS, 2014b). Stiglingh *et al.* (2014) indicate that where a debt reduction occurs, one should not apply paragraph 20(3)(b) as it is the debt that is being reduced, and not the expense (base cost) that is being recovered or reduced. SARS holds that where a direct link exists between the base cost expenditure of the asset and the debt that is being reduced, paragraph 20(3)(b) should be applied (SARS, 2014b).

SARS is therefore of the view that, in certain instances, a debt reduction can result in a reduction or recoupment of the base cost expense. SARS holds that where a debt reduction occurs after the disposal of the asset, and such disposal occurred in the same year of assessment as the debt reduction, paragraph 20(3)(b) should be applied to reduce the base cost of the asset as a capital gain or loss is calculated on an annual basis. Paragraph 12A takes 'precedence' over paragraph 20(3)(b) of the Eighth Schedule due to the general rule that specific legislation takes precedence over general legislation. The Draft Comprehensive Guide to Capital Gains Tax provides an example to illustrate the interaction between paragraph 12A and paragraph 20(3)(b) (SARS, 2014b).

When a debt reduction occurs that is excluded from the debt reduction provisions in terms of paragraph 12A(6)(b) due to it being a donation, paragraph 20(3)(b) cannot be applied since paragraph 12A takes precedence (SARS, 2014b). The wording in the legislation is not as clear as that in the Draft Comprehensive Guide to Capital Gains Tax, which clearly states that paragraph 12A takes precedence. Although the Draft Comprehensive Guide to Capital Gains Tax clarifies this matter, the guide is not binding on SARS or taxpayers and does not represent practice generally prevailing in terms of the Tax Admin Act. A similar view is held by PWC in their Tax Law Review on the 2012 Taxation Laws Amendment

Acts, in which they indicate that the interaction between paragraph 20(3)(b) and paragraph 12A of the Eighth Schedule is not clear. It would appear that both paragraphs may apply in certain instances and questions may be asked about which one takes precedence (PWC, 2013). The researcher therefore recommends that the interaction between paragraph 12A and paragraph 20(3)(b) be clarified by the legislator in the legislation to avoid uncertainty or misinterpretation.

5.2.3 Recoupments

To avoid any potential double taxation, section 8(4)(a) excludes any recoupments that may be deemed to be created in terms of sections 19(4), 19(5) or 19(6), or where section 19 reduces the cost or expenses incurred. Broadly speaking, section 8(4)(a) ensures that a recoupment exists where a previous deduction is recouped or recovered. The exclusion of section 19 from section 8(4)(a) effectively ensures that the latter does not override the debt reduction provisions and its specific rules.

5.2.4 Donations

Donations tax (sections 54 to 64) may be applicable where a debt reduction occurs. In this study the impact of donations tax in respect of a debt reduction was considered in section 4.2.1.1.

5.2.5 Intragroup transactions

Section 45(3A) deals with a situation where assets were acquired and a company that 'forms part of the same group of companies' issued debt or shares (other than equity shares) to directly or indirectly fund the acquisition of such assets (section 45(3A)(a)). The section has the effect that the creditor company is deemed to have acquired the debt at a zero base cost. For purposes of sections 11(a), 22(1) and 22(2), the debt is also deemed to have been acquired for a zero value. Where repayment of the loan occurs (in a form other than interest or a dividend), such amount will not be considered when calculating the capital gain or loss (sections 45(3A)(c) and 45(3A)(d)).

In the case of an intragroup transaction that meets the above criteria, the creditor will not be in a position to create a capital loss in terms of paragraph 56 of the Eighth Schedule (where a debt reduction occurs) due to the loan having a zero base cost (see section 5.2.2 for details on paragraph 56). Section 45(3A) views the base cost to be zero or to have a zero value for the purposes of sections 11(a), 22(1) and 22(2). A loan created for an intragroup transaction in terms of section 45 may still be subject to the debt reduction provisions in section 19 if it constitutes a debt. Where an unconditional obligation to settle or repay an amount exists, it may constitute debt and will be subject to the debt reduction provisions (see Chapter 2). The loan will effectively have a zero base cost in the hands of the creditor, but may still constitute debt in the hands of the debtor company and be subject to the debt reduction provisions in section 19. Paragraph 12A will not apply where the parties form part of the 'same group of companies' and the debt arose after they became part of the said group (Paragraph 12A(6)(d) of the Eighth Schedule). This may create a form of mismatch (specifically in a group environment) and careful consideration should therefore be given when an asset is acquired on loan account or through the issuing of shares in terms of section 45.

5.2.6 Preliminary conclusion

Any gain or loss on an interest-bearing debt as a result of a debt reduction will only fall within the ambit of section 24J if the gain or loss is a revenue gain or loss. Section 24J will not apply to the extent that section 19 created a recoupment in the hands of the debtor (section 24J(4A)(b)). Where the loan is repayable on demand, section 24J will not be applicable as this situation is specifically excluded in terms of section 24J(12) (Dachs, 2014).

The capital gain in respect of a debt reduction will be dealt with in accordance with paragraph 12A of the Eighth Schedule, and a revenue recoupment will be dealt with in accordance with section 19. Where a debt reduction occurs between connected persons, the creditor can only claim a capital loss to the extent to which:

- the debt reduction provisions reduced the base cost of the assets of the debtor, or
- the debt reduction provisions reduced the capital loss in the hands of the debtor, or
- the debt is included in the gross income of the debtor (Dachs, 2014).

Where the debt that is being reduced was the result of an intragroup transaction in terms of section 45, no capital loss will be created as the base cost is deemed to be zero (section 45(3A)).

The base cost of an asset in the hands of the debtor will be reduced where a debt reduction occurs and a direct link exists between the debt being reduced and the asset acquired (paragraph 20(3)(b) of the Eighth Schedule) (SARS, 2014b). The base cost reduction will not occur where a recoupment in terms of section 8(4)(a) is created, or where the balance of the trading stock is reduced in terms of section 19. SARS holds the view that paragraph 12A takes precedence over paragraph 20(3)(b) and that the base cost reduction will not occur where, for example, a debt reduction occurs that is excluded from the debt reduction provisions (for example a donation) (SARS, 2014b). Where the disposal of the asset and the debt reduction occur in the same period, SARS holds that the base cost of the asset should still be reduced in terms of paragraph 20(3)(b) (SARS, 2014b). The wording of the legislation is not clear regarding the interaction between paragraphs 12A and 20(3)(b) and more specifically it is unclear when each of the paragraphs should be applied and which one will take precedence. PWC (2013) confirmed this concern in their Tax Law Review. A recommendation is that the legislation be clarified to demonstrate that paragraph 12A takes precedence over paragraph 20(3)(b) of the Eighth Schedule, and also how the two paragraphs interact with one another. This will prevent misinterpretation by taxpayers and reduce any potential disputes between taxpayers and SARS.

To avoid any double taxation, the general recoupment provisions in section 8(4)(a) will not be applied to the extent that a debt reduction occurs and section 19 will be applied. A debt reduction can also potentially create donations tax implications, but where a donation exists it is excluded from the debt reduction provisions.

5.3 VAT LEGISLATION

Where a creditor company has irrecoverable debts, section 22(1) of the VAT Act enables a creditor company to claim an input tax adjustment in respect of such a bad debt. Where a debtor company claimed input tax on the invoice basis, section 22(3) will create an output

tax adjustment if the debt remains unpaid for longer than twelve months after payment was due to the creditor company (Kriel, 2014). Section 22(3) will not apply where the supply was made between a 'group of companies' and when the companies remain part of the same 'group of companies' (Section 22(3A)). Where the repayment terms between the debtor and the creditor are contained in a contract, the twelve-month period will only commence after such payment has become due (section 22(3)(b)(i)) (Stiglingh *et al.*, 2014). The following example will explain this: *Where a contract provides for the payment for the supply of goods or services four months after the actual supply, the value-added tax (VAT) will only be levied in terms of section 22(3) after 16 months (Stiglingh et al., 2014).* Section 22(3)(b)(ii) applies to businesses that are being sequestered, are insolvent, or have entered into a compromise or similar arrangement with their creditors (for example business rescue in terms of the Companies Act).

Section 22(3)(b)(ii) applies to a VAT vendor who is facing insolvency and enters into a compromise with its creditors (or has made a similar arrangement) or is sequestered before the twelve-month period mentioned in section 22(3)(b)(i) has been reached. A deemed output tax will exist in these circumstances on the date that the VAT vendor becomes insolvent, enters into the compromise or is sequestered (Silver & Beneke, 2015). A VAT vendor who repays a portion of the unpaid debt will be entitled to an input tax deduction in terms of section 22(4) (Kriel, 2014).

The problem with the existing legislation is that the moment a financially distressed taxpayer enters into business rescue, a VAT obligation may be created in the hands of the distressed company (if that company is a VAT vendor) (Kriel, 2014). The obligation will exist only where the 'supply' was between VAT vendors that did not form part of the 'same group of companies' (Section 22(3A)). The company entering into the business rescue will be able to claim input tax only on the portion of the debt being repaid and at the time of the debt repayment. A recommendation is that the legislator considers the additional VAT burden being placed on a VAT vendor when business rescue proceedings are undertaken in terms of the Companies Act. The researcher further recommends that the legislator determines whether this additional VAT burden is in line with government's strategy of providing relief to financially distressed firms that undertake business rescue proceedings, and whether some alternative form of relief can be provided.

5.4 FINAL CONCLUSION

Overall, the legislation appears to provide some relief from double taxation where the debt-reduction provisions in section 19 and paragraph 12A of the Eighth Schedule to the Income Tax Act overlap with other sections in the Income Tax Act. A potential anomaly exists in the hands of a creditor company where debt was created through an intragroup transaction in terms of section 45 of the Income Tax Act. The anomaly or mismatch will exist only where the debt reduction provisions were applied and the debtor company included an amount in its 'gross income'. Paragraph 12A will not apply where the entities form part of the 'same group of companies' and the debt arose after they became part of the 'same group of companies'. The anomaly therefore only really exists where section 19 was applied to the debtor company. Section 45(3A) deems the debt to have a zero base cost and the creditor company will not be in a position to claim a capital loss even though the debtor company may have been subject to income tax or have reduced its assessed loss.

Paragraph 20(3)(b) of the Eighth Schedule to the Income Tax Act may reduce the base cost of the assets in certain instances where debt is reduced and a direct link exists between the debt and the asset acquired. SARS holds the view that paragraph 12A of the Eighth Schedule takes precedence over paragraph 20(3)(b). SARS will apply paragraph 20(3)(b) where a debt reduction occurs and where the disposal of the asset occurred prior to, but in the same year of assessment as a debt reduction (SARS, 2014b). A recommendation is that the interaction between paragraph 12A and paragraph 20(3)(b) of the Eighth Schedule be clarified in the formal legislation as the guide is not binding on a taxpayer.

The VAT legislation can place an additional financial burden on a financially distressed company that undertakes business rescue, sequestration or becomes insolvent. Output tax will be payable to SARS by the debtor company when it enters into any of these transactions (but not for supplies between a 'group of companies'). The output tax will therefore place an additional liability on the taxpayer and the taxpayer will only be in a position to claim the input tax when it repays a portion of the outstanding debt.

Consideration should be given to whether the additional liability in terms of the VAT legislation is supported by the purpose for business rescue proceedings in terms of the Companies Act, and whether a change is required to implement some form of relief.

CHAPTER 6

CONCLUSION

6.1 INTRODUCTION

In South Africa, recent legislative changes focused strongly on providing relief to companies experiencing financial difficulties. The debt reduction provisions in the Income Tax Act are an example of such changes. Misinterpretation of legislation or confusion created by the various sections in the Income Tax Act and the VAT Act could result in penalties and interest levied by SARS, or to potential loss of income to the revenue authority. Such penalties and interest will place an additional tax burden on a company experiencing financial difficulties.

The main purpose of this research was therefore to critically analyse the debt reduction provisions (contained in section 19 and paragraph 12A of the Eighth Schedule) of the Income Tax Act, to consider their interaction with other sections in the Income Tax Act and the VAT Act and to discuss the practical difficulties and uncertainty regarding the meaning of the legislation that could result in misinterpretation or confusion. The main purpose of the study was supported by the following research objectives that were achieved in the respective chapters:

- *To determine, through critical analysis, what constitutes a debt and a debt reduction in terms of the debt reduction provisions of the Income Tax Act, taking into consideration the definition currently enacted.*

The definition of the term debt for purposes of the debt reduction provisions of the Income Tax Act was considered in Chapter 2. This chapter also considered SARS's potential reclassification of an instrument as either debt or equity, as well as the treatment of hybrid instruments. Chapter 3 offered a critical analysis of what constitutes a 'reduction amount' for purposes of the debt reduction provisions, and whether issuing of shares as repayment of debt will impact the 'reduction amount'. The 'reduction amount' is in effect the amount on which the tax consequences in terms of the debt reduction provisions are calculated.

- *To discuss practical considerations for both the taxpayers and the legislators where clarification is required in terms of the existing Income Tax Act.*

Chapter 4 considered the currently enacted debt reduction provisions in section 19 and paragraph 12A of the Eighth Schedule to the Income Tax Act. The interpretation of the legislation, as well as practical considerations and difficulties for taxpayers and the legislators were highlighted. The chapter contains recommendations for taxpayers and legislators.

- *To explore the interaction between the debt reduction provisions and other relevant sections in the Income Tax Act, as well as the applicable sections in the VAT Act.*

Chapter 5 explored the impact of the debt reduction provisions on other sections in the Income Tax Act and the VAT Act and highlighted the interaction between the different legislation. The practical difficulties, considerations and potential changes in legislation were highlighted.

6.2 SUMMARY OF FINDINGS AND CONCLUSIONS

The debt reduction provisions will apply only where debt is reduced. The classification of an instrument as either debt or equity can be challenged by SARS in light of the substance over form doctrine, the simulation doctrine or the GAAR provisions in the Income Tax Act. Based on case law, taxpayers can plan their affairs in a tax-efficient manner, but where the 'sole or main purpose' is to obtain a tax benefit, the GAAR provisions in the Income Tax Act may potentially reclassify the instrument. A form of double taxation can exist with hybrid instruments due to the fact that the existing legislation (Section 8E to 8FA) focuses on reclassifying the interest or dividends, but the classification of the instrument as either debt or equity will not be amended. The interest or dividend of the hybrid instrument will effectively be reclassified based on the substance of the instrument, while it may continue to constitute a debt for purposes of the debt reduction provisions. The Davis Tax Committee highlighted the complexity of the existing legislation on hybrid instruments and indicated that the legislation should focus on where a mismatch arises. The existing legislation creates a form of mismatch, and amendment should be considered.

The debt reduction provisions will effectively use the amount of debt reduced less any 'consideration' 'applied' against such reduction to establish the tax consequences in terms of the debt reduction provisions (called the 'reduction amount'). Careful consideration is required when debt is settled through the issuing of shares. The debt should be legally discharged (by set-off or cash settlement) before it can be held that the shares or cash constitute 'consideration' that can be 'applied' against the debt reduction. Recent legislative changes ensure that the issue of shares or debt to acquire an asset is recorded at market value and is deemed an expense incurred by the party issuing the shares (section 24BA and 40CA). A recommendation is that consideration be given to amending the debt reduction provisions so that when shares are issued as repayment of a loan such shares will be deemed to be a 'consideration' that is 'applied' against the debt reduction.

The existing debt reduction provisions require a significant amount of tracing as the tax consequences are determined based on what the outstanding debt proceeds were used. Taxpayers should put measures in place to ensure that they can establish on what the outstanding debt was used. A recommendation is that the legislation on the application of the debt reduction provisions in a situation where a partial debt reduction occurs and the debt was used for a dual purpose, be clarified. Where a taxpayer enters into a debt reduction, section 19 will only provide relief in respect of deductible expenses or allowances to the extent that an assessed loss is brought forward or it constituted a donation. Similarly, a VAT liability is also created in certain instances. Where a debtor company claimed input tax on expenditure that has not yet been paid and then enters into business rescue, becomes insolvent or is sequestrated, output tax will become payable. A taxpayer experiencing financial difficulty can therefore have an additional normal tax and VAT burden and it is recommended that government consider the possibility of providing some form of relief to companies entering into business rescue in terms of the Companies Act.

The interaction between the debt reduction provisions and other sections of the Income Tax Act generally does not create an additional financial burden on a taxpayer. The interaction between paragraph 20(3)(b) of the Eighth Schedule of the Income Tax Act and paragraph 12A should perhaps be clarified in the legislation. Careful consideration should

be given to debt acquired in terms of a section 45 intragroup transaction as the creditor company may potentially not be able to claim a capital loss in case of a debt reduction.

6.3 SUMMARY OF THE CONTRIBUTIONS OF THE STUDY

The study critically analysed the debt reduction provisions in the Income Tax Act, highlighted some practical difficulties and its interaction with various other legislation, and highlighted areas in which change is required. This research will benefit tax practitioners, tax governing bodies and the legislators.

6.4 FUTURE RESEARCH

Some recommendations were made, focusing on where relief can be provided or clarification is required with regard to the debt reduction provisions. The study did not holistically consider the impact of the recommendations to taxpayers or government, which could be explored in further research. Further research could also be undertaken on hybrid instrument legislation, which should be followed by a proposal regarding how the hybrid instrument legislation should interact with the debt reduction provisions. A similar study could also be undertaken on trusts and individuals, with a specific focus on debt reductions relating to deceased estates.

6.5 CONCLUDING REMARKS

Where a debt is reduced, a taxpayer may be subject to various legislative requirements and uncertainty may exist regarding the interaction of the different laws and their interpretation. This research will assist not only taxpayers and tax governing bodies, but also legislators for whom areas requiring change have been clearly indicated.

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