

The prescription of interest-free loans and the tax implications thereof

by

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Declaration

I, Bianca Potgieter, hereby declare that this dissertation is my own, unaided work. It is being submitted in the partial fulfilment of the prerequisites for the degree of Master's in Law at the University of Pretoria. It has not been submitted before for any degree or examination in any other University.



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ABSTRACT

In *Trinity Asset Management (Pty) Ltd v Grindstone Investments 132 (Pty) Ltd*¹ the court held that debt in terms of a contract would become due on the specified date in terms of the agreement; when there is no specified date, the debt will be due immediately upon conclusion of the contract. The applicable period for the prescription of a debt arising from a loan agreement is three years.

In the normal course of business, an interest-free loan is perceived to have no tax consequences for the debtor or the creditor. The reason for this is that even though the debtor becomes the owner of the loan capital, he is under obligation to repay the creditor. When the loan prescribes, the tax implications will differ, resulting in either donations tax, capital gains tax or dividends tax.

This dissertation considers the tax implications of prescribed debt in South Africa with specific focus on interest-free loans. In South Africa, interest-free loans form an important commercial part of the economy, commonly found between individuals, companies and trusts as they usually form part of a financing structure. These loans tend to be informal agreements between parties with no specified due date for debt. This can easily result in the extinction of debt, due to prescription, that may give rise to various tax implications.

Keywords: Prescription, interest-free loans, capital gains tax, donations tax, dividends tax, *Trinity Asset Management (Pty) Ltd v Grindstone Investments 132 (Pty) Ltd*, taxation of debt relief in South Africa.

¹ *Trinity Asset Management (Pty) Ltd v Grindstone Investments 132 (Pty) Ltd* 2017 SA 32 (CC).

LIST OF ABRIVIATIONS

1943 Act	<i>Prescription Act 18 of 1943</i>
Act	<i>Prescription Act 68 of 1969</i>
Brummeria case	<i>Commissioner, South African Revenue Service v Brummeria Renaissance (Pty) Ltd 2007 6 SA 601 (SCA)</i>
CIR	Commissioner for Inland Revenue
CSARS	Commissioner, South African Revenue Service
Eighth Schedule	<i>Eighth Schedule of the Income Tax Act 58 of 1962</i>
ITA	<i>Income Tax Act 58 of 1962</i>
ITC	Income Tax Court
NCA	<i>National Credit Act 35 of 2005</i>
SARS	South African Revenue Service
SCA	Supreme Court of Appeal
Stell LR	Stellenbosch Law Review
THRHR	Tydskrif vir Hedendaagse Romeins-Hollandse Reg
Trinity Asset Management	<i>Trinity Asset Management (Pty) Ltd v Grindstone Investments 132 (Pty) Ltd 2017 SA 32 (CC)</i>
TSAR	Tydskrif vir die Suid-Afrikaanse Reg

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CHAPTER 1

BACKGROUND AND INTRODUCTION

Persons who owe money are usually delighted when their debts prescribe, are waived by the creditor or are paid by another person on their behalf. However, joy may turn to anguish for the benevolent creditor or payer if the tax consequences of the prescription, waiver or payment become evident.²

1.1 Prescription of debt in South Africa

In South Africa, prescription is regulated in terms of the *Prescription Act* 68 of 1969.³ In terms of this *Act*, the prescription of a debt commence to run as soon as a debt is payable and shall be extinguished after the lapse of the applicable period.⁴ The applicable period for the prescription of a debt arising from a loan agreement is three years.⁵ A creditor must interrupt the running of prescription by way of instituting legal proceedings before the end of the three-year period or lose his legal right to enforce a claim.⁶ The *Act* further states that a debt will not be payable until the creditor has knowledge of the identity of the debtor and the facts from which the debt arise.⁷

The *Trinity Asset Management (Pty) Ltd v Grindstone Investments 132 (Pty) Ltd*⁸ judgment created doubt regarding the three years period for the prescription of a debt arising from a loan agreement. In this case, the court had to consider the interaction between prescription and contractual freedom.⁹ In short, the parties entered into a written loan agreement in terms of which the respondent borrowed R3,050,000.00 from the applicant in September 2007.¹⁰ In September 2013, the applicant addressed an email to the respondent requesting repayment of the loan.¹¹ The respondent made

² Strauss "Income tax Waving goodbye to waiving of debts" 2003 *De Rebus* 57.

³ Hereafter "*Act*".

⁴ Section 12 of the *Act*.

⁵ Section 11(d) of the *Act*.

⁶ Gabryk et al "Prescription revisited" 2019 *Without Prejudice* 7.

⁷ Section 12(3) of the *Act*.

⁸ Hereafter "*Trinity Asset Management*". *Trinity Asset Management (Pty) Ltd v Grindstone Investments 132 (Pty) Ltd* 2017 SA 32 (CC).

⁹ *Trinity Asset Management* para 8.

¹⁰ *Trinity Asset Management* para 10.

¹¹ *Trinity Asset Management* para 12.

no payment and consequently a letter of demand was served on the respondent by way of the sheriff in December 2013.¹² The respondent denied his indebtedness to the applicant and in July 2014, the applicant applied to the High Court for the provisional liquidation of the respondent on the basis that he is unable to pay his debts.¹³ The respondent raised the preliminary defence of prescription and the High Court held that prescription was indeed a valid defence in this case.¹⁴

The High Court granted leave to appeal to the Supreme Court of Appeal¹⁵ where the majority of the court found that the debt was due the moment it was lent and therefore the debt has prescribed.¹⁶ The applicant appealed to the Constitutional Court submitting that the SCA erred in finding that a debt which is payable on demand becomes due the moment the advanced was made.¹⁷ Consequently, the court had to interpret the contract between the parties and determine whether a demand for payment was a prerequisite for the enforcement of the claim.¹⁸ If demand is a prerequisite, the debt will only become due after demand was made, if not a prerequisite, then the debt would be due immediately.¹⁹ According to the respondent, a creditor cannot postpone the running of prescription by refraining from performing a certain act, in this event by not demanding payment.²⁰

The Constitutional Court found that debt, in terms of a contract, would be due on the specified date in terms of the contract. In addition, when there is no specified date, the debt will be due immediately on conclusion of the contract.²¹ The consequence of this judgment is that agreements must be drafted in clear terms indicating the exact time of repayment for the debt to become due and thereby determining when prescription commences to run.²²

¹² *Trinity Asset Management* para 12.

¹³ *Trinity Asset Management* para 13.

¹⁴ *Trinity Asset Management* para 15.

¹⁵ Hereafter "SCA".

¹⁶ *Trinity Asset Management* para 18.

¹⁷ *Trinity Asset Management* para 23.

¹⁸ *Trinity Asset Management* para 23.

¹⁹ *Trinity Asset Management* para 23.

²⁰ *Trinity Asset Management* para 25.

²¹ *Trinity Asset Management* para 47.

²² Lane "Prescription of debts payable on demand" 2017 *Without prejudice* 9.

1.1.2 South African income tax implications of prescribed interest-free loans

1.1.2.1 The *Genn*²³ principal

Income tax in South Africa is levied by the *Income Tax Act* 58 of 1962.²⁴ In the normal course of business, an interest-free loan is perceived to have no tax consequences for the debtor or the creditor.²⁵ In *Commissioner for Inland Revenue v Genn & Co. (Pty) Ltd*²⁶ the court considered that a close link must exist between expenditure and the production of income in order to deduct the expenditure from income tax.²⁷ Here, the respondent was a private company that deducted certain commissions paid from its total amount income.²⁸ These commissions were raising fees paid to a trust and investments company on loans raised for financing the respondent's stock-in-trade purchases.²⁹ The court held that:

It is difficult to see how money obtained on a loan can, even for purposes of the wide definition of "gross income", be part of the income of the borrower, any more than the value of the tractor which a farmer borrows is to be regarded an income received otherwise than in cash. The borrowing for use differs from a borrowing for consumption in that the borrower in the former case does not become the owner of the thing borrowed, and must return it *in specie*. While in the latter case, he does not become the owner and is only obliged to return what is similar, for present purposes there would seem to be no difference between the two cases.³⁰

Obtaining physical control over money or money's worth does not in every case establish a receipt.³¹ The court concluded that the borrower of a capital amount is under the obligation to repay the capital amount once he is given possession thereof. The court also held that:

²³ *Commissioner for Inland Revenue v Genn & CO (Pty) Ltd* 1955 3 SA 293 (A).

²⁴ Hereafter "ITA".

²⁵ Brincker *Taxation principals of interest and other financing transactions* (2011) A-2.

²⁶ *Commissioner for Inland Revenue v Genn & CO (Pty) Ltd* 1955 3 SA 293 (A).

²⁷ *Commissioner for Inland Revenue v Genn & CO (Pty) Ltd* 1955 3 SA 293 (A) 293.

²⁸ *Commissioner for Inland Revenue v Genn & CO (Pty) Ltd* 1955 3 SA 293 (A) 293.

²⁹ *Commissioner for Inland Revenue v Genn & CO (Pty) Ltd* 1955 3 SA 293 (A) 293.

³⁰ *Commissioner for Inland Revenue v Genn & CO (Pty) Ltd* 1955 3 SA 293 (A) 301.

³¹ *Commissioner for Inland Revenue v Genn & CO (Pty) Ltd* 1955 3 SA 293 (A) 301.

What is borrowed does not become his, except in the sense, irrelevant for present purposes, that what is borrowed is consumable there is in law a change of ownership in the actual things borrowed.³²

It can therefore be concluded that, according to the *Genn*³³ principal, even though the debtor becomes the owner of the loan capital, he is under the obligation to repay the capital to the creditor and therefore the capital does not form part of the debtor's gross income.³⁴ However, when the capital loan prescribes the tax implications may be either donations tax in the hands of the lender or capital gains tax in the hands of the borrower. The reason being as follows:

1.1.2.2 Donations tax

Donations tax is paid on the value of any property disposed of under any donation by any resident.³⁵ The *ITA* defines a donation as any gratuitous disposal of property.³⁶ In the event that property is disposed of and the consideration given for the property is in the opinion of the Commissioner not adequate consideration, this disposal is viewed as a donation and taxed accordingly.³⁷ An example of a loan that would be subject to donations tax is the following: By agreement, the lender borrows the borrower money in the amount of R100 000 at no interest. When the amount borrowed prescribes, it will be regarded as a gratuitous disposal of property.³⁸ The reason being that the lender demanded or received no consideration for the loaned amount.

1.1.2.3 Capital gains tax

The disposal of a capital asset of a resident on or after the 1st of October 2001 is subject to capital gains tax.³⁹ During the current year of assessment, a person's capital gain is equal to the amount received from the disposal of an asset where the disposal

³² *Commissioner for Inland Revenue v Genn & CO (Pty) Ltd* 1955 3 SA 293 (A) 301.

³³ *Commissioner for Inland Revenue v Genn & CO (Pty) Ltd* 1955 3 SA 293 (A).

³⁴ Van Rensburg "Commissioner, South African Revenue Service v Brummeria Renaissance (Pty) Ltd and Others: Does the Judgement Benefit an Understanding of the Concept Amount?" 2008 *Stell LR* 45.

³⁵ Section 54 of the *ITA*.

³⁶ Section 55(1) of the *ITA*.

³⁷ Section 58 of the *ITA*.

³⁸ Unknown "Donations tax and estate planning – Immovable property sales" 2017 *Schindlers Attorneys* 2.

³⁹ Para 1 of the *Eighth Schedule to the ITA*.

exceeds the base cost of the asset.⁴⁰ When a person owes a debt to a creditor, and this debt has been reduced or discharged by the creditor, in that no consideration was paid or the consideration paid was less than the face value the debt, this will be regarded as a disposal for capital gains tax purposes.⁴¹

An example of a loan that would be subject to capital gains tax is the following: The lender waives his right to receive payment in full of the loan to the borrower, the lender would be subject to donations tax as discussed above. The borrower would be subject to capital gains tax because he has the benefit of the capital gain to the extent of the waiver.⁴² A person's capital gain in respect of the disposal of an asset for the year of assessment is equal to the amount received for the disposal that exceeds the base cost of the asset.⁴³

1.2 Fundamental research question

The central research question is how will prescription affect the taxation of interest-free loans? Generally, all amounts received or accrued by a taxpayer should be included in a taxpayer's gross income, excluding receipts and accruals of a capital nature, and these amounts will be liable for income tax.⁴⁴ However, in terms of an interest-free loan agreement, the debtor is under the obligation to repay the capital to the creditor, and therefore the capital does not form part of the debtor's gross income. When the interest-free loan prescribes, the tax consequences differ. The creditor neglected to pursue his claim with the result that his claim has prescribed. Prescribed debt is deemed a disposal of property liable for capital gains tax.⁴⁵ Therefore, the capital gain in the hands of the debtor will be equal to the amount in which the debt was reduced or discharged by the creditor.⁴⁶

⁴⁰ Para 3(a) of the *Eighth Schedule to the ITA*.

⁴¹ Para 12(5) of the *Eighth Schedule to the ITA*.

⁴² Unknown "Donations tax and estate planning – Immovable property sales" 2017 *Schindlers Attorneys* 3.

⁴³ Para 3 of the *Eighth Schedule to the ITA*.

⁴⁴ SARS *Interpretation note no.58* (2012) 9.

⁴⁵ Para 12(5) of the *Eighth Schedule to the ITA*.

⁴⁶ Strauss "Income tax Waving goodbye to waiving of debts" 2003 *De Rebus* 57.

1.3 Specific research questions

To answer the fundamental research question of how prescription will effect the taxation of interest-free loans, the question will be broken down into the following sub-enquiries:

- 1.3.1 What is prescription and how is prescription regulated in South Africa?
- 1.3.2 What is an interest-free loan?
- 1.3.3 How will prescription in terms of the *Trinity Asset Management* judgment effect the taxation of interest-free loans?
- 1.3.4 How is debt relief taxed in South Africa and how do these provisions apply to the prescription of debt?

1.4 Importance and benefits of the proposed study

It is not uncommon to come across loans that do not attract interest. Interest-free loans form an important commercial part of the economy and are commonly found between individuals, companies and trusts, - forming part of a financing structure.⁴⁷

As mentioned, interest-free loans are regarded as the pillars of the commercial sector. The parties to these loan agreements do not necessarily strive to be financially benefited from these loans, hence not charging interest. These loans are often granted as financial aid in assisting to fund small businesses, families providing financial assistance to each other or trusts acquiring assets while not incurring the debt. Entering into these loan agreements also have various tax benefits, which will be discussed in depth in the following chapter.

If the lender had the intention to gain financially from the loan by charging interest, granting a loan for a short period at a high interest rate would be the shrewdest way to achieve this. With interest-free loans on the other hand, no such intention exists.

⁴⁷ Although prescribed debt in general may have various tax implications, this study focusses on the tax implications of interest-free loans. Arendse "The perils of low interest and interest-free loans" 2013 *Taxtalk* 2.

With no interest charged and no intention to financially gain from interest-free loans, then do these loans need not to be repaid within two or three years. If the *Trinity Asset Management* judgment applies and no mention of a due date for repayment is made, interest-free loan agreements repaid over a period longer than three years would prescribe. It is also unlikely that parties to these agreements have entered into a formal agreement stating a repayment due date. Informal loans between families and friends, meant to serve as financial aid, would not necessarily have a repayment due date which means that these loans will be due and payable once the advance has been made. A layman might not be aware or even consider the prescription of these loans and the possible tax implications thereof.

The aim of this study is to consider the tax implications of prescribed interest-free loans so that taxpayers are informed of the tax consequences of such transactions and approach such transactions cautiously.

1.5 Methodology

This will be a qualitative study and the main resources that will be consulted are scholarly journals, books and electronic books available at the University of Pretoria's library catalogue, applicable legislation and case law as well as tax interpretation notes.

Certain resources will form a central part of this dissertation, namely: The *Trinity Asset Management* case, the *Act* and the *ITA*.

1.6 Structure

Chapter One is an introduction to the dissertation. In a short summary, the theme of every chapter will be discussed asking the research question namely: How will prescribed interest free loans be taxed? This summary will be followed by an overview of the study discussing the methodology and structure of the dissertation.

In Chapter Two, the central theme of this chapter will be prescription in South Africa. There will be focused on what prescription is, how prescription is regulated in South Africa and the consequences of prescription. This will be followed by a discussion of the *Trinity Asset Management* judgment.

Chapter Three will focus on interest and interest-free loans. A brief discussion on how interest is generally taxed in South Africa will be followed by an in-depth discussion on the taxation of interest-free loans with specific reference to the *Brummeria*⁴⁸ case. Capital gains tax and donations tax will also be discussed. There will be focused on what each of these taxes are as well as when a person will be liable to pay such taxes.

Chapter Four will answer the fundamental research question applying the *Trinity Asset Management* judgment to the principals regarding the taxation of interest-free loans with possible capital gains tax and donations tax consequences.

Chapter Five will focus on the taxation of debt relief in South Africa and will consider whether these provisions apply to the prescription of debt.

Chapter Six will contain the conclusion of the study.

⁴⁸ *Commissioner, South African Revenue Service v Brummeria Renaissance (Pty) Ltd* 2007 6 SA 601 (SCA).

CHAPTER 2

PRESCRIPTION OF DEBT IN SOUTH AFRICA

2.1 Introduction

The extinctive prescription of debt is one of the central themes of this study. This chapter aims to define prescription as well as explain its purpose. In South Africa, extinctive prescription is regulated in terms of the *Act*. The regulation of prescription under the *Act* as well as the previous *Act*, *Prescription Act 18 of 1943*,⁴⁹ will be discussed with specific reference to the extinctive prescription of debt. This will be followed by a discussion of the *Trinity Asset Management* judgment. This judgment is relevant to the dissertation because the Constitutional Court had to consider whether a debt had prescribed in terms of an agreement. The Constitutional Court considered the following: what the definition of "debt" is, when debt is due and how the running of prescription can be interrupted. Each of these considerations is applicable to this study and will be discussed below.

2.2 What is prescription?

The court held in *Duet and Magnum Financial Services CC v Koster*⁵⁰ that "prescription is about rights that have come into existence but have ceased to exist with the passage of time".⁵¹ The passage of time give rise to ways for one to acquire and lose rights, or to free oneself of obligations.⁵² This is referred to as extinctive prescription. Extinctive prescription extinguishes a debt, which *inter alia* means that the debt cannot be revived. In short: when a person (creditor) lends another person (debtor) an amount of money in terms of a loan agreement, and the creditor neglects to enforce his claim by not demanding the debtor repay the loan, the loan will prescribe after the lapse of

⁴⁹ Hereafter "*1943 Act*".

⁵⁰ *Duet and Magnum Financial Services CC v Koster* 2010 4 All SA 154 (SCA).

⁵¹ *Duet and Magnum Financial Services CC v Koster* 2010 4 All SA 154 (SCA) para 9.

⁵² Schrage "The comparative legal history of limitation and exception" 2018 *Obiter* 780.

the applicable time period and the creditor will not be allowed to claim repayment from the debtor.

2.2.1 History of prescription

Prescription is not a new concept and was commonly found in the Roman- and Common-law. According to Schrage,⁵³ the *Limitations Act* of 1624 aimed to provide protection for the debtor and was one of the cornerstones of the Common-law. The principle behind this legislation was to presume that payment that remained unclaimed for a long time, because the person did not pursue his rights, might have already taken place or the evidence may be lost.⁵⁴ This protects a debtor against unfair exploitation from a neglectful creditor. According to the Common-law view, both the peaceful co-existence and the common good is threatened by the neglect of a claimant.⁵⁵

In the Roman-Dutch Common-law, the period for extinctive prescription was a third of a century, or 30 years.⁵⁶ Modern jurist uses the term prescription where the lapse of time prohibits either the remedy of the former owner, or where the right of the former owner is extinguished and transferred to the possessor.⁵⁷ Prescription still forms a significant part of South African legislation today.

2.2.2 The purpose of prescription

Prescription implies protection for a debtor against a creditor's claim resting too long.⁵⁸ In *Mohlomi v Minister of Defence*,⁵⁹ Didcott J clarified the rationale for extinctive prescription:

Rules that limit the time during which litigation may be launched are common in our legal system as well as many others. Inordinate delays in litigation damage the interests of justice. They protract the disputes over the rights and obligations sought

⁵³ Schrage "The comparative legal history of limitation and exception" 2018 *Obiter* 782.

⁵⁴ Lord Hatherley in 1879. Schrage "The comparative legal history of limitation and exception" 2018 *Obiter* 782.

⁵⁵ Schrage "The comparative legal history of limitation and exception" 2018 *Obiter* 784.

⁵⁶ Grotius *Dutch Jurisprudence* 3.46. 2-8, Maasdorp's translation 1868 second edition 340; Unknow "Prescription under the common law" 1970 *Rhodesian law journal* 47.

⁵⁷ Mackenzie *Studies in Roman law with comparative views of the laws of France, England, and Scotland* (1870) 186.

⁵⁸ Schrage "The comparative legal history of limitation and exception" 2018 *Obiter* 781.

⁵⁹ *Mohlomi v Minister of Defence* 1997 1 SA 124 (CC).

to be enforced, prolonging the uncertainty of all concerned about their affairs. Nor in the end is it always possible to adjudicate satisfactorily on cases that have gone stale. By then witnesses may no longer be available to testify. The memories of ones whose testimony can still be obtained may have faded and become unreliable. Documentary evidence may have disappeared. Such rules prevent procrastination and those harmful consequences of it. They thus serve a purpose to which no exception in principle can cogently be taken.⁶⁰

This rationale was echoed in *Road Accident Fund v Mdeyide*⁶¹ where the Constitutional Court found that time plays a significant role in creating stability and certainty in legal affairs and upholding the quality of justice.⁶² The objective of prescription is therefore to prevent the debtor from having to raise a defence to a claim that arose long after the cause of action.⁶³ Prescription is not imposed to chastise innocent failure to act, but rather to put an end to the uncertainty that the lapse of time creates.⁶⁴ The lapse of time causes uncertainty and lost/destroyed evidence, which in turn might be financially detrimental to a debtor forced to pay more than initially indebted for. The law does not shield a creditor that is careless in protecting his assets⁶⁵ because it would not positively serve the common good.

To summarise, according to Loubser,⁶⁶ prescription serves the following purpose: to protect the interest of the debtor, to enhance the effectiveness and efficiency of the court in that parties are to bring their disputes to court without undue delay, to promote social stability in that it brings certainty in the debtor-creditor relationship. South Africa implemented the *Act* to regulate extinctive prescription and to ensure the purpose and rationale for prescription is imposed.

⁶⁰ Own emphasis. *Mohlomi v Minister of Defence* 1997 1 SA 124 (CC) para 11.

⁶¹ *Road Accident Fund v Mdeyide* 2011 2 SA 26 (CC).

⁶² *Road Accident Fund v Mdeyide* 2011 2 SA 26 (CC) para 8; Van Heerden and Boraine "The impact of section 129(1)(a) of the National Credit Act on the prescription of credit agreement debt" 2015 *THRHR* 459.

⁶³ Saner *Prescription in South African Law* (2014) para 1.2; Van Heerden and Boraine "The impact of section 129(1)(a) of the National Credit Act on the prescription of credit agreement debt" 2015 *THRHR* 458.

⁶⁴ Saner *Prescription in South African Law* (2014) para 1.2; Van Heerden and Boraine "The impact of section 129(1)(a) of the National Credit Act on the prescription of credit agreement debt" 2015 *THRHR* 458.

⁶⁵ Schrage "The comparative legal history of limitation and exception" 2018 *Obiter* 780.

⁶⁶ Loubser "The prescription period applicable to a debt secured by notarial bond" 2016 *Stell LR* 375.

2.3 Regulation of extinctive prescription of debt in South Africa

2.3.1 Extinctive prescription under the 1943 Act

The *1943 Act* defines prescription as "the rendering unenforceable of a right by the lapse of time".⁶⁷ According to Saner,⁶⁸ this definition is vague because it creates uncertainty whether it is the right itself or the right to institute legal proceedings that is extinguished by the lapse of time. The extinction of a right to enforce an obligation is referred to as "weak" prescription.⁶⁹ The concept of "weak" prescription⁷⁰ was understood to mean that even though the rendering of a right was unenforceable due to the lapse of time, the right itself remained in existence and could operate to set off countervailing debts.⁷¹ "Weak" prescription had the consequence that a right to enforce will be extinguished before the obligation that initially give rise to this right to enforce, is extinguished.⁷² In terms of the *1943 Act*, every civil action to enforce a right will expire at one time or another.⁷³ The *1943 Act*, received a lot of criticism from Prof De Wet⁷⁴ who was requested to draft a memorandum that was eventually promulgated by the legislature and replaced the *1943 Act*.

2.3.2 Extinctive prescription under the Prescription Act 68 of 1969

In 1967 Professor De Wet's Memorandum on prescription became the *Act*.⁷⁵ In South Africa, extinctive prescription of debt is regulated in terms of Chapter III of the *Act*. Opposed to the "weak" prescription referred to in the previous *1943 Act*, the *Act* now provides for a prescription regime that can extinguish a prescribed debt.⁷⁶ Prescription

⁶⁷ Section 3(1) of the *1943 Act*.

⁶⁸ Saner *Prescription in South African Law* (2014) 4.

⁶⁹ Saner *Prescription in South African Law* (2014) 5.

⁷⁰ Contained in section 3(1) of the *1943 Act*.

⁷¹ *Duet and Magnum Financial Services CC v Koster* 2010 4 All SA 154 (SCA) para 21.

⁷² Saner *Prescription in South African Law* (2014) 5.

⁷³ *Duet and Magnum Financial Services CC v Koster* 2010 4 All SA 154 (SCA) para 21.

⁷⁴ Professor Johannes Christiaan de Wet 1912-1990; Breuer *JC de Wet 1912-1990* undated <http://www.stellenboschwriters.com/dewetjc.html>.

⁷⁵ Loubser "The prescription period applicable to a debt secured by a notarial bond" 2016 *Stell LR* 374.

⁷⁶ *Desai NO v Desai* 1996 1 SA 141 (A) 9.

shall extinguish a debt after the lapse of the applicable period in terms of law.⁷⁷ The *Act* sets out the deferent periods in which a debt will prescribe:

(a) thirty years in respect of- (i) any debt secured by mortgage bond; (ii) any judgment debt; (iii) any debt in respect of any taxation imposed or levied by or under any law; (iv) any debt owed to the State in respect of any share of the profits, royalties or any similar consideration payable in respect of the right to mine minerals or other substances; (b) fifteen years in respect of any debt owed to the State and arising out of an advance or loan of money or a sale or lease of land by the State to the debtor, unless a longer period applies in respect of the debt in question in terms of paragraph (a); (c) six years in respect of a debt arising from a bill of exchange or other negotiable instrument or from a notarial contract, unless a longer period applies in respect of the debt in question in terms of paragraph (a) or (b); (d) save where an Act of Parliament provides otherwise, three years in respect of any other debt.⁷⁸

The result of a prescribed principle debt is that any subsidiary debt, arising from the principle debt, will also be extinguished.⁷⁹ The running of prescription can also be interrupted. An express or tacit acknowledgement of liability by the debtor will interrupt the running of prescription.⁸⁰ Prescription will be interrupted by the service of process⁸¹ on the debtor in which the creditor claims payment.⁸² The result of this is that prescription will start to run afresh on the day which the interruption took place.⁸³ In the event that the parties decide to postpone the due date of the debt at the time that the interruption of prescription takes place; the debt will become due again on the postponed date.⁸⁴

It is important to note that when the debtor pays a debt after the debt prescribed, the payment shall be regarded as the payment of the debt.⁸⁵ Additionally, the court may only take note of prescription when a party to the proceedings raised prescription as

⁷⁷ Section 10(1) of the *Act*.

⁷⁸ Own emphasis. Section 11 of the *Act*.

⁷⁹ Section 10(2) of the *Act*.

⁸⁰ Section 14(1) of the *Act*.

⁸¹ The word "process" includes the service of any document which commence legal proceedings such as a notice of motion, pleading in reconvention and a third party notice for example. Section 15(6) of the *Act*.

⁸² Section 15(1) of the *Act*.

⁸³ Section 14(2) of the *Act*.

⁸⁴ Section 14(2) of the *Act*.

⁸⁵ Section 10(3) of the *Act*.

a defence; the court may not *mero moto* raise prescription.⁸⁶ The word "debt", as understood in terms of the *Act*, needs to be considered.

2.4 Trinity Asset Management Constitutional Court judgment

2.4.1 The facts of this case

The facts of this case were briefly referred to in Chapter One. To summarise: the parties entered into a loan agreement in September 2013, the respondent failed to make payment and a letter of demand was served on the respondent in December 2013. The applicant applied to the High Court in 2014 for the provisional liquidation of the respondent and the respondent raised prescription as his defence.

In the Constitutional Court, the applicant argued that a debt, repayable on demand, would only become due once the monetary advance is made and that the expressed intention of the parties must be disregarded.⁸⁷ The respondent argued that a creditor could not postpone the running of prescription by refraining from performing a certain act.⁸⁸ The parties agreed that the fundamental issue the court needed to resolve was whether the debt in terms of the agreement had prescribed.⁸⁹ The court held that in terms of the old *Companies Act* 61 of 1973,⁹⁰ a company that does not settle its debt within three weeks after being served a letter of demand, is unable to pay its debt.⁹¹

⁸⁶ Section 17 of the *Act*; Davies *The influence of the prescription act, 68 of 1969 on selected aspects of the notice in terms of section 129(1)(a) of the national credit act, 34 of 2005* 8.

⁸⁷ *Trinity Asset Management* para 23.

⁸⁸ *Trinity Asset Management* para 24.

⁸⁹ *Trinity Asset Management* para 1.

⁹⁰ *Companies Act* 61 of 1973.

⁹¹ In terms of Section 345(1) of the *Companies Act* 61 of 1973: "A company or body corporate shall be deemed to be unable to pay its debts if- (a) a creditor, by cession or otherwise, to whom the company is indebted in a sum not less than one hundred rand then due- (i) has served on the company, by leaving the same at its registered office, a demand requiring the company to pay the sum so due; or (ii) in the case of any body corporate not incorporated under this Act, has served such demand by leaving it at its main office or delivering it to the secretary or some director, manager or principal officer of such body corporate or in such other manner as the Court may direct, and the company or body corporate has for three weeks thereafter neglected to pay the sum, or to secure or compound for it to the reasonable satisfaction of the creditor; or (b) any process issued on a judgment, decree or order of any court in favour of a creditor of the company is returned by the sheriff or the messenger with an endorsement that he has not found sufficient disposable property to satisfy the judgment, decree or order or that any disposable property found did not upon sale satisfy such process; or (c) it is proved to the satisfaction

In terms of the agreement between the parties, it was a suspensive condition that a demand had to be served before the respondent is obliged to pay.⁹² The court held that the difficulty of this was that section 345 of the *Companies Act*⁹³ provide the debtor with 21 (twenty-one) calendar days to pay its debt and the agreement between the parties provides the debtor 30 (thirty) days to repay the debt.⁹⁴ The following question arises: which one of the time periods referred to above should be taken into account in order to determine whether the debtor is unable to repay its debt?

2.4.2 Definition of the word debt

The *Act* does not define the word "debt". It is therefore necessary to turn to the court's interpretation of the word. In *Escom v Stewarts and Lloyds*⁹⁵ the court held that the word "debt" can be defined as follows:

It was common cause in the Court that a debt is: that which is owed or due; anything (such as money, goods or services) which one person is under obligation to pay or render to another.⁹⁶

The word "debt" must be given a general meaning.⁹⁷ In *Makate v Vodacom*,⁹⁸ the High Court applied a general meaning to the word "debt" and held that the word also includes the claim of a defendant in terms of a contract.⁹⁹ The Constitutional Court found that in the interpretation of the word, an interpretation less intrusive on the right of access to courts would be preferred.¹⁰⁰ The wide and general meaning will be the

of the Court that the company is unable to pay its debts; *Trinity Asset Management* para 7.

⁹² *Trinity Asset Management* para 7.

⁹³ Section 345 of the *Companies Act* 61 of 1973.

⁹⁴ *Trinity Asset Management* para 7.

⁹⁵ *Escom v Stewarts and Lloyds* 1981 3 SA 340 (A).

⁹⁶ *Escom v Stewarts and Lloyds* 1981 3 SA 340 (A) para 3 44 F-H.

⁹⁷ *Saner Prescription in South African Law* (2014) 64; *African Products (Pty) Ltd v Venter* 2007 3 All SA 605 (C); Van Heerden and Boraine "The impact of section 129(1)(a) of the National Credit Act on the prescription of credit agreement debt" 2015 *THRHR* 458.

⁹⁸ *Makate v Vodacom* 2016 6 BCLR 709 (CC).

⁹⁹ *Makate v Vodacom* 2016 6 BCLR 709 (CC) para 82; *Saner Prescription in South African Law* (2014) 65.

¹⁰⁰ This principle was confirmed in the *South African Transport and Allied Workers Union (SATAWU) and Others v Moloto NO and Another* 2012 6 SA 249 (CC) para 44, when the court found that: "Constitutional rights conferred without express limitation should not be cut down by reading implicit limitations onto them, and when legislature provisions limits or intrudes upon those rights they should be interpreted in a manner least restrictive of

less intrusive on the right of access to courts because the word is generally understood to mean an amount of money owed or due. In *Desai NO v Desai*,¹⁰¹ the court held that: "The term debt is not defined in the Act, but in the context of section 10 it has a wide and general meaning and includes an obligation to do something or refrain from doing something".¹⁰² The court held in *Frieslaar NO v Ackerman*,¹⁰³ that the word "debt" is a wide concept that does not include a cause of action but rather a right of action. The court further held that a debt is:

Something owed or due; something (such as money, goods or services) which one person is under an obligation to pay or render to another. A liability or obligation to pay or render something; the condition of being obligated.¹⁰⁴

In *Duet and Magnum Financial Services CC v Koster*,¹⁰⁵ the court held that:

A 'debt' for purposes of the Act is sometimes described as entailing a right on one side and a corresponding 'obligation' on the other. However, if 'obligation' is taken to mean that a 'debt' exists only when the 'debtor' is required to do something then I think the word is too limiting. At times, the exercise of a right calls for no action on the part of the 'debtor', but only for the 'debtor' to submit himself or herself to the exercise of the right. Moreover, if a 'debt' is merely the complement of a 'right', and if all 'rights' are susceptible to prescription, then it seems to me that the converse of a 'right' is better described as a 'liability', which admits of both an 'active and passive meaning'.¹⁰⁶

the right if the text is reasonably capable of bearing that meaning"; *Makate v Vodacom* 2016 6 BCLR 709 (CC) para 91.

¹⁰¹ *Desai NO v Desai* 1996 1 SA 141 (A).

¹⁰² *Desai NO v Desai* 1996 1 SA 141 (A) para 146; *Saner Prescription in South African Law* (2014) 67.

¹⁰³ *Frieslaar NO v Ackerman* 2017 SA 03 (SCA) para 19; The court held: "In short, the word 'debt' does not refer to the 'cause of action', but more generally to the claim", *Drennan Maud & Partners v Town Board of the Township Pennington* 1998 3 SA 200 (SCA) para 212F-J.

¹⁰⁴ *Frieslaar NO v Ackerman* 2017 SA 03 (SCA) para 39; *Saner Prescription in South African Law* (2014) 68.

¹⁰⁵ *Duet and Magnum Financial Services CC v Koster* 2010 4 All SA 154 (SCA).

¹⁰⁶ *Duet and Magnum Financial Services CC v Koster* 2010 4 All SA 154 (SCA) para 24; This passage was quoted with approval in *Bester NO and Others v Schmidt Bou Ontwikkelings CC* 2013 1 SA 125 (SCA) para 13.

In this case, the court further held that the word "debt" must be regarded to include all the rights that was subjected to prescription in terms of the *1943 Act*.¹⁰⁷

To conclude, the word "debt" in terms of prescription is regarded to mean something due or owed and is not limited to a monetary amount but can include any service or goods that is due or owed.

2.4.3 When is a debt due?

In the *Trinity Asset Management* case, the parties agreed that the fundamental dispute was whether the debt had prescribed. This dispute was placed before both the SCA as well as the Constitutional Court to answer the following question: whether a creditor may be given the right, by agreement between the parties, to determine when a debt falls due and therefore when prescription will commence to run?¹⁰⁸

Prescription commences to run as soon as a debt is due.¹⁰⁹ The court held in *Frieslaar NO v Ackerman*,¹¹⁰ that the ordinary meaning of the phrase is understood to mean: "that a debt owing and already payable or immediately claimable or immediately eligible at the election of the creditor".¹¹¹ This was confirmed in the *Trinity Asset Management* judgment, where the court held that a debt is due when it is immediately payable by a debtor and immediately claimable by a creditor.¹¹² A debtor is thus compelled to act immediately.¹¹³

Prescription does not commence until the creditor becomes aware of the existence of the debt.¹¹⁴ In *Deloitte Haskins & Sells Consultants (Pty) Ltd v Bowthorpe Hellerman*

¹⁰⁷ *1943 Act, Duet and Magnum Financial Services CC v Koster* 2010 4 All SA 154 (SCA) para 22.

¹⁰⁸ *Trinity Asset Management* para 32.

¹⁰⁹ Section 12(1) of the *Act*.

¹¹⁰ *Frieslaar NO v Ackerman* 2017 SA 03 (SCA).

¹¹¹ *Frieslaar NO v Ackerman* 2017 SA 03 (SCA) para 22; The court also refers to the following judgments in this regard: *Electricity Supply Commission v Stewarts & Lloyds SA (Pty) Ltd* 1979 4 SA 905 (W) para 908E; *Deloitte Haskins & Sells Consultants (Pty) Ltd v Bowthorpe Hellerman Deutsch (Pty) Ltd* 1991 1 SA 525 (A) para 532H.

¹¹² *Trinity Asset Management* para 38.

¹¹³ *Frieslaar NO v Ackerman* 2017 SA 03 (SCA) para 22.

¹¹⁴ Section 12(2) of the *Act*.

Deutsch (Pty) Ltd,¹¹⁵ the court held the following requirements must be met before prescription starts to run:

There has to be a debt immediately claimable by the creditor or, stated in another way, that there has to be a debt in respect of which the debtor is under an obligation to perform immediately.¹¹⁶

In *Truter and Another v Deyse*¹¹⁷ the court held the following:

For the purposes of the Prescription Act, the term 'debt due' means a debt, including a delictual debt, which is owing and payable. A debt is due in this sense when the creditor acquires a complete cause of action for the recovery of the debt, that is, when the entire set of facts which the creditor must prove in order to succeed with his or her claim against the debtor is in place or, in other words, when everything has happened which would entitle the creditor to institute action and to pursue his or her claim.¹¹⁸

According to Saner,¹¹⁹ the legislature clearly distinguished between when a debt comes into existence and when a debt is recoverable, prescription does not necessarily run when a debt arises, only when the debt is due. The court held that a right is not capable of expiring if it has not come into existence yet.¹²⁰

In the *Trinity Asset Management* judgment the court held that, in light of the above mentioned, the terms of a contract/agreement will determine when a contractual debt becomes due.¹²¹ If the parties to an agreement intends that a creditor will be entitled to determine the time for performance, the debt will become due once demand has been made.¹²² If a creditor fails to demand payment, the court will interpret the agreement to disregard the parties' intention that the creditor has the right to demand

¹¹⁵ *Deloitte Haskins & Sells Consultants (Pty) Ltd v Bowthorpe Hellerman Deutsch (Pty) Ltd* 1991 1 SA 525 (A).

¹¹⁶ *Deloitte Haskins & Sells Consultants (Pty) Ltd v Bowthorpe Hellerman Deutsch (Pty) Ltd* 1991 1 SA 525 (A) para 532H.

¹¹⁷ *Truter and Another v Deyse* 2006 4 SA 168 (SCA).

¹¹⁸ *Truter and Another v Deyse* 2006 4 SA 168 (SCA) para 16.

¹¹⁹ Saner *Prescription in South African Law* (2014) 77.

¹²⁰ *Duet and Magnum Financial Services CC v Koster* 2010 4 SA 154 (SCA) para 9.

¹²¹ *Trinity Asset Management* para 47.

¹²² *Trinity Asset Management* para 47.

payment within a reasonable time.¹²³ Reasonable time will depend on the facts and circumstances of each case.¹²⁴

The Constitutional Court held that in order to determine whether or not the debt had prescribed, the answer is dependent on the proper interpretation of the contract.¹²⁵ In the interpretation of the agreement between the parties, the ordinary grammatical meaning of the words and the language in the agreement will be the starting point.¹²⁶

¹²³ *Trinity Asset Management* para 48.

¹²⁴ In *Stockdale v Stockdale* 2004 1 SA 68 (C) para 15, the court held that: "Voet 12.1.19 says that in the case of a loan for consumption, where no time for repayment has been fixed, the money must be repaid 'not forthwith, but after the passage of a moderate time, so that in the meantime the borrower will have been able to enjoy at least some advantages out of the loan and the use of the money'. This sentiment was echoed by Mason J in the case of *Mackay v Naylor* 1917 TPD 533 at 538, where the Court held that a reasonable time must be allowed to the borrower to enable him to have some 'real benefit from the transaction'." Furthermore, in *Fluxman v Brittain* 1941 AD 273 para 294, the court held that: "Voet (45.1.19) states that the rule must be accepted with some moderation of the time for performance, and in regard to the contract of *mutuum* he states in the passage already quoted (12.1.19) that the loan must be repaid after a reasonable time, remarking that, although it is true that in all obligations in which the time for fulfilment is not fixed, the debt is presently due, yet it should not be presumed that for that reason the humanity and even the discretion of the Judge are taken away, so that a reasonable delay may be given ('must be given' – according to the translation in the *Aanhangzel tot het Hollandsch Rechtsgeleerdheid Woordenboek, s.v. Mutuum*) by the lender or the Judge to the borrower who is sued, as the nature of the case requires. Pothier (*Mutuum, Oeuvres*, vol. 5, sec. 48), dealing with contracts of loan in which no term is mentioned for repayment states that the lender ought to grant a time more or less long according to the circumstances, in the discretion of the Judge, for the restitution of the sum lent, and that the borrower has against the demand of the lender, if he sues him before this time, an exception by which he ought to obtain from the Judge a delay for the payment.", *Trinity Asset Management (Pty) Ltd v Grindstone Investments 132 (Pty) Ltd* 2017 SA 32 (CC) para 48; *Munnikhuis v Melamed NO* 1998 3 SA 873 (W) para 887E the court held the following: "A right to claim performance under a contract ordinarily becomes due according to its terms or, if nothing is said, within a reasonable time, which, in appropriate circumstances, can be immediately".

¹²⁵ *Trinity Asset Management* para 51.

¹²⁶ The court quoted relevant paragraphs from various judgments: "Interpretation is the process of attributing meaning to the words used in a document, be it legislation, some other statutory instrument or contract, having regard to the context provided by reading the particular provision or provisions in the light of the document as a whole and the circumstances attendant upon its coming into existence. Whatever the nature of the document consideration must be given to the language used in the light of the ordinary rules of grammar and syntax; the context in which the provision appears; the apparent purpose to which it is directed and the material known to those responsible for its production. Where more than one meaning is possible, each possibility must be weighed in the light of these factors. The process is objective, not subjective. A sensible meaning is to be preferred to one that leads to insensible or unbusiness-like results or undermines the apparent purpose of the document. Judges must be alert to, and guard against, the temptation to substitute what they regard as reasonable, sensible or business-like for the words actually used. To do so in regard to a statute or statutory instrument is to cross the divide between interpretation and legislation; in a contractual context, it is to make a

This is an objective assessment where the specific provision in the agreement and the agreement as a whole will be taken into regard.¹²⁷

The court held that demand was a material condition in the contract that would determine the date that the debt is due – the creditor would put the debtor under a duty to pay the debt.¹²⁸ The parties further agreed that interest would only be charged at a future date once demand was made.¹²⁹ The parties intended that the agreement be a long-term agreement in that the loan will be paid a long period after the advance has been made.¹³⁰ They were specific with things to happen before the debt will become due, namely that there has to be a written demand giving the debtor 30 (thirty) days to repay the loan before the creditor may enforce repayment.¹³¹ The Constitutional Court summarised its view as follows:

In summary, the relevant principles may, in my view, be restated as follows: A contractual debt becomes due as per the terms of that contract. When no due date is specified, the debt is generally due immediately on conclusion of the contract. However, the parties may intend that the creditor be entitled to determine the time for performance, and that the debt becomes due only when demand has been made as agreed. Where there is such a clear and unequivocal intention, the demand will be a condition precedent to claimability, a necessary part of the creditor's cause of action, and prescription will begin to run only from demand. This, in my view, is not an incident of the creditor being allowed to unilaterally delay the onset of prescription. It is the parties, jointly and by agreement seriously entered into, determining when and under what circumstances or conditions a debt shall become due.¹³²

contract for the parties other than the one they in fact made. The inevitable point of departure is the language of the provision itself, read in context and having regard to the purpose of the provision and the background to the preparation and production of the document." *Natal Joint Municipal Pension Fund v Endumeni Municipality* 2012 4 SA 593 (SCA) para 18. "The first step in construing a contract is to determine the ordinary grammatical meaning of the words used by the parties (*Jonnes v AngloAfrican Shipping Co (1936) Ltd* 1972 2 SA 827 (AD) para 834E). Very few words, however, bear a single meaning, and the 'ordinary' meaning of words appearing in a contract will necessarily depend upon the context in which they are used, their interrelation, and the nature of the transaction as it appears from the entire contract." *Sassoon Confirming and Acceptance Co (Pty) Ltd v Barclays National Bank Ltd* 1974 1 SA 641 (A) para 646B; *Trinity Asset Management* paras 52 and 53.

¹²⁷ *Trinity Asset Management* para 55.

¹²⁸ *Trinity Asset Management* para 56.

¹²⁹ *Trinity Asset Management* para 57.

¹³⁰ *Trinity Asset Management* para 57.

¹³¹ *Trinity Asset Management* para 63.

¹³² Own emphasis. *Trinity Asset Management* para 47.

The court held that the agreement between the parties did not specify a date for repayment and the parties therefore clearly intended that prescription would commence to run when demand was made.¹³³ Demand must have been made within a reasonable time. An email Trinity send to Grindstone regarding repayment did not constitute a valid demand for contractual purposes, even though Grindstone understood the email to be a demand.¹³⁴ The court concluded that the agreement between the parties did not postpone the onset of prescription because "it is not the law that a debtor must be placed in mora before he may be sued for specific performance".¹³⁵ The clause in the agreement that deals with demand was a term of the agreement and had nothing to do with prescription.¹³⁶ The court agrees that the claim had prescribed and the appeal is dismissed with costs.¹³⁷

2.5 Written and verbal agreements

The question arises whether this judgment is applicable to both written and verbal agreements, in other words if the parties to a verbal agreement agree verbally on a date that prescription will commence to run will it comply with this judgment? To answer this question, one must first distinguish between written and oral agreements.

An agreement between parties does not have to be in a specific form to constitute a contract.¹³⁸ The law acknowledges all agreements whether in writing or verbal in which the intention of the parties thereto can be ascertained.¹³⁹ In short, a written agreement is an agreement written on paper while an oral agreement is a verbal understanding between the parties. The requirement for a written agreement between the parties can be a formality prescribed by the parties to the agreement or it can be prescribed by legislation.¹⁴⁰ If the contracting parties requires the agreement to be in writing, no

¹³³ *Trinity Asset Management* paras 129 and 130.

¹³⁴ The court held that the email did not set out the amount due, nor determine a fixed date for repayment. The debtor was not placed on terms therefore, the court concluded that the email demanded nothing. *Trinity Asset Management* para 135.

¹³⁵ *Theron v Theron* 1973 3 SA 667 (C) para 672; *Trinity Asset Management* para 159.

¹³⁶ *Trinity Asset Management* para 163.

¹³⁷ *Trinity Asset Management* para 165.

¹³⁸ *Build-a-brick BK v Eskom* 1996 1 SA 115 (O); Van der Merwe et al *Die algemene beginsels van kontraktereg* (2012) 137.

¹³⁹ Van der Merwe et al *Die algemene beginsels van kontraktereg* (2012) 137.

¹⁴⁰ Van der Merwe et al *Die algemene beginsels van kontraktereg* (2012) 138.

verbal agreement will be of force until reduced into writing, the written agreement will also reflect the parties' wishes.¹⁴¹ There are a few statutes that require an agreement to be reduced in writing. These include for example the *Alienation of land Act*¹⁴² that requires any agreement regarding the alienation of land to be reduced in writing and signed by all parties.¹⁴³

The *Act* does not require agreements to be in writing. The *Trinity Asset Management* is also silent on whether a verbal agreement would be sufficient to determine the date of the commencement of prescription. Parties to an interest-free loan agreement are however advised to determine in writing the onset of prescription because it will be easier to enforce between parties and to prove in legal proceedings.

2.6 Conclusion

Needless to say, this judgment bears consequences for loan agreements. The SCA judgment held that the wording of the agreement between the parties also appeared in the wording of many loan agreements,¹⁴⁴ therefore the judgment will have serious implications for commerce in general and "will raise an arguable point of law of general public importance".¹⁴⁵ If it is the intention between the parties to a loan agreement that a debt will only become due once demand has been made, they must explicitly state the date Lenders must formulate their agreements in such a way that the risk of an on-demand debt owed to them be extinguished in cases similar to this one.¹⁴⁶ Parties must therefore specify when the repayment of a debt is due to determine when prescription will commence to run.¹⁴⁷ It is also important to note that when the abovementioned express conditions in an agreement is met, the creditor must still

¹⁴¹ For a full discussion on the requirements determined by the contracting parties, see Van der Merwe et al *Die algemene beginsels van kontraktereg* (2012) 138.

¹⁴² *Alienation of land Act* 68 of 1981.

¹⁴³ Van der Merwe et al *Die algemene beginsels van kontraktereg* (2012) 147.

¹⁴⁴ *Trinity Asset Management* para 20.

¹⁴⁵ *Trinity Asset Management* para 32.

¹⁴⁶ Scott and Cole-Morgan "Prescription of claims: On demand loans" 2016 *Werksmans Legal Brief* 1.

¹⁴⁷ Lane "Prescription of debts payable on demand" 2017 *Without prejudice* 9.

ensure that proper demand is made. A demand must state the amount and a request for payment must be made.

CHAPTER 3

LOW INTEREST AND INTEREST-FREE LOANS

3.1 Introduction

The aim of this chapter is to provide background on what low interest and interest-free loans are. In this chapter, consideration will be given to the definition and history of loan agreements. Interest and the regulation thereof will also be briefly discussed. Reference will be made to interest-free loans and why these loans are important to this study.

3.2 Background to loan agreements

3.2.1 Definition and history of loan agreements

To grasp the nature of low interest and interest-free loans, the definition of "loan" needs to be ascertained. The general meaning of the word can be found in the English dictionary. The dictionary defines a loan as a sum of money that the lender borrows to someone and in return the borrower is expected to repay the amount.¹⁴⁸ Phrases such as "financing", "credit" and "overdraft" are often used to refer to something that is in essence loans.¹⁴⁹ The definition of the word used in banking and finance is:

Money lent on condition that it is repaid, either in instalments or all at once, on agreed dates and usually that the borrower pays the lender an agreed rate of interest (unless it is an interest-free loan).¹⁵⁰

With these definitions in mind, it can be concluded that a loan is money advanced with the expectation that it will be repaid on a specified future date or within a specified period. As none of these definitions mentions the charging interest as an

¹⁴⁸ Stevenson and Waite *Concise Oxford English Dictionary* (2011) 835; Tennant *The nature of interest-free loans and the tax implications thereof* 12.

¹⁴⁹ Brentley *Impact CSARS v NWK in determining whether an interest free loan can be regarded as a simulated transaction* 12.

¹⁵⁰ Law and Smullen *Oxford Dictionary of Finance and Banking* (2008) 145.

essential part of a loan, one needs to determine whether interest is an "integrated part of any loan".¹⁵¹ The application of either the Common-law principals or the *National Credit Act 35 of 2005*¹⁵² will provide guidance in this regard.

3.2.1.1 Loan agreements in terms of the Common-law

The Roman-Dutch law distinguishes between two types of loan agreements namely, loans for use (*commodatum*) and loans for consumption (*mutuum*).¹⁵³ In terms *commodatum* the borrower undertakes to bind himself to return the borrowed thing to the lender at the end of the loan period.¹⁵⁴ The borrower is provided with the borrowed thing for a fixed or determined period and for a specific purpose.¹⁵⁵ An example of *commodatum* agreements is renting machinery for agricultural use. Once the machinery is used for its specific purpose, it is returned to the lender.

On the other hand, a loan for *consumption* is an agreement in terms of which the lender transfers ownership of the thing to the borrower.¹⁵⁶ This study will focus on *mutuum* (loan for consumption) because these loan agreements are usually repaid over a period and the lender may decide whether to charge interest on the loan agreement.¹⁵⁷ At the end of the loan period, the borrower is expected to return the same object or of similar value to the lender.¹⁵⁸ The borrower can for example not borrow wine and return bread to the lender. It must be wine or something else of similar value that is returned. Therefore, in terms of these agreements the lender and the borrower reach consensus that the borrower is to return, in similar kind, the equivalent of whatever is borrowed.¹⁵⁹

¹⁵¹ Preston *Interest-free loans or low-interest loans and estate planning: Life after Brummeria* 9.

¹⁵² Hereafter "NCA".

¹⁵³ Tennant *The nature of interest-free loans and the tax implications thereof* 17.

¹⁵⁴ Thomas et al *Historiese Grondslae van die Suid-Afrikaanse Privaatreg* (2006) 290.

¹⁵⁵ Tennant *The nature of interest-free loans and the tax implications thereof* 17.

¹⁵⁶ Thomas et al *Historiese Grondslae van die Suid-Afrikaanse Privaatreg* (2006) 287.

¹⁵⁷ Preston *Interest-free loans or low-interest loans and estate planning: Life after Brummeria* 10.

¹⁵⁸ Willie et al *Wille's Principles of South African Law* (2007) 948.

¹⁵⁹ Thomas et al *Historiese Grondslae van die Suid-Afrikaanse Privaatreg* (2006) 287.

3.2.1.2 Essential elements of loans for consumption

A valid loan agreement gives rise to several obligations for both the lender and the borrower. The first obligation places a duty upon the lender to give possession and title of the loan capital to the borrower.¹⁶⁰ The lender must therefore ensure that the borrower is given ownership of the loan capital. The lender must transfer its title in the thing borrowed to the borrower to entitle the borrower to consume the loan capital.¹⁶¹ The second obligation places a duty on the borrower to return the capital amount to the lender at the expiration of the loan agreement.¹⁶² The borrower will in return bear the risk for any loss or decline in the loan capital.¹⁶³ Because the lender is deprived of his use of the loan capital, a reward such as interest may be charged in these types of agreements.¹⁶⁴ Therefore, depending on the agreement, there might also be a third obligation placed on the borrower namely the obligation to pay interest.¹⁶⁵

Initially loans for consumption were used as short-term financing between natural persons with no interest charged.¹⁶⁶ As time progressed, the use of these types of loans started to form part of the commercial sector resulting in interest being charged and placing an obligation on the borrower to repay the loan with interest.¹⁶⁷ These types of contracts/agreements developed independent from loans for consumption and were concluded verbally known as *stipulatio*.¹⁶⁸ The *NCA* is the main regulatory

¹⁶⁰ Van Rensburg "Commissioner, South African Revenue Service v Brummeria Renaissance (Pty) Ltd and others: does the judgement benefit an understanding of the concept 'amount'?" 2008 *Stell LR* 43.

¹⁶¹ Willie et al *Wille's Principles of South African Law* (2007) 950.

¹⁶² Van Rensburg "Commissioner, South African Revenue Service v Brummeria Renaissance (Pty) Ltd and others: does the judgement benefit an understanding of the concept 'amount'?" 2008 *Stell LR* 43.

¹⁶³ Willie et al *Wille's Principles of South African Law* (2007) 950.

¹⁶⁴ Tennant *The nature of interest-free loans and the tax implications thereof* 17.

¹⁶⁵ Van Rensburg "Commissioner, South African Revenue Service v Brummeria Renaissance (Pty) Ltd and others: does the judgement benefit an understanding of the concept 'amount'?" 2008 *Stell LR* 43.

¹⁶⁶ Tennant *The nature of interest-free loans and the tax implications thereof* 17.

¹⁶⁷ Tennant *The nature of interest-free loans and the tax implications thereof* 17.

¹⁶⁸ Tennant *The nature of interest-free loans and the tax implications thereof* 17.

legislation of these credit and loan agreements.¹⁶⁹ The *NCA* is responsible for regulating the credit market and protecting the consumer.

3.2.2 Interest on loans

The *ITA* defines interest as follows:

'interest' includes the- (a) gross amount of any interest or related finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement; (b) amount (or portion thereof) payable by a borrower to the lender in terms of any lending arrangement as represents compensation for any amount to which the lender would, but for such lending arrangement, have been entitled; and (c) absolute value of the difference between all amounts receivable and payable by a person in terms of a sale and leaseback arrangement as contemplated in section 23G throughout the full term of such arrangement, to which such person is a party, irrespective of whether such amount is - (i) calculated with reference to a fixed rate of interest or a variable rate of interest; or (ii) payable or receivable as a lump sum or in unequal instalments during the term of the financial arrangement.¹⁷⁰

Therefore, loans usually incur interest on the basis that the lender is deprived of the use of the borrowed capital amount and expect some form of compensation in return from the borrower.¹⁷¹ Also, if the borrower repays the loan and the amount exceeds the capital amount initially borrowed, the difference between the initial capital amount and the amount repaid will be regarded as the incurred interest. Interest must be incurred in the production of income actually incurred before it can be deducted.¹⁷² Interest will usually not be charged unless there is an agreement between the parties to that effect.¹⁷³

Thus, interest charged on a loan agreement give rise to a third contracting obligation namely, that the lender is entitled to receive interest.¹⁷⁴ The charging of interest on

¹⁶⁹ Preston *Interest-free loans or low-interest loans and estate planning: Life after Brummeria* 7.

¹⁷⁰ Own emphasis. Section 1 of the *ITA*.

¹⁷¹ Brincker *Taxation Principles of Interest and other Financing Transactions* (2011) V-2.

¹⁷² Brincker *Taxation Principles of Interest and other Financing Transactions* (2011) A-3.

¹⁷³ Willie et al *Wille's Principles of South African Law* (2007) 950.

¹⁷⁴ Brentley *Impact CSARS v NWK in determining whether an interest free loan can be regarded as a simulated transaction* 20.

loans is not a statutory requirement in South Africa.¹⁷⁵ The creditor has the right to charge interest and it is in his sole discretion to decide to exercise this right or not.

3.3 Low interest and interest-free loans

Interest on loans have been a topic for religious debate dating back as far as biblical times.¹⁷⁶ There are several references in the Bible where the Old Testament objects to receiving interest.¹⁷⁷ Today some religions still do not believe in receiving or charging interest.¹⁷⁸ In the Islamic religion for example, the Shari'ah¹⁷⁹ prohibits the charge of interest.¹⁸⁰ Interest-free loans is therefore an effective solution to accommodate both religion and the commercial sector. According to Ger,¹⁸¹ interest-free loans in South Africa can be regarded as the pillars of the commercial sector because, apart from its religious function, parents provide these loans to their children, they are made to trusts, and they feature in many business transactions. According to Carroll,¹⁸² there can be distinguished between three types of interest-free loans:

- (i) The Brummeria scenario where the right to use an interest free loan is granted as a quid pro quo as part of the taxpayer's trade Taxable.
- (ii) Interest free/low interest loans granted by employers to employees Taxable as fringe benefit in terms of the Seventh Schedule to the Income Tax Act.
- (iii) Interest free loans made in family and estate duty planning situations where the transactions are of a capital nature not taxable because of the exclusion of capital amounts from gross income.¹⁸³

¹⁷⁵ Tennant *The nature of interest-free loans and the tax implications thereof* 16.

¹⁷⁶ Tennant *The nature of interest-free loans and the tax implications thereof* 12.

¹⁷⁷ Examples of these references are as follows: "You shall not charge interest on loans to your brother, interest on money, interest on food, interest on anything that is lent for interest. You may charge a foreigner interest, but you may not charge your brother interest, that the Lord your God may bless you in all that you undertake in the land that you are entering to take possession of it" Deuteronomy 23:19-20; "If your brother becomes poor and cannot maintain himself with you, you shall support him as though he were a stranger and a sojourner, and he shall live with you. Take no interest from him or profit, but fear your God, that your brother may live beside you. You shall not lend him your money at interest, nor give him your food for profit" Leviticus 25:35-37.

¹⁷⁸ Brincker *Taxation Principles of Interest and other Financing Transactions* (2011) V-2.

¹⁷⁹ Shari' ah (also spelled Sharia) is the law that forms the fundamental concept of the Islamic religion. Coulson *Shari ah Islamic Law* 2019 <https://www.britannica.com/topic/Shariah>.

¹⁸⁰ Stigling ea *Silke: South African Income Tax* (2017) 812.

¹⁸¹ Ger "Interest-free loans and tax" 2007 *De Rebus* 2.

¹⁸² Carrol "Interest-free loans" 2009 *Insurance and Tax Journal* 1.

¹⁸³ Carrol "Interest-free loans" 2009 *Insurance and Tax Journal* 1.

It is fairly common to come across loans between companies and shareholders.¹⁸⁴ Small businesses tend to be funded primarily by loans that is recorded in their books as shareholder's loans.¹⁸⁵ These loans can either form part of the company's financing structure or simply apply to advanced loans from the company to shareholders or other companies in which the company has an interest.¹⁸⁶ Shareholders loans are loans payable on demand that may or may not incur interest.¹⁸⁷

Trusts are often chosen in estate planning in order to protect assets from creditors.¹⁸⁸ In estate planning assets are often transferred to a trust by way of donation or sale of the asset a market value.¹⁸⁹ Often the trust does not have the financial means to buy the asset at market value and acquires the asset by way of an interest-free loan agreement.¹⁹⁰ The result of this transaction is that the trust becomes the owner of the asset while the purchase price is still due and payable to the seller, without incurring interest.¹⁹¹

3.4 Conclusion

A loan is money advanced with the expectation that it will be repaid on a specified future date or within a specified period. In the Roman-Dutch law, there was distinguished between two types of loan agreements namely, loans for use (*commodatum*) and loans for consumption (*mutuum*). *Mutuum* (loan for consumption) are loan agreements that's usually repaid over a period of time and the lender may decide whether to charge interest on the loan agreement. Charging interest does not form part of the essential elements of a loan and will usually only be charged when there is an agreement between the parties to that effect. When there is an agreement

¹⁸⁴ Arendse "Tax perils of low-interest and interest-free Loans" 2013 *TaxTalk* 27.

¹⁸⁵ Jones "Interest-free loans: nothing to worry about" 2007 *Moneyweb's personal finance* 13.

¹⁸⁶ Arendse "Tax perils of low-interest and interest-free Loans" 2013 *TaxTalk* 27.

¹⁸⁷ Brincker *Taxation Principles of Interest and other Financing Transactions* (2011) A-2.

¹⁸⁸ Croome "Interest-free loans to a trust" 2009 *Tax Planning Corporate and Personal*.

¹⁸⁹ Carrol "Interest-free loans" 2009 *Insurance and Tax Journal* 1.

¹⁹⁰ Section 7C of the *ITA* deals with loans made to a trust. Preston and Kloppers "Proposed changes to tax law in South Africa: Interest-free loan as a tool in estate planning" 2016 *International Journal of Economics and Finance Studies* 237.

¹⁹¹ Preston and Kloppers "Proposed changes to tax law in South Africa: Interest-free loan as a tool in estate planning" 2016 *International Journal of Economics and Finance Studies* 237.

between parties to charge interest, a third contracting obligation arises. Interest-free loans form an important part of the commercial sector and it is therefore important to consider how these loans are taxed in the normal course of business and what the tax consequences will be if these loans prescribe.

CHAPTER 4

TAXATION OF PRESCRIBED INTEREST-FREE LOANS

4.1 Introduction

This chapter discusses the taxation of low interest and interest-free loans. In the previous chapter the nature of an interest-free loan was established, and a few examples of interest-free loans were briefly mentioned. In this chapter there will be referred to the taxation of interest-free loans in the normal course of business to ascertain whether the tax implications will differ once an interest-free loan has prescribed. Ways in which the taxpayer can prevent an interest-free loan from prescribing will also be considered with specific reference to the *Trinity Asset Management* judgment.

4.2 Taxing low interest and interest-free loans

Chapter Three briefly referred to three different types of interest-free loans namely: interest-free loan as *quid pro quo*, shareholders interest-free loans and interest-free loans to a trust. As a starting point one must consider how an interest-free loan is taxed in the general course of business.

4.2.1 Low interest and interest-free loans in general

Income tax is levied in terms of the *ITA* with section 1 defining who is liable to pay tax.¹⁹² For low interest and interest-free loans to be liable for income tax, it must form part of the taxpayer's gross income. Gross income is defined as follows:

'gross income', in relation to any year or period of assessment, means- (i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or (ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such

¹⁹² Phasha *A critical analysis of the implications of Commissioner of South African revenue services v Brummeria Renaissance (Pty) Ltd on the taxation of the benefits of interest-free shareholders' loans* 1.

person from a source within or deemed to be within the Republic, during such year or period of assessment, excluding receipts or accruals of a capital nature, but including, without in any way limiting the scope of this definition.¹⁹³

For an amount to form part of a person's gross income, each of the sub-requirements in terms of the definition must be met.¹⁹⁴ The definition of gross income is two-fold in that it separately stipulates the criteria that must be met by residents as well as non-residents.¹⁹⁵ In terms of the definition, receipts and accruals of a capital nature are explicitly excluded from the definition of gross income. An interest-free loan will therefore not form part of a taxpayer's gross income if it represents a receipt or accrual of a capital nature. So, what exactly are receipts and accruals of a capital nature?

The court held in *CIR v Visser*¹⁹⁶ that capital produces income, or "is something in the nature of fruit as opposed to principal or tree".¹⁹⁷ An example of this is interest (income) derived from the capital (money) in the bank.¹⁹⁸ An amount must be classified as either income or capital,¹⁹⁹ and the taxpayer bears the onus to prove on a balance of probabilities that an amount received is not income.²⁰⁰ In *Brincker et al*, the following was concluded:

It is true that there is no definite test that can always be applied in order to determine whether a gain or profit is income or not, but it may safely be asserted that the revenue or profit derived from a thing without its changing owners is rather to be considered as income than as capital.²⁰¹

¹⁹³ Section 1 of the *ITA*.

¹⁹⁴ Phasha *A critical analysis of the implications of Commissioner of South African revenue services v Brummeria Renaissance (Pty) Ltd on the taxation of the benefits of interest-free shareholders' loans* 1.

¹⁹⁵ This study will only focus on the tax implications of prescribed loans on South African tax residents. Phasha *A critical analysis of the implications of Commissioner of South African revenue services v Brummeria Renaissance (Pty) Ltd on the taxation of the benefits of interest-free shareholders' loans* 10.

¹⁹⁶ *CIR v Visser* 1937 TPD 77, 8 SATC paras 271 and 276.

¹⁹⁷ Croome ea *Tax Law an Introduction* (2013) 83.

¹⁹⁸ Croome ea *Tax Law an Introduction* (2013) 83.

¹⁹⁹ The court held: "It seems to me that in a proper case apportionment provides a sensible and practical solution to the problem which arises when a taxpayer receives a single receipt and the quid pro quo contains two or more separate elements, one or more of which would characterize it as capital", *Tuck v CIR* 1988 3 SA 819 (A) para 114.

²⁰⁰ Section 102 of the *Tax Administration Act* 28 of 2011; Croome ea *Tax Law an Introduction* (2013) 84 and 85.

²⁰¹ *Brincker et al The new SCA judgement on interest-free loans* (2007) 20 as referred to in Phasha *A critical analysis of the implications of Commissioner of South African revenue*

Where a taxpayer disposes of an asset held in an unproductive form, the amount received from the disposal would be a receipt or accrual of a capital nature, however when an asset is disposed of as part of a profit-making scheme, the receipt or accrual will be of a revenue nature.²⁰² The golden rule is the taxpayer's intention and is one of the most important test that courts apply to determine whether an amount is capital or revenue in nature.²⁰³

In Chapter Three, it was established that a lender who borrows an amount to the borrower interest-free has no intention to financially gain from the transaction. This interest-free loan may be regarded as capital in nature if no capital of the borrowed amount is employed or any services rendered by the borrower to the lender.²⁰⁴ An interest-free loan can be regarded as the "continues donation" of interest, however a donation requires waiver of a right and because there is no right to interest in the first place, an interest-free loan cannot be regarded as a donation.²⁰⁵ Neither the creditor nor the debtor would be taxed on an interest-free loan in the normal course of business. The reason for this is that not every acquisition of money resulting in the physical control thereof constitutes a receipt in terms of the definition of gross income.²⁰⁶ As discussed in Chapter One, in *Commissioner for Inland Revenue v Genn & Co (Pty) Ltd*²⁰⁷ the court held that the borrower is not perceived to receive the loan capital because he is under the obligation to repay it. The loan capital also does not accrue to the borrower.²⁰⁸

services v Brummeria Renaissance (Pty) Ltd on the taxation of the benefits of interest-free shareholders' loans 34.

²⁰² Croome ea *Tax Law an Introduction* (2013) 85.

²⁰³ *ITC 1185* 1972 35 SATC 122 (N) paras 123 and 124; Stigling ea *Silke: South African Income Tax* (2017) 33.

²⁰⁴ Tennant *The nature of interest-free loans and the tax implications thereof* 36.

²⁰⁵ *Commissioner, South African Revenue Service v Woulidge* 2002 1 SA 68 (SCA) para 10; *Coronel's Curator v Estate Coronel* 1941 AD 323; Van Rensburg "Commissioner, South African Revenue Service v Brummeria Renaissance (Pty) Ltd and Others: Does the Judgement Benefit an Understanding of the Concept Amount?" 2008 *Stell LR* 43.

²⁰⁶ *Commissioner for Inland Revenue v Genn & Co (Pty) Ltd* 1955 3 SA 293 (A) para 301. Van Rensburg "Commissioner, South African Revenue Service v Brummeria Renaissance (Pty) Ltd and Others: Does the Judgement Benefit an Understanding of the Concept Amount?" 2008 *Stell LR* 45.

²⁰⁷ *Commissioner for Inland Revenue v Genn & Co (Pty) Ltd* 1955 3 SA 293 (A) para 301.

²⁰⁸ *ITC 1778* 2004 66 SATC 334 para 46.

4.2.2 Interest-free loan as quid pro quo

The first type of interest-free loans are interest-free loans as *quid pro quo*. In the past, this type of interest-free loans was the subject of a great debate. The following serves as an example of an interest-free loan as *quid pro quo*: Potential residents of a retirement village grants a developer an interest-free loan to develop property in the retirement village. In return, the potential residents would be granted life rights to occupy a certain unit. This was in short, the facts of *CSARS v Brummeria Renaissance (Pty) Ltd and Others*²⁰⁹, the Commissioner for SARS argued that receiving an interest-free loan in exchange for life rights constituted an amount in terms of the definition of gross income. The Supreme Court of Appeal held that the right to retain and use loan capital interest-free had a monetary value,²¹⁰ and that value of that right must form part of the taxpayer's gross income and should be taxed accordingly. According to Olivier,²¹¹ the value of the interest-free loans in the *Brummeria case* was calculated by applying the overdraft prima rate for Banks to the average amount of the interest-free loans.

The legal principal concluded in the *Brummeria case* judgment was that the value of the use of a loan interest-free should be included in the gross income of the taxpayer, this principal is however not generally applied to all interest-free loan agreements.²¹² The *Brummeria case* only apply to interest-free loans as a quid pro quo.

4.3 Prescription of low interest and interest-free loans

In Chapter Two it was determined that "debt" is deemed to mean something that is due or owed, not limited to a monetary amount, but can include any service or goods due or owed. Chapter Three established that a loan is money advanced with the expectation that it will be repaid on a specified future date or within a specified period

²⁰⁹ Hereafter "*Brummeria case*". *Commissioner, South African Revenue Service v Brummeria Renaissance (Pty) Ltd* 2007 6 SA 601 (SCA).

²¹⁰ *Brummeria case* para 12.

²¹¹ Olivier "Taxability of interest-free loans: A storm in a teacup" 2008 *TSAR* 152.

²¹² *SARS Interpretation note no. 58* (2012) 9.

and that interest is not an integrated part of a loan. It can therefore be concluded that a low interest or interest-free loan qualifies as a "debt" for purposes of this study.

4.4 The tax implications of prescribed debt for the debtor

4.4.1 Capital gains tax implications for the debtor

Capital gains tax is regulated in terms of the *Eighth Schedule to the Income Tax Act* read together with section 26A of the *ITA*. When there is a disposal²¹³ of an asset by a resident there is a liability for capital gains tax.²¹⁴ The proceeds received from the disposal of an asset²¹⁵ is regarded as an "amount received by 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".²¹⁶ Capital gains tax form part of a person's income tax and is not a tax separately imposed.²¹⁷ A person's capital gain²¹⁸ or capital loss²¹⁹ is determined separately during the year of assessment in which the disposal occurred.²²⁰ A capital gain will be the difference between the base cost of the asset and the proceeds received from the disposal thereof,²²¹ while a capital loss will be the amount equal to the amount by which the base cost exceeds the proceeds received in respect of the disposal of the asset.²²²

A loan therefore qualifies as an asset in capital nature. The amount advanced by the lender to the borrower as well as any incidental cost results in the lender's expenditure actually incurred in acquiring the right to claim payment.²²³ In terms of paragraph 20

²¹³ "'Disposal' means an event, act, forbearance or operation of law envisaged in paragraph 11 or an event, act, forbearance or operation of law which is in terms of this Schedule treated as the disposal of an asset, and 'dispose' must be construed accordingly", para 1 of the *Eight Schedule to the ITA*.

²¹⁴ Para 1 of the *Eight Schedule to the ITA*; Croome ea *Tax Law an Introduction* (2013) 336.

²¹⁵ An "asset" is defined to include: "(a) property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum; and (b) a right or interest of whatever nature to or in such property", Para 1 of the *Eight Schedule to the ITA*.

²¹⁶ Para 35(1) of the *Eight Schedule to the ITA*.

²¹⁷ Tennant *The nature of interest-free loans and the tax implications thereof* 53.

²¹⁸ To determine capital gain, see Para 3 of the *Eight Schedule to the ITA*.

²¹⁹ To determine capital loss, see Para 4 of the *Eight Schedule to the ITA*.

²²⁰ Croome ea *Tax Law an Introduction* (2013) 338.

²²¹ Para 3(a) of the *Eight Schedule to the ITA*.

²²² Para 4(a) of the *Eight Schedule to the ITA*.

²²³ SARS *Comprehensive guide to capital gains tax* (2018) 826.

"the expenditure actually incurred in respect of the cost of acquisition or creation of that asset", is included in the base cost of an asset.²²⁴

In the hands of the borrower receiving the loan, the borrower receives the capital with the obligation to repay it; therefore, the capital received is not an asset.²²⁵ According to Tennant,²²⁶ the borrower does not have a right to claim performance (personal right) from the lender and the debtor also has no claim to a thing (real right), concluding that the debtor does not receive an asset. However, when a creditor's claim prescribes, and the borrower is no longer obligated to repay the interest-free loan, the borrower received an asset (capital) liable for capital gains tax. The reason being that the debt has been discharged by prescription, no consideration was paid for the interest-free loan, this is regarded as a disposal for capital gains tax purposes. The capital gain of the borrower will therefore be taxed accordingly.

4.4.2 Deemed dividend received by the debtor

A second type of interest-free loans are shareholders interest-free loans. When an interest-free shareholder loan prescribes, these loans may in certain circumstances, fall within the ambit of dividends tax because these loans are regarded as deemed dividends in terms of section 64EB of the *ITA*.²²⁷

4.4.2.1 What is dividend's tax?

A dividend is a special form of tax that differs from normal income tax,²²⁸ even though dividends tax forms part of the *ITA* a dividend will be subject to either dividend tax or normal tax, but never both.²²⁹ When a company pays dividends to its shareholders, the dividends will form part of the shareholders' gross income.²³⁰ Before dividends tax

²²⁴ Para 20(1)(a) of the *Eight Schedule to the ITA*; SARS *Comprehensive guide to capital gains tax* (2018) 826.

²²⁵ Tennant *The nature of interest-free loans and the tax implications thereof* 55.

²²⁶ Tennant *The nature of interest-free loans and the tax implications thereof* 55.

²²⁷ Kruger "Interest-free shareholder loans" 2015 *Tax Professional* 20.

²²⁸ "Normal tax is levied on taxable income and tax will therefore be paid on a dividend or foreign dividend received or accrued which has been included in gross income and is not exempt from normal tax.", SARS *Comprehensive guide to dividends tax* (2017) 5.

²²⁹ SARS *Comprehensive guide to dividends tax* (2017) 5.

²³⁰ Croome ea *Tax Law an Introduction* (2013) 402.

can be explained, the meaning of the word "dividend" and what it entails needs to be determined. A dividend is defined as:

any amount transferred or applied by a company that is a resident for the benefit or on behalf of any person in respect of any share in that company, whether that amount is transferred or applied (a) by way of a distribution made by; or (b) as consideration for the acquisition of any share in, that company, but does not include any amount so transferred or applied to the extent that the amount so transferred or applied (i) results in a reduction of contributed tax capital of the company; (ii) constitutes shares in the company; or (iii) constitutes an acquisition by the company of its own securities by way of a general repurchase of securities as contemplated in subparagraph (b) of paragraph 5.67(B) of section 5 of the JSE Limited Listings Requirements, where that acquisition complies with any applicable requirements prescribed by paragraphs 5.68 and 5.72 to 5.84 of section 5 of the JSE Limited Listings Requirements.

According to SARS, a dividend is in short, any payment a company makes to its shareholders in respect of a share held in that company.²³¹ The beneficial owner of the dividend is liable to pay the dividend's tax.²³² Dividend tax is withheld from the dividend payment and a withholding agent²³³ pays the amount to SARS.²³⁴

4.4.2.2 What is a deemed dividend?

When a company grants an interest-free loan to its shareholders or any connected person to the company, these loans will automatically be regarded as a deemed dividend.²³⁵ Deemed dividends are regulated in terms of section 64EB of the *ITA* and this section is an anti-avoidance provision. This section applies to transactions entered into on or after 1 September 2012.²³⁶ Section 64EB(1) state the following:

(1) For the purposes of this Part, where (a) a person contemplated in section 64F(1) acquires the right to a dividend in respect of a share, including a dividend that has not yet been declared or has not yet accrued, by way of cession; and (b) an amount in respect of that dividend is received by or accrues to the person who acquired that right, the person ceding that right is deemed to be the beneficial owner of that dividend: Provided that this subsection does not apply to any cession in respect of a share if the person to whom those rights are ceded holds all the rights attaching to the share after the cession.

²³¹ SARS 2019 *Dividends tax* <https://www.sars.gov.za/TaxTypes/DT/Pages/default.aspx>.

²³² Section 64EA(b) of the *ITA*; Croome ea *Tax Law an Introduction* (2013) 16.

²³³ A withholding agent is an agent interposed between the company paying the dividend and the beneficial owner.

²³⁴ SARS 2019 *Dividends tax* <https://www.sars.gov.za/TaxTypes/DT/Pages/default.aspx>.

²³⁵ Kruger "Interest-free shareholder loans" 2015 *Tax Professional* 20.

²³⁶ SARS *Comprehensive guide to dividends tax* (2017) 80.

Interest-free loans to shareholders will be regarded as a deemed dividend if the debt arose by virtue of a share held in the company and in the following circumstances: (i) the debtor is not a company but any other person; (ii) the debtor is a South African resident; (iii) the debtor is a shareholder or a connected person to the company.²³⁷ A "connected person" in relation to a company is defined as:

(i) its holding company as defined in section 1 of the Companies Act, 1973 (Act 61 of 1973); (ii) its subsidiary as so defined; (iii) any other company where both such companies are subsidiaries (as so defined) of the same holding company; (iv) any person, other than a company as defined in section 1 of the Companies Act, 1973 (Act 61 of 1973), who individually or jointly with any connected person in relation to himself, holds, directly or indirectly, at least 20 per cent of the company's equity share capital or voting rights; (v) any other company if at least 20 per cent of the equity share capital of such company is held by such other company, and no shareholder holds the majority voting rights of such company.²³⁸

The company would be deemed to have paid a dividend *in specie* when all three these requirements have been met.²³⁹ An interest-free loan will be a deemed dividend if there is a direct relationship between the shareholding and the advanced loan.²⁴⁰ According to Kruger,²⁴¹ shareholder must be granted an interest-free loan "by virtue of" his shareholding and not because of another reason.

4.5 The tax implications of prescribed debt for the creditor

4.5.1 Donation of deemed donation by the creditor

4.5.1.1 What is donations tax?

The third type of interest-free loans are interest-free loans to a trust. A South African resident pays donations tax on the value of disposed property under any donation.²⁴² A donation is defined as "any gratuitous disposal of property including any gratuitous

²³⁷ Section 64EB(2) of the *ITA*. Kruger "Interest-free shareholder loans" 2015 *Tax Professional* 20.

²³⁸ Section 1(d) of the *ITA*.

²³⁹ Kruger "Interest-free shareholder loans" 2015 *Tax Professional* 21.

²⁴⁰ Kruger "Interest-free shareholder loans" 2015 *Tax Professional* 21.

²⁴¹ Kruger "Interest-free and low interest shareholder loans" 2014 *Business Tax & Company Law Quarterly* 24. For a discussion on the interpretation of "by virtue of" see Kruger "Interest-free and low interest shareholder loans" 2014 *Business Tax & Company Law Quarterly* 24 to 26.

²⁴² Section 54 of the *ITA*.

waiver or renunciation of a right".²⁴³ The aim of donations tax is to prevent tax avoidance.²⁴⁴ The word "property" referred to is defined as: "any right in or to property movable or immovable, corporeal or incorporeal, wherever situated".²⁴⁵ The definition of property is wide enough to include a creditor's gratuitous waiver to receive repayment of debt owed to him.²⁴⁶

The court held in *Welch's Estate v Commissioner, South African Revenue Service*²⁴⁷ that the common-law principals of "pure liberality or disinterested benevolence" applies to the definition as set out in the *ITA*. According to Seligman,²⁴⁸ it can therefore be concluded that if there was a *quid pro quo* for the disposal of the asset it cannot qualify as a donation.

If property is disposed of and the consideration received for the disposal is in the Commissioner's opinion not adequate, the disposal of the property will be deemed as a donation.²⁴⁹ The value of such property will be determined by deducting the inadequate consideration received from the value of the property.²⁵⁰ In *Welch's Estate v Commissioner, South African Revenue Service*,²⁵¹ the court held that the motive for the disposal is irrelevant; all that needs to be determined is whether the consideration given for the disposal was adequate in the Commissioner's opinion.²⁵² SARS is of opinion that adequate consideration does not mean fair market value, to determine whether consideration was adequate one needs to regard the circumstances and the object of donations tax.²⁵³

²⁴³ Section 55(1) of the *ITA*.

²⁴⁴ *ITC 1599* 1995 58 SATC 88 (T) para 97.

²⁴⁵ Section 55(1) of the *ITA*.

²⁴⁶ Seligman "Waiving debt: The fiscal price of forgiveness" 2010 *Business Tax & Company Law Quarterly* 8.

²⁴⁷ *Welch's Estate v Commissioner, South African Revenue Service* 2005 4 SA 173 (SCA).

²⁴⁸ Seligman "Waiving debt: The fiscal price of forgiveness" 2010 *Business Tax & Company Law Quarterly* 8.

²⁴⁹ Section 58(1) of the *ITA*.

²⁵⁰ Section 58(1) of the *ITA*.

²⁵¹ *Welch's Estate v Commissioner, South African Revenue Service* 2005 4 SA 173 (SCA) para 315.

²⁵² SARS *Comprehensive guide to capital gains tax* (2018) 161.

²⁵³ SARS *Comprehensive guide to capital gains tax* (2018) 161.

As previously mentioned, the definition of a donation is wide enough to include the gratuitous renunciation of waiver or right of the creditor to claim repayment.²⁵⁴ A creditor neglecting to pursue his claim may be deemed to have gratuitously waived his right to claim repayment for the debtor. As the creditor does not financially benefit from granting an interest-free loan, it can be deemed as a gratuitous disposal of the loan amount when the creditor's claim prescribes. According to Seligson,²⁵⁵ a creditor waiving his claim to enforce repayment may be subjected to donations tax in terms of section 58 of the *ITA* in that the Commissioner may be of the opinion that the creditor received inadequate consideration for the loan.

4.5.1.2 Why a creditor would be liable for donations tax on an interest-free loan to a trust?

A low interest or interest-free loan agreement between a connected person and a trust may give rise to donations tax.²⁵⁶ The loan agreement between the parties will determine whether the interest-free loan should be regarded as a donation.²⁵⁷

Failing to charge interest at the market value on a loan, can have tax implications. In terms of section 7C of the *ITA*, these loans can incur donations tax liability.²⁵⁸ It is important to note that when assets are sold to a trust, there must be a loan or sale agreement otherwise SARS will regard the sale or loan as a donation.²⁵⁹ Section 7C of the *ITA* serves as an anti-avoidance tax provision applicable to any loan, credit or advance made to a trust.²⁶⁰ The selling price in relation to the market value at the time of sale is the criteria of whether a sale of an asset to a trust will give rise to donations tax.²⁶¹ When the lender can charge interest but decides not to, it can be regarded as

²⁵⁴ Seligson "Waiving debt: The fiscal price of forgiveness" 2010 *Business Tax & Company Law Quarterly* 8.

²⁵⁵ Seligson "Waiving debt: The fiscal price of forgiveness" 2010 *Business Tax & Company Law Quarterly* 8.

²⁵⁶ Stigling ea *Silke: South African Income Tax* (2017) 856.

²⁵⁷ Stigling ea *Silke: South African Income Tax* (2017) 855.

²⁵⁸ Stigling ea *Silke: South African Income Tax* (2017) 883.

²⁵⁹ Stephens 2019 *Trust guide 2018-2019*
<https://southafrica.moorestephens.com/MediaLibsAndFiles/media/southafricaweb.moorestephens.com/Guides/Moore-Stephens-Trust-Guide-Digital.pdf>.

²⁶⁰ Stigling ea *Silke: South African Income Tax* (2017) 885.

²⁶¹ Kamdar "When assets are sold to a trust via loan accounts- what are the tax implications" 2016 *Tax Professional* 10.

a "gratuitous waiver or renunciation of a right" liable for donations tax.²⁶² On the other hand, when the lender does not stipulate to charge interest in terms of the agreement, no right to interest arises resulting in no "waiver or renunciation of a right" thus no donations tax liability.²⁶³

An asset donated to a trust will be liable for donations tax at the rate 20% of the value of the donation.²⁶⁴ A seller selling an asset at a loss to a trust will be liable for capital gains tax and consequently the loss can be deducted from the capital profits realised on transactions with the same trust.²⁶⁵

4.5.2 Capital gains tax implications for the creditor

Paragraph 11²⁶⁶ specifically refers to "waiver, renunciation, expiry or abandonment of an asset" as included in the definition of a disposal. According to Seligson,²⁶⁷ a creditor renouncing his right to claim repayment would qualify as a disposal for capital gains tax liability. Regarding the prescription of a claim, the definition in paragraph 11 also refers to expiration or abandonment of a claim. A creditor's claim prescribing due to his neglect to enforce repayment may be deemed as his abandonment of the claim and will be regarded as the expiration of the claim resulting in capital gains tax liability. However, when an interest-loan prescribes that the creditor will not receive any consideration from the debtor. Therefore, there would be no financial gain liable for capital gains tax and may lead to donations tax consequences.²⁶⁸

²⁶² Stark "Is the Granting of an Interest-free Loan for Tax Planning Purposes from the Lender's Perspective Under Threat?" 2008 *Aantekeninge/notes* 149.

²⁶³ Stark "Is the Granting of an Interest-free Loan for Tax Planning Purposes from the Lender's Perspective Under Threat?" 2008 *Aantekeninge/notes* 150.

²⁶⁴ Croome "Interest-free loans to a trust" 2004 *Tax Planning Corporate and Personal* 1.

²⁶⁵ Paragraph 39 of the *Eight Schedule to the ITA*.

²⁶⁶ Para 11(1)(b) of the *Eight Schedule to the ITA*.

²⁶⁷ Seligson "Waiving debt: The fiscal price of forgiveness" 2010 *Business Tax & Company Law Quarterly* 8.

²⁶⁸ Seligson "Waiving debt: The fiscal price of forgiveness" 2010 *Business Tax & Company Law Quarterly* 8.

4.6 How taxpayers can avoid the prescription of low interest and interest-free loans

4.6.1 Contractual freedom

According to Pillay,²⁶⁹ contractual freedom dictates that a contract between parties is entered through free choice and that the state should not interfere. In *Barkhuizen v Napier*²⁷⁰ the court held as follows:

Public policy, as informed by the Constitution, requires in general that parties should comply with contractual obligations that have been freely and voluntarily undertaken. This consideration is expressed in the maxim *pacta sunt servanda*, which, as the Supreme Court of Appeal has repeatedly noted, gives effect to the central constitutional values of freedom and dignity. Self-autonomy, or the ability to regulate one's own affairs, even to one's own detriment, is the very essence of freedom and a vital part of dignity.²⁷¹

Contractual freedom enables a person to decide whether, on what terms and with whom to contract with.²⁷² In the *Trinity Asset Management* case, the court considered the tension between prescription and contractual freedom.²⁷³ According to Pillay, freedom of contract implies that courts will enforce a contract if it is provided that the parties entered into the agreement voluntarily and will not be concerned with the substantive fairness of the terms in the contract.²⁷⁴ On the other hand, prescription ensures that the debtor is protected and creates legal certainty and finality between the debtor and creditor.²⁷⁵ Tension is created as prescription aims to protect the debtor against a creditor's claim resting to long, and contractual freedom enables the parties to exclude the running of prescription. Contractual freedom therefore assists parties to exclude the protection that prescription aims to provide.

In *De Bruyn v Du Toit*²⁷⁶ the court held:

²⁶⁹ Pillay *The impact of pacta sunt servanda in the law of contract* 6.

²⁷⁰ *Barkhuizen v Napier* 2007 5 SA 323 (CC).

²⁷¹ *Barkhuizen v Napier* 2007 5 SA 323 (CC) para 57.

²⁷² Pillay *The impact of pacta sunt servanda in the law of contract* 6.

²⁷³ *Trinity Asset Management (Pty) Ltd v Grindstone Investments 132 (Pty) Ltd* 2017 SA 32 (CC) para 35.

²⁷⁴ Pillay *The impact of pacta sunt servanda in the law of contract* 6.

²⁷⁵ Loubser *Extinctive Prescription* (1996) 24; *Trinity Asset Management* para 35.

²⁷⁶ *De Bruyn v Du Toit* 2015 ZAWCHC 20.

In keeping with the principle that a creditor cannot delay the commencement of prescription by failing to take a step within his power, it has been held on a number of occasions that a loan repayable on demand is immediately due for purposes of prescription. It is only where the giving of notice is a condition precedent for a claim, and thus a necessary ingredient of the creditor's cause of action, that the running of prescription is deferred until the giving of notice.²⁷⁷

The Constitutional Court concluded that a contractual debt would become due as per the terms of the agreement.²⁷⁸ Parties can therefore prevent an interest-free loan from prescribing by specifying in writing when the loan will be due and payable.

4.7 Conclusion

In the normal course of business, an interest-free loan does not form part of a taxpayer's gross income because the borrower is not perceived to receive the loan capital because he is under the obligation to repay it. There are three different types of interest-free loans, namely: interest-free loan as *quid pro quo*, shareholders interest-free loans and interest-free loans to a trust. Each of these interest-free loans result in various tax implications once it has prescribed. These tax implications include capital gains tax, dividends tax and donations tax.

²⁷⁷ *De Bruyn v Du Toit* 2015 ZAWCHC 20 para 6; *Trinity Asset Management* para 43.

²⁷⁸ *Trinity Asset Management* para 47.

CHAPTER 5

THE TAXATION OF DEBT RELIEF IN SOUTH AFRICA

5.1 Introduction

In the current economic climate, the implementation of debt restructuring and relief have significantly increased.²⁷⁹ When a creditor abandons his/her right to claim repayment of debt, it is generally referred to as the "waiver" of debt and requires both parties to agree thereto.²⁸⁰ Ultimately, these debt relief provisions apply to instances where a debt is discharged to the benefit of the debtor. Because prescription also results in the discharge of debt, this chapter aims to briefly discuss the taxation of debt relief in order to determine whether these provisions are applicable to the prescription of debt. A brief overview of debt relief provisions in South Africa is given and the application of these provisions is discussed. This chapter will be concluded with a discussion on whether these provisions apply to prescribed debt and if not, whether these provisions ought to apply.

5.2 Overview to debt relief provisions in South Africa

5.2.1 Background

Debt relief provisions have been incorporated within the *ITA* in one form or another with the purpose to tax any debt relief benefit a taxpayer receives because of the waiver, cancellation, reduction or discharge of debt owed by the taxpayer.²⁸¹ Before 1 January 2013, a reduction of debt resulted in the debt being subjected to either income

²⁷⁹ Brink "Taxpayers seeking debt relief should feel relieved" 2018 *Tax & Exchange Control Alert* 2.

²⁸⁰ Seligson "Waiving debt: The fiscal price of forgiveness" 2010 *Business Tax & Company Law Quarterly* 2.

²⁸¹ Anon "Legislative developments: Revisions to the debt relief rules" 2018 *Tax alert national tax technical* 1.

tax, donations tax or capital gains tax.²⁸² While a creditor was able to claim loss, the debtor must be taxed on the gains, resulting in tax symmetry.²⁸³ However, according to SARS, taxing a debtor in financial distress on a debt relief benefit received, undermined the economic purpose of receiving the benefit.²⁸⁴ Section 19 of the *ITA* and paragraph 12A of the *Eighth Schedule to the ITA* was consequently implemented and these provisions set out South Africa's debt restructure rules.²⁸⁵

Both section 19 and paragraph 12A regulates the reduction of debt, which may in certain circumstances, provide debt relief to persons under financial distress.²⁸⁶ In short, these provisions regulate the tax consequences of the waiver, cancellation, reduction or discharge of debt owed by the taxpayer (debtor).²⁸⁷ Section 19 regulates the income tax consequences of waived debt and paragraph 12A regulates the capital gains tax consequences thereof.²⁸⁸ These provisions ensure that debt relief is subjected to only one of the following taxes: capital gains tax, donations tax, income tax on fringe benefits received by an employee and income tax taxed on income.²⁸⁹ It can therefore be established that section 19 and paragraph 12A intends to aid to taxpayers rather than to financially wound them.

5.2.2 Application of section 19 and paragraph 12A

In 2017 amendments to the *ITA* resulted in the term "reduction amount" being replaced with the definitions of "debt benefit" and "concession or compromise", these new definitions listed the events that would trigger tax consequences under debt relief.²⁹⁰ Due to the amendment of these provisions, both section 19 and paragraph

²⁸² Brink "Taxpayers seeking debt relief should feel relieved" 2018 *Tax & Exchange Control Alert* 2.

²⁸³ Brink "Taxpayers seeking debt relief should feel relieved" 2018 *Tax & Exchange Control Alert* 2.

²⁸⁴ SARS *Interpretation note no. 91* (2016) 3.

²⁸⁵ Keirby-Smith and Van Den Berg "South Africa proposes amendments to debt restructure rules" 2018 *Global tax alert* 1.

²⁸⁶ SARS *Interpretation note no. 91* (2016) 3.

²⁸⁷ National Treasury *Draft explanatory memorandum on the taxation laws amendment bill 2018* (2018) 11.

²⁸⁸ Dachs "Tax consequences arising from the writing off of loans" 2015 *ENSafrica* 28.

²⁸⁹ SARS *Interpretation note no. 91* (2016) 4.

²⁹⁰ The following sections were deleted with the implementation of section 19 and paragraph 12A of the *ITA*: Section 8(4)(m), paragraph (ii) of section 20(1)(a) and paragraph 12(5).

12A now apply where a debt benefit arises because of a concession or compromise and the debt amount was used to finance expenditure addressed in these provisions.²⁹¹

"Concession or compromise" is defined as follows:

- a) The cancellation, waiver or remittance of a debt;
- b) When a debt is extinguished by way of a redemption of the debt claim or by way of a merger by reason of the acquisition of the debt claim by the person owing that debt; and
- c) When an interest-bearing debt owed by a company to a person is settled by way of a conversion or exchange for shares in that company or by applying the proceeds from shares issued by that company to a person in the instance that immediately after this arrangement, the company is a connected person in relation to that person.²⁹²

Section 19 of the *ITA* will apply to any arrangement that is waived, cancelled or extinguished by redemption of the debt by the person owing the debt or by a connected person to the debtor.²⁹³ Section 19 applies to any debt arising out of a concession or compromise where the debt was used to directly or indirectly fund expenditure of which the *ITA* grants a deduction or allowance.²⁹⁴ According to the National Treasury *Draft Explanatory Memorandum on the Taxation Laws Amendment Bill 2018*, the debt relief rules would be triggered if one of the following occurs:

- (a) A change in the terms or conditions of a debt or the substitution of a debt occurs;
- (b) An obligation in respect of a debt is substituted for another obligation; and (c) A debt is converted into shares.²⁹⁵

Only changes in the terms and conditions that result in an actual realisation event, will trigger the application of section 19.²⁹⁶ Furthermore, "debt benefit" is defined as:

National Treasury *Draft explanatory memorandum on the taxation laws amendment bill 2018* (2018) 11.

²⁹¹ Keirby-Smith and Van Den Berg "South Africa proposes amendments to debt restructure rules" 2018 *Global tax alert* 2.

²⁹² Own emphasis. Section 19(1) of the *ITA*; National Treasury *Draft explanatory memorandum on the taxation laws amendment bill 2018* (2018) 13.

²⁹³ Section 19(1)(a) of the *ITA*.

²⁹⁴ Section 19(2) of the *ITA*.

²⁹⁵ National Treasury *Draft explanatory memorandum on the taxation laws amendment bill 2018* (2018) 11.

²⁹⁶ Brink "Taxpayers seeking debt relief should feel relieved" 2018 *Tax & Exchange Control Alert* 3.

a) In the case of a debt that is cancelled, waived or remitted, the debt benefit will be the amount that is cancelled, waived or remitted. b) In the case of a redemption of a debt claim or merger by reason of the debtor acquiring the claim in respect of the debt, the debt benefit will be the amount by which the face value of the claim exceeds the market value of the debt after such redemption or merger. c) In the case of debt to equity conversion where the creditor or another person that subscribes for or acquires shares in a company did not a direct or indirect interest in that company prior to the conversion, the debt benefit will be the amount by which the face value of the claim prior to the conversion exceeds the market value of the shares held or acquired by reason of or as a result of that conversion. d) In the case of a debt to equity conversion where the creditor or another company that subscribes for or acquires shares in a company held a direct or indirect interest in that company prior to the conversion, the debt benefit will be the amount by which the face value of the claim prior to the conversion exceeds the amount by which the market value of the shares held by the creditor or that other company after the conversion exceeds the market value of the shares held by that person in that company prior to that conversion.²⁹⁷

5.2.3 Instances where these provisions are not applicable

Section 19(8) and paragraph 12A(6) of the *ITA*, sets out various instances where the debt relief provisions will not be applicable, these instances are as follows: (i) where a debt is owed to a person that is an heir or legatee of a deceased estate and the debt is owed to or reduced by the deceased estate;²⁹⁸ (ii) where the debt is reduced by way of a donation or in terms of section 58;²⁹⁹ (iii) where the debt is reduced in terms of paragraph 2(h) of the *Seventh Schedule* by an employer;³⁰⁰ (iv) where the debt owed to a company is reduced by another company in the same group of companies and

²⁹⁷ National Treasury *Draft explanatory memorandum on the taxation laws amendment bill 2018* (2018) 13.

²⁹⁸ Section 8(a) of the *ITA*.

²⁹⁹ Section 58 of the *ITA* states as follows: "(1) Where any property has been disposed of for a consideration which, in the opinion of the Commissioner, is not an adequate consideration that property shall for the purposes of this Part be deemed to have been disposed of under a donation: Provided that in the determination of the value of such property a reduction shall be made of an amount equal to the value of the said consideration. (2) Where a person disposes of a restricted equity instrument, as defined in section 8C, to any other person under the circumstances contemplated in section 8C (5), that restricted equity instrument shall for the purposes of this Part be deemed to have been donated at the time that it is deemed to vest for the purposes of section 8C and to have a value equal to the fair market value of that instrument at that time: Provided that in the determination of the value of that restricted equity instrument a reduction shall be made of an amount equal to the value of any consideration in respect of that donation". It is not a prerequisite that the debt must be subjected to donations tax before this exclusion applies; Section 8(b) of the *ITA* 58 of 1962.

³⁰⁰ Section 8(c) of the *ITA*.

the other company has not carried on trade;³⁰¹ (v) where the debt owed to a company is reduced by another company in the same group of companies and the other company settles debt by way of issued shares.³⁰² These provisions do not apply to tax debt or interest debt.³⁰³ Furthermore, paragraph 12A contains additional exemptions for debt being reduced by connected persons in the course or anticipation of liquidation or deregistration company proceedings.³⁰⁴

5.2.4 Will debt reduction tax provisions be applicable to prescribed loans?

According to Kruger,³⁰⁵ "prescription is a trap for the unwary". The debtor is no longer obligated to repay the debt because the creditors claim had prescribed and as such, section 19 and paragraph 12A may apply.

Extinctive prescription of debt ceases a debt after the lapse of three years. Apart from prescription, there are also other means to terminate the existence of a debt. These include the waiver, cancellation, reduction or discharge of debt. Each of these methods results in the termination of the existence of debt and provides relief for the debtor in that the debtor will no longer be liable to repay the debt. The main difference between extinctive prescription and the waiver, cancellation, reduction or discharge of debt lays in the fact that the creditor may decide to waive, cancel, reduce or discharge a debt owed to him. The creditor is under no obligation to terminate this debt and deciding whether to do so remains within his sole discretion. On the other hand, extinctive prescription of debt terminates a debt by operation of law, the creditor has no decision or say in this matter and the law obligates him/her not to pursue the debt. It can be concluded that the creditor cannot pursue his claim because either extinctive prescription or the waiver, cancellation, reduction or discharge of debt, completely extinguished the debt.

³⁰¹ Section 8(d) of the *ITA*.

³⁰² Section 8(e) of the *ITA*.

³⁰³ SARS *Comprehensive guide to capital gains tax* (2018) 144.

³⁰⁴ SARS *Comprehensive guide to capital gains tax* (2018) 144.

³⁰⁵ Kruger "The reduction of debt and taxation: some takeaways" 2016 *Business Tax & Company Law Quarterly* 18.

Section 19 of the *ITA* will only apply in two instances, namely: (i) where the debt is extinguished through a concession or compromise, and (ii) where the debt was used to directly or indirectly fund expenditure in terms of which the *ITA* grant a deduction or allowance. Whether the debt funded expenditure that is subject to a deduction or allowance will be a factual question to be answered by the circumstances of each case. It is however the extinction of debt through a "concession or compromise" that will determine whether prescribed interest-free loans fall within the ambit of these debt relief provisions.

As mentioned, the definition of "concession or compromise" specifically applies to an arrangement between the debtor and creditor in terms of which a debt is waived, cancelled or extinguished by redemption. Even though prescription extinguishes debt, it does not fall within the ambit of "concession or compromise". The reason being that debt does not prescribe by way of an arrangement between the debtor and the creditor. Prescription is the result of a creditor not enforcing his claim. If the parties arranged that the creditor's claim prescribe, this arrangement will fall within the definition of a creditor waiving his right to claim repayment from the debtor. The study therefore submits that the debt relief provisions as set out in section 19 and paragraph 12A of the *ITA* do not apply to prescribed debt.

5.3 Conclusion

A debtor relieved from his obligation to repay his debt because the creditor waived or cancelled his right to claim repayment will incur tax consequences in terms of section 19 and paragraph 12A of the *ITA*. These provisions only apply to debt that is cancelled by a concession or compromise between the parties and the debt was used to directly or indirectly fund expenditure in terms of which the *ITA* grants a deduction or allowance. It was concluded in the aforementioned that these debt relief provisions do not apply to prescribed debt.

It is, however, the study's submission that these provisions should be amended to make provision for prescribed interest-free loans. The creditor granting an interest-free loan does not financially gain from the transaction, which is merely the temporary

transfer of capital to the debtor who in turn is obligated to repay the full capital amount. As mentioned, interest-free loans are usually advanced to debtors as financial aid. Where a debtor uses an interest-free loan to fund expenditure in terms of which a deduction or allowance is granted by the *ITA*, it is the studies submission that the provisions of section 19 and paragraph 12A ought to apply when these loans prescribe. The purpose of these provisions is to ensure that the debtor financially gaining from debt relief or debt restructuring will be subjected to one of the following taxes, namely: capital gains tax, donations tax, income tax on fringe benefits received by an employee and taxed income. This is in line with the economic objective of granting the debt relief in the first place.

In the previous chapter the various tax consequences of prescribed interest-free loans for both the debtor and the creditor was discussed in detail. If the purpose of an interest-free loan is to financially aid the debtor, and this loan prescribes within three years, will the tax consequences of the prescribed loan not also undermine the economic objective of granting the interest-free loan in the first place? The provisions as set out in section 19 and paragraph 12A of the *ITA* should be amended to include the prescription of interest-free loans because rather than being subjected to various taxes due to the prescription of an interest-free loan, the debtor must also only be subjected to one of the abovementioned taxes in terms of the debt relief provisions.

CHAPTER 6

FINAL REMARKS AND CONCLUSION

The central research question was as follows: How will prescription affect the taxation of interest-free loans? A loan is money advanced with the expectation that it will be repaid on a specified future date or within a specified period. The creditor has the right to charge interest and it is in his sole discretion to decide whether to exercise this right or not. In the normal course of business, an interest-free loan has no tax consequences for neither the debtor nor creditor because it is merely the transfer of capital. In *Commissioner for Inland Revenue v Genn & Co. (Pty) Ltd*³⁰⁶ this was confirmed when the court held that even though the debtor gains possession of the capital amount borrowed, he/she is under the obligation to repay the capital to the creditor. The capital amount does not form part of the debtor's gross income. However, when an interest-free loan prescribes various tax implications arise as the debtor is no longer under the obligation to repay the loan.

The *Act* regulates the prescription of debt. Prescription is the extinction of debt through the passage of time. The purpose of prescription is to protect a debtor from a creditor failing to enforce his claim. In terms of the *Act*, a debt will prescribe within three years. In the *Trinity Asset Management* judgment, the court concluded that the terms of a contract/agreement would determine when a contractual debt becomes due. Parties must therefore specify when the repayment of a debt is due in order to determine when prescription will commence to run. If they fail to do so, prescription will commence to run immediately after the advanced have been made.

Prescribed interest-free loans result in various tax implications for both the debtor and the creditor. The debtor may incur capital gains tax. The proceeds (capital amount) received by the debtor is perceived to be a disposal of an asset accrued or in favour

³⁰⁶ *Commissioner for Inland Revenue v Genn & CO (Pty) Ltd* 1955 3 SA 293 (A).

of the debtor. The debtor may also be regarded as to have received a deemed dividend. When a company grants an interest-free loan to its shareholders or any connected person to the company, these loans will automatically be regarded as deemed dividends and taxed accordingly. On the other hand, a creditor whose claim prescribed in the granting of an interest-free loan may incur donations tax. A donation is the gratuitous disposal of property including any gratuitous waiver or renunciation of a right. A creditor neglecting to pursue his claim may be deemed to have gratuitously waived his right to claim repayment for the debtor.

Both section 19 and paragraph 12A of the *ITA* regulate the reduction of debt, which may in certain circumstances, provide debt relief to persons under financial distress. These provisions ensure that debt relief is subjected to only one of the following taxes: capital gains tax, donations tax, income tax on fringe benefits received by an employee and income tax taxed on income. The provisions as set out in section 19 and paragraph 12A of the *ITA*, should be amended to include the prescription of interest-free loans. The debtor must only be subjected to one of the abovementioned taxes in terms of the debt relief provisions. Taxpayers need to be cautious with their dealings in interest-free loans as these loans may give rise to various unintended tax implications.

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