sait South African Institute of Tax Professionals

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The South African Revenue Service
Lehae La SARS, 299 Bronkorst Street
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BY EMAIL: policycomments@sars.gov.za

RE: DRAFT INTERPRETATION NOTE: SECTION 19 AND PARAGRAPH 12A OF THE EIGHTH SCHEDULE: REDUCTION OF DEBT

Attached are the comments associated with the draft provides guidance on the interpretation and application of section 19 and paragraph 12A as well as the overlap with some other sections in the Act.

Section 19 and paragraph 12A deal with the income tax consequences that arise when, a debt or a portion of a debt is forgiven without adequate consideration

Yours sincerely,

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Draft Interpretation Note: section 19 and paragraph 12a of the eighth schedule: reduction of debt

Preamble

The term 'debt relief'

It is not clear why the term "debt relief" is defined. It is clear that this definition, i.e. "the reduction of debt for consideration that is less than the face value of the debt" is the same as the definition for reduction amount.

It is suggested that the definition be removed. The term is used three times in the Draft Note and in the context used it takes its ordinary meaning.

Paragraph 4.1.1

It is not clear why, in the second paragraph in paragraph 4.1.1, it is stated that "the expenditure and the reductions in expenditure referred to in paragraph 20 that are required to be taken into account in the determination of an asset's base cost must be ignored in determining whether an asset constitutes an "allowance asset"."

The definition of an allowance asset, which follows from the definition of capital asset, makes it clear that an asset will be an allowance asset if a deduction or allowance is allowable, essentially under the Income Tax Act, excluding base cost.

It is suggested that this paragraph be re-worded.

Paragraph 4.1.3 Debt

In paragraph 2.3 of the 2012 Explanatory Memorandum it was stated that "… all the various concepts utilising the term debt (e.g. debt instruments, loans and advances) be unified within a single term. Under the revised formulation, the term "debt" will be used throughout the Income Tax Act. All other related terms will be dropped. The term "debt" will bear its ordinary meaning." These amendments made in that amendment Act and subsequent ones, replaced the words 'debt instruments, loans and advances' with debt.

It may well be useful to state in the Draft Note that the term debt is used throughout the Act as section 19 and paragraph 12A would apply to all.

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Paragraph 4.1.4 - Example 1 – Reduction amount

From the amounts used in this example, it is clear that the underlying supplies could have been subject to Value-Added Tax. The example, and some of the other examples, is silent about the Value-Added Tax implications.

It is suggested that the example deals with the Value-Added Tax implications as well.

Paragraph 4.1.4 – Payment by third parties

The analysis in paragraph 4.1.4 includes two scenarios where a third party (Company A in the examples) settles the indebtedness with the creditor (Company C in the examples) on behalf of the debtor (Company B in the examples) and draws a distinction between the tax position where the payment results in Company B being indebted to Company A and position where Company B is not required to reimburse Company A.

Whilst we are in agreement with the application of the debt reduction rules in the above scenarios, we submit that the examples highlight a potential anomaly which should be addressed. Where Company B is not required to reimburse Company A, the provisions of section 19 would be triggered in the hands of Company A. However, where Company B becomes indebted to Company A, there is no reduction amount. The example should however contain a third scenario which addresses the position where Company B becomes indebted to Company A, discharging the debt used to acquire the trading stock, and the debt between Company B and Company A is subsequently reduced for no consideration. In these circumstances does one have regard to the original indebtedness i.e. to the fact that Company B acquired trading stock or is the loan between Company A and Company B merely an inter-company loan which can be waived without consequence?

Paragraph 4.1.4 – Amount applied as consideration where shares are issued

In the analysis relating to the amount applied as consideration, reference is made to the Lace Propriety Limited case in which the court held that the true consideration had to be valued by determining the market value of the shares issued and this valuation was not affected by reference to the stated purchase price or the nominal value of the shares allotted.

However, on page 9 on the draft note, the situation is that a creditor subscribes for shares under a subscription agreement at an amount higher than the market value of the shares (but which equals the face value of the loan). The value placed on the right to claim the subscription price and the consideration applied to the reduction of the loan, is determined with reference to the subscription amount in the agreement and not with reference to the value of the shares to be issued. This appears to be at odds with the principle set-out in the Lace decision.

Paragraph 4.1.4 - Anti-avoidance and sham transactions

At page 9 of the draft note, reference is made to sham transactions. We suggest that this aspect requires further elaboration, particularly in circumstances in which a creditor subscribes for shares with a subscription price higher than the market value of the shares which will be issued but which equals the face value of the debt owed to that creditor. In these circumstances, the parties may validly intend for the creditor to subscribe at a premium and to use the proceeds of that share subscription to settle the face value of the debt. If the parties transact on this basis, it is difficult to see how the sham transaction doctrine can be invoked. Furthermore, if the purpose of entering into the transactions was primarily commercially driven i.e. to improve the balance sheet of the company, remedy technical insolvency etc. a successful challenge under GAAR appears unlikely.

Taxpayers who restructure their debt on this basis are however in a better tax position than a taxpayer who is merely released of the obligation and who would therefore have triggered the provisions of section 19 and / or paragraph 12A. The inequity of the position is particularly marked where the creditor is also the sole shareholder and the subscription for shares does not fundamentally effect the creditor's position.

Replacement of debt instruments with preference shares

Companies who unable to service existing debt or who are technically insolvent may seek to restructure existing financing arrangements. In particular it is not uncommon for companies to replace debt with preference share funding, with the funding party remaining unchanged. This debt refinance can be structured either as a capitalization of the debt with preference shares or through a subscription for preference shares for an amount equal to the face value of the debt followed by a discharge of the debt either through set-off or in cash.

These transactions will invariably be structured in a manner which circumvents the application of section 19 and paragraph 12A. We suggest that a simpler and more transparent solution would be to allow the replacement of debt with preference shares with a redemption amount equal to the face value of the loan and to defer any debt forgiveness triggers until the redemption date of the preference shares i.e. to only trigger section 19 and / or paragraph 12A if the preference shares are redeemed at a discount.

Application of section 8(4)(a) to the reduction of foreign denominated debt

One of the areas which is not addressed in the draft note is the waiver of foreign denominated loans. We set out below an example which highlights the issue at hand.

The example

Section 24I provides for a deduction from income of foreign exchange gains and losses in respect of debt owing in a foreign denomination.

By way of example, a South African resident taxpayer owes a loan of USD100. At the time the loan was advanced the exchange rate was R10:USD1. The amount owing by the taxpayer at the time was therefore R1 000. The creditor waives the loan on a date that the exchange rate is R12:USD1. At the time of waiver the debt expressed in ZAR is R1 200, of which R200 is a deductible foreign exchange loss in terms of section 24I.

Had the debt not been waived, the taxpayer would have paid R1 200 (USD100 expressed in ZAR at the time of payment) to settle the loan. The amount of R1 200 consists of:

- Repayment of the original loan capital of R1 000; and
- And additional R200 because the exchange rate has moved in favour of the creditor. Unless the taxpayer has cash on hand in USD, the taxpayer will have to exchange R1 200 into USD100 so as to repay the loan. The additional amount is a deductible foreign exchange loss of R200 in terms of section 24I. If the loan is waived, the taxpayer no longer has to pay.

It is suggested that an example that deals with the provisions of section 19 and the possible recoupment under section 8(4)(a), should be included.

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