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The National Treasury

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The South African Revenue Service

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RE: REVISION OF DEBT REDUCTION PROPOSALS IN DRAFT 2017 TAXATION LAWS AMENDMENT BILL – SIGNIFICANT NEW ADDITION: DEBT BENEFIT TRIGGERED BY CHANGE IN ANY TERM OR CONDITION OF A DEBT

1. Introduction

Following the public workshop held by National Treasury and SARS on 4 September 2017, to discuss various submissions made by stakeholders with regard to the 2017 Draft Taxation Laws Amendment Bill (the DTLAB), National Treasury indicated that there may be a further reengagement to specifically discuss the issue of debt reductions.

Therefore, a further public workshop was held by National Treasury and SARS on 26 September 2017 (the workshop) to engage again with stakeholders to discuss the revised debt reduction proposals.

We would like to thank National Treasury for the consultation process which has been held in this regard and reiterate our willingness to assist in ensuring that the proposals achieve their desired objectives.

At the workshop, National Treasury's intention that the debt reduction proposals would be revised was indicated (subject to due process and without creating expectations). The principles related to the proposed changes were discussed, as contained in a handout of slides (the revised proposal). The public representatives who attended the workshop raised certain concerns, especially in relation to the new proposal that the *change of terms or conditions of a loan would trigger a debt benefit*. (As far as the changes to the original debt reduction proposals contained in the DTLAB were concerned, including debt to equity conversations, there were still some concerns but recognition was given that the revised proposals took into account some of the original concerns raised throughout the consultation process. As such, it was accepted that further changes could be considered in future legislative cycles.)

This submission is made by SAIT and SAICA, jointly, to present concerns discussed by participants from various accounting and law firms at a subsequent meeting of such participants held on 2 October 2017 only in relation to the new proposal that the *change of terms or conditions of a loan would trigger a debt benefit*. Due to the tight timeframe before the DTLAB is updated and sent to the state law advisor, and in the interest of making this submission sooner rather than later, our opportunity for further detailed consideration of the potential impact and engagement with National Treasury at this stage has been limited.

In this submission, we set out why we strongly recommend that the proposal that the *change of terms or conditions of a loan would trigger a debt benefit* should not be proceeded with at this stage. We suggest that, if National Treasury wishes to proceed with this proposal, adequate consultation should take place in another full legislative cycle as the consequences of such a change are likely to be significant.

2. Background

It was foreshadowed in Annexure C to the 2017 Budget that the tax implications of debt foregone would be addressed. This included the alignment of the tax treatment of debt foregone for dormant group companies or companies under business rescue by extending the group relief in paragraph 12A of the Eighth Schedule (CGT) to section 19 (income tax). It also included the introduction of tax legislation to allow for the conversion of debt into equity but with the recoupment of capitalised interest on the debt in respect of which an interest deduction was previously allowed.

The DTLAB was published for public comment on 19 July 2017. The initial proposal in relation to dormant group companies extended the group relief to section 19, as foreshadowed in the Budget. However, the dormancy requirements were very onerous. This was recognised by National Treasury and in terms of the revised proposal a company will be considered to be dormant if it did not trade in a year a debt is forgiven and the immediately preceding year. This revision recognises commercial reality and is welcomed.

Another amendment proposed in the DTLAB is that the existing group relief in paragraph 12A (CGT) that is available to domestic groups in relation to debt foregone will be repealed (unless the debtor is dormant which is often not the case e.g. where a company is struggling but trying to trade itself out of losses with the assistance of its holding company). This was not foreshadowed in the Budget. It is also contrary to public submissions made to National Treasury for the 2017 Budget that the group relief should be extended to section 19 (income tax). The initial proposal in relation to conversions of debt to equity in a group context was that the debt forgiveness rules would not apply but that there would be a claw-back of interest previously deducted where the interest was not subject to normal tax in the hands of the creditor. In addition, a de-grouping charge based on the amount of debt deemed to be forgiven could be applied for 6 years. However, the revised proposal is significantly different and goes much further with potentially far reaching consequences.

3. Revised proposal – Concessions or compromises in respect of debt (pertinent aspects)

We briefly summarise our understanding of the pertinent revisions as far as they are relevant to the change in any condition or term of a debt trigger. In terms of the revised proposal, the definition of "reduction amount" in section 19 will be deleted and replaced with two new concepts, namely "debt benefit" and "concession or compromise".

A "concession or compromise" will include *a change in any condition or term of debt* (although National Treasury is understood to have accepted that an amendment in the interest terms going forward should be excluded from this trigger, which was the bare minimum in terms of acceptable changes to the revised proposal). A "concession or compromise" event would trigger the existing debt reduction consequences in section 19 and paragraph 12A and the relevant amount would be determined in terms of a "debt benefit".

A "debt benefit" arises for the debtor where the face value of the debt exceeds in the context of changes of conditions or terms of debt, the market value of the debt after the change.

There is no proposal for group relief for changes in the terms and conditions of debt (e.g. by way of debt subordinations) although National Treasury has indicated that this may be reconsidered in the 2018 Taxation Laws Amendment Bill. The proposal is for the revised amendments to apply for years of assessment commencing on or after 1 January 2018.

4. Significant new addition: debt benefit triggered by change in any term or condition of debt

The triggering of a debt benefit by *a change in any term or condition of the debt* was not consulted on prior to the 26 September 2017 National Treasury workshop. It was first alluded to in the National Treasury Draft Response Document on Taxation Laws Amendment Bill, 2017 and Tax Administration Laws Amendment Bill, 2017 dated 14 September 2017.

In terms of the revised proposal, *any change in a term or condition of a debt* (other than the change in future interest terms which it is understood that National Treasury were agreeable for it to be ignored) will be a trigger event as it is included in the definition of “concession or compromise”. Once there is a trigger event it means that the “debt benefit” must be

determined. This will require that the market value of the debt claim must be quantified. Therefore, although the capital amount of the loan remains intact and outstanding the debt reduction rules would apply to the debtor (if the market value is less than the face value). There is also no group relief.

We believe that this change has too much of an anti-avoidance perspective. In a commercially driven restructuring, the parties are seeking to preserve market value and ensure that "face value" is ultimately repaid. Notes may change to have an extended period (by 1-3 years) to add repayment headroom for debtor recovery but no more. This revised debt will often come with tighter restrictions but with a reduced value due to the credit worthiness of the debtor. The proposal, however, would trigger tax just at the moment the parties are seeking to rescue the ultimate "face value" replacement of the debt. The real issue is that the pre-existing debt has devalued long before the restructuring. In essence, the proposed charge seeks to tax the restructuring as the "realisation" of lost fair value when the restructuring attempt is precisely to ensure that the fair value lost is never realised.

We also note that the proposed "any change in term or condition" trigger differs from the "disposition" trigger at the creditor level. Creditors may have a disposition under paragraph 11 and section 22 (depending whether they have capital or trading stock) or even an adjustment to floating capital. There is no co-ordination between these trigger points and what level of materiality is required.

We again also question whether fair value versus cost is the true differential at the debtor level. The real issue is whether the face value of the debt is genuinely intended to be repaid. If full repayment is the genuine intention, we see no reason that debt cancellation should arise despite the decline in value caused by the debtor's condition.

At a compliance/administrative level, the valuation of the debt at market value for this purpose amounts to a fair value basis of accounting for tax purposes. This is a departure from the receipt/accrual basis. We would like to understand the policy considerations. Practical considerations should also be taken into account. In other words, in respect of every debt, the debtor must constantly monitor whether there is any change in a term or condition of the debt and as soon as there is any change, the market value of the debt claim/loan must be quantified to determine the amount, if any, of the "debt benefit" in order to apply the debt

reduction rules. This is an onerous requirement for taxpayers and a possible trap for the unwary.

Valuing a debt claim could be a very complicated, expensive and time-consuming exercise. Consider for example, where there is a loan by a parent company to an unlisted subsidiary company which the parent company subordinates in favour of the bank until a bank loan is repaid. The market value of the subordinated loan would depend, amongst other things, on the market value of the subsidiary company. The subsidiary company would have to be valued which likely means that its cash flows for the foreseeable future would have to be forecast under different scenarios taking for example expected exchange rates into account. A management decision would also have to be taken regarding the appropriate discount rate. This is an art, not a science, and there is no right answer. The valuation would be open to dispute between SARS and the taxpayer. It would be very burdensome for the taxpayer to prepare and for SARS to consider these valuations. It should be borne in mind that the taxpayer would not necessarily need to prepare a valuation of the debt at that point for any other purpose, so it would add costs. We are of the view that performing these “notional” valuations for various changes in terms/conditions e.g. interest holidays, parent guarantees, etc. would be practically unworkable.

This new proposal also means that an event that is reversible, such as a subordination of a loan by a parent company until the subsidiary becomes solvent again, will trigger the debt reduction rules. It was briefly mentioned in the workshop that maybe the debt reduction should be reversed when the subordination reverses (and the market value goes up). We think that it would be wholly unworkable. For example, it may be difficult to monitor when and to what extent there is a reversal of the subordination, depending on the agreement. Also, if you have triggered cash tax upfront, how will you get it back when the subordination “reverses”? What if you no longer hold the assets whose tax characteristics were reduced, what do you do with the reversal then?

Group lenders often agree to amend the terms and/or conditions of a loan to give the company head-room to enable them to trade out of a tight spot. For example, if a company has cash-flow problems and/or is technically insolvent, it is likely that its suppliers (third party creditors) would get nervous and start refusing to provide goods/services on credit terms. However, should the group lender agree to subordinate its loan, the suppliers should no

longer have that concern. This could prevent the company from going into distress. Triggering debt reduction tax consequences at that point would be counter-productive as the assistance provided by the group company may be negated by the tax burden. This begs the question why the proposal specifically excludes group relief in the case of changes to the terms and conditions of loans. Should this proposal be implemented, we are of the view that group relief should be available from the effective date. In this regard, it should be borne in mind that parent companies often subordinate their loans to ensure that their subsidiaries meet the going concern requirements for audit purposes. In other words, they will not be in a position to delay the subordination until the group relief is extended at a later stage, if at all.

In 'underwater' empowerment transactions, the funders also often provide a package of debt relief to give the company some head-room.

We are concerned that this proposal, if implemented, may give rise to a minefield of unintended consequences that have not yet been identified, and taxpayers will be obliged to actually apply the provisions, in this environment of uncertainty, given that the effective date is years of assessment commencing on or after 1 January 2018. We think that the proposal goes too far in trying to address perceived mischief that National Treasury and/or SARS might be aware of. We would therefore like to understand what, if any, the perceived mischief is and also what the policy considerations are. Commercial considerations should receive due cognisance and should be balanced with tax avoidance concerns. We submit that commercial considerations should override tax considerations in any event in this instance, as debt relief is required to promote economic recovery in the current tough economic climate and the tax should not hamper or interfere with such economic dynamics.

We also note that many distressed debtors lack the losses and other tax attributes in sufficient amounts to avoid debt cancellation gain/income. Many losses have already been used up in notional earnings. Most debtors suffer a cash shortage where cash receipts fall below "accruals". Accruals give rise to taxable income but leave a company distressed if payment is delayed or uncertain. This notional taxable income absorbs the loss but continues to leave the company distressed. Other common notional non-cash streams of income include unanticipated amounts stemming from notional foreign currency section 24I gains.

5. Recommendation

The triggering of a debt benefit by a change in any term or condition of the debt was not consulted on prior to the workshop. This proposal goes much further than what was foreshadowed in the 2017 Budget and proposed in the DTLAB. The change proposed is far-reaching and the potential impacts are not known. We think that it would be too risky to proceed now.

We strongly recommend that the proposal that *the change of terms or conditions of a loan would trigger a debt benefit* should not be proceeded with. We suggest that, if National Treasury wishes to proceed with this proposal, adequate consultation should take place in a future full legislative cycle, as the consequences of such a change are likely to be significant and cannot all be foreseen and considered at this stage.

We look forward to future engagement.

Yours sincerely

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