South African Institute of Tax Professionals

20 April 2018

The National Treasury
240 Madiba Street
PRETORIA
0001

The South African Revenue Service
Lehae La SARS, 299 Bronkhorst Street
PRETORIA
0181

BY EMAIL: Yanga Mputa
Lerato Makhetha
Gerrie Swart
Johan de la Rey

RE: DEBT REDUCTION PROPOSALS FOR THE 2018 DRAFT TAXATION LAWS AMENDMENT BILL

We would like to thank you for the consultation meeting held on 13 April 2018 and the opportunity to make further written submissions regarding the debt reduction proposals for the 2018 Draft Taxation Laws Amendment Bill (DTLAB).

We are concerned that amounts that are **unrealised** in the hands of the debtor could trigger tax consequences (either recoupments in terms of section 19 of the Income Tax Act or base cost reductions in terms of paragraph 12A of the Eight Schedule depending on the use of the funding).

One of these proposed triggers is certain changes in the terms or conditions applying to a debt between connected persons, mainly in relation to the enforceability or recoverability of the debt and the term thereof. It is proposed that the amount of the "debt benefit" arising from the "concession or compromise" be calculated as the amount by which the face value of a claim in respect of a debt, exceeds the market value of the claim in respect of that debt following the change.

We question whether it is appropriate from a policy perspective to value the debt and to then tax the debtor on any unrealised gain calculated. This treatment is not aligned with the scheme of the Income Tax Act whereby realised amounts are included in gross income on the earlier of receipt or accrual. Taxing a debtor on the decrease in the value of a debt that remains fully repayable also does not make economic sense, particularly given the current state of the South African economy. Taxing such an unrealised gain will often undermine the recovery/rehabilitation process of a company in distress. In this regard it is important to bear in mind that a cash tax liability in one year might be the final blow to a company that is being assisted by its creditors/shareholders as it may not have the cash flow to fund its day-to-day operations let alone any additional cash tax. A reversal of the cash tax liability in a later year might simply be too late. In other words, the company might go into insolvency due to the additional tax burden that is triggered by the rescue attempt.

A practical consideration, which should not be underestimated, is the complexity of valuing a debt where the debtor is in financial distress. Under these circumstances, the market value of the debt is dependent on the ability of the debtor to make the repayments of the capital and interest as and when they fall due. This would require cash flow projections from the company's operations for a number of years. The net present value of these future cash flows must then be determined with reference to a discount factor (the required internal rate of return). Both the cash flow projections and the determination of the discount factor involves a degree of subjectivity. This process is likely to be very time-consuming and costly for taxpayers. Verifying such valuations would also add to the administrative burden of SARS. In addition, because of the judgement and subjectivity involved, it is likely to give rise to disputes between SARS and taxpayers.

As a general matter, tax consequences should only be triggered when a gain is **realised** in the hands of the debtor, for example when the debt or a portion thereof is waived, cancelled or remitted. However, we understand from the consultations that there are some instances of mischief involving debt restructuring. We would recommend that specific anti-avoidance measures be used to attack these. For example, should a loan become a hybrid debt instrument as contemplated in section 8F, such event could perhaps be treated as a debt-equity conversion for purposes of the debt reduction rules.

It is not clear to us why it is only in the case of direct/indirect debt to share conversations that group relief will be available. We suggest that consideration should be given to the extension of group relief to all the concession or compromise triggers to ensure parity of treatment. If the creditor will be denied a capital loss the debtor should not suffer tax consequences.

We appreciate and welcome the consultation in advance of the publication of the DTLAB and look forward to future consultations.

Yours sincerely

Erika de Villiers

Head of Tax Policy