THE EXTINCTION OF ‘INTRA-GROUP’ DEBT – A CASE STUDY ANALYSIS OF THE INTERACTION BETWEEN SECTIONS 8(4)(m) and 20(1)(a)(ii) and THE APPLICABILITY OF THE EIGHTH SCHEDULE TO THE INCOME TAX ACT 58 OF 1962

by

DIRK ESAU HUISAMER

(STUDENT NO: HSMDIR001)

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DECLARATION

I, Dirk Esau Huisamer, hereby declare that the work on which this research paper is based is my original work (except where acknowledgements indicate otherwise) and that neither the whole work nor any part of it has been, is being, or is to be submitted for another degree in this or any other university.

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Dirk Esau Huisamer

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LIST OF MAIN ABBREVIATIONS

BPR	- Binding private ruling
CGT	- Capital gains tax
CIR	- Commissioner for Inland Revenue
COT	- Commissioner of Taxes
CSARS	- Commissioner for the South African Revenue Service
IRC	- Inland Revenue Commissioners
ITA	- Income Tax Act No. 58 of 1962
ITC	- Income Tax Case
KBI	- Kommissaris van Binnelandse Inkomste
p/pp	- Page/s
para/paras	- Paragraph/s
SARS	- South African Revenue Service
SIR	- Secretary for Inland Revenue
STC	- Secondary tax on companies
Vol	- Volume

CHAPTER 1: INTRODUCTION

1.1 BACKGROUND

A group finance company (or treasury company) is often established within a 'group of companies'[1] on the basis that all excess cash of the group will be deposited with that finance company and said finance company will act as a moneylender to the rest of the group.[2] It is however not only the finance company that acts as a lender; loan accounts commonly exist between various companies within a group. These loans are required for a number of reasons, ranging from capital to operating requirements. It also happens that goods are supplied or services rendered between companies within the group which are not immediately paid for but remain outstanding on the loan account.

For a number of reasons it could happen that a company within the group does not have the means to settle an amount owing to another company within the group. The recent recession further contributed to this, and the closure and restructuring of companies has been widely publicised.[3] These outstanding loans are invariably extinguished through various means.[4] This raises the question of whether the extinction of these intra-group[5] loans could have unforeseen tax implications within the group.

The above-mentioned question is compounded because of the fact that South Africa does not have a system of group taxation; each company within a group is taxed in its own capacity. A number of tax concessions[6] are however granted for companies within the same group to eliminate unwarranted tax consequences caused by certain

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[1] 'Group of companies' as defined in section 41 of the Income Tax Act No. 58 of 1961 (the ITA)

[2] Also refer to *Solaglass Finance Company (Pty) Ltd v CIR* (1991 A), 53 SATC 1 where the use of such a finance company was described

[3] An example hereof can be found in an article published on the Sake24.com website (South African Press Association, 2010) – In that article Statistics South Africa stated that the total number of liquidations recorded for May 2010 was up 35.7% year-on-year

[4] The various means though which loans could be extinguished will be discussed in Chapter 2 of this paper

[5] 'Intra-group' refers to a transaction between two or more companies that form part of the same 'group of companies' as that term is defined in section 41 of the ITA

[6] Refer Part III of Chapter II to the ITA

transactions within that group. This raises the next question: Is the extinction of these intra-group loans adequately covered by these concessions or is there any reason(s) why it should not be? A negative answer to the first part of this question often causes companies within a group to enter into elaborate schemes and transactions in an attempt to shift around income and losses between those group companies to achieve favourable tax results.

The waiver of loans[7] has always been a widely debated and controversial subject, more so after the introduction of Capital Gains Tax (CGT), and specifically because of the introduction of paragraph 12(5) of the Eighth Schedule to the Income Tax Act No. 58 of 1962 (the ITA).[8] Yet, despite there being much literature on paragraph 12(5), and its interaction between sections 20(1)(a)(ii) and 8(4)(m) of the ITA,[9] the South African Revenue Service (the "Commissioner" or "SARS") was recently requested to provide a binding private ruling (BPR) on this very issue. BPR 073 was therefore issued by SARS on 29 January 2010. It provides important insight into SARS' view on this topic and how it would consequently treat the extinction of intra-group debt.

It should however be noted that disputes arise as a result of the fact that taxpayers and SARS have different interpretations regarding the application of the ITA. Judgements by the courts create precedents for these matters which are usually adhered to in subsequent court cases depending on the status of the court delivering the judgement. Such judgements are also used by SARS and by taxpayers as a reference when they apply the ITA to a specific issue. A BPR by no means creates such a precedent and the courts have held on a number of occasions that a taxpayer cannot rely on SARS practice if it is different to legal interpretation.[10]

1.2 PROBLEM STATEMENT

A BPR merely sets out SARS' opinion on its interpretation of certain sections of the

[7] Used interchangeably with the term 'extinction of debt'
[8] Unless otherwise indicated, all references to paragraphs refer to that specific paragraph in the Eighth Schedule to the ITA
[9] Unless otherwise indicated, all references to sections refer to that specific section of the ITA
[10] Refer *ITC 1830* (2007 G), 70 SATC 123

ITA and has no authority for any person other than the applicant thereof.[11] However, this does give a clear indication of how SARS would deal with similar issues in practice. Whereas section 8(4)(m) has remained unchanged since it was added by section 6(1)(b) of Act No 28 of 1997, section 20(1)(a)(ii) and paragraph 12(5) have been amended on a number of occasions. It is therefore important to determine whether the questions raised in previous studies have now been addressed and whether the ruling agrees to the interpretation of tax practitioners and experts or whether it could be challenged in a court of law where differences exist.

1.3 RATIONALE

The reason for choosing to carry out this research is because of the uncertainty, controversy and misunderstanding that still surround this topic. An attempt will now be made to resolve such uncertainty. As noted before, the extinction of intra-group debt is common practice but yet the treatment thereof remains inconsistent. Different opinions exist between various tax advisors and academics alike. These different opinions will be summarised and analysed in this research paper. Previous studies on this topic were mostly carried out before the latest amendments were made, and it is therefore important to revisit this topic.

Furthermore, a practical question will now be tested against the existing literature, and a conclusion reached on the BPR issued by SARS.

1.4 RESEARCH OBJECTIVES

The primary objective of this study is to understand the tax consequences arising from the extinction of intra-group loans, specifically where the debtor company has an assessed loss, and with particular reference to the ruling in BPR 073. The essential question that will be examined is the following: To what extent would sections 8(4)(m) and 20(1)(a)(ii) and paragraph 12(5) apply to a situation where an intra-group loan is extinguished and the debtor company has an assessed loss or previously had an assessed loss that was subsequently interrupted?

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[11] Section 76H(4)

In order to achieve the primary objective the following secondary objectives were set:

- Analyse the meaning of 'extinction of a loan' for the purposes of sections 8(4)(m) and 20(1)(a)(ii) and paragraph 12(5).
- Determine the continued relevance of section 8(4)(m) after the ruling given in the Omnia Fertilizer case[12], because a number of academic writers commented that section 8(4)(m) is potentially no longer relevant after the Omnia Fertilizer judgement (*supra*).
- Analyse section 20(1)(a)(ii) and its interaction with section 8(4)(m).
- Determine the applicability of the Eighth Schedule.

1.5 THEORETICAL FRAMEWORK

This study is limited to income tax in terms of the ITA, including legislation promulgated up to 30 September 2009 (Taxation Laws Amendment Act, No. 17 of 2009 and the Taxation Laws Second Amendment Act, No. 18 of 2009) with specific reference to sections 8(4)(m) and 20(1)(a)(ii) and paragraph 12(5) and their interaction in this context. A brief analysis of other provisions of the ITA dealing with the extinction of debt will also be given. Paragraph 12(5) has been analysed in various studies and could possibly not apply to the extinction of intra-group debt, hence this study will only focus on its applicability in that scenario and will further only provide an overview of its application in general.

A detailed discussion of the Corporate Rules (sections 41 to 47) falls outside the scope of this study. Donations tax (sections 54 to 64) is also not referred to in this research paper, as donations made by a company to any other company that is a member of the same group of companies are exempt from donations tax (section 56(1)(r)). Secondary tax on companies (STC) (sections 64B and 64C) is also not covered because a company can elect that dividends declared by the company to a resident shareholder that forms part of the same group of companies be exempt from the payment of STC. The dividend should, moreover, be paid out of profits earned during the period when the shareholder formed part of the group (section 64B(5)(f)).

[12] *Omnia Fertilizer Ltd v CSARS* (2003 SCA), 65 SATC 159

The study will only deal with groups of companies that are all registered, managed and controlled in South Africa; all aspects of international tax (including, but not limited to, transfer pricing and thin capitalisation (section 31)) will be ignored. This paper will not include indirect taxes (such as value-added tax, transfer duty and securities transfer tax).

1.6 RESEARCH DESIGN AND METHODOLOGY

This research paper will primarily be a literature study. Firstly, a study of the relevant literature is required to gain a body of knowledge regarding the current interpretation of the extinction of intra-group loans by the taxing authorities and the tax community, and to understand the relationship between sections 8(4)(m) and 20(1)(a)(ii) and the Eighth Schedule to the ITA in that context. Secondly, the knowledge gained from the literature study will be used to investigate the ruling issued by SARS in BPR 073. Emphasis will be given to those points where disagreement exists between the outcome of the literature study and the ruling given. Finally, a conclusion is reached and summarised.

The reason for choosing this approach is to consolidate the numerous literature on this topic and test it against a practical scenario, and then incorporate all into a single document. This would facilitate future analysis and evaluation of this topic.

The information will be gathered from relevant legislation, textbooks, articles (setting out the views of reputable legal and tax experts) published in legal and business journals and on relevant Internet websites, completed research studies and applicable court cases. The information will then be summarised, documented and evaluated. The case study details will primarily be taken from BPR 073 issued by SARS on 29 January 2010.

1.7 INTERPRETATION OF FISCAL LEGISLATION

In analysing the relevant sections of the ITA it is important to interpret it in terms of the rules adopted by our courts. Those rules that will be used for the purpose of this paper are now described.

In the English case of *Partington v The Attorney-General*[13] Lord Cairns laid down the following rule of interpretation:

> *"If the person sought to be taxed comes within the letter of the law, he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the law the case might otherwise appear to be. In other words, if there be an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute."*[14]

Our courts have accepted this rule when interpreting our statutes and have held that, in the interpretation of fiscal laws, our courts must apply the literal language of a statute, where such language is unambiguous and its meaning is clear.[15] The court should not apply the literal language if it would lead to "… absurdity so glaring that it could never have been contemplated by the legislature, or if it leads to a result contrary to the intention of Parliament as shown by the context or by such other considerations as the court is justified into taking into account".[16]

Also refer *Shenker v The Master and Another*[17] where the judge said that it is dangerous to speculate as to the intention of the legislature and what seems an absurdity to one man does not appear absurd to another. He goes on to say that the absurdity must be utterly glaring and the intention of the legislature must be clear, and not a mere matter of surmise or probability.[18]

Where it is found that the wording of the statute is not absurd but merely ambiguous, the court will follow an interpretation favourable to the taxpayer and against the *fiscus*. This is called the *contra fiscum* rule of interpretation.[19] In *CIR v Widan*[20] the Appellate Division made it clear that the *contra fiscum* rule only found application where there is doubt as to the intention of the legislature.

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[13] 21 LT 370 (HL)
[14] As cited in *Glen Anil Development Corporation Ltd v SIR* (1975 A), 37 SATC 319 at pp 333-334
[15] Steyn, 2009 ("Steyn") at p 5
[16] See *Venter v Rex* 1907 TS 910; *Shenker v The Master and Another* 1936 AD 136; *Barkett v SA Mutual Trust and Assurance Company Ltd* 2 SA 353 and *Savage v CIR* 18 SATC 1 at p 9
[17] 1936 AD 136 at p 143
[18] As cited by Steyn at p 8
[19] Refer Steyn at p 13
[20] (1955 A), 19 SATC 341 at p 352

In *Badenhorst & others v CIR*[21] the Appellate Division considered the relevance of equity in the context of fiscal legislation. At p 49 the court said that the mere existence of hardship or inequity resulting from the application of the plain provisions of fiscal legislation is beside the point. Hardship and inequity are not to be used for the purpose of reading into plain terms a meaning that they do not otherwise bear, so that where logic and argument by analogy show that it would be equitable for a person to escape tax in certain circumstances because he would escape tax in specified other analogous circumstances, equity is not allowed to equate the two sets of circumstances.[22]

It also happens that our courts find that they cannot make sense of the wording of the legislation because it appears that certain word(s) have been omitted. The court would then add to or replace wording in the statute, in order to make it read in a manner that the court finds logical and which the court holds was probably the intention of the legislature, having regard to the main aim of the legislation and the context in which the wording appears. The court would also use other rules of construction permitted by common law.[23]

In the interpretation of statutes courts have cautioned taxpayers against relying on practices followed by SARS and on practice notes issued by SARS. This is because the Commissioner is not always consistent in following those practices and will not be allowed by the courts to rely on a practice note where it is in contravention of the provisions of the ITA.[24]

In *Baron & Jester v Eastern Metropolitan Local Council*[25] the judge highlighted the following aspects as set out by Kellaway, 1995 ("Kelleway") on the evolution of the 'golden rule'[26] of interpretation in the South African context:

- *Interpretatio quae pari absurdum non est admittenda* (an interpretation that creates an absurdity is not acceptable).
- The function of a Court of Law is to construe the language of the legislature

[21] (1955 N), 20 SATC 39
[22] Also refer Steyn at p 12
[23] Refer Steyn at p 14
[24] Refer *ITC 1675* (1998 G), 62 SATC 219 and Steyn at p 21
[25] [2002] JOL 9412 W
[26] See Kellaway at p 57

and arrive at its intention in that way, it has no power to redraft or alter the language.[27]

- Intention must clearly appear either from the language used, or from the nature of the enactment. We are not, in ascertaining the intention of the legislature, restricted to the language of the enactment, but may look at the surrounding circumstances, and may consider its objects, its mischief and its consequences.[28]
- The context in which the words appear is a relevant factor in construing a statute.
- The ascertainment of the purpose of the legislation concerned is of cardinal importance in ascertaining the meaning thereof.
- There can be no mere speculation as to the purpose of the legislation. It is necessary to carefully consider the entire Act, including, but not limited to, the short title, the long title, the headings, the interrelationship between the enacting clauses, the surrounding circumstances, and the apparent scope and purpose thereof.[29]
- The court may, on a full and proper consideration of the enactment, find that its purpose is manifest. Thus, *ex ratione legis colligitur mens legis* (when the purpose of the law ceases, the law ceases) and *quia voluntas semper potior est voce dicentis* (the purpose of an enactment is always more powerful than the words used).[30]
- Kellaway[31] further notes the following:

"For more than half a century in South Africa, courts have given effect to the manifest purpose of an enactment where the language was not clear in a provision of an Act that had to be interpreted. And where the scope of a provision in a statute appeared to be wide, its extent was necessarily restricted, or extended, to give effect to the manifest purpose of the Act."[32]

[27] Per Stratford JA at p 480 in *Ex Parte Minister of Justice: In re Rex v Jacobson & Levy* 1931 AD 466
[28] Per Innes CJ at p 541 in *Union Government v Tonkin* 1918 AD 533
[29] Baron & Jester (*supra*) at p 12
[30] Kellaway at p 67
[31] At p 68
[32] As cited in Baron & Jester (*supra*) at pp 13-14

The approach of Hurt AJA in *CSARS v Airworld CC and Another*[33] is as follows:

> *"In recent years courts have placed emphasis on the purpose with which the Legislature has enacted the relevant provision. The interpreter must endeavour to arrive at an interpretation which gives effect to such purpose. The purpose (which is usually clear or easily discernible) is used, in conjunction with the appropriate meaning of the language of the provision, as a guide in order to ascertain the legislator's intention."*[34]

Hurt AJA also refers to the words of Nienaber JA in *De Beers Marine (Pty) Ltd v CSARS*[35] when dealing with the meaning of 'export' for the purpose of section 20(4) of the Customs and Excise Act No. 92 of 1964 – which draws a distinction between export and home consumption-

> *"…the word must 'take its colour, like a chameleon, from its setting and surrounds in the Act'."*[36]

In analysing the different sections of the ITA the rules summarised above will be considered to ensure that proper effect is given to the purpose of the relevant sections.

1.8 STRUCTURE OF THE RESEARCH PAPER

The research study will comprise seven chapters.

1.8.1 Introduction

This current chapter describes the background to the study. The problem statement is defined, the importance of the study is emphasised and the research objectives are outlined. Furthermore, the research methodology is given and the scope of the study demarcated. The rules of interpretation are also addressed to the extent required for the purpose of this paper.

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[33] 70 SATC 48
[34] At pp 59-61
[35] (2002 SCA), 65 SATC 14
[36] As cited in Airworld (*supra*) at p 61

1.8.2 The meaning of the term 'extinction of debt' in the context of sections 8(4)(m) and 20(1)(a)(ii) and the Eighth Schedule

Chapter 2 will focus on the nature of the relevant legal terms dealing with the extinction of debt. The intention will be to analyse the different means by which a loan (debt) can be extinguished. The relationship between the different terms will be investigated and discussed.

1.8.3 Details of the case study

Chapter 3 will set out the details of the case study that will be used to analyse the tax consequences of the extinction of intra-group loans.

1.8.4 An interpretation of section 8(4)(m)

In Chapter 4 an attempt will be made to analyse the provisions of section 8(4)(m). The reasons necessary for the introduction of this section to the ITA will be looked at briefly. This section may be considered by some to be self-explanatory, but it will be demonstrated that it is not always easy to consider the applicability of this section. The effect of the Omnia Fertilizer case (*supra*) on the relevance of this section will also be discussed in this chapter.

1.8.5 Section 20(1)(a)(ii) and its interaction with section 8(4)(m)

The main literature published on section 20(1)(a)(ii) will be summarised in Chapter 5 and the legislature's intention with the latest amendment(s) to this section will be analysed. A conclusion will be reached as to whether the issues identified by previous writers have now been addressed through the latest amendment(s).

1.8.6 The applicability of the Eighth Schedule

Chapter 6 will provide a brief overview of paragraph 12(5) and other applicable paragraphs relating to the extinction of loans in general. The group company exemption will be discussed to determine when this paragraph could be applicable in a group scenario.

1.8.7 Conclusion

In Chapter 7 a conclusion is reached and recommendations are presented.

CHAPTER 2: THE MEANING OF THE TERM 'EXTINCTION OF DEBT' IN THE CONTEXT OF SECTIONS 8(4)(m) and 20(1)(a)(ii) and THE EIGHTH SCHEDULE

2.1 INTRODUCTION

The financing of a company's capital and/or operating requirements is a common concept in modern society. There are various channels through which the financing could be realised and, given the constant technological improvements, this could also become very complex. This would include financing through the traditional loan agreement to preference share schemes, options, hedge funding, etc. Invariably the debtor (person requiring funding) would settle its obligation with the creditor (person providing funding) in terms of the agreement.

There are, naturally, various ways through which the obligation could be settled. Accordingly, in this chapter there will be a discussion of the nature of the relevant legal terms used in the sections[37] dealing with the extinction of debt. The intention is to analyse the different means by which a loan (debt) could be extinguished as described in the different sections. The relationship between the different terms will also be investigated and discussed.

2.2 TERMINOLOGY USED

The sections relevant to this research paper make use of different terms to describe the term 'extinction of debt' as a requirement for each specific section. In terms of section 8(4)(m) the debt[38] should be extinguished as a result of "the cancellation, termination or variation of an agreement or due to the prescription, waiver or release of a claim for payment". However, in terms of section 20(1)(a)(ii) the extinction of

[37] In this context the term sections collectively refers to sections 8(4)(m) and 20(1)(a)(ii) as well as paragraph 12(5)
[38] The term 'obligation' is used in the section

the debt[39] should result from "a concession granted by or compromise made with any creditor". Lastly, paragraph 12(5)(a) requires the debt[40] to be "reduced or discharged by that creditor".

2.3 DEBT

The term 'debt' will now be considered based on the different meanings attributable to it in the specific sections of the ITA. For the purpose of this paper, the term 'debt' will be used to describe the various terms 'obligation,'[41] 'liability'[42] and 'debt owed'[43] as used in the context of the different sections and these terms will be used interchangeably throughout this paper.

2.3.1 Obligation

The term obligation is defined as "[a] binding agreement committing a person to a payment or other action."[44] According to A Dictionary of Finance and Banking in Economics & Business it is "[t]he duty of a borrower to repay a loan and that of the lender to ensure that repayment is made."[45] An obligation is further also described as "a legal or *jural* bond (*jural tie*) between two legal subjects in terms of which the one, the creditor, has a right to a particular performance against the other, the debtor, while the debtor has a corresponding duty to render the performance."[46] Therefore, the contents of an obligation could be summarised as the right of performance and the corresponding duty to perform.[47]

There are different types of performance in terms of an obligation, namely *dare* (paying a specific amount or delivering a specific thing), *facere* (doing something, i.e., rendering a particular service) and *non facere* (to refrain from doing something).[48]

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39 The term 'liability' is used in the section
40 The term 'debt owed' is used in the paragraph
41 As used in section 8(4)(m)
42 As used in section 20(1)(a)(ii)
43 As used in paragraph 12(5)
44 Oxford English Dictionary Online, 2010
45 A Dictionary of Finance and Banking, 2008
46 Joubert and Faris, Vol 19 at para 218; also refer Van der Merwe *et al.*, 2007 at p 3, where it is stated that there can be more than two parties to an obligation
47 See Van der Merwe *et al.*, 2007 at p 2
48 See Van der Merwe *et al.*, 2007 at p 3

The main sources of obligations are contract, delict, *negotiorum gesto* ('saak-waarneming') and enrichment.[49] As we are only concerned here with obligations arising through contract,[50] the reference to obligations will be considered in that context.[51]

2.3.2 Liability

Liability is said to mean 'something for which one is liable; a financial obligation'.[52] The words 'obligations' and 'liabilities' are often used interchangeably, and the word 'liabilities' as used in section 20(1)(a)(ii) concerns itself with contractual obligations and will be used as such for the purpose of this paper.[53]

2.3.3 Debt owed

McAllister[54] suggests that the words 'debt owed' as used in paragraph 12(5) refer to amounts in respect of which there is an unconditional liability to pay, and that this would include debts incurred that are not yet due and payable.

The term 'debt' is not defined and the courts have therefore held that it must be given a wide and general meaning.[55] In *Stockdale and Another v Stockdale*[56] it was held to include any liability arising from and being due (*debitum*) or owing under a contract.[57]

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49 See Van der Merwe *et al*., 2007 at p 6 – these are however not the only sources of obligations
50 i.e. obligations as the legal consequence of a contract
51 Also refer comments of Cilliers, 2000 ("Cilliers") at p 3 in footnote 18
52 Merriam-Webster Online Dictionary
53 Also refer Cilliers paras 1.5-1.7 at pp 2-4
54 McAllister, 2010 at p 85
55 Joubert and Faris, Vol 21 at para 125 and the case cited in footnote 2
56 (2003 C), 3 All SA 358
57 Joubert and Faris, Vol 21 at para 125

Also, 'debt' in relation to the Prescription Act[58] refers to an obligation to do something, whether by payment or by the delivery of goods and services, or not to do something.[59] Debt is therefore the duty to perform in terms of an obligation.[60]

The meaning of the term 'debt is due', as used in the Prescription Act, has also been considered by our courts on numerous occasions. It has been held that a debt must be immediately enforceable before it can be claimed.[61] Therefore, normally, a debt is 'due' when it is claimable by the creditor and, consequently, payable by the debtor.[62] In *Deloitte Haskins & Sells Consultants (Pty) Ltd v Bowthorpe Hellerman Deutsch (Pty) Ltd*,[63] the court held that, for prescription to commence running, "there has to be a debt in respect of which the debtor is under an obligation to perform immediately".[64] In *The Master v IL Back & Co Ltd*[65] it was held that the words "debt is due" in section 12(1) of the Prescription Act meant there had to be a money obligation presently claimable by the creditor, for which an action could be brought against the debtor. The debt must be one in respect of which the debtor is under an obligation to pay immediately.[66]

Van Heerden JA in *Truter & another v Deysel*,[67] in relation to section 12(1) of the Prescription Act, said the following:

> *"[T]he 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*

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58 Prescription Act No. 68 of 1969 (the "Prescription Act")

59 Refer Joubert and Faris, Vol 21 at para 125 and the cases cited in footnote 4. See *Electricity Supply Commission v Stewarts & Lloyds of SA (Pty) Ltd* (1981 A), 3 SA 340 at pp 344F-G, in which it was held that a debt is "that which is owed or due; anything as money, goods or services which one person is under an obligation to pay or render to another". Also see *Leviton & Son v De Klerk's Trustee* 1914 CPD 685 at p 691 *et seq*, where debt was held to mean "whatever is due – *debitum* – from any obligation".

60 Van der Merwe *et al*., 2007 para 13.4.4 at p 557

61 Joubert and Faris, Vol 21 at para 125 and authorities cited in footnote 10

62 Joubert and Faris, Vol 21 at para 125 and the cases cited in footnote 11

63 (1991 A), 1 SA 525

64 Refer *Singh v CSARS* (2003 SCA), 65 SATC 203. In *Desai v Desai* (1996 A), 1 SA 141 at p 146I it was stated that (referring to the Prescription Act) "the term 'debt' is not defined in the Prescription Act but in the context of section 10(1) it has a wide and general meaning, and includes an obligation to do something or to refrain from doing something" – Joubert and Faris, Vol 21 at para125.

65 (1983 A), 1 SA 986

66 Joubert and Faris, Vol 21 at para 125 and the cases cited in footnote 15

67 (2006 SCA), 4 SA 168

creditor to institute action and to pursue his or her claim."[68]

The above *dictum* would suggest that a debt must be owed and payable for it to be due. Therefore, it appears that a debt could be owed without being due. This could be illustrated through an instalment sale agreement whereby the debt is owed immediately but only becomes due at each instalment date.

2.4 EXTINCTION OF DEBT

Debt can be extinguished in a number of different ways. The sections also use different phrases as requirements for that specific section with reference to the extinction of debt, as indicated in 2.2.

Contractual obligations (debt) are extinguished (terminated) by a juristic act or by an operation of law.[69] Extinction by a juristic act includes termination by performance, release, novation, compromise or a condition (suspensive or resolutive) in the contract. On the other hand, extinction by operation of law happens by supervening impossibility of performance, extinctive prescription, merger (*confusio)* or set-off.[70] In terms of an agreement or by operation of law, it could also happen that a party to an obligation has the right to terminate the obligation unilaterally.[71]

2.4.1 Termination by performance

The obvious object of every obligation is performance by the debtor as specified in the agreement.[72] Once the debtor has performed in terms of the agreement it follows that the purpose of the obligation has been achieved.[73] The obligation has no further effect and is terminated. An obligation is thus extinguished or terminated when its terms are complied with,[74] i.e., the debtor has performed in terms of his obligation. It

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[68] At p 9
[69] Van der Merwe *et al*., 2007 para 13.1 at p 511
[70] Van der Merwe *et al*., 2007 para 13.1 at pp 511-512
[71] Refer Joubert and Faris, Vol 19 at para 241 and cases cited in footnote 1. The breach of an obligation may, for example, entitle the innocent party to terminate the obligation, and so may fraud, duress or undue influence. Unilateral termination will not be considered in further detail for the purpose of this paper.
[72] Refer 2.3.1
[73] Joubert and Faris, Vol 19 at para 236
[74] Van der Merwe *et al*., 2007 – the intention of the parties must also be to extinguish the obligation

is noted that a third party could also perform on the debtor's behalf, but that third party must have intended to discharge the debtor's debt unconditionally.[75]

Furthermore, performance must be rendered to the creditor or its agent[76] and if it is rendered to any other person the debtor is not discharged.[77] The creditor may, however, direct the debtor to perform to a third person and should the debtor comply he or she is also discharged.[78]

The creditor is further entitled to full performance and may reject partial performance, unless it is so stipulated in an agreement.[79] If partial performance is accepted the debtor is discharged *pro tanto*.[80]

Performance of an obligation is usually a bilateral *jural* act[81] that requires the cooperation and agreement of both debtor and creditor.[82]

The facts of each case will need to be considered to determine whether any of sections 8(4)(m), 20(1)(a)(ii) or paragraph 12(5) could find application if there is proper performance but such performance is for less than the full face value of the debt.[83]

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[75] Joubert and Faris, Vol 19 at para 236 and cases cited in footnote 3

[76] Van der Merwe *et al*., 2007 para 13.2.5 at p 524

[77] Refer Joubert and Faris, Vol 19 at para 236 and cases cited in footnote 8. In *Bouwer v Saambou Bank Bpk* (1993 T), 4 SA 492 at pp 500A-501C the court, discussing *inter alia* the statements that "performance must be rendered to the creditor" and that "if it is rendered to any other person the debtor is not discharged", held that authority exists for the view that the rule as stated therein is subject to an exception which the court framed as follows (p 501C): that if a debtor has an acceptable reason for believing that a particular act, even though not actually authorised by his creditor, would amount to a discharge of his obligation towards the creditor, and he *bona fide* so acts and the creditor's estate is enriched thereby, then the debtor is discharged to the extent that the creditor's estate is enriched.

[78] Van der Merwe *et al*., 2007 para 13.2.5 at p 524

[79] Joubert and Faris, Vol 19 at para 236

[80] Joubert and Faris, Vol 19 at para 236 and cases cited in footnote 17

[81] Refer Joubert and Faris, Vol 19 at para 236 in footnote 23 – 'usually' but not invariably. *Obligationes non faciendi* do not require the cooperation of the creditor for their performance and even *obligationes faciendi* can sometimes be performed by the debtor without the creditor's cooperation.

[82] Joubert and Faris, Vol 19 at para 236 and authorities cited in footnote 24

[83] Also refer 6.3.1.4

2.4.2 Release[84]

Release takes place when a creditor and debtor agree that the debtor is released from the obligation between them.[85] In other words, it is an agreement[86] between creditor and debtor to terminate the obligation.[87]

It has been submitted that an agreement to release will amount to a donation by the creditor to the debtor,[88] but an intention to donate is not a requirement for a valid release;[89] for instance, a mutual release from reciprocal obligations is not a donation.[90]

A release agreement may be oral, even where the original obligation arose from a written contract, unless the contract contains a 'non-cancellation' clause.[91] The effect of the release depends on the intention of the parties.[92] The onus of proving a release is on the person who claims to have been released.[93]

The terms 'waiver' or 'release' are specifically used in section 8(4)(m) but that does not detract the terms also finding application in section 20(1)(a)(ii) and paragraph 12(5). This is because, in my opinion, the 'waiver' or 'release' would be a concession granted by the creditor and a reduction or discharge of the debt.

2.4.3 Novation

Novation is an agreement[94] whereby an obligation is terminated by the creation of a new one in its place.[95]

One type of novation would be whereby the original parties to the agreement merely

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[84] Occasionally referred to as waiver – Van der Merwe *et al*., 2007 para 13.3.1 at p 526
[85] Joubert and Faris, Vol 19 at para 238 and cases cited in footnote 1
[86] As such must comply with the general requirements imposed by law for the validity of agreements – Van der Merwe *et al*., 2007 para 13.3.1 at p 528
[87] Joubert and Faris, Vol 19 at para 238 and cases cited in footnote 2
[88] Joubert and Faris, Vol 19 at para 238 and cases cited in footnote 3
[89] Joubert and Faris, Vol 19 at para 238 and cases cited in footnote 4
[90] Joubert and Faris, Vol 19 at para 238 and cases cited in footnote 5
[91] Joubert and Faris, Vol 19 at para 238 and cases cited in footnote 7
[92] Van der Merwe *et al*., 2007 para13.3.1 at p 528
[93] Joubert and Faris, Vol 19 at para 238 and cases cited in footnote 8
[94] The agreement must comply with all the general requirements imposed by the law for an agreement to have juridical consequences – Van der Merwe *et al*., 2007 para 13.3.2 at pp 531-532
[95] Van der Merwe *et al*., 2007 para 13.3.2 at p 530

substitute a new obligation for the original obligation.[96] Novation may also have the intention to substitute a new party (*delegatus*) for one of the original parties (*delegans*).[97] This second type of novation is called delegation.

If the novation agreement is void it has no effect on the original obligation[98] and if it is voided on the ground of, for example, fraud, duress or undue influence, the creditor can also revert to the original obligation.[99]

When the original obligation is extinguished by an effective novation, pledges and securities held in respect of the obligation are released, sureties for due performance are discharged, and interest in respect of it ceases to run.[100]

In terms of delegation a new creditor may be substituted for the original creditor[101] or a new debtor may be substituted for the original debtor. In both cases the delegation will only be valid if the agreement is concluded with all three parties concerned.[102] An agreement between only two of the parties cannot effect a delegation.[103] Delegation results in the discharge of the original debt.[104]

2.4.4 Compromise *(transactio)*

A compromise is an agreement[105] by which parties agree to settle an outstanding dispute between them.[106] If the dispute concerns an existing obligation, that obligation

[96] The content of the obligation need not necessarily change. The parties may e.g. reconstitute an obligation by way of novation without a change in content, in order to counter the operation of prescription – Van der Merwe *et al*., 2007 para 13.3.2 at p 531.
[97] Van der Merwe *et al*., 2007 para 13.3.2 at p 531
[98] Joubert and Faris, Vol 19 at para 239 and cases cited in footnote 15
[99] Joubert and Faris, Vol 19 at para 239 and cases cited in footnote 16
[100] Van der Merwe *et al*., 2007 para 13.3.2 at p 534
[101] Refer Joubert and Faris, Vol 19 at para 239 and the case cited in footnote 19. This substitution of one creditor for another by a novation agreement must not be confused with a cession. In the case of a cession the right which the creditor has in terms of a particular obligation is transferred to another. The obligation continues to exist; the cessionary merely acquires the same right that the cedent had. In the case of a delegation which substitutes one creditor for another, the original obligation between the old creditor and the debtor is extinguished and a new obligation between the new creditor and the debtor comes into existence.
[102] As in the case of novation proper, there must be a clear intention to effect a delegation – Joubert and Faris, Vol 19 at para 239
[103] Refer Joubert and Faris, Vol 19 at para 239 and the cases cited in footnote 20. Without the consent of the creditor the agreement may simply be an undertaking by a third party to pay the creditor.
[104] Van der Merwe *et al*., 2007 para 13.3.2 at p 535
[105] As such must comply with the general requirements imposed by law for the validity of agreements
[106] Joubert and Faris, Vol 19 at para 240 and cases cited in footnote 1

is terminated by the compromise.[107]

It is a requirement for a valid compromise that there must be a dispute between the parties, although it is not required that the dispute must be the subject of litigation.[108]

If a compromise is voided (e.g., because of fraud, duress or undue influence) it can have no effect on the obligation in dispute[109] and the aggrieved party could still rely on the original disputed obligation.[110]

A valid compromise extinguishes any legal relationship that may previously have existed between the parties.[111]

2.4.5 Set-off

Set-off (*compensatio*) takes place when debts are owed in such a way that two persons are the debtor and creditor of each other simultaneously.[112] If both debts are for the same amount, they are discharged simultaneously and completely, and with them the obligations from which they arose. If they are not for the same amount, the smaller debt and the obligation from which it arose are extinguished while the larger debt is reduced by the amount of the smaller.[113]

Set-off has the same effect as payment[114] but must also be distinguished from it.[115] In *Great North Farms (Edms) Bpk v Ras*[116] the judge quoted from *In re Trans-African Insurance Co Ltd (in liquidation)* (1958 W), 4 SA 324:

> "*Set-off or compensation by our law is really equivalent to payment; it operates ipso facto as a discharge. So soon as there are two debts in existence between which there*

[107] Joubert and Faris, Vol 19 at para 240
[108] Van der Merwe *et al*., 2007 para 13.3.3 at p 538
[109] Joubert and Faris, Vol 19 at para 240 and cases cited in footnote 5
[110] Joubert and Faris, Vol 19 at para 240 and cases cited in footnote 6
[111] Van der Merwe *et al*., 2007 para 13.3.3 at p 540
[112] Joubert and Faris, Vol 19 at para 243
[113] Refer Joubert and Faris, Vol 19 at para 243
[114] Refer Joubert and Faris, Vol 19 at para 243 and cases cited in footnote 2. Also refer *Penny v 600 SA Holdings (Pty) Ltd* [2003] JOL 10422 LC at p 6.
[115] *Absa Bank Limited v Standard Bank of SA Limited* (1997 A), 4 All SA 673: "When a customer pays a cash amount equal to the debit balance of his overdrawn account into that account, there is no question of set-off operating. He simply pays the amount owing to the bank. The position is no different if the customer deposits a cheque drawn on another bank into his account. If his bank collects payment and effectively credits his account, the debt is likewise paid (or partially paid)." – Joubert and Faris, Vol 19 at para 243 and cases cited in footnote 3.
[116] (1972 T), 4 All SA 124

is mutuality, so that the one can be compensated against the other, then by operation of law the one debt extinguishes the other pro tanto…."[117]

Furthermore, in ITC 1440[118] the judge said that "[i]n my view, it would be giving the word 'paid' much too restricted a meaning if I were to hold that the appellant had not paid his former spouse the $100 which he set off. He did actually pay her the money when he made her the loan. Moreover, our law recognises methods of payment which do not involve the actual transfer of money *viz*., set-off and merger."[119]

A requirement for set-off is that the reciprocal debts must be due and enforceable.[120] This means that there cannot be set-off where the debt is conditional or it is subject to a time clause and the time stipulated in the agreement has not yet arrived.[121]

A further requirement is that both debts must be liquidated, i.e., the debt must be capable of speedy and easy proof.[122]

There is a wealth of *dicta* in the case law to the effect that the operation of set-off is automatic and *ipso jure*.[123] In *Schierhout v Union Government (Minister of Justice)* 1926 AD 286 it was stated that:

"The doctrine of set-off with us is not derived from statute and regulated by rule of court, as in England. It is a recognised principle of our common law. When two parties are mutually indebted to each other, both debts being liquidated and fully due, then the doctrine of compensation comes into operation. The one debt extinguishes the other pro tanto as effectually as if payment had been made. Should one of the creditors seek thereafter to enforce his claim, the defendant would have to set up the defence of compensatio by bringing the facts to the notice of the court – as indeed the defence of payment would also have to be pleaded and proved. But, compensation once established, the claim would be regarded as extinguished from the moment the mutual debts were in existence together."[124]

However, there are also *dicta* in case law to the effect that set-off has to be invoked.

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117 As cited in Great North Farms (*supra*) at p 127
118 (1987 Z), 51 SATC 1
119 At p 5
120 Joubert and Faris, Vol 19 at para 244 and authorities cited in footnote 13
121 Joubert and Faris, Vol 19 at para 244 and case cited in footnote 14
122 Joubert and Faris, Vol 19 at para 244 and authorities cited in footnote 17
123 Joubert and Faris, Vol 19 at para 245 and authorities cited in footnote 14
124 At pp 289-290

Refer to *Herrigel NO v Bon Roads Construction Co (Pty) Ltd and another*,[125] where it was said:

> *"…once set-off is claimed or relied on, it relates back to the time when the two respective debts were mutually in existence. However, if a party to an action wants to obtain the benefit of set-off, he must claim to be entitled to set-off…."*[126]

Even if set-off operates automatically and *ipso jure* the parties may still exclude its operation in a particular case by a prior agreement between them.[127]

Whether set-off operates *ipso jure* or by way of reliance, the debts are extinguished at the moment when they first became capable of being set-off and the obligations are extinguished as effectively as if they have been discharged by performance.[128]

2.4.6 Merger *(confusio)*

Merger is where the capacities of a debtor and creditor are fused in the same person and in respect of the same obligation.[129]

The obligation is extinguished, but only to the extent to which the merger of the two opposing capacities renders it impossible to exist, i.e. where the merger would effectively cause the person to be his own debtor or creditor. [130]

2.4.7 Extinctive prescription

An obligation may be terminated by the passing of time if the creditor is inactive and fails to enforce his rights under the obligation within a certain time period.[131] This manner of termination is also known as 'extinctive prescription'.

Section 10(1) of the Prescription Act provides as follows: "…a debt shall be extinguished by prescription after the lapse of the period which in terms of the relevant law applies in respect of the prescription of such debt." Debt is therefore

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[125] (1980 SWA), 4 SA 669 at p 676
[126] Joubert and Faris, Vol 19 at para 245 and authorities cited in footnote 18
[127] Joubert and Faris, Vol 19 at para 245 and case cited in footnote 19
[128] Refer Van der Merwe *et al*., 2007 para 13.4.2 at p 552 and Joubert and Faris, Vol 19 at p 245
[129] Refer Van der Merwe *et al*., 2007 para 13.4.3 at p 553 and Joubert and Faris, Vol 19 at p 246
[130] Van der Merwe *et al*., 2007 para 13.4.3 at p 553 and Joubert and Faris, Vol 19 at p 246
[131] Joubert and Faris, Vol 19 at para 247

extinguished after the lapse of the time period applicable to that specific debt.[132] The view has also been advanced that prescription does not automatically extinguish an obligation, but merely affords the debtor an election to refuse to perform.[133]

Prescription in terms of the Prescription Act begins to run not necessarily when the debt arises, but only when it becomes due.[134] However, where the debtor wilfully prevents the creditor from becoming aware of the debt, the period of prescription commences only when such knowledge is obtained.[135]

2.4.8 Termination by non-fulfilment of suspensive or fulfilment of resolutive condition

If a suspensive condition is not fulfilled or a resolutive condition is fulfilled the obligation subject to the condition is terminated.[136]

A time clause is suspensive when it is stipulated that the date on which the debt falls due will be postponed until a fixed or determinable future time. The effect thereof is that the stage at which the obligation becomes due and enforceable is postponed until the agreed date or time.[137]

A time clause is resolutive when it provides that an obligation or obligations arising from the contract will be effective only until a certain date in the future.[138] The effect thereof is that the obligation is extinguished on that date. Rights and obligations that have accrued to the parties are not affected by the operation of a resolutive time clause, unless the parties have agreed otherwise.[139]

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[132] Joubert and Faris, Vol 21 at para 123 and case cited in footnote 4
[133] Van der Merwe *et al*., 2007 para 13.4.4 and the authorities cited in footnote 368
[134] Refer Joubert and Faris, Vol 21 at para 125 and cases cited in footnote 9. In *Njongi v MEC Department of Welfare*, Eastern Cape 2008 4 SA 237 (CC) the court held that prescription in respect of disability grant arrears unpaid because of an unlawful administrative decision could not begin to run until the administrative decision had been set aside.
[135] Van der Merwe *et al*., 2007 para 13.4.4 at p 560
[136] Joubert and Faris, Vol 19 at para 248
[137] Joubert and Faris, Vol 2(2) at para 190
[138] Refer De Wet and Van Wyk at p 146 and Joubert and Faris, Vol 2(2) at para 191
[139] De Wet and Van Wyk at p 146 gives as an example the instance where parties have agreed that a debt would not be collected after a certain day. In this way an existing obligation can be extinguished by a resolutive time clause.

2.4.9 Termination by supervening impossibility of performance

When it becomes impossible for a debtor to perform in terms of an agreement, the obligation is extinguished.[140] Therefore, if the object of an obligation falls away, the obligation itself falls away.

It has been said that the obligation is only extinguished if the impossibility is absolute (objective),[141] i.e., impossible for everyone in the world. However, impossibility of performance is determined with reference to the standard of conduct generally acceptable in business dealings in a particular community, which means that a particular performance might legally be regarded as impossible although theoretically possible.[142] Mere difficulty of performance is not, however, sufficient to extinguish a debt.[143] Furthermore, where performance only becomes partially impossible the whole obligation is not terminated, but the debtor is only released *pro tanto*.[144]

When an obligation is extinguished by supervening impossibility of performance, any reciprocal obligation is also extinguished.[145] There are circumstances where this is not the case and where the reciprocal obligation remains unaffected. These are where the creditor is to blame for the impossibility of the debtor's performance[146] or the creditor bears the risk of impossibility of the debtor's performance.[147]

If performance becomes temporarily impossible[148] the obligation is not extinguished. It is merely suspended for the period during which the impossibility continues and with it any reciprocal obligation is suspended.[149]

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140 Joubert and Faris, Vol 19 at para 249 and authorities cited in footnote 1
141 Joubert and Faris, Vol 19 at para 249 and authorities cited in footnote 3
142 Joubert and Faris, Vol 19 at para 249 and authorities cited in footnote 4
143 Joubert and Faris, Vol 19 at para 249 and authorities cited in footnote 5
144 Joubert and Faris, Vol 19 at para 249 and authorities cited in footnote 6
145 Joubert and Faris, Vol 19 at para 249 and authorities cited in footnote 18
146 De Wet and Van Wyk at pp 175-176
147 That risk may be assumed: Joubert and Faris, Vol 19 at para 249 and authorities cited in footnote 19. He or she may also bear the risk by operation of law, e.g., a creditor who is in *mora* bears the risk of supervening impossibility of the debtor's performance; see De Wet and Van Wyk, pp 186-187; and a buyer bears the risk of accidental destruction of the thing sold from the moment the contract of sale is *perfecta*.
148 Performance, that is, of an obligation which does not require continuous performance - Joubert and Faris, Vol 19 at para 249 and the authorities cited in footnote 28
149 Joubert and Faris, Vol 19 at para 249

2.4.10 Cession

Cession is a bilateral juristic act whereby a right is transferred by agreement from the creditor (*cedent*) to the transferee (*cessionary*),[150] who thereafter becomes the creditor. Cession therefore concerns the transfer of rights rather than their demise.[151]

It could be argued that the cession results in the termination of the obligation towards the original creditor. However, the obligation remains intact and is merely transferred to the cessionary.[152]

Furthermore, whereas other forms of termination agreements require an agreement involving both debtor and creditor, cession does not require the prior knowledge or consent of the debtor.[153] Notice is also not a prerequisite[154] for the validity of the cession.

Cession will therefore not have the effect of the extinction of a debt.

2.5 CONCLUSION

Each of sections 8(4)(m) and 20(1)(a)(ii) and paragraph 12(5) use different phrases as its 'requirement' for the extinction of a debt. However, this does not mean that a specific section or paragraph would only apply in the case of the termination of debt in respect of the specific term used in that section or paragraph.

For example, in section 8(4)(m) the debt should be extinguished as a result of "the cancellation, termination or variation of an agreement or due to the prescription, waiver or release of a claim for payment." Therefore, section 8(4)(m) could

[150] Joubert and Faris, Vol 2(2) at para 1 and the authorities cited in footnote 1
[151] Joubert and Faris, Vol 2(2) at para 2 and authorities cited in footnote 2
[152] Van der Merwe *et al*., 2007 at pp 349-350
[153] Joubert and Faris, Vol 2(2) at para 6
[154] Joubert and Faris, Vol 2(2) at para 6 and authorities cited in footnote 7 – Scott Cession Chapter 7, following some continental precepts, argues for a reinstatement of the *denuntiatio* (notice to the debtor) of Roman law as a formal requirement – if not for the transfer from the cedent to the cessionary of the right as an asset, then at least for the "completion" of the substitution of the cessionary as creditor in place of the cedent. In addition she advocates the introduction of a formal deed of cession. Thus it is stated at p 99: "In my opinion the substitution of creditors is completed only when the debtor has knowledge of the cession, either through notice by the cedent or submission by the cessionary of a deed of transfer drawn up by the cedent. In other words, the substitution of creditors is completed only when the debtor is obliged to pay the cessionary . . . that is, when he receives notice of the cession from the cedent or when the cessionary submits a deed of transfer."

potentially be applicable with regards to any ‘cancellation, termination or variation of an agreement’ and not only because of ‘the prescription, waiver or release of a claim for payment.’ Thus, even though the term ‘novation’ is not specifically used in the section, it could still find application, because it would result in the termination of the original agreement for a new agreement, alternatively, it would at least result in a variation of the original agreement.

Hence, it is important to determine, based on the facts and circumstances of each case, whether a specific action could fall foul of the provisions of the relevant section or paragraph of the ITA. All other requirements of that section or paragraph should still be met before it could be applied.

It is submitted that the extinction of debt for a consideration less than the face value of the debt is required for each of the relevant sections or paragraphs to find application. Therefore, some act of forgiveness is required whereby the other party’s debt is partially or wholly extinguished in law.[155]

The first step would therefore be to determine whether there was an extinction of a debt as required by that section or paragraph. Each case should thus be analysed and all the facts be considered in determining whether the specific section or paragraph could apply.

[155] This will be considered and dealt with in the analysis of the relevant sections in Chapters 4, 5 and 6, respectively

CHAPTER 3: DETAILS OF THE CASE STUDY

3.1 INTRODUCTION

A BPR is an advance tax ruling regarding the application or interpretation of the ITA in respect of a proposed transaction that is issued in terms of section 76Q in response to an application by an applicant.[156] A BPR therefore merely sets out SARS' opinion on its interpretation of a specific section(s) of the ITA and has no authority for any person other than the applicant thereof.[157] It should also be noted that a BPR does not have a binding effect on the applicant of the ruling. However, a BPR does give a clear indication of how SARS interprets a specific section and how it would deal with similar issues in practice.

Hence, for the purpose of the case study, the main set of facts will be extracted from BPR 073 which was issued by SARS on 29 January 2010, dealing with the extinction of loans. Those facts will be slightly adjusted and expanded to incorporate specific objectives that need to be answered throughout this research paper. The facts will be incorporated into one proposed transaction. This chapter sets out the facts of the case study.

3.2 DESCRIPTION OF THE FACTS

The facts that will be used to analyse the tax consequences on the extinction of debt within a group of companies and to evaluate the correctness of BPR 073 can be summarised as follows:

3.2.1 The parties

- V, a company incorporated in South Africa
- W, X, Y, Z and AA, companies incorporated in South Africa which are wholly owned subsidiaries of V.

[156] The definition of a BPR in terms of section 76B
[157] Section 76H(4)

3.2.2 The transaction

V advanced working capital to its subsidiaries over the years, and charged interest on the capital so advanced. It also charged them an administration fee, rent and insurance over the years (hereinafter referred to as 'on-charged expenditure'), which was not paid by them but credited to their respective loan accounts with V.

The subsidiary companies do not have the means to settle the amounts outstanding on the loan account and these loans will therefore be extinguished within the meanings provided for in sections 8(4)(m), 20(1)(a)(ii) and paragraph 12(5).

3.2.2.1 Facts extracted from BPR 073

- W has a balance of assessed loss but did not trade during the current year of assessment.
- Y had a balance of assessed loss in a previous year but that balance of assessed loss was subsequently disallowed because the company did not trade during that year. The company did not trade during the current year of assessment.
- Z has a balance of assessed loss and traded during the current year of assessment.

3.2.2.2 Additional case study facts

- X has no balance of assessed loss and its only income was a management fee it received from V for certain services delivered to V. The fee was calculated at arm's length and was not paid for but set-off against the loan account with V. At the end of the current year of assessment, X has a balance outstanding to V.
- AA entered into an interest-free loan agreement with V, which provided for that loan to be written off after a period of five years. It used this money to settle its existing loan account with V.

As noted above, the facts relating to W, Y and Z agree to that of BPR 073 and will be specifically tested against the ruling issued by SARS. Those facts relating to X and AA are included for further analysis in this paper, and any conclusion will be based on the literature review.

3.2.3 Assumptions

It is not entirely clear from the BPR whether 'on-charged expenditure' includes interest charged by V on the working capital advanced. On a strict reading of the ruling it would appear that it only refers to the administration fee, rent and insurance. However, in terms of the ruling it states that V will be entitled to deduct the amounts relating to on-charged expenditure, which became bad under the provisions of section 11(i), to the extent that the amounts were included in income. It is submitted that V would also be entitled to a bad debt claim in terms of section 11(i) for the interest that had become bad.[158] It will therefore be assumed that 'on-charged expenditure' refers to the administration fee, rent, insurance and interest.

It is also not sufficiently clear from the ruling whether the term 'expenditure' includes the administration fee, rent, insurance, interest and other expenditure financed with the working capital advanced by V or whether this does not include such other expenditure. To give proper effect of the assumption above, it will further be assumed that 'expenditure' refers to 'on-charged expenditure' (as assumed above) and all other expenditure financed with the working capital advanced by V.

3.2.4 The questions for consideration

The main purpose is to understand the tax consequences for each of the subsidiaries when the debts are extinguished. The tax consequences for V will not be examined in this paper.[159]

3.3 CONCLUSION

The main question has been outlined above and the answers provided in the ruling will be used as a starting block to answer that question. The tax consequences will ultimately be tested against the provisions of sections 8(4)(m) and 20(1)(a)(ii) as well as the Eighth Schedule to the ITA.

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[158] This falls beyond the scope of this paper and will not be considered further

[159] This is assumed correct as per the ruling

CHAPTER 4: AN INTERPRETATION OF SECTION 8(4)(m)

4.1 INTRODUCTION

In the previous chapter the details of the case study were described. In this chapter the current interpretation of section 8(4)(m) in the context of the case study will be examined. The purpose is to comment on the correctness of the BPR with specific reference to section 8(4)(m). The reasons necessary for the introduction of this section to the ITA will be considered briefly. The effect of the Omnia Fertilizer case (*supra*) on the relevance of this section will also be considered (in the context of the comments of the judge on its relevance).

4.2 THE INTRODUCTION OF SECTION 8(4)(m)

Section 8(4)(m) reads as follows:

> *"Subject to the provisions of section 20, where-*
>
> *(i) as a result of the cancellation, termination or variation of an agreement or due to the prescription, waiver or release of a claim for payment, any person was during any year of assessment relieved or partially relieved from the obligation to make payment of any expenditure actually incurred;*
>
> *(ii) such expenditure was at the date on which such person was so relieved or partially relieved not paid; and*
>
> *(iii) such expenditure or any allowance in relation to such expenditure was in the current or any previous year of assessment allowed as a deduction from such person's income,*
>
> *such person shall for the purposes of paragraph (a) be deemed to have recovered or recouped an amount equal to the amount of the obligation from which the person was so relieved or partially relieved during the year of assessment in which the person was so relieved or partially relieved."*

This section was introduced into the ITA by section 6(1)(b) of Act No. 28 of 1997.

The Explanatory Memorandum on the Income Tax Bill, 1997 describes the reason for the introduction of this section as follows:

"Where any amount has in the current or any previous year of assessment been allowed as a deduction and such amount is subsequently recovered or recouped, such amount is included in a person's taxable income in terms of section 8(4)(a). At present it is uncertain whether amounts not actually recovered or recouped, may be recouped in terms of this section. To remove any uncertainty in this regard, it is proposed that where an amount of any expenditure actually incurred has been allowed as a deduction, but has not yet been paid and the obligation to pay such amount is subsequently reduced or extinguished, by reason of either the termination or variation of an agreement or prescription or waiver of a claim, the amount so reduced or extinguished will, under the provisions of the proposed section 8(4)(m), be deemed to be recovered or recouped for the purposes of section 8(4)(a). The effect of the amendment is therefore that the amount of the obligation so reduced or extinguished will, to the extent that it was allowed as a deduction, be included in gross income for the year of assessment during which the obligation is reduced or extinguished."[160]

Zeller Karro[161] commented on the introduction of this section and stated that in the past (prior to the introduction of section 8(4)(m)) it was reasonably widely accepted that recoupments could only be subject to tax if there was an actual receipt or accrual of the amount recouped. The introduction of this section therefore clarified that amounts will be deemed to have been recovered or recouped (and thus be taxable) in the circumstances provided by section 8(4)(m).

At the time of its introduction there were two Special Court cases dealing with similar issues.

In *ITC 1634,*[162] the taxpayer was a shipping agent that incurred liabilities on behalf of its principal. In its books it raised a liability for amounts due to suppliers for services rendered and raised a debtor for the amount recoverable from the client as a regular part of its business. From time to time the suppliers failed to issue an invoice to the taxpayer and, after a reasonable period of time, the taxpayer wrote these liabilities back to income. The Commissioner had included these amounts in the taxpayer's income. The taxpayer argued that the mere accounting entries reflected in the books of account, whereby the credit amounts were transferred from its balance sheet to profit through its income statement, could not result in any 'amount' being received by or accruing to the taxpayer. It further contended that it did not, as a consequence

[160] At pp 11-12
[161] Zeller Karro, 1997 - Integritax at 463
[162] (1997 T), 60 SATC 235

of the accounting entries, derive any property and, because there was no receipt or accrual, the amount was not ‘gross income’. Furthermore, taxable income is an artificial concept, determined by identifying the gross income and deductions permitted under the ITA, without reference to the accounting policies and practices.

The court said that, in the course of the taxpayer’s business, amounts were subject to change. Amounts of reduced or extinguished liabilities were benefits derived by a taxpayer in the course of carrying on its business and arose from the business or were incidents of it. They ‘accrued’ to it in the same way that an adjustment to a liability in a subsequent year, where the original liability had been underestimated, would be incurred in the year of adjustment, and be deductible.

The Special Court found that there had been a recoupment of expenditure incurred, despite the fact that the creditor had not raised invoices. Therefore, it rejected the contention of the taxpayer that no amounts had accrued as required by the income tax definition of ‘gross income’ and that the credits were merely accounting entries.[163]

In the other case, *ITC 1704,*[164] the taxpayer argued that unless an amount had been ‘received or accrued’, it would not have the characteristics required for inclusion in ‘gross income’.

The court found that the plain wording and effect of the definition of ‘gross income’ was to include in gross income all amounts referred to in section 8(4)(a), i.e., amounts previously deducted and now recouped in the year of assessment. It was not necessary for an amount to have been ‘received or accrued’ for section 8(4)(a) to apply.[165]

In both cases it was thus found that where a debtor is released from an obligation to pay a debt and the amounts were previously deducted for income tax purposes those amounts are subject to a recoupment in terms of section 8(4)(a). The introduction of section 8(4)(m) was no doubt fuelled by these two cases, and was intended to put this issue beyond any further doubt.

[163] Also see Anglovaal Limited, 1998 - Integritax at 558 and Deneys Reitz, 2003 – Integritax at 1132
[164] (1997 C), 63 SATC 258
[165] Also refer Anglovaal Limited, 1998 - Integritax at 558

4.3 THE RELEVANCE OF SECTION 8(4)(m)

Lynette Olivier, on the introduction of section 8(4)(m), says that "[t]he subsection was no doubt added to counter the argument that no recoupment arises under the general recoupment provision, i.e., section 8(4)(a), where a debt that had been deducted for income tax purposes is recouped or recovered."[166] She goes on to say that "[i]nterestingly, the introduction of section 8(4)(m) for the purpose of recouping expenditure where the corresponding debt has prescribed was probably unnecessary. In both *ITC 1634*[167] and *ITC 1704*[168] it was held that such amounts are subject to recoupment in terms of section 8(4)(a)."

Section 8(4)(a) reads as follows:

> *"There shall be included in the taxpayer's income all amounts allowed to be deducted or set off under the provisions of sections 11 to 20, inclusive … whether in the current or any previous year of assessment which have been recovered or recouped during the current year of assessment …."*

The purpose of the general recoupment provision (as contained in section 8(4)(a)) is to deny the taxpayer the benefit of a deduction or allowance by requiring the inclusion, in the taxpayer's income, of an amount allowed as a deduction or allowance that is later recovered or recouped.[169] The taxpayer is therefore only allowed to claim a deduction if he ultimately bears the expense.[170] It is therefore important to determine whether something happened which resulted in the taxpayer not actually bearing the expense for which a deduction was claimed.

In *Sub-Nigel Ltd v CIR*[171] it was held that "the court is not concerned with deductions which may be considered proper from an accountant's point of view or from the view of the prudent trader, but merely with the deductions which are permissible according to the language of the Act."[172] Expenditure would therefore only be deducted in the tax year in which a taxpayer incurs an unconditional legal obligation, even if that

[166] Olivier, 2006(2) at p 303
[167] *Supra*
[168] *Supra*
[169] Also refer Swart, 2003(15) at p 464
[170] It should be noted that the deduction will not be reduced but a recoupment will be recognised and included in the taxpayer's taxable income
[171] (1948 A), 15 SATC 381
[172] Sub-Nigel (*supra*) at p 389; Also refer *Joffe and Co (Pty) Ltd v CIR* (1946 AD) at p 165 and *SIR v Eaton Hall (Pty) Ltd* (1975 A) at p 958B

obligation is only discharged in a later year.[173]

Now, the question that arises is whether section 8(4)(a) requires the taxpayer to account as a recoupment an anticipated benefit in the form of a likely reduction of the amount required to discharge the liability, or an anticipated failure of the creditor to claim it, or only once the previously recognised legal obligation has been reduced.[174]

Brincker[175] notes that "[t]he question arises whether this section[176] is still relevant pursuant to the decision of the Supreme Court of Appeal in *Omnia Fertilizer Limited v CSARS*."[177]

In Omnia Fertilizer (*supra*) the thrust of the argument for the taxpayer was that there cannot be a recoupment where the indebtedness that gave rise to an allowed deduction still exists in law.[178] The taxpayer incurred expenditure for the purchase of raw materials. Certain suppliers failed to claim payment and the taxpayer allocated these unclaimed amounts to income in its financial statements prior to the expiry of the three-year period after which the claim of the suppliers would have prescribed.

The court noted that the word 'recouped' in section 8(4)(a) has a wide meaning and would also include a scenario where the liability has not been extinguished. Thus, even though the claim had not yet expired by way of prescription, here the word 'recoup' means 'to deduct, to take off or to keep back'. The court further held that although the relevant book entries did not in themselves result in the recoupment, the conduct of the taxpayer and surrounding circumstances confirmed that the taxpayer subjectively regarded the liabilities to have been recovered. The judge ultimately said if the amount has for all practical purposes reverted back to the taxpayer's pocket, the amount would be recouped. The judge held that:

> *"Although the debts here were still legally due when the sums in issue were credited to income the vital consideration in my view is that s 8(4)(a) has to do with the recoupment of amounts, not the extinction of liabilities. This indicates that the legislature contemplated that recoupment could occur despite the continuing chance that the taxpayer might after all be called on to pay. The reason for that stance would*

173 See, for example, *CIR v Golden Dumps (Pty) Ltd* (1993 A); *Edgars Stores Ltd v CIR* (1988 A)
174 Also refer Swart, 2003(15) at p 467 and p 471
175 Brincker, 2004 at p JJ-6
176 Section 8(4)(m)
177 *Supra*
178 See para 10 at p 162 of the judgement

be, no doubt, that the legislature wished to ensure that if the deduction of expenditure was once allowed a taxpayer should not escape taxation if alleged expenditure was not to be expenditure after all, whether or not liability was legally terminated. Had it been intended that an amount previously allowed as deductible expenditure would become taxable only if legal liability for payment ceased to exist (whether by way of prescription, agreement or otherwise) then the legislature could have said so simply. Instead it linked taxability only to recovery or recoupment."[179]

During argument it was indicated by Howie P that section 8(4)(m) still plays a role, as it deems a release from indebtedness to be a recoupment. As the termination of a liability in itself is not a recoupment, but merely enables a recoupment, section 8(4)(m) does therefore play a role.

Howie P's reasoning can be summarised as follows:

"Release from indebtedness is not entailed in the ordinary meanings of 'recovered' or 'recouped'. Termination of liability is not itself a recoupment. It merely enables recoupment. If anything the new paragraph detracts from the taxpayer's argument because it signifies that ordinarily the termination of legal liability is not a requirement for recoupment. There was therefore a need for the inserted paragraph to introduce the deemed meaning."[180]

Brincker comments that "[t]his view is with respect questionable, as it is unlikely that the termination of a liability will not otherwise result in a recoupment. If anything, the ambit of section 8(4)(m) is narrower than the interpretation of 'recoup', as one can hardly envisage a scenario where a recoupment will take place after the termination of a liability, rather than before such date."[181]

Swart states that "[t]he court's reasoning and its underlying logic is rather difficult to follow."[182] He goes on to say that the court seems to suggest that the resultant saving will constitute a recoupment only once the taxpayer has recognised it as such in its books of account.

It is difficult to understand how the court could place reliance on the accounting entries of a taxpayer given the number of cases that had held to the contrary. It is submitted that the provisions covered by section 8(4)(m) would fall within the ambit

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[179] Omnia Fertilizer (*supra*) at pp 162-163
[180] Omnia Fertilizer (*supra*) at p 164
[181] Brincker, 2004 at p JJ-6
[182] See Swart, 2003(15) at p 473

of section 8(4)(a) and that section 8(4)(m) does not add to the meaning of 'recoup' within the context of section 8(4)(a).[183]

That being said, we are bound by the Omnia Fertilizer judgement (*supra*) and, as a result, amounts that are still legally owed but which will probably not be claimed would be a recoupment in terms of section 8(4)(a),[184] and an amount that is no longer legally enforceable could not fall within the ambit of section 8(4)(a) and would possibly be covered by the provisions of section 8(4)(m).

4.4 ANALYSIS OF SECTION 8(4)(m) IN THE CONTEXT OF THE CASE STUDY

The rest of this chapter proceeds to examine the current interpretation of section 8(4)(m) with specific reference to the case study as set out in Chapter 3.

4.4.1 Subject to the provisions of section 20

Where two provisions are in conflict, the provision that is intended to be subordinate is made 'subject to' the other provision.[185]

In *S v Marwane*[186] the Appeal Court considered the meaning of the words "subject to the provisions of this Constitution" appearing in section 93(1) of the Republic of Bophuthatswana Constitution Act 18 of 1977. Miller JA, delivering the majority judgment, stated (at 747H-748A):

> *"The words 'subject to the provisions of this Constitution' in s 93(1) of the Constitution clearly govern the provision that laws in operation immediately prior to the commencement of the Constitution are to continue in operation. The purpose of the phrase 'subject to' in such a context is to establish what is dominant and what subordinate or subservient; that to which a provision is 'subject', is dominant – in case of conflict it prevails over that which is subject to it. Certainly, in the field of legislation, the phrase has this clear and accepted connotation. When the legislator wishes to convey that that which is now being enacted is not to prevail in*

[183] Also refer Swart, 2003(15) at p 475
[184] Also refer Olivier, 2004(1) at p 163
[185] *S v Marwane* (1982 A), 3 SA 717; cited with approval in *Sentra-Oes Koöperatief Bpk v KBI* (1995 A), 57 SATC 109
[186] [1982] 4 All SA 405 (AD)

circumstances where it conflicts, or is inconsistent or incompatible, with a specified other enactment, it very frequently, if not almost invariably, qualifies such enactment by the method of declaring it to be 'subject to' the other specified one. As Megarry J observed in C & J Clark v IRC (1973) 2 All ER 513 at 520: 'In my judgment, the phrase 'subject to' is a simple provision which merely subjects the provisions of the subject subsections to the provisions of the master subsections. When there is no clash, the phrase does nothing: if there is collision, the phrase shows what is to prevail'."[187]

This *dictum* of Miller JA has been approved in subsequent cases, by (*inter alia*) both the Supreme Court of Appeal and the Constitutional Court: see, for example, Sentra-Oes Koöperatief (*supra*); *Zantsi v Council of State, Ciskei and others* 1995 (4) SA 615 (CC) at para 27; *Ynuico Ltd v Minister of Trade and Industry and others* 1996 (3) SA 989 (CC) at para 8; and *Ex Parte Speaker of the Western Cape Provincial Legislature: In re Certification of the Constitution of the Western Cape* 1997 (4) SA 795 (CC) at 32.

In *Hickman v The Attorney-General* (1980 SR) 2 SA 583 at 585E, Golden J, on the meaning of the words 'subject to', had this to say:

"Generally speaking, the words 'subject to' have the effect of introducing a qualification, limitation or condition precedent, thereby curtailing a person's exercise of otherwise unlimited or unrestricted rights …."[188]

Recently the Supreme Court in *Attorney-General v Makamba*[189] held that:

"The governing phrase 'subject to subsection (2)' can only mean 'Except as provided for by subsection (2)', or to similar effect, 'Without prejudice to what is provided for by subsection (2)'."[190]

Marlie[191] concludes that section 8(4)(m) will not apply to any discharge of a debt that has already been taken into account in the reduction of the taxpayer's assessed loss (in terms of section 20(1)(a)(ii)).[192] Where the assessed loss is completely wiped out by

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[187] See also *Rennie NO v Gordon and another NNO* (1988 A), 1 SA 1 at pp 21D-22D and *Pangbourne Properties Ltd v Gill and Ramsden (Pty) Ltd* (1996 A), 1 SA 1182 at pp 1188A-B
[188] See also *Commissioner of Police v Wilson* 1981 (4) SA 726 (ZAD)
[189] [2006] JOL 17207 (ZS)
[190] At p 6
[191] Marlie, 2005 ("Marlie") at p 64
[192] He would not make any express statement whether a provision that is subject to another provision can be applied if the provision to which it is made subject to has already been applied but not to the extent of the full amount

the discharge of the debt, the balance of the discharge will be taxable under section 8(4)(m), if it meets the requirements of that section.[193]

Cilliers[194] pointed out that, even if its own requirements are met, section 8(4)(m) can only come into play to the extent that the situation cannot be accounted for in terms of section 20(1)(a)(ii). He states that this would occur if section 20(1)(a)(ii) cannot be applied or can only be applied partially because of the complete or partial non-fulfilment (for example the 'ordinary trade' requirement[195] may apply to certain debts affected by the compromise, but not to others) of the requirements of section 20(1)(a)(ii) itself.

It is considered that section 8(4)(m) requires that any compromise be first used to reduce a balance of assessed loss brought forward. The remaining balance, if any, is then brought into the calculation of 'taxable income' as indicated above. If the compromise exceeds the balance of assessed loss then the remainder of the compromise is brought into 'income' as required by section 8(4)(m)."[196]

The phrase 'subject to' is used throughout the ITA and the question arises whether it carries the same meaning wherever it is used.[197]

For instance, section 8(1)(b)(ii) is made 'subject to' section 8(1)(b)(iii). It is clear from analysing that section that subsection (iii) (the dominant provision) would apply where the travel allowance is based on actual distance travelled. Subsection (ii) could never apply in that instance. Therefore if subsection (iii) applies, subsection (ii) cannot be applicable.

Also refer to section 13*quat* (7)(a) which is made 'subject to' paragraph (d). There, if the instances listed in paragraph (d) apply, the area demarcated may exceed the limits, notwithstanding the provisions of paragraph (a).

In another example, section 20 is made 'subject to' section 20A. According to section

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[193] See De Koker, 2010 ("Silke") at para 4.64B and para 8.129
[194] At p 44
[195] This is no longer a requirement of this section
[196] Clegg, 2010 at para 11.10
[197] A detailed analysis of these other sections is not relevant for the purpose of this paper. Hence, the discussion of the examples where the phrase 'subject to' is used in other places of the ITA that follows should be read in that context.

20 there shall be set off against the income derived by any person from carrying on any trade, for the purpose of determining taxable income, any assessed loss incurred by the taxpayer during the same year of assessment in carrying on any other trade.[198] Section 20A states that where a person carries on certain trades, any assessed loss incurred during that years in carrying on that trade may not be set off against any income of that person derived during that year otherwise than from the carrying on of that trade. It should be noted that a taxpayer would still be able to set off assessed losses from trades not listed in section 20A against other income. Therefore, to the extent that section 20A applies, section 20 could not apply, but section 20 could still apply to that same taxpayer even though section 20A also applies to that taxpayer, but only to the extent that section 20A does not apply.

It is also noted that the dominant and subservient provision are normally cross-referenced to indicate the extent to which the sections apply. However, section 20 does not refer back to section 8(4)(m) and there is thus no real indication of the extent to which that section applies.

My own view is that the phrase ‘subject to’ (in this context) should mean ‘to the extent that the taxpayer has a balance of assessed loss and the dominant provision applies, the subservient provision cannot also apply’. Therefore, if all the requirements of section 20(1)(a)(ii) are fulfilled and hence the section applies then section 8(4)(m) cannot also apply, but only to the extent of the balance of the assessed loss.

It is further my opinion that where both provisions could be applicable they should be applied proportionately.[199] The reason why I say this can be illustrated through the example that follows. Consider Z mentioned in 3.2.2.1 as the taxpayer. The balance of Z’s assessed loss brought forward is R50 000 and the outstanding loan account with V amounts to R180 000, which comprises on-charged expenditure of R80 000 and working capital funding of R100 000. In terms of section 20(1)(a)(ii) the company will have to reduce the balance of its assessed loss in respect of the R80 000

[198] Section 20(1)(b)
[199] The expenditure should therefore be apportioned

and the R100 000.[200] Only R50 000 of the total possible reduction of R180 000 would be used to reduce the balance of assessed loss. After that reduction, the balance of the R80 000 not used in terms of section 20(1)(a)(ii) would be recouped in terms of section 8(4)(m).[201] The issue is whether the reduction of the R50 000 balance of assessed loss in terms of section 20(1)(a)(ii) should be from the on-charged expenditure, other expenditure, or proportionately between the expenses. Should it be from the on-charged expenditure it would mean that there will be a R50 000 reduction in the balance of assessed loss in terms of section 20(1)(a)(ii) and a R30 000 recoupment in terms of section 8(4)(m). On the other hand, if it is from the other expenses it would also mean a R50 000 reduction in the balance of assessed loss in terms of section 20(1)(a)(ii) but it would result in a R80 000 recoupment in terms of section 8(4)(m). Based on the example above, it is my opinion that a fair and reasonable basis would be to apply it proportionately between the expenses.

4.4.2 The obligation to make payment of any expenditure actually incurred

The wording of this specific provision suggests that there needs to be a link between the obligation to make payment and the expenditure actually incurred. The question therefore arises as to the closeness of this link.

Marlie only submits that section 8(4)(m) requires that there be a direct link between the obligation that the taxpayer is being relieved of and the expenditure that was claimed as a deduction or allowance.[202] He uses the following example to illustrate this:

> *"Where the taxpayer purchases trading stock on credit, the resulting obligation is directly linked to the income tax deduction claimed in terms of section 11(a). Any discharge of such debt will result in a recoupment of the deduction previously claimed. Where the taxpayer however borrows money from a third party to purchase trading stock, the outstanding obligation is not directly linked to the purchase of the trading stock and any discharge of such obligation will arguably not give rise to the*

[200] Assuming all the other requirements of that section are met – refer Chapter 5 for an analysis of section 20(1)(a)(ii)
[201] Also refer 4.4.3
[202] He qualifies this by adding that the validity of the submission is not given any further thought for the purpose of his technical report

recoupment of the deduction claimed." [203]

Huxham and Haupt, 2010 ("Huxham and Haupt") has the same view and uses the following example:

> *"If stock was purchased on credit and the creditor was not paid, and the debt prescribed, the amount of the expenditure for the stock will be recouped. If a loan was raised, however, and the proceeds of the loan were used to buy stock, then if the loan prescribes, no amount can be recouped because the expenditure for the purchase of the stock was actually paid."* [204]

Edward Nathan Sonnenbergs simply states that "the debt and the expenditure must be linked."[205]

The ITA specifically requires the taxpayer to be relieved (or partly relieved) from the obligation to make payment of any <u>expenditure</u> actually incurred.

In the English case *Allen (HM Inspector of Taxes) v Farquharson Brothers and Co*[206] it was noted that "Expenditure means something or other which the trader pays out; I think some sort of volition is indicated. He chooses to pay out some disbursement; it is an expense; it is something which comes out of his pocket." Watermeyer CJ said in Joffe and Co (*supra*) "expenditure usually means a voluntary payment of money."[207]

It is submitted in both Silke[208] and Huxham and Haupt[209] that the word 'expenditure' is not restricted to an outlay of cash, but that the word 'expenditure' includes outlays of amounts in a form other than cash. It should also be noted that for the purpose of this subsection[210] the legislature is not concerned with whether the expenditure is laid out for capital or revenue purposes. It should further be noted that the wording of the subsection only refers to expenditure and does not also refer to the word 'losses' as used in section 11(a).

In *Caltex Oil (SA) Ltd v SIR*[211] it was held that "expenditure actually incurred" does

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203 Marlie at pp 66-67
204 Huxham and Haupt at p 70
205 Edward Nathan Sonnenbergs Inc., 2008 - Integritax at 1610
206 17 TC 59
207 Joffe and Co (s*upra*) at p 360
208 De Koker, 2010 ("Silke") at para 7.4
209 Para 5.4.1 at p 92
210 Section 8(4)(m)
211 (1975 A), 37 SATC 1

not mean expenditure actually paid during the year of assessment. It was said to mean "all expenditure for which a liability has been incurred during the year, whether the liability has been discharged during that year or not." Corbett JA held in *Edgars Stores Ltd v CIR*[212] that "it is clear that only expenditure … in respect of which the taxpayer has incurred an unconditional legal obligation during the year of assessment in question may be deducted in terms of s 11(a) …."[213]

It is common cause that the obligation to repay borrowed money is not expenditure, neither is the actual repayment of the money borrowed. However, if the loan is used to fund the payment of expenditure, would that link between the obligation and the payment of the expenditure be sufficient to cause the taxpayer to fall within the provisions of section 8(4)(m)(i)?

It should be borne in mind that section 8(4)(m) deems an amount to be recovered or recouped for purposes of section 8(4)(a) and that amount is ultimately included in gross income.

Also of relevance is the fact that section 20(1)(a)(ii) was amended and now specifically includes the wording "to the extent that the amount advanced … was used, directly or indirectly, to fund expenditure or an asset."[214] The legislature therefore clearly intended for the above scenario to be covered by section 20(1)(a)(ii). Therefore, if it was the intention of the legislature that this scenario should also be covered by section 8(4)(m) it can be reasonably assumed that it would have amended section 8(4)(m) at the same time that it amended section 20(1)(a)(ii). The inference that can be drawn from this is that the legislature did not intend for that scenario to be covered by section 8(4)(m), alternatively, the legislature was of the opinion that it was already sufficiently covered by section 8(4)(m) in its current form.

It was held in *CIR v Genn & Co (Pty) Ltd*[215] that it is not every obtaining of physical control over money that constitutes a receipt for the purposes of the 'gross income' definition. If, for instance, money is obtained and banked by someone as the agent of another, the agent has not received it as his own income. The court further stated that

[212] (1988 A), 50 SATC 81
[213] Also refer *Nasionale Pers Bpk v KBI* (1986 A); *Port Elizabeth Electric Tramway Co Ltd v CIR* (1936 CPD); *Concentra (Pty) Ltd v CIR* (1942 CPD)
[214] Refer Chapter 5 for a detailed discussion on section 20(1)(a)(ii)
[215] (1955 A), 20 SATC 113

borrowed money is not received by the borrower within the meaning of the definition of 'gross income', since he falls under an obligation to repay such money. It is therefore not received 'for his own benefit'.

Should the obligation to repay the money be extinguished within the provisions of section 8(4)(m) (and ignoring the provisions of section 20(1)(a)(ii)[216]) there is a potential recoupment if the money was used to fund certain expenditure.

In the instance where the money is borrowed to fund a specific expenditure and the terms of the agreement is such that the goods acquired remain the property of the financier until fully paid for, irrespective of the fact that the goods were paid for by the financier, it could be argued that the link between the obligation and the expenditure is close enough to bring it within the ambit of section 8(4)(m)(i). However, if a general pool of money is borrowed and no link to specific expenditure is agreed upon, it would be difficult to bring that obligation within the ambit of section 8(4)(m)(i).

Therefore, a finance lease agreement entered into between a taxpayer and a bank to finance the purchase of a vehicle in respect of which a section 11(e) allowance was claimed could fall within the provisions of section 8(4)(m)(i) in the case of an extinction of that obligation. It would however be difficult to bring an overdraft facility into the provision of section 8(4)(m)(i) even if the funds were used to finance trading stock for which a section 11(a) deduction was claimed, when the obligation to repay the overdraft facility is extinguished.

4.4.3 Such expenditure was not paid

'Pay'[217] means 'to give, transfer, or hand over (money or its equivalent) in return for goods or services, or in discharge of an obligation'.[218] It is easy to establish when something has been paid where money changes hands in return for the expenditure.

The issue arises where something other than money is transferred. Again, if something is given specifically in exchange for that expenditure it would follow that

[216] This will be dealt with in Chapter 5
[217] Extinction of debt through performance – also refer Chapter 2
[218] Oxford English Dictionary Online, 2010

the obligation has been discharged and consequently the expenditure paid. However, if different transactions are entered into between two companies with no reference to the other transactions and because of that both companies ultimately have obligations towards each other the question arises whether set-off could be applied with the effect that both obligations have been discharged and the expenditure consequently paid.[219]

Marlie[220] finds it difficult to understand why the legislature has deemed it fit to include a requirement that the expenditure must not be paid in order for section 8(4)(m) to apply. He submitted that a taxpayer could only be relieved from an obligation to make payment where payment has not been made, but did not validate this submission for the purpose of his paper. It is noted that the section requires the expenditure to be unpaid at the date of relief or partial relief, and not the obligation. Marlie's submission that a taxpayer could only be relieved from an obligation to make payment where payment has not been made is therefore irrelevant for the purpose of analysing this section.

The legislature therefore had to have had a reason for including this requirement in order for section 8(4)(m) to apply. Hence, if it was the legislature's intention that even an indirect link between the obligation and expenditure (as discussed in 4.4.2) is necessary for section 8(4)(m) to apply this would mean that if the funds were actually used to pay for the expenditure then that expenditure should not be caught within the provisions of section 8(4)(m), irrespective of the fact that the obligation is still outstanding. Therefore, if a company borrowed money from the bank to buy trading stock and pays for the trading stock with that borrowed money, the expenditure has been paid for, but the obligation to the bank remains outstanding. Therefore, even if it is found that 8(4)(m)(i) is applicable, there would be no recoupment because 8(4)(m)(ii) is not applicable. This should put it beyond any doubt that there should be a direct link between the obligation and the expenditure for this section to be applicable.

As it has been established that the obligation to repay borrowed money is not expenditure, therefore, if an obligation to repay borrowed money remains unpaid it cannot be said that any expenditure is not paid. This can however only be determined

[219] Refer Chapter 2 for a discussion of set-off as means for extinction of debt
[220] At p 66

from the facts and circumstances of each case.

4.4.4 Such expenditure was allowed as a deduction from income

This requirement contained in subsection 8(4)(m)(iii) appears to be straightforward as it merely requires the expenditure to have been allowed as a deduction from income. Therefore, if the expenditure was not previously allowed as a deduction from income the provisions of section 8(4)(m) could not be applicable. Unfortunately, tax is not always as simple, and it is submitted that this provision is not necessarily straightforward.

The general deductions allowable in the determination of taxable income are contained in section 11. Subsection 11(x) brings into the ambit of the general deduction provision any amounts which are allowed to be deducted in terms of any other provision in Part I of the ITA, from the income of the taxpayer.

It is relatively easy to establish whether an amount has been allowed as a deduction from income. The taxpayer would submit his annual return whereby he claims certain deductions from his income. The Commissioner would then issue an assessment and would either allow all the deductions claimed or would disallow certain expenditure. Should the taxpayer not be in agreement with the adjustments made by the Commissioner, the taxpayer would object to the original assessment issued by the Commissioner and request that a revised assessment be issued. Where the objection is allowed this means that the expenditure previously disallowed has now been allowed as a deduction from income for purposes of section 8(4)(m). Furthermore, the Commissioner could initially have allowed all the taxpayer's deductions, but after an audit could have found that certain expenditure was incorrectly claimed and at that stage would disallow that expenditure.

The issue that could arise would be in the case of an assessed loss. The term 'assessed loss' is defined in section 20(2) and means 'any amount by which the deductions admissible under section 11 exceeded the income in respect of which they are so admissible.'

In Interpretation Note No. 33[221] a balance of assessed loss is referred to as the assessed loss that is brought forward from the preceding year. It therefore follows that there cannot be a balance of assessed loss without an assessed loss having been carried forward. It is submitted that this is important in determining whether deductions had been allowed for purposes of section 8(4)(m).

There are certain requirements that must be met before a company can carry forward its assessed loss. All those requirements are not relevant for the purpose of this paper and will not be analysed in any further detail.[222] Of relevance is the fact that should all the requirements not be met, the company will forfeit the right to carry forward its balance of assessed loss in terms of section 20(1)(a). Where the taxpayer has an assessed loss carried forward from the previous year this loss will also rank as a deduction, which will go either to diminish the taxable income or increase the assessed loss for the year of assessment, as determined under section 20(1)(b).[223]

The inferences that could be drawn from this are the following: (1) to the extent that the taxpayer has an assessed loss all deductions were not allowed and would only be allowed as soon as the taxpayer has sufficient taxable income to cover the balance of assessed loss or (2) because the taxpayer does not have a balance of assessed loss brought forward[224] it could not have had an assessed loss to be carried forward and therefore its admissible deductions under section 11 could not have exceeded its income and thus certain deductions that were previously allowed were subsequently disallowed.

It is conceded that there is no equity in tax,[225] but we would otherwise have the anomaly where the taxpayer would not be allowed the deduction (balance of assessed loss forfeited) and would also be taxed on a recoupment in respect of that expenditure.

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[221] South African Revenue Service, 2010(33) para 4.1.1 at p 3
[222] Refer Chapter 5 for a further discussion on assessed losses
[223] If the result is an assessed loss that loss is carried forward to rank as a deduction in the next year – see Meyerowitz, 2008 ("Meyerowitz") at para 12.128
[224] In the instance where the assessed loss is forfeited
[225] *Partington v Attorney-General* LR 4 HL 100 and *Pyott Ltd v CIR* 1925 AD 298

4.5 COMMENTS ON THE CASE STUDY

As stated earlier, the facts relating to W, Y and Z agree to the facts stated in BPR 073 and the ruling will therefore directly be tested against the findings above. In terms of the ruling Z will have to take the portion of its benefit that is not set off against its balance of assessed loss under section 20(1)(a)(ii), which relates to expenditure that has been set off by Z against actual income into account as a recoupment. Furthermore, in terms of the ruling, W and Y must take into account as a recoupment the portion of its benefit that relates to expenditure that has been set off by each of them against actual income.

SARS therefore interprets the phrase ‘subject to’ (in this instance) to mean that the balance of the discharge[226] will be taxable under section 8(4)(m) if it meets the requirements of that section, where the assessed loss is completely wiped out by the discharge of the debt. There is no clear legal indication that this interpretation is correct and it would be interesting to test this in a court of law. Legislative intervention is ultimately required to bring much needed certainty on the legislature’s intention with regards to this matter.

In terms of the ruling it appears that it is not only the on-charged expenditure that should be recouped but also all other expenditure referred to in the ruling. This would include expenditure incurred with working capital advanced by the holding company and used by the subsidiary to pay for such expenditure. This could not be correct because the expenditure has already been paid for and it could therefore not fall within the ambit of section 8(4)(m). The unpaid expenditure would relate to the on-charged expenditure and section 8(4)(m) could therefore only apply in respect of the on-charged expenditure.

The ruling also does not take into account the fact that W and Y would have forfeited its balance of assessed loss. As discussed in 4.4.4, those unpaid expenditure in respect of which the balance of assessed loss is not carried forward are effectively not allowed as a deduction and therefore section 8(4)(m) should, arguably, not be applicable in respect thereof.

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[226] After the application of section 20(1)(a)(ii)

The loan account between X and V would have to be analysed on a first-in-first-out basis to determine what portion of the outstanding balance relates to on-charged expenditure and what portion to other expenditure. The portion that relates to on-charged expenditure would have to be accounted for as a recoupment in terms of section 8(4)(m).

AA would not account for a section 8(4)(m) recoupment because the on-charged expenditure has been paid for.[227] This is despite the fact that the obligation is with the same creditor. Furthermore, the resolutive time clause contained in the agreement does not detract from the validity of the agreement.

4.6 CONCLUSION

If the ruling is a proper indication of how SARS interprets section 8(4)(m) it is evident that the taxpayer should not accept the ruling given by SARS.

Legislative intervention is required to provide clarity on the issues mentioned above because it is difficult to imagine that the intention of the legislature with section 8(4)(m) was properly interpreted by SARS when it issued the ruling.

[227] The taxpayer used the money to settle its previous obligation and effectively paid for that expenditure

CHAPTER 5: SECTION 20(1)(a)(ii) AND ITS INTERACTION WITH SECTION 8(4)(m)

5.1 INTRODUCTION

When section 20(1)(a)(ii) was originally introduced it read as follows:

> *"20.* ***Set-off of assessed losses.****-(1) For the purpose of determining the taxable income derived by any person from carrying on any trade within the Republic, there shall be set off against the income so derived by such person –*
>
> *(a) any balance of assessed loss incurred by the taxpayer in any previous year which has been carried forward from the preceding year of assessment: Provided that-*
>
> *(i) …*
>
> *(ii) the balance of assessed loss shall be reduced by the amount or value of any benefit received by or accruing to a person resulting from a concession granted by or a compromise made with his creditors whereby his liabilities to them have been reduced or extinguished, provided such liabilities arose in the ordinary course of trade."*

Various academic writers and commentators have noted a number of issues relating to this section and have proposed certain amendments to resolve it. The legislature subsequently amended[228] this subsection and the intention of the latest amendment(s) to this section will now be analysed. An attempt will be made to consider whether the issues identified by the various academic writers and commentators have now been addressed through the latest amendment(s).

5.2 ANALYSIS OF SECTION 20(1)(a)(ii)

Section 20 contains the provisions relating to assessed losses.

The revised paragraph (ii) reads as follows:

> *"20.* ***Set-off of assessed losses.****-(1) For the purpose of determining the taxable income derived by any person from carrying on any trade* ***[within the Republic]****, there shall,*

[228] Amended by section 32(a) of Act No. 35 of 2007

subject to section 20A, be set off against the income so derived by such person –

(a) any balance of assessed loss incurred by the taxpayer in any previous year which has been carried forward from the preceding year of assessment: Provided that-

(i) … and

(ii) the balance of assessed loss shall be reduced by the amount or value of any benefit received by or accruing to a person resulting from a concession granted by or a compromise made with ***[his creditors]*** *any creditor of such person whereby* ***[his liabilities]*** *any liability owed by such person to* ***[them have]*** *such creditor has been reduced or extinguished,* ***[provided]*** *to the extent that-*

(aa) the amount advanced by such ***[liabilities arose in the ordinary course of trade]*** *creditor was used, directly or indirectly, to fund expenditure or an asset; and*

(bb) a deduction was allowed, in terms of section 11, in respect of such expenditure or asset;"

5.2.1 Assessed loss[229]

Section 20 could only be applicable if the taxpayer has a balance of assessed loss carried forward from the preceding year of assessment. It has further been held that section 20(1)(a)(ii) could only be applicable if the taxpayer has a balance of assessed loss at the end of the current year of assessment.[230]

In Louis Zinn (*supra*) Schreiner A.C.J. explained the determination of the balance of assessed loss as follows:

"Whenever there has been a trading loss in the tax year, or where there has been a balance of assessed loss brought forward from the previous year, there has to be a determination of the balance of assessed loss to be carried forward into the next year. There may have been a profit in the tax year, but not large enough to obliterate the balance of assessed loss carried over from the previous year. Then the new balance of assessed loss will be smaller than the previous one. If there has been a working loss in the tax year the balance to go forward will be increased. If there has been no previous balance the assessed loss in the tax year will be the balance of assessed loss carried forward. The point to keep in mind is that, although at the stage where it is to be used,

229 Refer definition in 4.4.4
230 Refer *CIR v Louis Zinn Organization (Pty) Ltd* (1958 A), 47 SATC 179

> *i.e. when it is to be set off against a profit, a balance of assessed loss looks back to the past, at the stage when it is determined, i.e. when its amount is being calculated it looks forward to the future when it will be used. At the determination stage it is being prepared for future use ….”*

On determining whether a balance of assessed loss could be carried forward to a next year, Beyers JA said in *New Urban Properties v SIR*[231] that:

> *“According to both decisions subsection (3) envisages a continuity in setting off an assessed loss in every year succeeding the year in which it was originally incurred, so that in each succeeding year a balance can be struck to the satisfaction of the Secretary which can then be carried forward from year to year until it is exhausted; if, for any reason, the assessed loss cannot be so set off and balanced in any particular year, there is then no ‘balance of assessed loss’ for that year which (viewed from that year of assessment) can be carried forward to the succeeding year, or (viewed from the succeeding year of assessment) there is no ‘balance of assessed loss which has been carried forward from the preceding year of assessment’; in other words, the essential continuity has been fatally interrupted.”*

SARS is of the view that section 20 contains a trade requirement and an income from trade requirement. According to SARS both requirements must be satisfied before an assessed loss may be carried forward.[232] It is questionable whether the view of SARS is correct based on a proper interpretation of the ITA.[233]

5.2.2 Amount or value of any benefit received by or accruing to

5.2.2.1 <u>Benefit</u>

The term ‘benefit’ is not defined in the ITA but the meaning was considered in *ITC 1613*.[234] In that case a scheme of arrangement approved in terms of section 311 of the Companies Act No. 61 of 1973 resulted in the taxpayer being discharged from liquidation and the taxpayer became a wholly owned subsidiary of Datakor Ltd. Thereafter, Datakor Ltd, in terms of the scheme, was obliged to provide the taxpayer with certain funds to pay administration expenses and amounts due to secured and preferential creditors, and the balance remaining was to be used as a *pro rata* payment

[231] (1966 A), 27 SATC 175
[232] South African Revenue Service, 2010(33)
[233] The validity hereof will not be considered further for the purpose of this paper
[234] (1996 T), 59 SATC 187

to concurrent creditors. The unpaid balance of the concurrent creditors' claims was capitalised by the creation of redeemable preference shares in the taxpayer equal to the face value of the claims. As consideration for the shares, the concurrent creditors waived payment of their claims and received a dividend of 43.48 cents in the Rand. For every 100 cents of claims not paid a share with a nominal value of one cent was issued at a premium of 99 cents. The creditors then renounced the shares in favour of Datakor Ltd.

The Special Court found that there had been a benefit and Wunsh J held that:

> *"Any arrangement or dispensation by which a company is protected from action by its creditors so as to enable it to continue with its business, whether by means of a subordination agreement or the capitalisation of the claims, that is converting them into permanent or long-term capital, must redound to its benefit. It enables the company to be discharged from liquidation, to continue with its business under its directors and to have to deal with a single well-disposed shareholder instead of the existing creditors, who could once again seek the company's liquidation ... Holders of redeemable preference shares cannot sue the company as creditors for the repayment of the capital when redemption becomes due, although they can, as shareholders, apply for a winding-up of the company ... I have no doubt that the company derived a benefit from the arrangement and the conversion of the creditors' claims to share capital, relieving it of the need to find external funds to pay these claims which were due and payable."*[235]

In the Supreme Court of Appeal Harmse JA said:

> *"The benefit, in the words of the Act, is to be found in the reduction or extinction of debt, something which and the extent of which, as said before, is common cause. Indeed, the concession by creditors (to waive the balance of their eligible claims against the taxpayer in return for a nebulous 'right' of redemption of redeemable preference shares) must of necessity translate into a benefit to the taxpayer."*[236]

The Brummeria case[237] concerned a group of companies (the taxpayers) that granted life rights over units in a sectional title scheme operating as a retirement village to the occupiers (life-right holders). As a *quid pro quo* (in exchange) the life-right holders granted interest-free loans to the taxpayers for as long as they occupied the units.[238]

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[235] ITC 1613 (*supra*) at p 194
[236] *CIR v Datakor Engineering (Pty) Ltd* (1998 A), 60 SATC 503 at p 511
[237] *CSARS v Brummeria Renaissance (Pty) Ltd and Others* (2007 SCA), 69 SATC 205
[238] South African Revenue Service, 2010(58)

The Supreme Court of Appeal found that the right to use the loan capital interest free was a benefit to the taxpayer.

It seems easy enough to determine whether there was a benefit, but each case will still have to be evaluated based on its own set of facts to determine whether there was actually a benefit to the taxpayer.

5.2.2.2 Received by or accruing to a person

It is submitted that the phrase 'received by or accruing to' is similar to the reference in the definition of the term 'gross income' in section 1, which refers to the total amount 'received by or accrued to or in favour of' a person during a year or period of assessment. The phrase 'received by or accruing to' should therefore be given the same meaning as that attributed to it in case law.[239] In other words, the term 'received by or accruing to a person' must mean 'received by the taxpayer on his own behalf for his own benefit'.[240]

5.2.2.3 Amount or value of any benefit

The balance of assessed loss must be reduced by the amount or value of any benefit received by the taxpayer. The requirement relating to the amount or value of a benefit usually poses no problem in traditional cases of release or compromise (where the amount/value is usually clearly equal to the face value of the extinguished/reduced debt), but in more complex cases it may become very difficult to ascertain whether it has been fulfilled.[241]

Even though it was found, in both Datakor (*supra*) and Brummeria (*supra*), that there was a benefit which has a monetary value, the ascertainment of that value was left open in both cases. In ITC 1613 (*supra*) at pp 194-195 it was said:

> *"It is difficult, if at all possible, to quantify or place a value on the benefit derived by the appellant. It seems to me that it is only if the amount or value of the benefit is equivalent to the nominal amount of the claims that were converted into shares, that the value of the benefit can be quantified and then, indeed, at the amount of those claims. If a creditor forgoes a part of its claim against a company, the amount*

239 A detailed analysis hereof falls outside the scope of this paper and is therefore not discussed further
240 Also refer *Mooi v SIR* (1972 A), 34 SATC 1; *Geldenhuys v CIR* (1947 C), 14 SATC 419
241 Refer Cilliers at p 25 and Marlie at p 56

abandoned is the amount of the benefit. Where a creditor accepts as a substitute for a part of its claim a stake in the company's capital, it is not immediately clear whether this is so … A benefit has an amount or a value if it has money's worth or can be turned into money. To be an 'amount' something must have an ascertainable money value (cf Commissioner for Inland Revenue v Butcher Bros (Pty) Ltd 1945 AD 301 at pp 318-3214 and WH Lategan v Commissioner for Inland Revenue 1926 CPD 203 at p 209) … A benefit has a money value or a worth in money to the extent that it compensates the recipient or saves it from expenditure or can be realised for money. The problem in the present case is that there is no way in which one can quantify the benefit received by the appellant on these principles …."

The judge in ITC 1613 (*supra*) went on to say at p 196 that:

> *"I find it impossible, on what has been submitted to us, to quantify the benefit in monetary terms. The value of the benefit is not the whole face value or amount of the previously existing claims, having regard to the nature of redeemable preference share capital and other factors which require examination. In my opinion, without a prescribed formula or a deeming provision in the Income Tax Act, it is not possible to ascribe a monetary value to the benefit."*

In contrast, the Supreme Court of Appeal judgement[242] did not examine this requirement and found that the Special Court (delivering the judgement in ITC 1613 (*supra*)) erred in placing the *onus* in respect of this requirement on the Commissioner.

The Special Court (delivering the judgement in ITC 1613 (*supra*)) relied on the *dictum* in Silke[243] and the judgement of the Butcher Bros case[244] to support its decision. The Supreme Court of Appeal found that the *dictum* in Silke (*supra*) did not support the Special Court's finding and appears to the contrary. It also held that the facts in Butcher Bros (*supra*) were distinguishable from the present case and therefore of no assistance.

In Brummeria (*supra*) the basis on which SARS valued those specific rights/benefits were not challenged by the taxpayer and the court merely accepted the approach taken by SARS without deciding on it. SARS confirmed in Interpretation Note No. 33[245] that arm's length principles of valuation must be applied in each case, having regard to the facts and circumstances and the intention of the parties.

[242] Datakor (*supra*)
[243] Para 18.27
[244] *CIR v Butcher Bros (Pty) Ltd* 13 SATC 21
[245] South African Revenue Service, 2010(33) at p 3

Hence, determining the amount or value of the benefit is still an important aspect of section 20(1)(a)(ii), and to which no clarity was given by the courts. Furthermore, the legislature, it appears, deemed it unnecessary to intervene in respect thereof when it affected all the other amendments to this section.

5.2.3 Any creditor

The question of whether the section only applies where a concession or compromise is made with all the taxpayer's creditors or whether it also applies where a concession or compromise was made with only a portion of the taxpayer's creditors (or even a single creditor) has been a widely debated issue amongst academic commentators.

Meyerowitz, 2005 ("Meyerowitz, 2005 edition") expressed the view that "what the provision deals with is a general compromise with or concession by creditors and not an arrangement with an individual creditor …"[246] De Koker, 2005 ("Silke, 2005 edition"), on the other hand, noted that the section not only applies in the case of an arrangement with a body of creditors, but also to a release by one creditor (or only some of the creditors).[247] Marlie concluded at p 60 that there is nothing in the wording of the section to indicate that the plural does not import the singular. Cilliers stated that, arguably, it could not apply where only one creditor is involved.[248]

It is submitted that after years of speculation this issue has finally been resolved through legislative intervention. The revised section 20(1)(a)(ii) now makes it clear that a compromise with any creditor (i.e. one, some, or all) could cause the balance of assessed loss to be reduced.

5.2.4 Liabilities arose in the ordinary course of trade

Much uncertainty also surrounds the phrase "liabilities arose in the ordinary course of trade".

Meyerowitz[249] concluded that "liabilities arising in the ordinary course of trade" would normally be liabilities in respect of which allowable deductions could be

[246] Meyerowitz, 2005 edition at para 12.141
[247] Silke, 2005 edition at para 8.129
[248] At pp 32-33 and in footnote 200
[249] Meyerowitz, 2005 edition

claimed. This would, for the most part, exclude expenditure of a capital nature.[250] Silke[251] was of the view that there is a clear distinction between liabilities incurred on revenue account and liabilities incurred on capital account. In his opinion only those incurred on revenue account was incurred in the ordinary course of trade. Huxham and Haupt, 2005 ("Huxham and Haupt, 2005 edition"), on the other hand, contended that "as long as there is a link between the liability and the trading activities the liability has arisen in the ordinary course of trade whether it is of a capital or revenue nature."[252] Cilliers concluded that "the current law gravitates towards the view that capital expenditure incurred for the purposes of establishing or adding to income-earning plant or equipment would usually not qualify as expenditure having arisen 'in the ordinary course of trade."[253]

The requirement for 'liabilities arose in the ordinary course of trade' no longer exist and has been substituted for the terms shown hereunder in an attempt to clarify its meaning. According to the Explanatory Memorandum[254] a previous issue relating to this section (20(1)(a)(ii)) was whether the liability must be linked to the expenditure in respect of which a deduction or allowance was allowed. It concluded that the amendments were aimed at clarifying the position in that regard.

5.2.4.1 <u>Amount advanced was used, directly or indirectly, to fund expenditure or an asset</u>

Through this amendment it appears as if the intention was that the capital or revenue nature was not important in establishing whether 'liabilities arose in the ordinary course of trade'. It is for that reason that the legislature substituted it with the wording 'expenditure' or 'an asset' to make it clear that this section now covers both revenue and capital expenditure.

Again, an important point for consideration (as is in the case of section 8(4)(m)[255]) is the link between the liability and the expenditure or asset. An interesting twist to this latest amendment is that it now does not require the taxpayer to determine how the

[250] Meyerowitz, 2005 edition at para 12.142
[251] Silke, 2005 edition
[252] Huxham and Haupt, 2005 edition at p 174, para 12.2.4
[253] Cilliers at p 42, para 2.67
[254] Explanatory Memorandum on the Revenue Laws Amendment Bill, 2007 at pp 64-65
[255] Refer 4.4.2

liabilities arose, but only how it was ultimately used or applied.

The obvious question is whether this was done deliberately, because it no longer hinges on the intention or purpose for which the money was borrowed. The importance of 'purpose' was illustrated in the following cases.

In *CIR v Standard Bank of SA Limited*[256] the court had to consider the deductibility of interest paid in terms of section 11(a) read with section 23(f) and 23(g). Corbett JA formulated certain principles established from *Financier v COT,*[257] *CIR v Genn & Co (Pty) Ltd*[258] and *CIR v Allied Building Society*.[259] He stated that, in determining whether interest (or other like expenditure) incurred by a taxpayer in respect of moneys borrowed for use in his business is deductible, a distinction may in certain instances have to be drawn between the case where the taxpayer borrows a specific sum of money and applies it to an identifiable purpose, and the case where the taxpayer borrows money generally and upon a large scale in order to raise floating capital for use in its business. In the former type of case both the purpose of the expenditure and what it actually affects can readily be determined and identified – a clear and close casual connection can be traced. Both these factors are, therefore, important considerations in determining the deductibility of the expenditure. In the latter type of case, however, there are certain factors that prevent the identification of such a casual connection and one cannot say that the expenditure was incurred in order to achieve a particular effect. All that one can say is that in a general sense the expenditure is incurred in order to provide the institution with the capital with which to run its business, but it is not possible to link particular expenditure with the various ways in which the capital is in turn used.

It is my opinion that the judge could thus correctly see that the ultimate use or destination of the borrowed money should not be considered as the deciding factor in that case.

In *A v COT*[260] the holding company waived its right to recover a portion of the debt from a subsidiary company. The Rhodesian High Court held that "a liability incurred

[256] (1985 A), 47 SATC 179
[257] (1950 SR), 3 SA 293
[258] *Supra*
[259] (1963 A), 4 SA 1
[260] (1969 R), 31 SATC 66

by borrowing money for the purpose of financing the usual income-producing activities which constitute the trade of the taxpayer is a liability which arises in the ordinary course of trade."[261]

As can be seen from the A v COT judgement (*supra*) the purpose of the financing had to be considered in reaching a conclusion on that matter. However, with the recent amendments, it appears that the purpose for borrowing the money would not necessarily be considered. Again, whereas it would be easy to determine this where money was borrowed and used for a specific purpose it would be more difficult to adjudge where a pool of money was borrowed and used for general business purposes. The legislature included the words "directly or indirectly" in a possible attempt to widen the application of this section. Could this also have been an attempt by the legislature to counter the judgement by Corbett JA in the Standard Bank case (*supra*)?

It is further noted that the section makes use of the phrase "to the extent that" and the inference drawn is that this would possibly allow for the apportionment of an amount to be deducted in terms of this section.

5.2.4.2 Deduction was allowed, in terms of section 11, in respect of such expenditure or asset

Only to the extent that the deductions were allowed in terms of section 11 would section 20(1)(a)(ii) apply. However, section 11(x) includes as a deduction any amounts which in term of any provision in Part 1 (i.e., section 5 to section 37H inclusive) are allowed to be deducted from the income of the taxpayer. Hence, it would appear that that the scope of the deductions extends to every admissible deduction under the ITA.

Again, it would appear easy to determine whether a deduction was allowed, but as already pointed out in 4.4.4 there are certain instances where this is not easily determined. However, this section could never be applicable if the taxpayer forfeits his balance of assessed loss because it requires a reduction of the balance of assessed loss.

[261] At p 68

5.3 THE INTERACTION BETWEEN SECTIONS 20(1)(a)(ii) and 8(4)(m)

It is evident from the above that section 20(1)(a)(ii) could only apply if the taxpayer has a balance of assessed loss at the end of the year of assessment during which the extinction of the loan occurs. If the taxpayer does not have a balance of assessed loss at the end of that year section 20(1)(a)(ii) could not apply, even if all the other requirements of that section are met. In that case the requirements of section 8(4)(m) would be considered.

Furthermore, section 8(4)(m) is made subject to section 20 and will therefore not apply if the taxpayer has a balance of assessed loss, i.e., if the requirements of section 20(1)(a)(ii) are met. However, it could, arguably, still apply where the amount of the benefit is sufficiently large enough to wipe out the balance of assessed loss, and the remaining portion of the benefit would then be accounted for in terms of section 8(4)(m), providing those requirements are met. Section 8(4)(m) should then be applied proportionately as illustrated in the example at 4.4.1.

Section 20(1)(a)(ii) does not have the 'expenditure was not paid' requirement as discussed in 4.4.3. The ambit of section 20(1)(a)(ii) is therefore wider than that of section 8(4)(m) and it follows that the amount or value of the benefit to account for in terms of section 20(1)(a)(ii) and 8(4)(m) would not necessarily be the same.

5.4 COMMENTS ON THE CASE STUDY

The ruling states that the balance of the assessed loss of Z will have to be reduced, to the extent indicated in section 20(1)(a)(ii). It further holds that section 20(1)(a)(ii) will not apply in respect of W and Y, as they do not have any balance of assessed loss as a result of having not carried on any trade during the year of assessment.

As stated earlier, section 20(1)(a)(ii) could only apply where the taxpayer has a balance of assessed loss carried forward from the previous year. The section could therefore only be applicable in respect of Z, being the only company with a balance of assessed loss carried forward.

It is interesting to note that this would also be correct in respect of AA if that company has no balance of assessed loss carried forward.[262]

5.5 CONCLUSION

The legislature finally amended section 20(1)(a)(ii) and brought much needed clarity to some of the past controversial issues. It is noted that most of the questions of tax practitioners and academic writers have now be answered.

However, the legislature obviously had no intention to make it too easy to interpret this section. The result is that there are still some unanswered questions relating to this section and even a few new questions, as indicated in the discussion above.

Hopefully the legislature will be bold and provide further clarity in future amendments to this section.

[262] It was already established in 4.5 that section 8(4)(m) should not be applicable

CHAPTER 6: THE APPLICABILITY OF THE EIGHTH SCHEDULE

6.1 INTRODUCTION

This chapter will provide a brief overview of paragraph 12(5) and other applicable paragraphs relating to the extinction of debt in general. The group company exemption will be discussed to determine when this paragraph could be applicable in a group scenario.

Paragraph 12(5) applies where a debt owed by a person to a creditor has been reduced or discharged by that creditor for no consideration or for a consideration which is less than the amount by which the face value of the debt has been so reduced or discharged.[263]

The Explanatory Memorandum on the Revenue Laws Amendment Bill, 2002[264] states that the purpose of this provision is to

> *". . . ensure that where a debtor is relieved of the obligation to pay any portion of the amount owing, [he] will be subject to CGT on a capital gain equal to the amount discharged. Such reductions may result from donations or offers of compromise. In this regard [it] refers to a debt being discharged without 'full consideration' being given. The term 'full consideration' is not defined but would seem to refer to a market related consideration. As a result where a debtor renegotiates the repayment terms, that debtor may end up settling the debt for a full consideration, which is less than the face value of the debt. This would result in the debtor escaping CGT on the amount discharged, [while] the creditor would be able to claim a capital loss in respect of the same amount. Paragraph 12(5) ensures that the difference between the amount of the debt so reduced and the amount of the consideration for the reduction or discharge is treated as a capital gain."*[265]

Another objective of paragraph 12(5) is to provide symmetry in the tax system by ensuring that there is a matching of capital gains and losses. In the absence of paragraph 12(5), creditors would be able to claim losses, while debtors would not be

[263] Paragraph 12(5)(a)
[264] Paragraph 12(5) was substituted by section 68(1) of Act No. 74 of 2002
[265] At p 51

taxed on the corresponding gains.[266]

6.2 THE GROUP OF COMPANIES EXEMPTION

It is necessary for the purpose of this paper to start this discussion with the group of companies' exemption because the case study specifically deals with the scenario of a group of companies. An attempt will therefore be made to determine when the group exemption applies and in which cases it will not apply.

6.2.1 Group of companies

Paragraph 12(5) does not apply where the debtor and creditor are members of the same group of companies as defined in section 41.[267]

The Explanatory Memorandum to the Revenue Laws Amendment Bill, 2003[268] describes the reason for the inclusion of this exemption as the potential tax consequences created by paragraph 12(5) on the deregistration or liquidation of dormant group companies.[269]

The term 'group of companies' is defined in section 1 and means two or more companies in which the controlling company[270] directly or indirectly holds at least 70 per cent of the shares of a controlled group company[271] (alone or together with any controlled group company) and the controlling group company directly holds at least 70 per cent of the equity shares in at least one controlled group company. The narrower definition in section 41 excludes certain companies within the group. Those exclusions are not relevant for the purpose of this paper and will not be considered further.

Of relevance is the fact that the relief is limited to situations where both companies (debtor and creditor) are fully within the tax system (so that the elimination of a

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[266] McAllister, 2010 at p 84
[267] The reference to section 41 was inserted by section 71 of the Revenue Laws Amendment Act No. 35 of 2007 and applies in respect of a disposal after that date
[268] The group of companies exemption was introduced into the Eighth Schedule by the Revenue Laws Amendment Act No. 45 of 2003
[269] Also refer McAllister, 2010 at p 94
[270] As referred to in the 'group of companies' definition in section 1
[271] As referred to in the 'group of companies' definition in section 1

capital gain for a taxable debtor is matched by the elimination of a capital loss for a taxable creditor).[272]

The group of companies exemption, as described above, will not apply (i.e., the provisions of paragraph 12(5) do apply) in the following two circumstances:

<u>(A) The debt was acquired directly or indirectly from a person who is not a member of that group of companies – par 12(5)(bb)(A)</u>

This simply means that the group exemption will not apply if the debt was acquired directly or indirectly from non-members of the group. It should also be noted that no time limit is imposed as to when the debt must have been acquired.

<u>(B) That person (debtor) or another person became members of that group of companies after the debt arose – par 12(5)(bb)(B)</u>

It is difficult to contemplate why the term ‘another person’ was used in this context. It is my view that ‘another person’ in this context means ‘any other person’ which is very wide. “In *Baron & Jester v Eastern Metropolitan Local Council* [2002] JOL 9412 (W) Counsel for the appellant submitted, correctly, that the word ‘any’ is *prima facie* a word of wide and unqualified generality. I accept too the appellant's further contention that there is nothing in the language or context within which the word ‘any’ appears which justifies placing a restriction on its wide and general meaning.”[273]

Even if read as ‘another company and the creditor company’,[274] it is my opinion that it still does not clarify the legislature’s intention.

The current wording suggests that the group of companies exemption will not apply if any other person (another person) became part of the group of companies after the debt arose.[275] If we explore the following example: HoldCo and SubCo are part of the same group of companies and SubCo (debtor) owes an amount to HoldCo (creditor). Based on the literal interpretation of this paragraph, it would appear that the group exemption would not apply if HoldCo acquired a 100 per cent interest in any other company (unrelated to the debt), i.e., any other company became part of the group of

[272] Explanatory Memorandum on the Revenue Laws Amendment Bill, 2007, at p 76
[273] *Arprint Ltd v Gerber Goldschmidt Group South Africa (Pty) Ltd* (1983 A), 1 SA 254 at pp 261B-E
[274] As suggested by Silke at para 24.33
[275] Marlie at p 82

companies.

It is submitted that it could not have been the intention of the legislature for the relief provided in paragraph 12(5) not to apply simply because the group was enlarged with the addition of another company (unrelated to the debt).

However, does this interpretation lead to an absurdity to make it necessary to depart from that meaning? It is submitted that the literal meaning is not in line with the intention of the legislature which is demonstrated through the examples contained in the Comprehensive Guide to Capital Gains Tax,[276] which shows that the exception is only intended to apply if either the debtor or creditor became a member of the group.

It is difficult to imagine that the courts would depart from the perceived intention of the legislature as demonstrated in the Comprehensive Guide to Capital Gains tax by McAllister above, but it could still be an interesting exercise to test this in a court of law, especially if the taxpayer wants paragraph 12(5) to apply. This could be the case where the debtor has an assessed loss that would absorb the paragraph 12(5) capital gain or the creditor has a capital gain that would absorb the capital loss.

However, a further requirement of the two circumstances mentioned above (A and B) is that these transactions must have been part of a scheme to avoid any tax otherwise imposed by virtue of the ITA. It is interesting to note that the paragraph only refers to a scheme whereas the general anti-avoidance rules have always referred to a transaction, operation or scheme. However, our courts[277] have interpreted the term to be of such a wide meaning that it is submitted that the word 'scheme' should be read in the context of the general anti-avoidance provisions of sections 80A-80L (the old section 103).

In *CIR v Conhage (Pty) Ltd*[278] Hefer JA stated that:

> *"[w]ithin the bounds of any anti-avoidance provisions in the legislation, a taxpayer may minimise his tax liability by arranging his affairs in a suitable manner. If e.g., the same commercial result can be achieved in different ways, he may enter into the type of transaction which does not attract tax or attracts less tax. But, when it comes to considering whether by doing so he has succeeded in avoiding or reducing the tax,*

[276] McAllister, 2010 at p 96
[277] Also refer *Meyerowitz v CIR*
[278] (1999 SCA), 61 SATC 391

> *the court will give effect to the true nature and substance of the transaction and will not be deceived by its form."*[279]

It therefore follows that the general anti-avoidance provisions will only be considered once the true nature and substance of the transaction has been established.[280] Also, a taxpayer may arrange his affairs in a suitable manner to minimise his tax liability. Refer to the often-quoted words of Lord Tomlin in the 1936 House of Lords decision in *IRC v Duke of Westminster* (1936) AC 1 where he said:

> *"[e]very man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be."*[281]

The above concept of tax avoidance can be distinguished from tax evasion which is characterised by fraud and deceit.

It is not clear whether the purpose or the effect of the 'scheme' should be considered when considering if the transactions were part of a scheme to avoid any tax imposed by the ITA. It has been said that the fact that a specific transaction results in a tax saving (tax avoidance) is not an indication that the purpose of the transaction was to avoid the liability to pay tax.[282] It is submitted that the wording used by the legislature alludes more to the purpose of the transaction, and the intention of the taxpayer will thus be important to determine whether the transaction was part of a scheme to avoid any tax that would otherwise be imposed.[283] This is because, if it were not for this transaction, paragraph 12(5) would apply, which would result in a capital gain in the hands of the debtor. The application of the group of companies exemption would thus always have the effect of tax avoidance.

Furthermore, there is no reference to 'sole or main purpose' as used in the general anti-avoidance provisions. Is the inference to be drawn that even a secondary intention of tax avoidance would render this part applicable? It is submitted that the legislature's intention could not have been to exclude genuine business transactions and therefore the main intention with the scheme had to have been tax avoidance.

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[279] Also refer *Erf 3183/1 Ladysmith (Pty) Ltd and Another v CIR* (1996 A), 58 SATC 229

[280] The substance vs form doctrine will not be discussed in further detail because it falls beyond the scope of this paper

[281] As cited in Erf 3183/1 Ladysmith (*supra*) at p 236

[282] Marlie at p 85

[283] This is a subjective test – refer *SIR v Geustyn, Forsyth and Joubert* (1971 A) and *Glen Anil Development Corporation v SIR* (1975 A), 37 SATC 319

It is proposed that the legislature amend this paragraph to give proper effect to its intention.

6.2.2 Connected person

Paragraph 12(5) also does not apply where the debtor company is a connected person[284] in relation to the creditor and the reduction or discharge was made in the course or in anticipation of the liquidation, winding up, deregistration or final termination of the corporate existence of the debtor company. The relief is only provided to the extent that the amount of the reduction or discharge did not exceed the amount of the creditor's expenditure contemplated in paragraph 20 of the debt at the time of the reduction or discharge.[285] This is only applicable to any reduction or discharge after 1 February 2006.[286]

However, similar to the group of exemption, the relief[287] will not apply if the debtor company became a connected person in relation to the creditor after the debt arose[288] and these transactions are part of a scheme to avoid any tax otherwise imposed by virtue of the ITA.[289] The exclusion contemplated in paragraph 12(5)(a)(cc) will also not apply if the debtor company has not within 18 months taken the necessary steps to liquidate, wind up, deregister or finally terminate its corporate existence[290] or has withdrawn steps taken to that effect[291] or does anything to invalidate the steps already taken.[292]

It should also be noted that any tax which becomes payable because of the application of paragraph 12(5)(c) must be recovered from the debtor company and the creditor company who shall be jointly and severally liable for the tax.

6.2.3 Other exclusions

Paragraph 12(5) will also not apply where the amount of the reduction or discharge

[284] The definition of 'connected person' is contained in section 1
[285] Paragraph 12(5)(cc)
[286] Date of promulgation of Act No. 31 of 2005
[287] Provided in paragraph 12(5)(a)(cc)
[288] Paragraph 12(5)(a)(cc)(A)
[289] Paragraph 12(5)(a)(cc)(B)
[290] Paragraph 12(5)(c)(i)
[291] Paragraph 12(5)(c)(ii)
[292] Paragraph 12(5)(c)(ii)

constitutes a capital gain in terms of paragraph 3(b)(ii) or it has been taken into account in terms of section 8(4)(m) or 20(1)(a)(ii) or paragraph 20(3).

6.3 RELEVANT LEGISLATION

It is submitted that the following paragraphs of the Eighth Schedule could apply to the extinction of loans. A brief analysis of these sections follows.

6.3.1 Paragraph 12(5)

6.3.1.1 Subject to[293] paragraph 67

Paragraph 12(5) is made subject to paragraph 67. Hence, paragraph 12(5) will not apply to the extent that it conflicts with paragraph 67, i.e., paragraph 67 takes precedence over paragraph 12(5).

Paragraph 67 deals with the transfer of assets between spouses and allows certain rollover relief.[294]

6.3.1.2 Debt owed[295]

In terms of McAllister "[t]he words 'debt owed' as used in paragraph 12(5) refers to amounts in respect of which there is an unconditional liability to pay. This would, of course, include debts incurred which are not yet due and payable."[296]

6.3.1.3 By that creditor

For paragraph 12(5) to find application it requires a reduction or discharge of the debt by the creditor. Refer to the judgement of Lacock J hereunder where he confirms that a conscious act by the creditor is required for the paragraph to apply.[297] It is however stated by McAllister[298] that a creditor will in most cases be a party to a discharge, albeit indirectly, or through an act of omission. He goes on to say that the fact that a

[293] Refer 4.4.1 for a discussion of the phrase 'subject to'
[294] The provisions of paragraph 67 are not relevant for the purpose of this paper and will not be discussed any further
[295] Refer 2.3.3 for a discussion of the term 'debt owed'
[296] McAllister, 2010 at p 85
[297] Refer 6.4.2
[298] Para 6.2.5.8 at p 88

debt is discharged by operation of law does not necessarily mean that the creditor has not taken an action to discharge a debt.

It is therefore important to consider the facts of each case and not only determine the intention and actions of the creditor but also to look at the surrounding circumstances through which the debt was extinguished.

6.3.1.4 Consideration

Paragraph 12(5) applies when a debt has been reduced or discharged for no consideration or for a consideration which is less than the face value of that debt. Boshoff AJP held in *Ogus v SIR*[299] that "[i]n the context of s 58 the word 'consideration' is used in the sense of a '*quid pro quo*', compensation or reward having some value." This meaning ascribed to the word 'consideration' was also accepted in *CSARS v Welch's Estate*[300] (also dealing with section 58).

Section 58 deems a disposal of property for a consideration which is not adequate to be a donation. It is submitted that this is similar to the provision in paragraph 12(5) and that in the context of paragraph 12(5) 'consideration' also refers to the *quid pro quo* received.

Paragraph 12(5) also refers to the phrase 'face value of the debt.'[301] According to McAllister[302] the provision also applies regardless of whether the consideration given by the debtor is market related.[303] An example is used whereby the debtor offers to pay the creditor a lesser sum (i.e., less than the face value of the debt) in full and final settlement in exchange for an early discharge[304] of the debt.

6.3.2 Paragraph 3(b)(ii)

In terms of paragraph 3(b)(ii) a capital gain will arise when any part of the base cost of an asset that has been taken into account in determining the capital gain or capital loss in respect of that disposal has been recovered or recouped during the current year

299 (1978 T), 40 SATC 100
300 (2003 C), 65 SATC 137
301 Paragraph 12(5)(a)(ii)
302 McAllister, 2010 at para 6.2.5.6
303 At p 87
304 It is submitted that discharge, in this context, would mean actual payment of the debt

of assessment and has not been taken into account in the re-determination of the capital gain or loss in terms of paragraph 25(2).

According to the example used by McAllister it appears that the interaction between paragraph 12(5)(a) and paragraph 3(b)(ii) refers to a direct link between the asset and the debt in relation to that asset. It is submitted that this intention of the legislature as described by McAllister that there should be a direct link between the asset and the debt in relation to that asset is not entirely clear from the reading of the ITA and the relevant paragraphs should therefore be amended to clarify the legislature's intention.

6.3.3 Paragraph 20(3)

Paragraph 20(3) allows for a reduction of the base cost[305] of an asset by any amount which is or was allowable as a deduction in determining the taxable income of a person[306] or has been reduced or recovered and is not otherwise included as gross income. Therefore, if the seller waives a portion of the purchase price that reduction will not form part of the base cost of the asset. The effect is that any future capital gain will be increased and any inclusion of the waiver in paragraph 12(5) would have resulted in double taxation.

6.3.4 Paragraph 38

When a person disposes of an asset to a connected person for a consideration that does not reflect an arm's length price, he is treated as having disposed of it for an amount received or accrued equal to the market value on the date of the disposal. The person who acquires that asset is treated as having acquired it at a cost equal to its market value on the date of the disposal. This cost must be treated as an amount of expenditure actually incurred and paid for the purposes of paragraph 20(1)(a).

This provision applies 'subject to'[307] paragraph 12(5) and the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2002 provides the following reason:

> *"Paragraph 38 in simple terms provides that transactions between connected persons*

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[305] As contemplated in paragraphs 20(1)(a) - (g)
[306] Paragraph 20(3)(a)
[307] Refer Chapter 4 for a discussion of the phrase 'subject to'

at a non-arm's length price must be treated as taking place at market value. Ostensibly this provision is at odds with paragraph 12(5) which deals with the waiver or cancellation of debt. Paragraph 12(5) provides that the debtor benefiting from the waiver of debt is deemed to have acquired the debt at a base cost of nil and to have immediately disposed of it at market value, thereby triggering a capital gain in the debtor's hands. On the face of it, therefore, paragraph 38 is at odds with paragraph 12(5). In terms of the principle of interpretation generalia specialibus non derogant, general provisions do not override specific provisions. Whilst the view is held that the specific provisions of paragraph 12(5) override the general provisions of paragraph 38, it is proposed for the purposes of clarity that paragraph 38 be made subject to paragraph 12(5)."[308]

It should also be noted that the Corporate Rules[309] could provide rollover relief in certain instances.[310]

6.3.5 Paragraph 39

When a person disposes of an asset to a connected person and makes a capital loss, that capital loss must be disregarded in the determination of the person's aggregate capital gain or loss. The capital loss is effectively 'ring-fenced' and may be deducted only from capital gains arising from disposals of assets to the same person and only if those persons are still connected persons at the time of the subsequent disposals.

6.3.6 Paragraph 56

Where a creditor disposes of a claim owed by a debtor, who is a connected person in relation to that creditor, the creditor must disregard any capital loss determined in consequence of that disposal.[311] This paragraph applies 'despite paragraph 39', which means that paragraph 56 takes precedence over paragraph 39.

However, paragraph 56 does not apply to a capital loss determined in consequence of the disposal of a creditor of a claim owed by a debtor to the extent that the amount of the claim so disposed of represents a capital gain which is included in the determination of the aggregate capital gain or loss of that debtor by virtue of

[308] At p 60
[309] Contained in sections 41-47
[310] This falls outside the scope of this paper and will not be considered further
[311] Paragraph 56(1)

paragraph 12(5)[312] or an amount which was included in the gross income of any acquirer of the claim[313] or an amount that was included in the gross income of the debtor or taken into account in the determination of the balance of assessed loss of the debtor in terms of section 20(1)(a)(ii).[314]

6.4 CASE LAW

To date there has been two cases dealing with paragraph 12(5), the facts of which can be summarised as follows.

6.4.1 ITC 1793[315]

In this case the deceased had sold some shares to her family trust on loan account. On 15 March 2002 she passed away with her last will and testament providing that the loan be bequeathed to the trust. The Commissioner applied paragraph 12(5) and taxed the resulting capital gain in the trust's hands on the basis that the loan had been discharged for no consideration. The assessment in dispute related to the 2003 year of assessment.

One of the issues before the court was whether the amendment, making paragraph 40(2) subject to paragraph 12(5), applied to the appellant. Under section 130(2) of Act 74 of 2002 the amendment came into operation with effect from the commencement of years of assessment ending on or after 1 January 2003. It was argued by counsel for the appellant that the amendment did not apply because the deceased's last year of assessment ended on her date of death. Bertelsmann J rejected this argument, pointing out that it was the trust's year of assessment that was relevant.

The court held that the creditor (the deceased) had discharged the debt for no consideration by operation of law when her last will and testament became effective upon her death. The appeal was accordingly dismissed.

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312 Paragraph 56(2)(a)
313 Paragraph 56(2)(b)
314 Paragraph 56(2)(c)
315 (2005 G), 67 SATC 256

6.4.2 ITC 1835[316]

In ITC 1835 (*supra*) a different result ensued. On 16 March 1992 the testatrix executed a joint will with her husband. She died on 10 June 2003, and under the joint will bequeathed the free residue of her estate to a family trust, which owed her R539 189 at the date of her death. In winding up the estate the executor did not collect the amount owing by the trust, but instead awarded it to the trust. The Commissioner applied paragraph 12(5) to the trust on the basis that the loan had been discharged for no consideration. As a result the trust was subjected to CGT on a capital gain of R539 189.

In dealing with the crux of the matter Lacock J stated the following:

> *"What is required in terms of this paragraph is an act by a creditor whereby he/she consciously intended to discharge a debt for no consideration. The determining factor is the intention of the creditor whereby he/she disposed of a debt or an asset, and not the subsequent manner in which that creditor's estate may be administered."*[317]

The court distinguished the case from ITC 1793 (*supra*) in which the testatrix had specifically awarded a loan to a family trust as a legacy.

After considering the evidence the court concluded that the testatrix did not intend to bequeath the loan to the trust and upheld the appeal.

6.5 CONCLUSION

In terms of the ruling it is easy to establish that paragraph 12(5) is not applicable in this instance. However, as noted above, there are instances when the paragraph could apply notwithstanding the group of companies exemption. There are even instances where the company would want it to apply.

This remains a controversial provision to the ITA and will invariably be subject to further court cases, as that is the only way in which the interpretation of this paragraph will be clarified.

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316 (2008 K), 71 SATC 105

317 At para13.3

CHAPTER 7: CONCLUSION

7.1 SUMMARY AND RECOMMENDATIONS

The extinction of intra-group debt could occur by means of several different ways and these have been highlighted in this paper.[318] Whether the extinction of a debt by means of a specific action could bring that action within the provisions of either one of or all of sections 8(4)(m), 20(1)(a)(ii) or paragraph 12(5) would depend on the facts and circumstances of each case. It is therefore important not to look blindly at the specific terms used but to consider whether the different means of extinction of debt could be read into that section(s) or paragraph(s).

It is arguable whether the introduction of section 8(4)(m) was necessary[319] and is still relevant after the Omnia Fertilizer judgement (*supra*),[320] but we are bound by this judgement and have to abide with the provisions of this section until such time as the judgement is overruled by a court of law or clarified through legislative intervention.

The phrase 'subject to' as used in section 8(4)(m) causes certain confusion, especially where both sections 8(4)(m) and 20(1)(a)(ii) could be applicable. It is submitted that a proportionate allocation[321] of expenditure would be a fair and reasonable approach until the legislature sets out the extent to which it would otherwise be applicable.

There is no consensus on the closeness of the link between the obligation to make payment and the expenditure actually incurred, but it is submitted that the requirement in section 8(4)(m)(ii) that "expenditure was not paid" puts it beyond doubt that there should be a direct link between the obligation and the expenditure for section 8(4)(m) to apply.[322]

It is submitted that it is relatively easy to determine if expenditure was allowed as a deduction from income, but in the case where a taxpayer forfeits his balance of assessed loss and have to account for a recoupment in terms of section 8(4)(m) it

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318 Refer 2.4
319 Refer 4.2
320 Refer 4.3
321 As illustrated in the example at 4.4.1
322 Refer 4.4.3

would result in double taxation. It is my opinion that if a taxpayer forfeits his balance of assessed loss then certain expenditure was consequently not allowed as a deduction, and section 8(4)(m) could therefore not be applicable.[323] It is however recommended that the wording in section 8(4)(m) should be amended to avoid this potential anomaly.

It is noted that the potential recoupment because of the extinction of intra-group debt in terms of section 8(4)(m) could potentially be avoided if money is borrowed, within the group, to actually pay for the expenditure.[324] The general anti-avoidance provisions should however be considered.

Section 20(1)(a)(ii) was amended in 2007 and resolved some of the issues raised by various tax commentators (e.g., which creditor – this could be one, some or all creditors;[325] ordinary course of trade – this could be revenue or capital expenditure[326]). A number of issues remain unresolved and some new issues have been introduced (e.g., the amount or value of the benefit;[327] a pool of money borrowed and used for general business purposes[328]). Further legislative intervention is recommended in this regard.

The ambit of section 20(1)(a)(ii) is wider than that of section 8(4)(m) and therefore the amount or value of the benefit in terms of the different sections would not necessarily be the same.[329]

Where debt is extinguished within a group of companies paragraph 12(5) would not necessarily apply, because of the group of companies exemption.[330] There are certain exceptions to this rule which should also be considered with the extinction of intra-group debt.[331] The only South African court cases on CGT dealt specifically with this paragraph 12(5) and, in my opinion, even more cases dealing with this paragraph could be expected.

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[323] Refer 4.4.4
[324] Also refer Chapter 4
[325] Refer 5.2.3
[326] Refer 5.2.4
[327] Refer 5.2.2.3
[328] Refer 5.2.4.1
[329] Refer 5.3
[330] Refer 6.2
[331] Also refer the discussion at 6.2.1(B) and the call for an amendment to that subparagraph

7.2 CONCLUSION

The incurring of debt is a worldwide occurrence that is very relevant in today's society. The concept of financing within a group of companies is also widely used. When companies are unable to settle their debt it is important to determine whether the unintended extinction of this debt, because of the hardship that led to the termination of the debt, could also lead to unintended tax consequences.

The ITA contains a number of provisions specifically dealing with the extinction of debt. The most significant of these are contained in sections 8(4)(m) and 20(1)(a)(ii) and paragraph 12(5). On numerous occasions our courts have been required to rule in respect of these provisions, and these sections have also gone through some changes in an attempt to give proper effect to the intention.

Despite this, commentators still have different views on the interpretation of these sections and the application thereof. The ruling issued by SARS shows that its interpretation thereof is also very different to that of some of the commentators.

It is submitted that legislative intervention had laid certain issues to rest and adequately highlighted the legislature's intention, but the need for further legislative intervention still remains.

In light of the above it is relevant to reiterate the words of Viscount Radcliffe in *IRC v Frere*[332]

> *"[I had] never understood the procedure of extra-statutory concessions in the case of a body to whom at least the door of Parliament is opened every year for adjustment of the tax code."*[333]

and the words of Scott LJ in *Absalom v Talbot*[334]

> *"The fact that such extra-legal concessions have to be made to avoid unjust hardships is conclusive that there is something wrong with the legislation."*[335]

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[332] (1965) AC 402 (HL) (E)) at pp 429A-B
[333] As cited in ITC 1675 (*supra*) at p 229
[334] (1943 CA), 1 All ER 589 at pp 598A-B
[335] As cited in ITC 1675 (*supra*) at p 229

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