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M.PHIL (TAX LAW)

THE INTERACTION OF PARAGRAPH 12(5) OF THE 8TH SCHEDULE TO THE ACT WITH
REFERENCE TO ESTATE PLANNING AND CORPORATE STRUCTURES

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I hereby declare that I have read and understood the regulations governing the submission of M.Phil (Tax Law) dissertations, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation confirms to those regulations.

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CHAPTER 1

INTRODUCTION

Paragraph 12 of the Eighth Schedule to the Income Tax Act No. 58 of 1962 (the Act) deals with events treated as disposals and acquisition for Capital Gains Tax purposes, i.e. deemed disposals and acquisitions. This dissertation will deal with subparagraph 5 of paragraph 12 of the Eighth Schedule, in specific, which deems the reduction or waiver of debt by a creditor to be a disposal for the purposes of Capital Gains Tax.

Due to the strict provisions of paragraph 12(5) it has an impact on both corporate structuring and transactions between connected persons, as well as, an influence on estate planning and the drafting of a will.

Paragraph 12(5) is quite a tricky paragraph, and has led to two opposing tax court decisions dealing with the waiver of a loan to a trust through way of a bequest. Unfortunately none of the cases have progressed on appeal to the High Court and, therefore, no precedent has been set.

This dissertation will firstly investigate the interaction of this paragraph with other sections in the Act in Chapter 2 and 3, as well as, the effect it has within a group structure in the corporate environment.

Secondly, it will investigate the application and implication of the two tax court cases mentioned above in Chapter 4 to estate planning.

Lastly, the interaction of paragraph 12(5) with suretyship agreements and its applicability where debt prescribes will be investigated in Chapter 5.

CHAPTER 2

THE GENERAL APPLICATION OF PARAGRAPH 12(5) OF THE EIGHTH SCHEDULE TO THE ACT

Paragraph 12(5) is applied where a debt owed by a debtor to a creditor is waived by the creditor for little or no consideration. The reductions may result from a waiver¹ of debt (whether or not gratuitous or otherwise), donations, bequests or offers of compromise by creditors.

In such cases, by applying paragraph 12(5), the base cost of the debt waived is zero and the proceeds are equal to that of the amount of debt waived, resulting in a capital gain for the debtor for the purposes of Capital Gains Tax². The application of the paragraph is subject to various exclusions and the paragraph interacts with various other sections of the Act, all of which will be discussed below.

Paragraph 12(5) of the Eighth Schedule reads as follows:

12. Events treated as disposals and acquisitions.—

(5) (a) *Subject to paragraph 67, this subparagraph applies where a debt owed by a person to a creditor has been reduced or discharged by that creditor—*

(i) *for no consideration; or*

(ii) *for a consideration which is less than the amount by which the face value of the debt has been so reduced or discharged,*

but does not apply where—

(aa) *the amount of that reduction or discharge—*

¹ Havenga, P et al *General Principles of Commercial Law* 6ed (2007) 143 explains the release of debt as follows:

'Release or waiver, as it is also often called, is an agreement between the creditor and the debtor in terms of which the creditor releases the debtor from his or her contractual obligations. Release is often accompanied by an intention to donate on the part of the creditor, but it can also be in exchange for something else, for example that the debtor in turn releases the creditor from an obligation. Since release is an agreement, there obviously has to be an offer and an acceptance. A mere offer of release does not constitute release, since consensus is still lacking. Like other contracts, release may be concluded expressly or tacitly. The creditor may tacitly offer to release the debtor by acting in a way that would lead a reasonable person in the position of the debtor to conclude that the creditor intends to make an offer of release. When the debtor accepts the tacit offer, his or her obligations are terminated.'

² Comprehensive Guide to Capital Gains Tax Issue 3 86

- (A) *constituted a capital gain in terms of paragraph 3 (b) (ii); or*
 - (B) *has been taken into account in terms of section 8 (4) (m) or 20 (1) (a) (ii) or paragraph 20 (3);*
- (bb) *that person and that creditor are members of the same group of companies as defined in section 41 unless—*
- (A) *that debt (or any substituted debt) was acquired directly or indirectly from a person who is not a member of that group of companies; or*
 - (B) *that person or another person became members of that group of companies after that debt (or any substituted debt) arose, and these transactions were part of a scheme to avoid any tax otherwise imposed by virtue of this Act; or*
- (cc) *that person is a company which is a connected person in relation to that creditor and that 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 that company to the extent that the amount of that reduction or discharge did not exceed the amount of the creditor's expenditure contemplated in paragraph 20 of the debt at the time of that reduction or discharge: Provided that this item will not apply if—*
- (A) *that person became a connected person in relation to that creditor after that debt (or any substituted debt) arose; and*
 - (B) *these transactions are part of a scheme to avoid any tax otherwise imposed by virtue of this Act.*
- (b) *Where this subparagraph applies the person contemplated in item (a) shall be treated as having—*
- (i) *acquired a claim to so much of that debt as was reduced or discharged for no consideration, or if a consideration was paid, to so much of the reduction or discharge of the debt as exceeds the consideration, which claim shall have a base cost of nil; and*
 - (ii) *disposed of that claim for proceeds equal to that reduction or discharge.*
- (c) *The exclusion contemplated in item (a) (cc) does not apply where that company—*
- (i) *has not within 18 months of that reduction or discharge, or such further period as the Commissioner may allow, taken such steps as contemplated in section 41 (4) to liquidate, wind up, deregister or finally terminate its corporate existence;*
 - (ii) *has at any stage withdrawn any step taken to liquidate, wind up deregister or finally terminate its corporate existence; or*
 - (iii) *does anything to invalidate any such step so taken with the result that the company is or will not be liquidated, wound up, deregistered or finally terminate its corporate existence.*

(d) Any tax which becomes payable as a result of the application of item (c) in respect of a company, must be recovered from that company and the creditor contemplated in this subparagraph who shall be jointly and severally liable for that tax.

The words 'debt owed' as used in paragraph 12(5) refer 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.³

From the above extract from the Act it is clear that various other paragraphs and sections of the Act influences the application of this paragraph, each of which will be discussed in more detail below.

Paragraph 67 of the Eighth Schedule to the Act

First and foremost, as stated in paragraph 12(5)(a), the paragraph is subject to paragraph 67. Paragraph 67 deals with the transfer of assets between spouses. The paragraph states the any capital gain or loss determined in respect of the disposal of an asset between spouses must be disregarded. The transferee is treated as having; acquired the asset on the same date on which it was acquired by the transferor, acquired the asset for an amount equal to the base cost expenditure incurred by the transferor prior to the disposal and incurred that expenditure on the same date that it was incurred by the transferor.⁴ If the terminology of paragraph 12(5) is applied, the transferee is the debtor and the transferor is the creditor.

In short, paragraph 12(5) and 67 will be applied to treat the waiver of the debt as follows. The debtor is treated as having acquired the debt on the same date as the creditor and at an equal expenditure as the creditor. Therefore, the base cost used to determine the capital gain for the debtor on the waiving of the debt is equal to the expenditure the creditor incurred in creating the debt, i.e. the debt amount waived. The proceeds are the amount of the debt waived, i.e. the debt amount. Therefore the capital gain is zero.

³ *CIR v Datakor Engineering (Pty) Ltd* 1998 (4) SA 1050 (SCA), 60 SATC 503 at 510.

⁴ M Stiglingh et al Silke: *South African income tax* (2009) 768

Continuing, where the reduction or discharge of the debt have been included or taken into account as part of paragraph 3(b)(ii), paragraph 20(3), section 8(4)(m) or section 20(1)(a)(ii), paragraph 12(5) will not be applicable as is illustrated below.

Paragraph 3(b)(ii) of the Eighth Schedule to the Act

This paragraph deals with capital gains arising from the recovery or recoupment of part of the base cost of an asset that was sold in the previous year of assessment. A further capital gain will arise in the current year when any portion of the base cost that was taken into account when the capital gain or loss was determined in the previous year, is recovered or recouped in the current year of assessment. The capital gain or loss is determined from scratch and any capital gain or loss included in the previous year of assessment is set off against the newly determined capital gain or loss.⁵

The recovery or recoupment may take place in the form of a cash refund, repossession of the asset or cancellation or reduction of all or part of the debt incurred in acquiring the asset, whether by prescription or otherwise.⁶

A later reduction in the base cost of an asset due to the reduction in debt cannot be treated as a capital gain in the year that the reduction takes place, as it is taken into account in re-determining the capital gain or loss on the asset and would result in double taxation.

Paragraph 20(3) of the Eighth Schedule to the Act

This paragraph states that the base cost of the asset must be reduced by any amount that is or was allowable or is deemed to have been allowed in determining the taxable income of a taxpayer, otherwise than under the Eighth Schedule. The paragraph therefore mirrors section 8(4)(a) to (m) of the Act and prevents the double deduction of expenditure in determining taxable income.⁷

⁵ Comprehensive Guide to Capital Gains Tax Issue 2 p52

⁶ ITC 1634 (1997) 60 SATC 235(T)

⁷ Comprehensive Guide to Capital Gains Tax Issue 2 p52

In applying this paragraph in the context of paragraph 12(5), paragraph 20(3) overrides paragraph 12(5). Paragraph 20(3) will apply where X buys an asset from Y on credit and Y later waives all or part of the debt while X still holds the asset. The waiving of the debt results in the base cost of the asset to be reduced by the amount of debt waived which, in turn, will increase future capital gains on disposal of the asset. Thus, if the decrease in liability is treated as a capital gain in this instance it will result in double taxation.⁸

However, if X has disposed of the asset at the time of the waiver, X will have a capital gain under paragraph 3. But if X borrows money from Z to pay Y for the asset, and Z later waives part of the debt paragraph 20(3)(b) will not apply since there has been no recovery of the expenditure incurred by X on the asset. Instead, X will have a capital gain under paragraph 12(5) while Z will have a capital loss, subject to paragraph 56.⁹

Section 20(1)(a)(ii) of the Act

This section deals with the reduction of an assessed loss due to a compromise benefit. The section states that any assessed loss shall be reduced by the value of any benefit received by a taxpayer from a concession granted by or compromise made with any creditor whereby a liability owed by the taxpayer to the creditor has been reduced. If such an amount was therefore used to reduce an assessed loss it will not result in a capital gain in terms of paragraph 12(5) of the Eighth Schedule.

Section 8(4)(m) of the Act

The section reads as follows:

8. Certain amounts to be included in income or taxable income.—

(4)(m) 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*

⁸ Comprehensive Guide to Capital Gains Tax Issue 2 p 88

⁹ Comprehensive Guide to Capital Gains Tax Issue 2 p143

- (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.

Where an amount has been included as a recouplement under this section, it will not be deemed as part of the capital gain under paragraph 12(5).

Intra-group waiver of debt or loans

Paragraph 12(5) of the Eighth Schedule continues by dealing with the waiver of debt and loans within a group of companies as defined in section 41 of the Act. A group of companies is defined in section one of the Act and essentially refers to a group in which the controlling company directly or indirectly holds at least 70% of the equity share capital of a controlled group company. Section 41 of the Act, however, narrows this definition further as can be seen in the extract below:

“group of companies” means a group of companies as defined in section 1: Provided that for the purposes of this definition—

- (i) *any company that would, but for the provisions of this definition, form part of a group of companies shall not form part of that group of companies if—*

- (aa) *that company is a company contemplated in paragraph (c), (d) or (e) of the definition of “company”;¹⁰*
- (bb) *that company is a company contemplated in section 21 of the Companies Act, 1973 (Act No. 61 of 1973);*
- (cc) *any amount constituting gross income of whatever nature would be exempt from tax in terms of section 10 were it to be received by or to accrue to that company;*
- (dd) *that company is a public benefit organisation or recreational club that has been approved by the Commissioner in terms of section 30 or 30A; or*
- (ee) *that company is a company contemplated in paragraph (b) of the definition of “company”, unless that company has its place of effective management in the Republic; and*

- (ii) *any share that would, but for the provisions of this definition, be an equity share shall be deemed not to be an equity share if—*

¹⁰ These include companies incorporated under foreign law.

- (aa) *that share is held as trading stock; or*
 (bb) *any person is under a contractual obligation to sell or purchase that share, or has an option to sell or purchase that share unless that obligation or option provides for the sale or purchase of that share at its market value at the time of that sale or purchase;*

Where the debtor and creditor are part of the same 'group of companies', paragraph 12(5) does not apply¹¹. The creditor is therefore able to waive any debt or loan without any Capital Gains Tax implications arising for himself or for the debtor.

The definition of a 'group of companies' makes it clear that where the debtor or creditor is a trust or individual, the exclusion from paragraph 12(5) of the Eighth Schedule is not applicable. The application of paragraph 12(5) to the above-mentioned persons is discussed in Chapter 4 and 5.

However, where the debt was acquired directly or indirectly from a person who is not a member of the 'group of companies, or the debtor or creditor became members of the 'group of companies' after the debt arose and the transactions are part of a scheme to avoid tax, paragraph 12(5) will be applicable¹².

The waiver of debt as part of the liquidation, winding up, deregistration or final termination of a company

Where the debtor is a company which is a connected person in relation to the creditor and the reduction or discharge of debt¹³ was made in the course or in anticipation of liquidation, winding up, deregistration or final termination of the corporate existence of that company, paragraph 12(5) will not apply¹⁴.

This provision does not apply to loans owed by a trust that is unable to pay its debts, as a trust is not part of a 'group of companies' as defined.

However, if the debtor became a connected person in relation to the creditor after the debt¹⁵ arose and the transactions were part of a scheme to avoid tax, paragraph 12(5) will apply¹⁶.

¹¹ Comprehensive Guide to Capital Gains Tax Issue 3 95

¹² Comprehensive Guide to Capital Gains Tax Issue 3 96

¹³ Provided it does not exceed the expenditure that the creditor incurred

¹⁴ Comprehensive Guide to Capital Gains Tax Issue 3 97

¹⁵ Or any substituted debt

Paragraph 34 of the Eighth Schedule to the Act

Even though paragraph 12(5) of the Eighth Schedule does not specifically mention paragraph 34, the paragraph still needs to be taken into account in evaluating the application of paragraph 12(5). Where a person reduces or discharges a debt owed by that person to a creditor by disposing of an asset to that creditor, that asset must be treated as having been acquired by the creditor at a cost equal to the market value of that asset at the time of that disposal, which cost must be treated as an amount of expenditure actually incurred and paid for the purposes of paragraph 20(1)(a) (i.e. the base cost).

CHAPTER 3

INTERACTION OF PARAGRAPH 12(5) OF THE EIGHTH SCHEDULE WITH PARAGRAPH 56 OF THE EIGHTH SCHEDULE TO THE ACT

Since paragraph 12(5) only deals with the Capital Gains Tax consequences for the debtor when debt is waived, we look at paragraph 56 of the Eighth Schedule which deals with the disposal by a creditor of a debt owed by a connected person for the Capital Gains Tax consequences for the creditor.

Paragraph 56 of the Eighth Schedule reads as follows:

'56. Disposal by creditor of debt owed by connected person.—(1) Where a creditor disposes of a claim owed by a debtor, who is a connected person in relation to that creditor, that creditor must disregard any capital loss determined in consequence of that disposal.

(2) Despite paragraph 39, subparagraph (1) does not apply in respect of any capital loss determined in consequence of the disposal by a creditor of a claim owed by a debtor, to the extent that the amount of that claim so disposed of represents—

- (a) a capital gain which is included in the determination of the aggregate capital gain or aggregate capital loss of that debtor by virtue of paragraph 12(5);*
- (b) an amount which the creditor proves must be or was included in the gross income of any acquirer of that claim;*
- (c) an amount that must be or was included in the gross income or 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); or*
- (d) a capital gain which the creditor proves must be or was included in the determination of the aggregate capital gain or aggregate capital loss of any acquirer of the claim.'*

In general paragraph 56 states that where a creditor disposes of his claim owed to him by a debtor, who is a connected person to him, he must disregard any capital loss on such a disposal.

Paragraph 56 is applicable despite the provisions of paragraph 39 of the Eighth Schedule, discussed below. In other words, paragraph 56 overrides paragraph 39¹⁷.

Furthermore, the provisions of paragraph 56 does not apply to the extent that the amount of the claim disposed is a capital gain that is included in the Capital Gains Tax calculation of the debtor under the provisions of paragraph 12(5); or to the extent that the amount was included in the gross income of any acquirer of that claim; or to the extent that the amount 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 under section 20(1)(a)(ii); or a capital gain that the was included in the Capital Gains Tax calculation of the acquirer of that claim¹⁸.

Paragraph 39 of the Eighth Schedule to the Act

Paragraph 39 deals with capital losses determined in respect of disposals to certain connected persons. It stipulates that when determining the aggregate capital gain or aggregate capital loss of the creditor, any capital loss determined in respect of the disposal of an asset to any person who was a connected person in relation to that person immediately before that disposal; or which is immediately after the disposal a member of the same group of companies as that person; or a trust with a beneficiary which is a member of the same group of companies as that person is disregarded¹⁹.

A capital loss disregarded as such may be deducted from that person's capital gains determined in respect of disposals of assets during that year or subsequent years to the same person to whom the disposal giving rise to that capital loss was made, if at the time of those subsequent disposals, that person is still a connected person in relation to that person.

In other words, paragraph 39 ring-fences the capital losses arising from transactions with connected persons. Paragraph 56, however, overrides this

¹⁷ Comprehensive Guide to Capital Gains Tax Issue 3 85

¹⁸ M Stiglingh et al Silke: *South African income tax* (2009) 759

¹⁹ Comprehensive Guide to Capital Gains Tax Issue 3 287

paragraph in some instances (as described at the start of this chapter) and therefore some capital losses are not ring-fenced.

Where a capital loss arises from the waiver of a loan to a trust, and the capital gain in the trust is attributed back to the 'donor' under, for instance paragraph 70 of the Eighth Schedule to the Act or to a resident beneficiary under paragraph 80(2) of the Eighth Schedule to the Act, the creditor that waived the loan will not be able to claim the capital loss. This is the case because the capital gain will have been removed from the trust (as it was attributed or distributed), and hence paragraph 56(2)(a) of the Eighth Schedule²⁰ cannot provide relief²¹.

Where the debtor and creditor is part of the same 'group of companies' as contemplated in paragraph 12(5) the creditor company will not be able to claim a capital loss in respect of the cancellation or discharge of the debt owed to it in terms of paragraph 56 (unless paragraph 56(2)(b)²² or (c)²³ applies).

If paragraph 12(5) had resulted in a capital gain in the hands of the debtor, the creditor would have been able to a capital loss deduct the assessed loss under paragraph 56. However, since the capital gain will not arise, paragraph 56 will not apply, and the loss is denied. This ensures that there is a symmetrical treatment of both the debtor and the creditor.²⁴

The relief provided under paragraph 12(5) with relation to a 'group of companies' is compulsory. Accordingly, a debtor and creditor group companies cannot elect out of the relief, even when it would be more advantageous to do so. An example of advantageous would be when the debtor has an assessed loss that would otherwise have absorbed any paragraph 12(5) capital gain, thereby enabling

²⁰ This section states that the capital loss for the creditor will not be ring fenced if the corresponding gain was included in the aggregate capital gain or aggregate capital loss of the debtor.

²¹ Comprehensive Guide to Capital Gains Tax Issue 2 p85

²² If the corresponding capital gain was included in the gross income of any acquirer of the claim.

²³ If the amount was included in the gross income or 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

²⁴ Comprehensive Guide to Capital Gains Tax Issue 2 p94

the creditor to claim a capital loss, thereby reallocating the tax liability within the group.²⁵

Similarly, the creditor will not be entitled to a capital loss where the debtor company and the creditor are connected persons and the paragraph 12(5) exclusion is applicable to the debtor.²⁶

As can be deduced from the information in Chapter 2 and 3, paragraph 12(5) of the Eighth Schedule, as well as, paragraph 56 of the Eighth Schedule can have far reaching effects if applied to companies within a group if the group structure is not properly set up with reference to tax planning. As is evident from the above, it is advisable to ensure that companies within the group qualifies within the definition of 'group of companies' in section 1 and 41 of the Act. Accordingly, the application of paragraph 12(5) and 56 of the Act will not apply within the group.

²⁵ Comprehensive Guide to Capital Gains Tax Issue 2 p94

²⁶ Comprehensive Guide to Capital Gains Tax Issue 2 p100

CHAPTER 4

APPLICATION OF PARAGRAPH 12(5) TO TRUSTS

In an attempt to reduce estate duty payable on the death, many individuals employed various structures or transactions over the years. Many individuals advanced monies to their heirs on loan or sold assets to them. They then proceeded to waive payment of the loan created when the asset was sold or the cash advanced in their will. Alternatively, testators or testatrices disposed of growth assets to their family trust, during their lifetime on loan account. Upon death the testator simply bequeathed the debt (the balance of the loan account owed by the trust) to the family trust, thereby cancelling the debt.²⁷

The favourable consequences of doing so, however, have changed and are much more limited with the introduction of Capital Gains Tax with effect from 1 October 2001, the further Revenue Laws Amendment Act 74 of 2002, as well as, more recent tax court cases.

After the introduction of Capital Gains Tax in 2001, two paragraphs could be applicable in cases as discussed above, namely, paragraph 40 of the Eighth Schedule to the Act and paragraph 12(5) of the Eighth Schedule. Paragraph 40 of the Eighth Schedule deems the heir or legatee to have acquired the inherited assets at market value, which was in conflict with paragraph 12(5) of the Eighth Schedule which deems the debt to be acquired by the heir or legatee at a base cost of nil. Many commentators expressed the view that the provisions of paragraph 40 of the Eighth Schedule should take precedence, obviously, because this was more beneficial for the taxpayer. With the introduction of the Revenue Laws Amendment Act 74 of 2002, however, any doubt regarding which paragraph is applicable was removed. The Amendment Act, amended paragraph 40 of the Eighth Schedule in such a way as to make it subject to paragraph 12(5) of the Eighth Schedule. This means that paragraph 12(5) of the Eighth Schedule takes

²⁷ Comprehensive Guide to Capital Gains Tax Issue 2 p92

precedence and a discharge of debt in the manner described above will trigger a Capital Gain in the hands of the heir or legatee.²⁸

This issue came before the Gauteng Tax Court in ITC 1793²⁹ and later again in ITC 1835³⁰ in the Kwazulu Natal Tax Court, each of which are discussed in more detail below.

ITC 1793

The facts of the case³¹

The deceased had sold some shares to the taxpayer, a family trust, on loan account some years earlier. On her death, the deceased bequeathed an amount equal to the amount owed to her, by the family trust, to the family trust. The Commissioner regarded the bequest as a discharge of debt for no consideration as contemplated in paragraph 12(5) of the Eighth Schedule to the Act, stating that the deceased (the creditor) had discharged the debt for no consideration by operation of law when her last will and testament became effective upon her death.³² Accordingly, a deemed capital gain was created in the hands of the family trust in accordance with paragraph 12(5) of the Eighth Schedule to the Act.

The taxpayer objected, holding that paragraph 12(5) of the Eighth Schedule to the Act only applies where a debt or liability is written off by agreement, it does not apply to testamentary dispositions (at least not to legacies or heirs) and that the legacy from the testatrix (the bequest) created a claim against the estate of the testatrix, the effect of this was to cancel out the taxpayer's liability to the estate by way of set-off³³, which operated automatically as a matter of law. Consequently, paragraph 12(5) did not apply.^{34 35}

²⁸Comprehensive Guide to Capital Gains Tax Issue 2 p92

²⁹ (2005) 67 SATC 256 (G)

³⁰ (2008) 71 SATC 105 (K)

³¹ Emslie, T et al *Supplement to Income Tax Cases & Materials* 3ed (2008) 169 & Comprehensive Guide to Capital Gains Tax Issue 2 92-93

³²Comprehensive Guide to Capital Gains Tax Issue 2 p93

³³ Set-off is the extinguishing of debts owed reciprocally by two parties. There are four requirements for set-off to take place.

- 1) The debts must be similar in nature, for example two monetary debts or two debts for the delivery of identical kinds of subject-matter.
- 2) The debts must be liquidated. A debt is liquidated when its exact monetary value is certain or can easily be ascertained.

Held by the Court

Bertelsmann J held the following in his judgement.³⁶

Whether an asset was disposed of is critical to the determination of the question whether a taxable capital gain had been created. In determining whether there had been a disposal, paragraph 1 of the Eighth Schedule needs to be taken into account.

The word 'disposal' is defined in paragraph 1 as:

'an event, act, forbearance or operation of law envisaged in paragraph 11 or an event, act, forbearance or operation of law which is in terms of this Schedule treated as the disposal of an asset'.

Paragraph 11(1)(b) defines a disposal as:

'the forfeiture, termination, redemption, cancellation, surrender, discharge, relinquishment, release, waiver, renunciation, expiry of abandonment of an asset'.

In addition to the above two paragraphs the Legislature provided in paragraph 12 of the Eighth Schedule for certain events to be regarded as disposals, even though they might not otherwise qualify as such.³⁷ As mentioned in an earlier Chapter, paragraph 12(5) applies where a debt owed by a person (the debtor) to a creditor is reduced or discharged by that creditor either for no consideration or for a consideration which is less than the amount by which the face value of the debt had been so reduced or discharged. Effectively paragraph 12(5) renders the amount of the discharge taxable as a capital gain.

Accordingly, paragraph 12(5) of the Eighth Schedule decreed that the acquisition of the claim was deemed to have been disposed of by the legatee or heir for proceeds equal to the reduction or discharge of the claim they (the heir or legatee) become beneficiary to through the testatrix.

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- 3) The debts must be claimable. A debt which is already claimable cannot be extinguished by one which is not yet claimable.
 - 4) The debts must be between the same persons. The debts must in fact be reciprocal, that is, they must exist between the same parties in the same capacities.

Set-off automatically terminates the obligations by operation of law. - Havenga, P et al *General Principles of Commercial Law* 6ed (2007) 145

³⁴ Emslie, T et al *Supplement to Income Tax Cases & Materials* 3ed (2008) 169

³⁵ ITC 1793 page 257 of 67 SATC 256

³⁶ Emslie, T et al *Supplement to Income Tax Cases & Materials* 3ed (2008) 169

³⁷ See chapter 2 for the extract dealing with paragraph 12(5)

The taxpayer argued that the discharge of his obligation did not amount to an event that ought to be regarded as a disposal by the trust (or acquisition by the trust), but should rather be regarded as a set-off. The argument was that an obligation was created in the estate in favour of the trust (by way of the testamentary disposition). This obligation equalled the liability which the taxpayer had towards the estate and accordingly, set-off took place.

The tax court held that the taxpayer's argument could not succeed for two reasons. Firstly, the situation through which set-off could occur was created by an act on the part of the testatrix, namely the discharge of the debt by way of bequest. The testatrix, thus, disposed of asset by discharging the trust's debt for no consideration. Secondly, it was not the act of set-off which rendered the amount taxable in terms of paragraph 12(5), but the act which amounted to the discharge of the debt, namely, the drawing up of the last will and testament and it coming into operation on the date of death.

Furthermore, paragraph 11(1) of the Eighth Schedule expressly includes any operation of law which resulted in the extinction of an asset. The estate's asset was extinguished by the operation of law, namely the set-off, which in turn was created by a disposition by the testatrix. Consequently, this transaction fall squarely within the ambit of the provisions of paragraph 12(5) and paragraph 40(2) of the Eighth Schedule, as the provisions of paragraph 12(5) determines the operation of paragraph 40(2) of the Eight Schedule in respect of the taxpayer.

The appeal was dismissed and the Commissioner's assessment for Capital Gains Tax was not set aside.

ITC 1835

Facts of the case³⁸

The testatrix and her husband executed a joint will. Upon her death she bequeathed the residue of her estate to the taxpayer, an inter vivos trust, as sole heir. The residue was subject to a usufruct in favour of the surviving spouse. One of the assets falling into the residue of the estate was a loan account owed to the testatrix (the deceased) by the taxpayer (the trust)³⁹.

In winding up the estate, the executor of the estate did not collect the amount of the loan account from the trust, but awarded such amount to the trust as part of the residue of the testatrix's estate⁴⁰.

Relying on the judgement in ITC 1793, the Commissioner levied capital gains tax on the trust in terms of paragraph 12(5), contending that, in terms of the will, the debt owed by the trust had been discharged for no consideration⁴¹.

It was conceded by the Commissioner that if the executor had demanded and received payment of the debt from the trust, no capital gains tax would have been payable. The Commissioner further submitted that in accordance with the wording of the will, the executor correctly elected not to collect the debt, but award the loan to the trust.⁴²

It was submitted on behalf of the taxpayer (the trust) that the wording of the will in this case was fundamentally different from the wording in the will dealt with in ITC 1793. Accordingly, the taxpayer felt that the solution of the matter was to found in the wording of the will, rather than the method employed in winding up

³⁸ Emslie, T et al *Capital Gains Tax – Bequest of a loan account owed by a trust to that trust as part of the residue of an estate – whether debt discharged for no consideration* The Taxpayer (Feb 2009) 33 - 34 & Comprehensive Guide to Capital Gains Tax Issue 2 93

³⁹ Emslie, T et al *Capital Gains Tax – Bequest of a loan account owed by a trust to that trust as part of the residue of an estate – whether debt discharged for no consideration* The Taxpayer (Feb 2009) 33 - 34 & Comprehensive Guide to Capital Gains Tax Issue 2 93

⁴⁰ Emslie, T et al *Capital Gains Tax – Bequest of a loan account owed by a trust to that trust as part of the residue of an estate – whether debt discharged for no consideration* The Taxpayer (Feb 2009) 33 - 34 & Comprehensive Guide to Capital Gains Tax Issue 2 93

⁴¹ Emslie, T et al *Capital Gains Tax – Bequest of a loan account owed by a trust to that trust as part of the residue of an estate – whether debt discharged for no consideration* The Taxpayer (Feb 2009) 33 - 34 & Comprehensive Guide to Capital Gains Tax Issue 2 93

⁴² Emslie, T et al *Capital Gains Tax – Bequest of a loan account owed by a trust to that trust as part of the residue of an estate – whether debt discharged for no consideration* The Taxpayer (Feb 2009) 34

the estate and that the intention of the testatrix expressed in her will should be regarded as the decisive factor.

Held by the Court

Lacock J held the following in his judgement.

It was clear from the wording of the will that the intention of the testatrix had been that the loan account should form part of the residue of the estate, and that it was not to be separately bequeathed to the trust as a legacy. Furthermore, the trust was at all material times in a liquid position and able to repay the loan on demand, should the testatrix requested it before her death⁴³.

It was a joint will and the debt had been due to the testatrix and not her husband. The testators jointly disposed of the residue of their estates in the will and showed that they had in mind no specific bequests of any of their individual or separate assets to the trust.

If it had been the intention of the testatrix to relinquish her claim in favour of the trust, she could easily have expressed her intention in the will. Accordingly, the loan formed part of the residue of the estate and it was not her intention to dispose of the claim for no consideration as contemplated in paragraph 12(5). This is clearly stated in the following extract from the Lacock J's judgement:

*'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.'*⁴⁴

Since the facts of this case could be clearly distinguished from those in ITC 1793 and taking the arguments above into account, the judgement in ITC 1793 was found to not be applicable to the facts of this case. The question, however, remained whether the method employed by the executor in winding up the estate (whereby the claim was never recovered from the trust, but merely awarded as

⁴³ Emslie, T et al *Capital Gains Tax – Bequest of a loan account owed by a trust to that trust as part of the residue of an estate – whether debt discharged for no consideration* The Taxpayer (Feb 2009) 33 - 34 & Comprehensive Guide to Capital Gains Tax Issue 2 93

⁴⁴ ITC 1835 71 SATC 105 (K)

part of the residue), brought this award within the purview of paragraph 12(5) of the Eighth Schedule⁴⁵.

It was held that the answer to the above question lay within the wording of paragraph 12(5). As quoted above, Lacock J stated in his judgement that paragraph 12(5) contemplates an act by the creditor whereby he or she consciously intended to discharge the debt for no consideration. The determining factor being the intention of the creditor to dispose of the debt and not the manner in which the estate was administered. Accordingly, the manner in which the executor wound up the estate in question will not affect the application of paragraph 12(5).

The taxpayer's appeal was allowed and the Commissioner's assessment for Capital Gains Tax was set aside.⁴⁶

APPLICATION

It has been held that ITC 1793 were incorrectly decided. Where a testator bequeaths an amount of money to a legatee (who owes him money) and the bequest serves to settle the debt owed, it does not 'discharge the debt for no consideration' as contemplated in paragraph 12(5) of the Eighth Schedule, but rather settles the debt in full.⁴⁷ It is also immaterial whether the same amount or a different amount is bequeathed.

Furthermore, in such circumstances, bequeathing an amount of money to a legatee is held to not be a discharge of debt. If the estate is insolvent, the debt may remain unpaid (undischarged). Accordingly, it can be argued that the same is true in the case were the residue of the estate is bequeathed to the debtor.⁴⁸

⁴⁵ Emslie, T et al *Capital Gains Tax – Bequest of a loan account owed by a trust to that trust as part of the residue of an estate – whether debt discharged for no consideration* The Taxpayer (Feb 2009) 33 - 34 & Comprehensive Guide to Capital Gains Tax Issue 2 93

⁴⁶ Emslie, T et al *Capital Gains Tax – Bequest of a loan account owed by a trust to that trust as part of the residue of an estate – whether debt discharged for no consideration* The Taxpayer (Feb 2009) 35

⁴⁷ Emslie, T et al *Capital Gains Tax – Bequest of a loan account owed by a trust to that trust as part of the residue of an estate – whether debt discharged for no consideration* The Taxpayer (Feb 2009) 35

⁴⁸ Emslie, T et al *Capital Gains Tax – Bequest of a loan account owed by a trust to that trust as part of the residue of an estate – whether debt discharged for no consideration* The Taxpayer (Feb 2009) 35

A further question to be raised is what the interaction of paragraph 12(5) will be with paragraph 56 of the Eighth Schedule to the Act in the case of trusts and the types of bequeaths as discussed above. Paragraph 12(5) was introduced as a complementary paragraph to paragraph 56 in order to ensure symmetry in the treatment of capital gains and capital losses when debt is waived.

Honiball and Olivier addresses this question in their book 'The taxation of trusts in South Africa' as follow:

'...symmetry is not guaranteed in all situations as for example in pre-valuation date debts and debts owed to a deceased estate. In effect an application of paragraph 12(5) often actually achieves the opposite as a debtor will be taxed on the capital gain resulting from the application of the paragraph whilst the creditor will not be in the position to claim the loss because the Eighth Schedule does not provide for such a loss to be claimed. This may happen, for example, if an ordinary loan is made which does not qualify for a deduction under the Act and the creditor releases the debtor in his or her last will. In this case a capital gain will arise in the hands of the heir or legatee, but the deceased estate will, it appears, not be entitled to a corresponding capital loss because it is deemed to award the loan to the heir at base cost on the date of death in terms of paragraph 40(2)(a). As paragraph 40(2) is expressly made subject to paragraph 12(5), it may well happen that the heir or legatee will realise a capital gain and the estate (creditor) may be unable to claim the capital loss as the estate is deemed to have disposed of the asset at base cost (paragraph 40(2)(a)).'⁴⁹

They go further to argue that the only relief provided can be found in the provisions of paragraph 56(2)(a) of the Eighth Schedule which provides that a loss incurred on a disposal of debt between connected persons can be recognised where the debtor is taxed on the gain under the provisions of paragraph 12(5). According to Honiball and Olivier, this is the only limited instance where symmetry in the treatment between gains and losses in the tax system is achieved⁵⁰.

IMPLICATION

Although the South African Revenue Services seems quite adamant to apply paragraph 12(5) of the Eighth Schedule where loans are bequeathed in a will, there are some measures that can be taken in order to try and avoid falling within the ambit of paragraph 12(5).

⁴⁹ Honiball, M et al *The taxation of trusts in South Africa* (2009) 160

⁵⁰ Honiball, M et al *The taxation of trusts in South Africa* (2009) 160

Given the Commissioner's concession in ITC 1835, it appears that, although it might not be practical, ensuring that the debt owing to the creditor is collected from the trust and the funds paid into the estate before the residue or bequest then paid to the trust (as legatee), might be the safest way to ensure the paragraph 12(5) is not applied by the Commissioner despite the Lacock J's judgement in ITC 1835 which states that manner in which the executor administrates the estate has no effect on the application of paragraph 12(5)⁵¹.

Based on the judgement in ITC 1835 and the facts of that case it appears to be acceptable for the will to leave the residue of the estate to the creditor as sole heir, even this residue includes a loan payable by the trust to the estate (or testatrix)⁵².

Further alternatives can be to roll over the claim against the trust to the surviving spouse by way of specific bequeath. The trust will therefore still owe the debt albeit to another person. Or leave the claim against the trust to a third party and bequeath a cash amount to the debtor (trust) to enable it to repay the loan to the third party⁵³.

Lastly, quantify the loan amount owing, bequest a specified amount to the trust, but preferably not the same amount as the loan owing while ensuring that the trust has sufficient cash flow at all material times to repay the loan on demand.⁵⁴

Since both court decisions were made by the Tax Court and none taken on appeal to a Provisional Court, the decisions does not bind the South African Revenue Services. Although the above measures will most probably lessen the risk of the South African Revenue Services applying the provisions of paragraph 12(5), they are still at liberty to argue any application to the contrary.

⁵¹ McKend, F *Bequest of a loan – The vexing question of how to avoid triggering capital gains tax* Cliffe Dekker Hofmeyr Trusts and Estates Alert (July 2010)

⁵² McKend, F *Bequest of a loan – The vexing question of how to avoid triggering capital gains tax* Cliffe Dekker Hofmeyr Trusts and Estates Alert (July 2010)

⁵³ McKend, F *Bequest of a loan – The vexing question of how to avoid triggering capital gains tax* Cliffe Dekker Hofmeyr Trusts and Estates Alert (July 2010)

⁵⁴ McKend, F *Bequest of a loan – The vexing question of how to avoid triggering capital gains tax* Cliffe Dekker Hofmeyr Trusts and Estates Alert (July 2010)

CHAPTER 5

APPLICATION OF PARAGRAPH 12(5) WITH REFERENCE TO SURETYSHIP AGREEMENTS AND THE PRESCRIPTION OF DEBT

Paragraph 12(5) and paragraph 56 of the Eighth Schedule reads as follows:

'12. Events treated as disposals and acquisitions.—

(5) (a) Subject to paragraph 67, this subparagraph applies where a debt owed by a person to a creditor has been reduced or discharged by that creditor—'

'56. Disposal by creditor of debt owed by connected person.—(1) Where a creditor disposes of a claim owed by a debtor, who is a connected person in relation to that creditor, that creditor must disregard any capital loss determined in consequence of that disposal.'

Each of these paragraphs refers to 'that creditor' which led me to the question of what happens in the case of a suretyship agreement and how this agreement would interact with paragraph 12(5) and paragraph 56 and whether these paragraph's provisions will be applicable.

In short, a contract of suretyship is a personal security given⁵⁵ by a person (usually related to the debtor), which grants the creditor the right, in case of non-payment of the debt, to secure payment by means of a personal right against the person providing the security.⁵⁶

General Principles of Commercial Law defines a contract of suretyship as follows:⁵⁷

'The contract of suretyship is an agreement by means of which one person (the surety) renders himself or herself liable towards a creditor for the proper compliance of the obligations of a debtor. In such a case there are, therefore, two debtors, namely the debtor in the first agreement (the principal debtor) and the debtor in the contract of surety (the surety). The principal debtor remains liable in terms of his or her agreement with the creditor. The liability of the surety is additional to this.'

⁵⁵ In writing and signed by or on behalf of the surety.

⁵⁶ Havenga, P et al *General Principles of Commercial Law* 6ed (2007) 359

⁵⁷ Havenga, P et al *General Principles of Commercial Law* 6ed (2007) 359

Therefore, in a situation where A owes B money and C signed a suretyship agreement as surety; would the provisions of paragraph 12(5) of the Eighth Schedule be applied to A when he indicates that he is unable to pay the debt and requires C to pay the debt in terms of the suretyship agreement. Linked to this is the question what rights C has to claim the debt back from A and whether paragraph 12(5) or paragraph 56 of the Eighth Schedule will come into play at the later stage if A fails to pay the debt back to C.

In answering the above question we need to look at the rights linked to a suretyship agreement. A surety's obligation only becomes enforceable if the principal debtor defaults in the performance of his principal obligation⁵⁸. In other words were A indicates that he is unable to pay the debt to B. Furthermore, a surety who has settled the principal debt will always enjoy a right of recourse against the principal debtor for the amount paid as well as any costs reasonably incurred.⁵⁹ This causes that the debt owing by A is not waived, he now merely owns it to a different creditor. Accordingly the provisions of paragraph 12(5) of the Eighth Schedule to the Act will not be applicable at this stage as A's debt was not waived. Furthermore, the creditor had not discharged the debt and had received the debt owing to him and has no reason to invoke the provisions of paragraph 56 of the Eighth Schedule to the Act.

Should A later fail to pay the debt owing to C, the provisions of paragraph 12(5) of the Eighth schedule to the Act will most likely be applicable to A. Furthermore, provided that the capital gain is included in the taxable income of A, C will be in a position to benefit from the provisions of paragraph 56 of the eighth Schedule.

It is interesting to note that in accordance with The General Law Amendment Act 50 of 1956, suretyship agreements are required to be in writing

⁵⁸ Havenga, P et al *General Principles of Commercial Law* 6ed (2007) 360

⁵⁹ Havenga, P et al *General Principles of Commercial Law* 6ed (2007) 360 & 361

and signed by, or on behalf of, the surety in order to be valid.⁶⁰ However, very often in practice connected parties will enter into verbal suretyship agreements for debts between group companies or with other connected parties. The question is whether the surety has a recourse against the principle debtor in such instances and, if not, whether the principle debtor will then fall within the provisions of paragraph 12(5) of the Eighth Schedule to the Act.

Where the suretyship agreement is invalid, it could be argued that A no longer has a debt owing once C pays B and will therefore have a capital gain in terms of paragraph 12(5). Alternatively, it could be argued that because the debt was not waived by 'that creditor' (i.e. B) as contemplated in paragraph 12(5), but rather by C due to an invalid suretyship agreement, there will be no capital gain in the hands of A.

Whether C will be able to benefit under the provisions of paragraph 56 of the Eighth Schedule will be reliant on the treatment of the capital gain in the hands of C.

The South African Revenue Service's Guide to Capital Gains tax (issue 2) states that for paragraph 12(5) to apply the debt owed must be reduced or discharged by the creditor, (i.e. 'that creditor' as contemplated in the paragraph itself). It further states that in a discharge of debt, a creditor will more often than not be a party to the discharge, albeit indirectly, or through an act of omission and that the fact that a debt is discharged by operation of law does not necessarily mean that the creditor has not taken an action to discharge a debt.⁶¹

For example, in ITC 1387⁶² and ITC 1448⁶³ it was held that the act of adiation was a donation even though what followed was by operation of law under s 37 of the Administration of Estates Act.

One of the ways that a debt can be discharged by operation of law is by prescription.

⁶⁰ Havenga, P et al *General Principles of Commercial Law* 6ed (2007) 98

⁶¹ Comprehensive Guide to Capital Gains Tax Issue 2 88

⁶² (1984) 46 SATC 121 (T).

⁶³ (1988) 51 SATC 58 (C).

A person may acquire rights or be released from obligations through the passage of time by means of prescription. The basic rule is that the period needed for prescription starts as soon as the claim becomes enforceable and the general period before prescription is usually three years, with some exceptions.⁶⁴ The South African Revenue Services' Capital Gains Tax Guide continues to state that a debt that is allowed to prescribe through the effluxion of time falls within the ambit of paragraph 12(5). The failure to enforce payment of a debt by the creditor is regarded as an act of omission by the creditor.⁶⁵

⁶⁴ Havenga, P et al *General Principles of Commercial Law* 6ed (2007) 149 & 148

⁶⁵ Comprehensive Guide to Capital Gains Tax Issue 2 88

CONCLUSION

In conclusion the implication of paragraph 12(5) of the Eighth Schedule is complex with far reaching effects in both the corporate world and the estate planning of individuals. The interaction of this paragraph with the various other sections of the Act, as investigated in earlier, as well as, the findings by the Tax Court needs to be taken into account when structuring loan agreements, drafting wills and setting up groups of companies.

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