The intended or unintended income tax consequences arising from losses on loans- a case study analysis

by

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Supervisor :Prof Jennifer Roeleveld

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DECLARATION

I NOMHLE CAROL NKUMANDA , 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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Chapter 1

1.1 Introduction

Losses in respect of loans occur in various circumstances. These include a deliberate action by the creditor to reduce or discharge a debt (sometimes referred to as "debt forgiveness or waiver"), a loss on a loan because of the liquidation of a debtor, the sale of a loan for an amount less than its face value, the prescription of debts and the conversion of a loan to shares of which the market value is less than the face value of the loan.

Depending on the nature of the loan such losses could have various income tax or capital gains tax implications for both the debtor and creditor, such as taxable recoupments, reduction of assessed losses or capital gains or losses. The tax effects may differ when the parties are connected or are part of the same group of companies.

Essentially, there are three core provisions in the Income Tax Act 58 of 1962 (ITA) which are applicable namely, section 8(4) (m), S20 (1)(a)(ii), and paragraph 12(5) of the Eighth Schedule. Identifying the facts resulting to a loss on a loan is not the tricky part but rather application of the correct section to those particular facts. The matter is sometimes further complicated by the terminology used and words in the ITA that have not yet been interpreted or defined in the Act.

There is often uncertainty where debt waivers are concerned, however court decisions in case law can assist with the interpretation of certain aspects contained in the aforementioned sections.

This research will introduce the concept of debt forgiveness and highlight various definitions and legal concepts such as prescription, compromise, and other forms of debt relinquishments. Part of the introduction will briefly discuss the treatment of debt relief in certain international countries namely, Belgium, Denmark, Japan, Switzerland and the Netherlands.

Chapter 1 will also discuss the two cases dealing with the application of paragraph 12(5) of the Eighth Schedule of the ITA namely ITC 1793 and the case number 12399 (the unreported decision of the Kimberley Tax Court taken in January 2009

Chapter 2 will deal briefly with the main income tax sections applicable namely, s 8(4)(m), s20, and paragraph 12(5) of the Eighth Schedule taking into account other authors views on the issues at hand. As losses on loans further result to capital gains tax consequences, it is important to briefly discuss the four building blocks of the Eighth Schedule which deals with capital gains and losses namely asset, proceeds, disposal and base cost.

Additional sections such as paragraph 39 and 56 of the Eighth Schedule will also be dealt with focusing on issues concerning connected persons. It is necessary to also examine the law dealing with donations and dividends as there are circumstances where these may give rise to debt forgiveness.

A case study will be presented in chapter 3, which will assist in the identification and subsequent application of the relevant sections of the ITA. In chapter 4 The applicable case law and various definitions will be discussed as they relate to the various scenarios presented in the case study.

The last Chapter will compare the South African tax system with that of some of other countries and will converse the differences and similarities relating to the treatment of the debt waivers.

I will make use of relevant Income Tax provisions, case law, articles, journals and various tax law textbooks in trying to address various issues that arise from each case study.

The focus of the paper is to introduce (and maybe add to) the existing problems discussed by various authors and highlight issues that are faced by taxpayers when dealing with losses on loans. The aim is to apply the relevant income tax provisions to each scenario in

the case study and then to reach a justifiable and logical conclusion. The complexity surrounding the application of these provisions will also be illustrated.

1.2. Definitions and concepts

1.2.1 Compromise

A compromise (settlement, *transactio),* is the settlement by agreement of disputed obligations, whether contractual or otherwise.[1] The agreement is characterized by uncertainty as to the existence or terms of a legal relationship and parties agree to regulate their relations by creating a new set of obligations between them.[2] A compromise has the ability to terminate uncertainties and is utilized by parties to avoid the inconvenience, costs and risk inherent in resorting to other methods of resolving disputes.[3]

Even though the contract may be described by the parties, the court will look at substance rather than form in determining whether a particular obligation or dispute has been compromised.[4] Distinct from a novation, a compromise is binding even though the original contract was invalid or illegal.[5]

A party alleging that a compromise has been reached bears the onus to prove its existence. This is because a compromise is a form of a novation and involves the waiver of existing rights (or claimed rights). It must be as clearly and unambiguously proved as any other waiver or novation.[6] Further, a compromise is a type of a contract and parties must have the capacity to contract with each other and comply with all the requirements of a valid contract. Furthermore, a compromise may be set aside on the

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[1] *RH Christie. 2006. The Law of Contract in South Africa: 5th Edition. Lexisnexis Elecronic version Page 446*

[2] *Van Der Merwe, Van Huyssteen, Reinecke, Lubbe. 2007. Contract General Principles:, Third Edition , Landsdowne: Juta law, Page 538*

[3] *Supra 538*

[4] *RH Christie. 2006. The Law of Contract in South Africa: 5th Edition. Lexisnexis Elecronic version,Page 446*

[5] *Supra 446*

[6] *Supra*

grounds of fraud or *iustus error*.[7] The latter statement finds support in the relevant case of *Wessels v Badenhorst where* Barry AJP said;

> *"In a proper case a compromise (like any other contract) can be set aside either on the ground of fraud or iustus error. In the case of the latter ground the mistake must be with regard to facts which affect the validity of the transaction and not, as Bristowe J points out in Natal Bank v Kuranda 1907 TH 155 167, ignorance of a point which it is intended to compromise."*[8]

Certain parties such as lawyers and advocates may have the power to compromise on behalf of their clients in accordance with what was said by Hutton J in *Alexander v Klitzke 1918 EDL 87 88*:

> *"The authority of a power of attorney which is filed by the client, to carry his case to a final end and determination does include authority to make a bona fide compromise in the interests of his client, and at any rate, if the client wishes to repudiate such a compromise made on his behalf, then I certainly think that the repudiation should be a timeous one.*[9]

An advocate may be briefed to conduct such a case and Rule 41(4) of the Uniform Rules does not require a written settlement of a suit to be signed by parties[10]. A mere instruction to claim an amount is not sufficiently wide to include power to compromise as this will depend on the nature of the instruction but the dictum quoted above will also find application in the case of an advocate.[11]

Executors and administrators have the power to compromise in the interests of the estate and where the compromise includes anything for which the leave of the court is required, that leave must be obtained.[12] The shares of co-debtors and co-creditors in a compromise are determined according to the ordinary rules applicable to such parties.[13]Lastly, any

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[7] *Supra*
[8] *Wessels v Badenhorst 1939 TPD 465 459*
[9] *Supra*
[10] *Siebert & Honey vVan Tonder 1981 SA 146 (O)*
[11] *RH Christie. 2006. The Law of Contract in South Africa: 5th Edition. Lexisnexis Elecronic version Page 446*
[12] *Supra*
[13] *Supra*

legal relationship that existed prior to a compromise is extinguished.[14] Further, a compromise brings any legal proceeding that is already instituted to an end and bars further legal proceedings in respect of the original or disputed cause of action.[15]

1.2.2 Prescription

Prescription, generally described, is when repayment of a debt can no longer be enforced. The Prescription Act 68 of 1969 came into operation on 1 December 1970, repealing Act 18 of 1943 which still finds application to any debts which arose before 1 December 1970.[16]

The Prescription Act is not a complete codification of the law of extensive prescription, so common law rules that are not inconsistent with the provision of the Act remain in force.[17] Wessels in para 2748-2848 deals with common law and the 1943 Act below;[18]

> *"The Act covers acquisitive prescription, with which we are not here concerned, and the extinctive prescription of debts of all types. We are here concerned only with the extinctive prescription of contractual debts. The Act refers exclusively to debts, which at once raises the question of what types of claim in the field of contract are covered. It might be thought that the word "debt" should bear its primary meaning of an obligation to pay [Page 483] money, but clearly this is not so. It is permissible to refer to the memorandum of Professor De Wet, the draftsman of the Act, paras 71-75 of which indicate that the word "debt" was chosen, not with the intention of restricting the scope of prescription, but in order to change from a "weak" prescription system of barring the remedy to a "strong" prescription system of extinguishing the right.*
>
> *There can be no quarrel with King J's words in Evins v Shield Insurance Co Ltd 1979 3 SA 1136 (W) 1141F:*
>
> *"The word 'debt' in the Prescription Act must be given a wide and general meaning denoting not only a debt sounding in money which is due, but also, for example, a debt for the vindication of property."*

There is no formula that can be used to determine a wide and general meaning of the word debt but it is sufficient to say that a debt is to be construed as the correlative of a

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[14] *Van Der Merwe, Van Huyssteen, Reinecke, Lubbe. 2007. Contract General Principles:, Third Edition , Landsdowne: Juta law,Page 540*
[15] *Supra*
[16] *RH Christie. 2006. The Law of Contract in South Africa: 5th Edition. Lexisnexis Electronic version Page 482*
[17] *Supra*
[18] *Supra*

right of action, the debt and the right of action being the opposite side of an obligation which generally embraces a proprietary element and duty.[19]

One may argue that the contractual remedy to rescind is not affected by the Act due to the fact that the word "debt" has not been stretched that far.[20]On the other hand, one may also argue in defense that there is a right of action to rescind based on a breach of an obligation not to induce a contract by misrepresentation, and the correlative of that right of action or the other pole of the obligation is therefore a debt.[21] A different view would mean that one has to go back to the common law periods of prescription for rescission since the 1943 Act is repealed and this would be contrary to Professor De Wet's (the draftsman of the Act) memorandum.[22]

It would be necessary to go back to the classification of actions by their Latin names, which Professor De Wet criticized in para 75, and if the action could be classified as an *action redhibitorio* it would prescribe in six months, but a court can use its discretion to extend this period.[23] If an action is classified as an action for *restitution in intergrum* it would prescribe in four years and action for *restitution in integrum on the ground of dolus or metus* would prescribe in thirty years.[24]

Previously, there was a distinction between the complete extinction of a right by prescription and the barring of a remedy by prescription, leaving a natural obligation. Section 10 of the 1969 Prescription Act makes it clear that a debt has to be extinguished completely leaving no natural obligation in cases where the period specified in section 11 or any other law as applicable to a particular debt has expired.[25] However, section 10(3) provides that payment of a prescribed debt shall be regarded as a payment of a debt

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[19] *Supra*
[20] *RH Christie. 2006. The Law of Contract in South Africa: 5th Edition. Lexisnexis Electronic version Page 483*
[21] *Supra*
[22] *Supra*
[23] *Supra 484*
[24] *Supra*
[25] *South Africa. 1969.The Prescription Act 68 of 1969*

meaning the *conditio* will not be liable to the return of such a payment.[26] Van Heerden J makes some comments concerning this anomaly in *Lipschitz v Dechamps Textiles GmbH* and says;

> *"Section 10(3) as pointed out by Mr. Berman does seem to contain an anomaly by regarding payment of a debt after it has been extinguished by prescription as payment of the debt. As far as anomalies are concerned however I find myself in respectful agreement with what Milne JP said on good authority in Manjra v Desai and Another 1968 (2) SA 249 (N) at 254:*
>
> *'Where the words of a statute are plain, mere anomalies would not justify a departure from their literal meaning unless they are such as to demonstrate that their literal meaning is not the meaning which the Legislature intended them to have.'*

This anomaly cause's confusion because section 10(1) clearly states that once the period provided has lapsed, the debt is extinguished, while section 10(2) further states that once the debt is extinguished it can not be recharged. Maybe section 10(3) was inserted to remove any doubt occasioned by differences of opinion which existed amongst Roman-Dutch authorities, and to settle the law as to whether a debtor who has paid a prescribed debt may reclaim his money or not.[27]

Section 11 of the Prescription Act provides us with the periods of prescription as follows;

> *"The periods of prescription of debts shall be the following:*
> *(a)*
> *Thirty years in respect of –*
>
> *(i) any debt secured by a mortgage bond;*
>
> *(ii) any judgment debt;*
>
> *(iii) any debt in respect of any taxation imposed or levied by or under any law;*
>
> *(iv) any debt owed to the State in respect of any share of the profits, royalties or any similar consideration payable in respect of the right to mine minerals or other substances;*
>
> *(b) Fifteen years in respect of any debt owed to the State and arising out of an advance or loan of money or sale or lease of land by the State to the debtor, unless a longer period applies in respect of the debt in question in terms of paragraph (a);*

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[26] *Supra*
[27] *RH Christie, 2006. The Law of Contract in South Africa: 5th Edition. Lexisnexis Electronic version, Page 484.*

(c) *six years in respect of a debt arising from a bill of exchange or other negotiable instrument or from a notarial contract, unless a longer period applies in respect of the debt in question in terms of paragraph (a) or (b);*

(d) *save where an Act of Parliament provides otherwise, three years in respect of any other debt."*

It is to be noted that there is no distinction between written, oral or tacit contracts, and that contractual debts are subject to the three year period.[28] Section 12(1) further states that prescription is to run as soon as the debt is due.

> *"this means that there has to be a debt immediately claimable by the debtor [sc creditor] or, as stated in another way, that there has to be a debt in respect of which the debtor is under an obligation to perform immediately."*[29]

In *List v Jungers* 1979 3 SA 106 (A) 121C Diemont JA observed that:

> *"Counsel pointed out that the date on which a debt arises usually coincides with the date on which it becomes due, but that is not always the case. The difference relates to the coming into existence of the debt on the one hand and the recoverability thereof on the other hand."*

A debt to perform a contractual duty by its nature becomes due in accordance with the contract and the interpretation of the contract will in the absence of relevant indicators show when prescription starts to run.[30]In the relevant case of *De Jager v ABSA Bank Bpk* 2000 4 All SA 481 (A) the court said that the Act is designed to promote certainty in the affairs of people and is aimed at fairness towards a debtor. It follows that an undertaking not to raise the defense of prescription is enforceable and not contrary to public policy.

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[28] *Supra Pg 485*

[29] *Deloitte Haskins & Sells Consultants (Pty) Ltd v Bowthorpe Hellerman Deutch (Pty) Ltd 1991 1 SA 525 (A) 532,H per Van Heerden JA*

[30] *RH Christie. 2006. The Law of Contract in South Africa: 5th Edition. Lexisnexis Electronic version Page 486*

1.2.3 Waiver

A waiver or release occurs when a debtor and creditor conclude an agreement, which frees the debtor from the obligation between them.[31]This agreement has an effect of extinguishing all the obligations arising from the contract. The release in this sense is a debt distinguishing agreement and does not constitute a contract.

Even though the release is not a contract it still has to be concluded expressly or tacitly and must comply with the general requirements of a valid contract.[32]One must not focus on the question of contractual capacity and whether or not there is a need to conform to public policy but carefully look at the intention of the parties as it is the decisive element.[33] One way of establishing intention to release or waive is to ascertain that the parties or at least the party alleged to have divested himself of the right had full knowledge of it.[34]

RH Christie makes an interesting observation regarding the habit of using the word 'waiver' and its synonyms and I feel it is necessary to quote him in full.

> *But, as will be seen, the water has been muddied by our habit of using the word "waiver" and its synonyms in the context of a right conferred by law, such as the right to rescind for misrepresentation. This habit has muddied the water because waiver of a right conferred by the terms of a contract should logically be regarded as a donation which, like any other donation, requires acceptance to be effective, whereas waiver of a right conferred by law does not require acceptance, and the courts have not always drawn this distinction. As a result the proposition that waiver is always unilateral and does not require acceptance has some support. The proposition should be resisted, not for the sterile reason of maintaining doctrinal purity, but for the practical reason of doing justice in those rare cases where a party has good reason for not accepting the unilateral variation or discharge of his contract by waiver.*
>
> *In Roman law discharge of a contract by agreement had to be by the same method by which the contract was made. As a result the method of discharge by agreement which was recognized as the most trustworthy – acceptilatio, which was a form of stipulatio in reverse – could be employed only if the contract was in the form of a*

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[31] *Van Der Merwe, Van Huyssteen, Reinecke, Lubbe. 2007. Contract General Principles:, Third Edition , Landsdowne: Juta law , Page 526*

[32] *Supra Pg 528*
[33] *Supra*
[34] *Supra*

stipulatio. It was therefore common practice to novate other forms of contract into a stipulatio in order to discharge them by acceptilatio.

The practical Dutch would have none of this and, just as they freed the making of contracts from the Roman formalities, so they freed their unmaking. Grotius 3 41 7, as usual, is like a breath of fresh air:

"In Roman law release by way of gift required a certain form of words: but with us, as in contracting so in discharging an obligation, it is enough that such words should be used as import an abandonment by the releaser of his right, and that this should be accepted by the debtor or in his name."

In the concluding words of that passage Grotius makes an important point which is often overlooked or obscured by our modern terminology. When the parties to an existing contract come together in an agreeing frame of mind and formally or informally agree to vary or discharge their contract we have no difficulty about describing what has happened as a variation or discharge by agreement, or a cancellation by agreement But when one of the parties, by his words, actions or inaction, has evinced an intention not to enforce one or more or all of his rights conferred by the contract we select whichever word seems most appropriate from a list which includes abandonment, acquiescence, release, renunciation surrender, election, relinquishing of a right and waiver. Of these words by far the most commonly used is waiver, which is regarded in many of the cases as interchangeable with any of the other words. There is no harm in using whichever word seems best descriptive of what has happened, provided it is remembered that the rules of English law which attach to some of these words are not necessarily part of our law and provided the point so clearly made by Grotius 3 41 is also remembered – that gratuitous waiver (or whatever one prefers to call it) of a right conferred by the terms of a contract is a donation[35].

I fully agree with the latter quote, it is understandable that, when a creditor releases the debtor of an obligation to pay and the debtor does not accept or reject the release, that may create an impression that the debtor approves the release. However, in a case where the debtor specifically rejects an offer to be released from an obligation for a relevant reason, it would be unfair to force such waiver on the debtor. In this instance, the waiver cannot be regarded as a donation because it was not accepted.

While RH Christie at [36]437 was addressing the nature of a waiver he submitted the following quote;

"Waiver of a right conferred by the terms of a contract should logically be regarded as a donation which like any other donation, requires acceptance to be effective..."

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[35] *RH Christie, Law of Contract in South Africa, 5th Edition (2006) Pg 347*
[36] *Supra 437*

The above view is supported by the decision in the *Sussens*[37] case where the requisites of a waiver were held to be as follows:

> *"waiver follows from the principle that waiver is a form of a contract in which one party is taken deliberately to have surrendered his rights: there must therefore be proof of an intention so to surrender, which can only exist where there is knowledge both of the facts and the legal consequences thereof."*

In the *Pretorius v Greyling*[38] case Price J also said;

"*Before there is a waiver there must be an unequivocal act done with full knowledge of all the relevant facts as well as of the rights which it is argued have been waived. This Knowledge, to be effective in the case of waiver, must be the knowledge of a single person, not partly of one and partly of another, because no intention to waive can be inferred unless the particular person himself who commits the act which is said to constitute waiver knew of the relevant facts and intended to waive the rights of which he was fully aware*".

A donation is a contract, not a unilateral effective act, so unless an offer to donate is accepted there can be no donation.[39] In the relevant case of *Free State mining and Finance Corp Ltd v Union Free State Gold Diamond Corpn Ltd* [40]Munnik AJ said;

> *"I do not think that a creditor can by the mere exercise of his will terminate the obligation without the concurrence of the debtor because as both Wessels [para 2344A] and Pothier [s 578] point out a release, waiver or abandonment is tantamount to making a donation to the debtor of the obligation from which he is to be released and until that donation has been accepted it has not been perfected. There may conceivably be circumstances in which a debtor does not wish to be released from his obligation. It may for a variety of reasons not suit him to be released. To allow the release, waiver or abandonment and the consequent making of a donation dependent solely on the will or action of the creditor would be*

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[37] *Ex parte Sussens 1941 TPD 15*

[38] *Pretorious v Greyling 1947 1 171 (W) 177*

[39] *Van Der Merwe, Van Huyssteen, Reinecke, Lubbe. 2007. Contract General Principles:, Third Edition , Landsdowne: Juta law , Page438*

[40] *1960 4 SA 457 (W) 459*

tantamount to creating a contract at the will of one party which is a concept foreign to our jurisprudence."

With reference to the above case a party relying on waiver has to prove that the waiver was accepted by the other party. In addition, the waiver has to be communicated (to the creditor) until then the party who has decided to waive may change his/her mind. There's a presumption in some cases against the waiver and the party asserting the waiver has to on balance of probabilities prove the existence of a waiver.[41] There are various cases proving that the onus is not easily discharged. In *Hepner v Roodepoort-Maraisburg Town council* [42]Steyn CJ said;

"There is authority for the view that in the case of waiver by conduct, the conduct must leave no reasonable doubt as to the intention of surrendering the right in issue (Smith v Momberg (1895) 12 SC 295 at p 304; Victoria Falls and Transvaal Power Co Ltd v Consolidated Langlaagte Mines Ltd 1915 AD 1 at p 62) but in Martin v de Kock 1948 (2) SA 719 (AD) at p 733 this Court indicated that that view may possibly require reconsideration. It sets, I think, a higher standard than that adopted in Laws v Rutherfurd 1924 AD 261 at p 263, where Innes CJ says:

'The onus is strictly on the appellant. He must show that the respondent, with full knowledge of her right, decided to abandon it, whether expressly or by conduct plainly inconsistent with an intention to enforce it.'

This accords with the test applied in City of Cape Town v Kenny 1934 AD 543 and was followed in Collen v Rietfontein Engineering Works 1948 (1) SA 413 (AD) at p 436 and Linton v Corser 1952 (3) SA 685 (AD) at p 695. (Cf. Ellis and others v Laubscher 1956 (4) SA 692 (AD) at p 702). In my opinion the test is more correctly stated in these cases."

In a related case of *Road Accident fund v Mothupi*[43] the court reviewed the requirements of an inferred waiver. The court held that the test must be objective, that the intention to waive must be adjudged by its outward manifestations and reservations that are not communicated are of no legal consequences. In addition, the intention must be considered from a reasonable person point of view in the position of the other party. Further, the court may look at what the parties believed and intended at the time but these two elements are not conclusive. Essentially, when one is dealing with a contract or a legal document that specifically states the detailed circumstances where a person is

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[41] *Van Der Merwe, Van Huyssteen, Reinecke, Lubbe. 2007. Contract General Principles:, Third Edition , Landsdowne: Juta law , Page441*

[42] *1962 4 SA 772 (A)*

[43] *2000 4 SA 38 A para 16-17*

deemed to have waived, this will be conclusive and no further inquiry is required in this regard.[44]

1.2.4 Liquidation / Sequestration

An application for sequestration may only be brought in relation to an estate of a debtor as defined in section 1 of the Insolvency Act.[45] In the relevant case of *Estate Logie v Priest* [46] Solomon JA said that "it is perfectly legitimate for a creditor to take insolvency proceedings against a debtor for the purpose of obtaining payment of his debt." Therefore, if a creditor has a case (and its liquidated claim is not less than R 100 000) it may initiate these proceedings provided that his proceedings do not constitute an abuse of the process of the court.[47]

1.2.4.1 Grounds for creditor's application

A creditor may only apply for sequestration of his debtor's estate in two instances, namely, when a debtor has committed an act of insolvency (described below) as defined in section 8 of the Insolvency Act and if the debtor is insolvent (when his liabilities exceed the value of his assets).[48] In addition to the existence of the two instances, the creditor must be able to prove that there is a reason to believe that it will be to the advantage of creditors of the debtor if his estate is sequestrated[49].

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[44] *RH Christie. 2006. The Law of Contract in South Africa: 5th Edition. Lexisnexis Electronic version Page 442*
[45] *Insolvency Act 24 of 1936*
[46] *1926 AF312 at 319*
[47] *PM Meskin; B Galgut; PAM Magid;JA Kunst; A Boraine; DA Burdette. Insolvency Law. Last updated June 2009. Lexisnexis,*
[48] *Supra*
[49] *Supra*

1.2.4.1.1 Acts of insolvency

Section 8 of the Insolvency Act provides us with a list of acts performed by a debtor which will constitute acts of insolvency.[50] These acts are as follows;

In terms of section 8(*a*) of the Insolvency Act 24 of 1936, a debtor commits an act of insolvency where he does any of the following: (i) he leaves the Republic or (ii) being outside the Republic, he remains absent therefrom or (iii) he departs from his dwelling or (iv) he otherwise absents himself, provided, in each case, he does so "with intent to evade or delay the payment of his debts".

In terms of Section 8(*b*) of the Insolvency Act:

> *"A debtor commits an act of insolvency – if a court has given judgment against him and he fails, upon the demand of the officer whose duty it is to execute that judgment, to satisfy it or to indicate to that officer disposable property sufficient to satisfy it, or if it appears from the return made by that officer that he has not found sufficient disposable property to satisfy the judgment."*
>
> *(c) "A debtor commits an act of insolvency – if he makes or attempts to make any disposition of any of his property which has or would have the effect of prejudicing his creditors or of preferring one creditor above another".*
>
> *(d) "if he removes or attempts to remove any of his property with intent to prejudice his creditors or to prefer one creditor above another".*
>
> *(e) "if he makes or offers to make any arrangement with any of his creditors for releasing him wholly or partially from his debts".*
>
> *(f) "where, after publishing a notice of surrender of his estate, which has neither lapsed nor been withdrawn, 1 he fails to lodge the requisite statement of his affairs or he lodges such a statement which is incorrect or incomplete in any material respect or he fails to apply for the acceptance of the surrender on the relevant date stipulated in such notice.*

[50] *Supra*

(g) "if he gives notice in writing to any one of his creditors that he is unable to pay any of his debts"

(h) "if, being a trader, he gives notice in the Gazette in terms of sub-section (1) of section thirty-four, and is thereafter unable to pay all his debts".

Submission of sufficient proof of any such act that is distinct from proof of actual insolvency is sufficient for the purposes of obtaining a sequestration order.[51] *The Legislature inserted these provisions to cater for the fact that in practice, a creditor might not have adequate evidence to prove that his debtor is insolvent.*[52]

An agent of a debtor commits an act of insolvency if the principal was aware of his agent's actions and gave consent, authorized accordingly, expressly or impliedly[53].Further, an act of insolvency in the name of a partnership that was committed by a partner within the scope of his authority as such is an act of insolvency by the partnership for the purpose of obtaining an order for the sequestration of its' estate.[54]

1.2.4.1.2 Actual insolvency

Actual insolvency is when the debtor's liabilities actually exceed the value of his assets.[55] A substantial amount of authority has pointed out that there must be clear proof of actual insolvency.[56] However in terms of general principle, it suffices to prove that actual insolvency exists on a balance of probabilities.[57]

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[51] *Supra 45*
[52] *Supra*
[53] *Supra*
[54] *C f Anderson & Co v Hutton & Co* (1875) Buch 73 at 74–75; and see, eg, *Stephen Fraser (Pty) Ltd v Ramla and Others* 1961 (2) SA 554 (W).

[55] *PM Meskin; B Galgut; PAM Magid;JA Kunst; A Boraine; DA Burdette. Insolvency Law.Last updated June 2009. Lexisnexis*
[56] *Supra*
[57] *Supra*

In cases where the creditor relies on both grounds for the sequestration of a debtor's estate and the alleged grounds of actual insolvency are disputed, proof of alleged acts of insolvency will suffice[58]. One may try to establish actual insolvency directly by producing evidence of the debtor's liabilities and of the market value of his assets at the date of the application.[59] Alternatively, one may try to institute actual insolvency indirectly by providing evidence of circumstances that indicate thereof i.e. the fact that the debts remain unpaid, or the debtor has reached a compromise with creditors[60]. Courts are careful in inferring insolvency to such circumstances but it suffices if such an inference can be drawn, notwithstanding that the precise amount of the deficiency is uncertain.[61]

1.2.4.2 Liquidation of a company

Item 9 of Schedule 5 of the new Companies Act[62] provides for continued application of provisions in the old Act that deal with the winding-up and liquidation of a company despite the repeal of the previous Act. Exclusively, Chapter 14 of the Companies Act 61 of 1973 continues to apply with respect to the winding-up and liquidation of companies under the new Act as if that Act had not been repealed subject to sub items (2) and (3).[63]

Specifically, section 349 of the old Act provides that a company may be wound up voluntarily if the company has by special resolution resolved that it be wound up[64]. The special resolution may provide for a members voluntary winding up or a creditors' voluntary winding up by means of sections 350 and 351[65]. Section 351 states that voluntary winding up of a company shall be a creditors' voluntary winding up if the resolution contemplated in section 349 has been registered (in terms of section 200)[66].

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[58] *Supra*
[59] *Supra*
[60] *Supra*
[61] *Supra*
[62] *South Africa. 2008. Companies Act 71 of 2008*
[63] *South Africa. Companies Act 61 of 1973*
[64] *Supra*
[65] *Supra*
[66] *Supra*

While for members voluntary winding-up, section 350 provides that the special resolution will not be in force and effective unless it is registered in terms of section 200 and prior to registration, security has been furnished prior to the satisfaction of the Master for the payment of the debts of the company within twelve months from the commencement of the winding up process.[67]

The Master may dispense with the furnishing of security requirement if the directors of the company provided him with a sworn statement[68] or a certificate by the auditor of the company that to the best of his knowledge and belief and according to the record of the company, it has no debts[69].

A company may be wound up by court if it is unable to pay its debts[70].A company is deemed to be unable to pay its debts if a creditor to whom the company is indebted in a sum not less than one hundred rand due and payable, served on the company by leaving the same at its registered office, a demand requiring the company to pay the sum due[71] and the company failed to do so within three weeks. Further, a judgment or decree or an order of any court issued in favor of the creditor of the company has been returned by a messenger or sheriff with an endorsement that he has not found sufficient property to satisfy the judgment, decree or order[72].

1.2.4.2 Conclusion

Where a loan or debt is not repayable it is critical to establish the reason for this as discussed in the definitions in this part. Once it is established it can then be determined which sections of the Income Tax Act may be applicable to the situation. These are discussed in Chapter 2.

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[67] *Supra*
[68] *Section 350 (a)(ii)(aa)*
[69] *Section 350 (a)(ii)(bb)*
[70] *Section 344 (f)*
[71] *Section 345 (1)(a)(i)*
[72] *Section 345 (1)(b)*

1.3 Losses on loans from an International tax perspective

Certain similar legislation of various countries regarding waivers is briefly highlighted in this part to illustrate that this area is not unique to South Africa.

1.3.1 Belgium

(Partial) Waiver of debt in the hands of the debtor creates a decrease of liabilities and correlatively, a taxable profit.[73] If the taxpayer has carried forward tax losses, it may use it to offset this taxable profit arising from the waiver provided that such a waiver cannot be considered as the granting of an abnormal or benevolent advantage.[74]

In the hands of the creditor, a (partial) waiver leads to a decrease of assets, which is in principle tax deductible if the following conditions are met[75]; the waiver

(i) does not constitute an abnormal or benevolent advantage,

(ii) it is not the counterpart of an increase of the creditor's assets and,

(iii) It meets the requirement for being considered as a professional expense.

The Belgium tax administration is reluctant to sign-off on a waiver of debt between related parties and the tax deductibility of such a waiver is often denied in the hands of the creditor and, moreover, if this at the time qualified as a abnormal or benevolent advantage received in the hands of the debtor, it can lead to double economic taxation.[76]

On the other hand, there are certain factual or judicial elements , that are more easily accepted by case-law than by tax administration, and can favor the creditor such as participating in a judicial recovery plan, saving the creditor's reputation, or having strong business relations with the debtor. Furthermore, a waiver of debt can be concluded with a "return to better fortune" clause, which means that the debtor is not released from its

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[73] *Ariane Brohez and Noe Denis. November 2008. Taxation of Corporate Restructuring in Belgium. III.A*
[74] *Supra*
[75] *Supra*
[76] *Supra*

obligation but that performance of this obligation is subject to the debtor escaping from its difficult financial status.[77] This clause is a compulsory requirement for the Belgium Ruling Commission considering the waiver to be at arms length.[78] On the other hand, if the debtor returns to better fortune, the repayment of the debt will lead to recapturing the previous write-downs.[79]

1.3.2 Denmark

Section 3 of the Taxation of Gains and losses on Claims Act ("The Act:)[80] provides that debts and financial instruments, capital gains and losses arising from the sale or repayment of claims and debts, such as bonds, debentures and other debt instruments, from the relinquishment of debt and from the sale of financial contracts including call and put options without any regard to the tax treatment of the underlying assets are, in the case of a company, generally subject to ordinary taxation.[81]

Furthermore, this provision will find application irrespective of whether the companies in question are domestic or foreign or whether they are jointly taxed.[82]

A release is taxable if the debt is reduced to an amount lower than the value of the debt at the time of the relinquishment.[83] If the parent company of a Danish subsidiary is a foreign company and is able to prove that the loss is not deductible under its domestic legislation, then the release also will not be taxable in the foreign state.[84]In that case the loss will also not be carried forward.

There is to some degree, similarities between the Denmark taxation laws and South African ("SA") tax law when dealing with the relinquishment of debt that is outstanding.

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[77] *Ariane Brohez and Noe Denis. November 2008. Taxation of Corporate Restructuring in Belgium. III.A*
[78] *Supra*
[79] *Supra*
[80] *Taxation of Gains and losses on Claims Act no. 832 of October 2, 2002*
[81] *Taxation of Gains and losses on Claims Act no. 832 of October 2, 2002, Section 3*
[82] *Supra Footnote 80*
[83] *Supra*
[84] *Supra*

The SA Law of Contract is familiar with the concept of debt waivers (discussed in paragraph 1.2.3). In terms of the law of contract, a waiver occurs when a debtor and creditor conclude an agreement where the debtor is released from its obligation to pay a debt outstanding.

The SA Income Tax Act 58 of 1962 deals with instances where a debtor is released from its obligation to pay in section 8(4) (m) and paragraph 12(5) of the Eighth Schedule. These provisions will be dealt with extensively in Chapter 2.

1.3.2.1 Compositions

Section 24 of the Taxation of Gains and Losses on claims Act provides that debt released under a general composition with a debtor and creditor is not taxable, subject to certain conditions.[85] This occurs if the composition is made with a majority of the creditors or with one major creditor provided that the claims of the creditors are reduced in accordance with the ranking set fourth in the Act on Bankruptcy.[86] The composition will usually qualify if more than 50% of the debt of the debtor is relinquished and also when there is a composition with the majority creditors where minor creditors are paid in full.[87]

1.3.2.2 Loss Carry Forward

Taxable losses that occurred from the income year 2002 may be carried forward indefinitely.[88] However, if the loss was incurred before 2002, it may only be carried forward for five years. If a taxpayer concluded a general composition with its creditors, the taxable losses incurred are reduced by the amount of debt relinquished consisting of the difference between the nominal value of the debt and the actual value of the debt released.[89]

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[85] *Taxation of Gains and losses on Claims Act no. 832 of October 2, 2002, Section 24*
[86] *Supra*
[87] *Supra*
[88] *Tax Assessment Act no. 791 of 17 September, 2002*
[89] *Section 15.2 and 3*

Section 20(1) (a) (ii) of the SA Income Tax Act applies where the debtor enters into a compromise or a concession with its creditors. The benefit received by the debtor as a result of such compromise or concession reduces the balance of the debtors assessed losses.

Section 24 of the Taxation of Gains and Losses on claims Act in Demark is similar to the latter section but specifically makes provision for a composition made with majority shareholders. If the composition is made with the majority creditors, the debt released by the creditors will not be taxable. In SA it remains unclear whether or not it matters that the minority or majority of the creditors enter into a compromise or a concession with the debtor (see discussion in chapter 2 paragraph 2.2.2)

A special provision applies if the creditor is not taxable in Denmark but is a member of the same group of companies as the debtor. The amount by which the taxable losses of the debtor is limited is reduced only by the amount released by the group company if the debtor is able to demonstrate that the loss may not be deducted for corporate income tax purposes under the laws of the country in which the creditor is incorporated.[90]

1.3.3 Japan

If a debt payable (*saimu menjo)* is cancelled, Japan's general tax practice will recognize the income for income tax purposes in the hands of the debtor.[91] Further, the whole amount of the cancelled debt will constitute the amount of taxable income regardless of the debtor's financial conditions.[92] However, the taxable income may be set off against carry over losses (similar to section 20(1) (a) (ii) of the SA tax law).[93] The carry over of losses is normally permitted for five years, but in some exceptional cases where the debtors' restructuring is involved it will carry over beyond the five-year period.[94]

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[90] *Taxation of Gains and losses on Claims Act no. 832 of October 2, 2002, Section 8*
[91] *Masatami Otsuka. December 2003. BNA International Inc forum. Host country Japan . Published by BNA International Inc; Subsection 2*
[92] *Supra*
[93] *Supra subsection III*
[94] *Supra subsection III*

On the other hand, a creditor cannot deduct, for income tax purposes, the waived outstanding debts payable (*saiken hoki*).[95]Technically, a waiver by a creditor of its debt receivable is recharacterised as consisting of a two step transaction, the first being the collection from the debtor of the debt receivable and the second being the donation to the debtor of the money received.[96] Even though the second transaction gives rise to a donation, such a donation expense is not deductible for income tax purposes.[97]

1.3.5 Netherlands

In the case of a conversion of a waiver of a debt the debtor will not be charged with a taxable gain.[98] The Dutch legislation seems to place the burden on the creditors and is more lenient to the debtor. It might be that the drafter of the legislation took into account the fact that the debtor's financial position led to the debt waiver or conversion of the debt. Further, that the waiver or conversion will not result to a real taxable gain in the hands of the debtor.

When dealing with the creditor, the term "group" is used to refer to the creditor and any affiliated related entities.[99].The Dutch Corporation Tax Act ("CTA") allows corporate taxpayers (creditors) to offset a loss against the profits of the previous year, and the following nine years.[100] Therefore, a one year carry back period, and a nine year carry forward period will find application.[101] The CTA provides various anti-abuse provisions which have the effect of limiting the carry over of losses, where there is a change in ownership and where losses have been incurred by a holding company[102] . For purposes of this paper I will not elaborate on the latter issues.

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[95] *Supra*
[96] *Supra*
[97] *Supra*
[98] *Olaf van der Donk. Sigrid Hemels. February 2004. Proposed changes in Dutch Tax Law Will Facilitate Financial Restructurings,Subsection 1*
[99] *Supra*
[100] *Willem Bon. Michiel Beudeker. January 2009. Taxation of Corporate Restructurings and the Reorganisations in the Netherlands Publishe by BNA International Inc. Subsection IA*
[101] *Supra*
[102] *Supra*

If a Dutch corporate lender waives a loan for business reasons, the CTA will allow him to deduct the loss arising from this write down.[103] But if the waiver is done for shareholder's reasons (i.e. where it is not at arms length), the amount is for tax purposes to be treated as an (informal) distribution of profits by the lender.[104] As a result, the loss is not deductible and such waiver might trigger Dutch dividend tax.[105]

The CTA also makes provision for the conversion of write down debts, where a corporate lender is able to write down a loan against its taxable profits if the fair market value of the loan falls below the tax book values.[106] In a situation where the loan subsequently recovers in value, a recapture of the written down loan will be required.[107] A mismatch may arise when a lender converts his loan into shares in the debtor as a consequence of the written down loan.[108] In doing so he may have acquired shareholding that falls under the participation exemption. Essentially, the participation exemption applies if (1) the Dutch corporate taxpayer owns at least 5% of the nominal paid up share capital for the shareholding and (ii) the shareholding is not a so-called "low taxed passive investment company"[109]. It exempts all benefits (such as dividends and capital gains) from the Dutch Corporation tax.[110] Case law has clarified the fact that the conversion of a loan into shares is not a reason to recognize taxable profits in relation to the debt for either the debtor or the lender and legislation has an anti-abuse provision to avoid this mismatch. .[111]

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[103] *Supra C.1*
[104] *Supra*
[105] *Supra*
[106] *Supra C.2*
[107] *Supra*
[108] *Supra*
[109] *Supra*
[110] *Supra*
[111] *Supra*

1.4 New developments

Recent case law in South Africa highlights the importance of establishing the nature of the write off, set off or waiver of a debt owing

1.4.1Comparison between the *ITC 1793* and the 2008 Kimberley Tax Court decision

In the *ITC 1793*[112] case, the testatrix sold shares to the value of R 2 628 340 to the appellant, being the family trust established by the testatrix. The appellant became liable to pay the testatrix a sum of R 2 628 340. The testatrix passed away on 15 March 2002 and according to her will bequeathed the aforementioned debt to the trust[113]. The court held that paragraph 12(5) of the Eighth Schedule of the Income Tax Act found application when the testatrix provided in her will that the trust be discharged from its debt and that this constituted a deemed disposal and further, that the trust was liable for capital gains tax on the amount of the discharged debt.

Also, the court said, the set off of the debt was a result of the testatrix's, decision to discharge the appellant from its obligation to pay the debt.[114] Further, the creditor disposed of an asset when it discharged the trust debt for no consideration. This created a situation where the claim against the trust was extinguished by operation of law, by means of a set off between the estate and the beneficiary[115].

Moreover, it is not the occurrence of the set off that resulted to a discharge of the debt that is taxable in the hands of the debtor but the drawing up and the execution of the last will and testament at the time of the testator's death.[116]

In the unreported Tax Court case number 12399 the facts are similar to *ITC 1793* but the court gave quite a surprising reasoning for its decision. The Commissioner relied heavily

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[112] *ITC 1793 67 SATC 256*
[113] *Supra Pg 258*
[114] *Supra Pg 261*
[115] *Supra*
[116] *Supra*

on the latter case and contended that the debt owed by the appellant trust was discharged by the testatrix for no consideration and that the appellant had acquired the claim for no consideration as contemplated in paragraph 12(5)[117]. The Commissioner argued that the appellant was liable for payment of capital gains tax on the value of such claim[118]. Judge Lacock looked at the wording of the will and said that it is clear and unambiguous[119]. He further said that the intention of the testators was clear, that the residue of the estate is bequeathed to the appellant as the sole heir thereof[120]. He said that there were probabilities indicative that it was not the intention of the testatrix to specifically bequeath the debt represented by her loan account to the appellant as a legatee.[121]

He concluded that it was not the intention of the testatrix to specifically bequeath the claim in question and the loan account formed part of the residue of the estate[122]. That it was not her intention to dispose of this claim in favour of the appellant for no consideration as contemplated in paragraph 12(5) of the Eighth Schedule of the Act[123].Therefore, the facts in *ITC 1793* were deemed to be distinguished from case number 12399.

In my view, the facts of these two cases are the same. It is just that the drafter of the will in case number 12399 was successful I submit, in hiding the fact that the testatrix wanted to benefit the trust without triggering paragraph 12(5). Case number 12399 merely opened doors for estate planners to avoid negative outcomes by carefully drafting wills giving effect to the testators wishes without necessarily forgiving the debt[124].That means a bequest in similar circumstances that is expressed as a residuary bequest, could avoid the capital gains tax catch discovered by *ITC 1793*. Both cases looked at the true intention of the testatrix so the drafter of the will should be careful of not only the

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[117] *Tax court Case no 12399(December 2008) para 6*
[118] *Supra*
[119] *Supra para 10*
[120] *Supra 10.1*
[121] *Supra 11*
[122] *Supra 12*
[123] *Supra*
[124] *Moneywebtax website.2009. Jenney Booth . Tax alarm for trusts. 10 February 2009*

significance of the specific language of the will but also that it conveys their true intention.

Both cases discussed above were decided by the Tax Court and therefore, no legal precedent has been created.

Chapter 2

2.1 Income tax sections relevant to losses on loans

2.1.1 Introduction

This chapter constitutes the focus of the paper since it will discuss each income tax provision relevant to the reduction or discharge of a debt. Debt waiver results to significant income tax consequences for both the debtor and the creditor. Amongst other relevant provisions, capital gains tax (CGT) consequences seem to be the most problematic and as a result, these will be discussed extensively. Irrespective of who waives (either the creditor or by operation of the law) the debt will still have income tax consequences. Creditors and debtors might even not be aware of the fact that debt forgiveness has occurred such as by prescription or on insolvency and liquidation as discussed in chapter one.

When a creditor relinquishes a debt there are three fundamental tax consequences that can arise. The assessed loss provision in section 20 of the ITA is considered first because section 8(4) (m) and paragraph 12(5) of the Eight Schedule are subject to the provisions of section 20.[125] Section 20 (1) (a) (ii) of the Income Tax Act ('the Act") provides –

> *20(1) For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall, subject to section 20A, be set off against the income so derived by such person –*
>
> *(a).....*
>
> *(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 or a compromise made with any creditor of such person whereby any liability owed by such person to such creditor has been reduced or extinguished .*[126]

[125] *South Africa 1962.Income Tax Act 58 of 1962*

Section 8(4) (m) will apply where section 20 is inapplicable, i.e where there is no assessed loss. The section provides that where a debtor is released from an obligation to pay a debt and the debt was previously deducted for income tax purposes, a recoupment will arise. For example, a capital asset is purchased on credit, capital allowances are claimed and the debtor is not paid for some reason.

Paragraph 12(5) of the Eighth is applicable to unpaid debt to the extent that section 20 and section 8(4) (m) are not applied. The paragraph applies where a debt has been reduced or discharged by a creditor for no consideration or a consideration less than market value of the debt owed. According to the SARS Capital Gains Tax guide, paragraph 12(5) was introduced to provide symmetry in the tax system by ensuring that any portion of the amount owing will be subject to capital gains tax on a capital gain equal to the amount discharged.[127]However, as paragraph 12(5) is limited to amounts not taken into account in terms of sections 20 and 8(4) (m), any set off under these sections must reduce the amount subject to capital gains tax.
While these three provisions are the most important ones, it is necessary to also consider the impact of a waiver for donations tax, secondary tax on companies (STC), value added tax (VAT) and fringe benefits purposes.

2.2 Assessed loss provisions s 20(1) (a) (ii)

Section 20(1) (a) (ii) provides –

> *"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 any creditor's of such person whereby any liability owed by such person to such creditor has been reduced or extinguished to the extent that*
> *(aa) the amount advanced by such 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;*[128]

[127] *South African Revenue Comprehensive Guide to Capital Gains Tax ,Issue 2, 15 March 2004, pg 84*

Silke has provided us with a formula of the section broken down into its various elements[129]: I will briefly touch upon some but not all of these elements.

- There must be a benefit.
- The benefit must have a value or be an amount.
- The benefit must be received by the person concerned or accrued to the debtor.

- The concession must result from a concession granted or a compromise made with creditors.
- The concession or compromise must result in the taxpayer's liabilities to the creditor being reduced or extinguished.
- The liabilities so reduced or extinguished must have arisen in the ordinary course of trade.

In addition, an article written by Edward Nathan Sonnenberg Inc includes a short summary of principles established by the courts regarding this section.

- The reduction should be applied to the balance of assessed loss brought forward from the preceding year of assessment after accounting for taxable income or an assessed loss for the current year determined before the application of the reduction, i.e. the taxable income or assessed loss determined up to the date of the compromise or concession [CIR v Louis Zinn Organization (Pty) Ltd (1958) 22 SATC 85].[130]
- In *CIR v Datakor Engineering (Pty) Ltd* (1998) 60 SATC 503 it was held that the words "any benefit" is of a wide and indeterminate meaning. The benefit, in the words of the Act, is to be found in the reduction or extinction of the debt. Thus, the concession by the 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.[131]
- The term "concession" connotes a concept different from that of a compromise or an arrangement. In determining whether a concession has been granted, one must look at

[129] *Silke . South African Income Tax 2009 LexisNexis Electronic version, Chapter 8.129 , June 2009*

[130] *Edward Nathan Sonnenbergs Inc 1610 Debt waiver , Issue 103, 2008 (SAICA Integritax)*

[131] *Supra*

the position of the debtor and not the creditor. The mere substitution of a creditor's claim with a share amounts to a concession (Datakor supra).[132]

- Compromise means an agreement or some mutual concession between parties where an adjustment of claims and disputes has taken place and not only a compromise as referred to in section 311 of the Companies Act, Act 61 of 1973.[133] (see also discussion in 1.2.1)
- A concession or compromise could be with only one creditor or a general body of creditors. [134]

2.2.1 The benefit

The word benefit is problematic because each person has a different view of what constitutes a benefit. Unfortunately, the Act does not provide a definition for "benefit' for the simple reason that it is not possible to point out exactly the qualities that will determine whether or not a benefit has been received[135]. In the applicable case of Datakor, the court addressed the question of what constitutes a benefit and this is discussed in Chapter 4.

2.2.2 Concession or compromise

The terms "concession" and "compromise" are not defined but one may consult the definition of a "compromise" discussed in Chapter 1 to gain clarity. However, Silke states that a concession is when a creditor waived some of its rights for a consideration that is of a lesser value than the debt. The concession may be done by a single creditor or by all the creditors. [136]

SARS, in practice, inclines to the view that section 20(1) (a) (ii) applies even when one or only some of the creditors release a taxpayer from his debts. But this practice conflicts with the decision in *Blue Moon Investments (PTY) Ltd v COT*_1966 (4) SA 205 (RAD), 28 SATC 173 which, although based on the Rhodesian law in force at the time, may support the view that

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[132] *Supra*

[133] *Supra*

[134] *Supra*

[135] *Silke. South African Income Tax 2009 LexisNexis Electronic version, Chapter 8.129 , June 2009*

[136] *Supra*

section 20(1) (a) (ii) applies only when a compromise is made with the general body of creditors and not merely with one or a few of the creditors. [137]

Support for the practice of SARS was expressed by Melamet J as follows:[138]

> *'[Section] 20(1) (a) (ii) does not specifically require the concession to be granted by, or the compromise to be made with, the general body of the taxpayer's creditors. There is nothing in the wording of the [subsection to justify such a limitation. The use of the plural 'creditors' and 'them' in themselves does not indicate that the general body or more than one creditor must make the concession to enter into the arrangement.*
>
> *'Subsection 6(b) of the Interpretation Act 33 of 1957 inter alia provides that: 'In every law unless the contrary appears words in the singular number include the plural, and words in the plural number include the singular.'*
>
> *'There is nothing in the context to indicate that the plural used in the section should not include the singular. On the contrary, it seems illogical to allow a taxpayer with an assessed loss to retain the full benefit of the allowance if he receives a concession conferring a large benefit from an individual creditor but not if such concession emanates from the general body of creditors. This savours of regarding such concession by the individual creditor as a windfall and runs contrary to the objective of the provisions which I have set out above.'*

In my view, a waiver from a single creditor carries more weight because it comes from a single mind and is voluntary. In a case where the debtor has eight creditors and five agree to a compromise but the remaining three do not approve the decision, despite the minority disapproval the concession will be carried forward. Some of the creditors therefore may not voluntary agree to concessions and compromises yet they will still suffer income tax consequences arising from the concession or compromise agreed to by the majority. SARS is of the view that section 20(1) (a) (ii) does apply even when one or only some of the creditors release a taxpayer from his debts.[139]

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[137] *Supra*
[138] *As yet unreported but quoted in Silke, South African Income Tax 2009 LexisNexis Electronic version, Chapter 8.129, June 2009*
[139] *Supra*

Some believe that a concession is different from a compromise or an arrangement.[140] Silke states that one has to look at the position of the debtor in determining the existence of a concession. Even a mere substitution of a creditor's claim with a share including redeemable preference shares, amounts to a concession.[141]

The Shorter Oxford English Dictionary defines a concession as-

> *"A thing that is conceded, a gesture made in recognition of a demand or prevailing standard or a reduction in price for a certain category of person."* [142]

While compromise is defined as –

> *" an agreement reached by each side making concessions, an intermediate state between conflicting opinions or the expedient accept standards that are lower than desirable."*[143]

In examining the two definitions, it is evident that to some degree a "concession" is distinguished from a "compromise". A concession occurs when one party makes a unilateral decision to concede a debt or reduce a price for a certain category of person. On the other hand, a compromise consists of two parties, who each make concessions regarding a certain issue and try to reach an agreement on their differences and each party gives up something that they initially demanded.

The law of contract defines a compromise as a settlement by agreement of disputed obligations, whether contractual or otherwise[144]. But in practice, a concession and a compromise are considered to be similar and tax practitioners do not really spent too much time analysing these terms. This may be due to the fact that whichever occurs both are subject to section 20(a)(1)(ii).

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[140] *Silke South African Income Tax 2008 Electronic version*

[141] *CIR v Datakor Engineering 60 SATC 503*

[142] *South African Concise Oxford Dictionary edited Pg 239*

[143] *Supra 237*

[144] *RH Christie.2006. The Law of contract in South Africa. 5th Edition. Page 446*

2.2.3 Subordination agreements vs. concession and compromise[145]

Kevin Burt makes an interesting concession point that a subordination agreement may be regarded as a concession granted by the company's creditors.[146] He discusses the legal effect of the subordination to illustrate the fact that it is similar to concession.

According to Burt a subordination agreement embodies three separate agreements namely:

- an obligatory agreement whereby the company's creditors and the company undertake to extinguish existing obligations by the substitution thereof later (new) obligations (*novatio in specie*).[147]
- an agreement setting forth the terms of the latter (new) obligatory relationship; and[148]
- a novating (or dispositive) agreement which actually affects the novation.[149]

He further states that its effects go beyond merely modifying the terms of the obligatory relationship existing between each of the company's creditors and the company, by for example, modifying the method of payment or extending the time for payment. [150] The existing obligations are extinguished by the later new obligations and the creditors will be regarded as having a concession to the company. Consequently, the proviso in section 20 will find application due to the creditor's claim that has either been reduced or extinguished.[151]

I disagree with Burt's contention. As he stated, a novation is an agreement whereby one obligation is extinguished and is replaced with a new obligatory relationship. In order for novation to be effective, there has to be an existence of an intention to affect the novation.

I do not think a subordination agreement is similar to or the same as a concession. For concession, a creditor gives up his right to claim or claims an amount that is less than the debt

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[145] *Burt K. Subordination agreements and the preservations of assessed losses (De Rebus) May , 2004*
[146] *Supra*
[147] *Supra*
[148] *Supra*
[149] *Supra*
[150] *Supra*
[151] *Supra*

in dispute, while in a novation agreement the debt is substituted but the debtor is still liable to pay the new obligation. If Burt's concession is correct, the amount in the agreement will reduce the debtor's assessed loss. Further, the debtor still has to meet the conditions laid down in the new obligatory agreement (that is to pay off the new debt). The difference between a novation and a concession is that the novation does not extinguish the debt; it substitutes the old obligations with the new obligation.[152] As he said, it merely modifies the payment method or extends the time of payment. It is incorrect to treat the subordination agreement as a concession because the debtor does not receive any benefit and his assessed loss cannot be reduced. The only similarly between the two agreements is that they both replace old obligations for new ones, but a novation agreement does not extinguish the debt. I seem to find support from TE Brincker where he states that

> *"Subordinated loans have gained popularity since the decision of the Appellate Division in Ex Parte De Villiers and Another NNO: In Re Carbon Developments (Proprietary) Limited (In Liquidation) 1993 1 SA 493 (A).[153] As opposed to capitalising a company, recourse is now often had to subordinating loan accounts or other claims against the company in order to enable it to continue trading.[154]It was indicated in the De Villiers case that subordination does not result in a company's assets exceeding its liabilities (the so-called insolvency test). It merely enables a company to continue paying its creditors as and when they become due (the so-called liquidity test).[155]*

I concur with Brincker where he states" *It merely enables a company to continue paying its creditors as and when they become due (the so-called liquidity test)".*[156]
This indicates that the subordination agreement does not have the effect of extinguishing or reducing the debt as required in S 20(1)(a)(ii).

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[152] *Supra*

[153] *TE Brincker , Taxation Principles of Interest and other Financing Transactions Issue 6 .March 2009 ,EE-12*

[154] *Supra*

[155] *Supra EE21*

[156] *Supra EE21*

2.2.4 Ordinary course of trade

The Act provides that any balance of assessed loss incurred shall be reduced by an amount or value of the benefit received by a debtor, resulting from a compromise or concession granted by creditors if the liabilities which have been reduced or extinguished arose in the ordinary course of trade. This means that only debts arising out of trading activities can be considered for the set off.

2.3 Recoupment provision s 8(4) (m)

When the debtor does not have any assessed losses or the debt has prescribed section 8(4) (m) may apply. If the taxpayer did not deduct any expenditure or allowances in the current or previous years of assessment in respect of the debt, section 8(4)(m) will also not apply and paragraph 12(5) will then find application.

Section 8(4)(m) provides that

> *"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 does not seem to be too problematic. If a taxpayer claimed any deductions in respect of the incurring of the debt, it is only fair to recoup whatever the taxpayer has deducted

if the debt is wiped out. The section provides for equilibrium in the tax system by ensuring that there is an inclusion in income for a deduction previously claimed which is no longer incurred. The section was legislated to include amounts that did not fall under the general recoupment provision –section 8(4)(a).[157] Section 8(4)(a) refers to amounts 'recovered or recouped' and therefore it could be argued would not include a debt forgiven as no amount is received.

Section 8(4) (m) is subject to section 20, therefore, it will not apply to amounts which have been taken into account in reducing the taxpayers balance of assessed loss.[158] If the value of the compromise benefit exceeds the assessed loss, the excess might be taxable.[159]It must be noted that s 8(4)(m) states "subject to" and not "to the extent that" .

It has been held that[160]:

> *'The words "subject to" can, depending upon the context in which they are used, infer or determine the existence of a condition precedent, or amount to no more than the term of an agreement. Where those words appear in a statutory provision*
>
> *". . . [g]enerally speaking, the words 'subject to' have the effect of introducing a qualification, limitation or condition precedent, thereby curtailing a person's exercise of otherwise unrestricted rights. It does not, in this sense, mean an alternative or optional right without affecting an unfettered original right."*
>
> *'(Per Goldin J in Hickman v The Attorney-General 1980 (2) SA 583 (R) at 585E–F.)*
>
> *'In other statutory provisions, the same words may mean "except as curtailed by"*
>
> . . . .
>
> *'Depending on the context, the same words can prescribe the manner and fashion in which certain powers and duties may, or must be exercised* . . . .

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[157] *Olivier.L Reduction or discharge of debts: The Hidden tax dangers, Stellenbosch Law Review Journal 2006 Volume 7, Issue 2, 303*

[158] *Silke. South African Income Tax, subsection 4,64B 2009*

[159] *Supra*

[160] *By Hancke J in CIR, Transkei, and another v JALC Holdings (SA) (Pty) Ltd and another 1991 (4) SA 646 (Tk), 54 SATC 7 at 10–11 (on appeal as Moodie v CIR, Transkei, and another; CIR, Transkei, and another v Moodie and another 1993 (2) SA 501 (Tk AD) 55 SATC 164). See the authorities cited there; see also Sentra-Oes Koöperatief Bpk v KBI 1995 (3) SA 197 (A), 57 SATC 109 at 115–6.*

'The words "subject to" could also constitute a condition precedent, meaning that a test or action must be completed, that something has to take place before the agreement does in fact become binding upon the parties thereto . . . .'

Despite the cited authorities, in my opinion, "subject to" should infer that in an event where section 20 finds relevance, section 8(4)(m) is not applicable. Further, that section 20 prevails over section 8(4)(m) and if the amount was taken into account into reducing the taxpayer's balance of assessed loss, the excess should not be taxable in terms of section 8(4)(m) .[161] For example, Debtor A is released from its debt obligation amounting to R 500 by creditor B. Debtor A has an assessed loss of R 300 and , the R 500 waived by Creditor B will be set off against the assessed loss of R 300.

The R 200 excess/ remainder cannot be taken into account in determining whether or not there has been a recoupment in terms of section 8(4)(m) . This is due to the fact that where section 20 is applicable the amount has been subjected to tax regardless of the limit imposed by the assessed loss amount. It must be noted at this point that the R 200 excess will however, fall under paragraph 12(5) of the Eighth Schedule.

In CIR v Louis Zinn Organisation the court chose not to decide whether or not section 8(4)(a) was meant to include a compromise benefit as a taxable recoupment.[162]
The main purpose of section 8(4)(m) is to ensure that any debtor, relinquished from his obligations to pay a debt either partially or fully where the underlying expense was deducted in terms of section 11, incurs a recoupment.[163]

Olivier makes an interesting observation. She examines the situation where a creditor cedes a debt owed to him to another and receives a concession for the cession.[164] She says, section

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[161] *Supra*

[162] *CIR v louis Zinn Organisation 22 SATC 85*

[163] *Lynette Olivier Organisation , Reduction or Discharge of debt: The Hidden tax danger Stellenbosch Law Review Journal 2006 Volume 7, Issue 2, 303*

[164] *Supra*

8(4)(m) will not apply because the debtor is still required to pay the debt but to a different person .[165] Therefore it cannot be argued that the debtor has been released from his or her obligation to pay.[166] I concur that the fact that an obligation has been shifted to a new creditor or substituted by a new one does not mean that the debtor has been released from his obligation to pay.

Justification for the recoupment arising in terms of section 8(4) (m) is found in the fact that the debt released was deducted for income tax purposes.[167] Since the amount deducted is no longer payable, it makes sense for it to be added back to the taxpayer's taxable income.[168] For example, A buys trading stock for R50 000 on credit from B. A incurs a section 11(a) deduction for R 50 000. If the R 50 000 is waived, a recoupment must occur to reverse the deduction albeit in a different year.

It must also be noted that section 8(4)(m) specifically includes prescription of debt (discussed in chapter 1) where as section 20(1) does not.

2.4 Paragraph 12(5) of the Eighth Schedule

This is a catch all section created to tax waiver arrangements that were able to escape section 8(4)(m) or section 20(1)(a)(ii) and tax any excess of the discharged or reduced amount after these two sections have been applied. In addition if the debtor did not have an assessed loss and did not deduct any expenditure in terms of section 11, the amount waived will be subject to capital gains tax ("CGT") in terms of paragraph 12(5) of the Eighth Schedule. The paragraph ensures that the same amount is not taxed twice. This is clear from the wording in paragraph 12(5) which excludes in (ii)(aa)B any amount taken into account in terms of section 8(4)(m) or 20(1)(a)(ii).

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[165] *Supra*

[166] *Supra*

[167] *Supra*

[168] *Supra*

Paragraph 12(5) provides that [169]

> *(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,*

Some basic rules and definitions of CGT are discussed below in order to achieve a better understanding of how paragraph 12(5) operates.

2.4.1 Determining a capital gain or loss

The Eighth Schedule provides for four key definitions (Asset, Disposal, Proceeds and Base Cost) which form the basic building blocks in determining a capital gain or loss. [170]

2.4.1.1 Asset

An asset is widely defined and includes any property of whatever nature and any interest therein. CGT applies to all assets disposed of on or after 1 October 2001 (valuation date), whether or not the asset was acquired before, on or after that date. Only the capital gain accruing from 1 October 2001 will be subject to CGT.

2.4.1.2 Disposal

The concept of disposal covers any event, act, forbearance or operation of law which results in a creation, variation, transfer or extinction of an asset. It also includes certain events treated as disposals, such as the change in the use of an asset, or a donation.

2.4.1.3 Proceeds

Once an asset is disposed for an amount which is received by or which accrues to the seller of the asset that amount constitutes the proceeds from the disposal.[171] If it is a deemed disposal such as a donation then the proceeds would be equal to the market value of the asset.

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[169] *Income Tax Act 58 of 1962*

[170] *The ABC of Capital gains Tax for Companies, Fourth Issue , June 2008 ,Pg 5*

[171] *Supra*

2.4.1.4 Base Cost

The base cost of an asset is generally the expenditure actually incurred in acquiring the asset together with expenditure directly related to its improvement and direct costs in respect of its acquisition and disposal and certain holding costs[172]. The base cost does not include any amounts allowed as a deduction against ordinary income, such as a capital allowance on plant and machinery.[173]

2.4.2 Paragraph 12(5)

If paragraph 12(5) did not exist, there would be no CGT implications for the debtor making the gain and there would only be CGT implications for the creditor who incurs a loss. The main purpose of the paragraph is to tax a benefit received by the debtor where a debt owed by it has been reduced for no consideration or for an amount that is less than the face value of that debt and such a benefit has not been taken into account in terms of section 8(4)(m) or section 20(1)(a)(ii).

As said earlier, CGT consists of four building blocks and all must be present to trigger a CGT event. If there was no para 12(5) the waiver of a debt transaction would not meet all of these criteria. Paragraph 12(5) has the effect of deeming the benefit received by the debtor to be a benefit and ultimately an asset.

According to paragraph 20, the base cost of the asset (being the creditors claim) is the amount spent by the creditor in creating it (that is the capital amount of the loan).[174] In a case where the creditor waives the debt and the asset is extinguished, this leads to a disposal in terms of paragraph 11(1). [175] The proceeds of the disposal will be equal to the amount discharged by the creditor, as contemplated in paragraph 35(1).

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[172] *Supra*
[173] *Supra*
[174] *Supra*
[175] *Supra*

Therefore, the proceeds are equal to the base cost.[176] As a result of the waiver or cancellation of the debt, the creditor does not make any capital gain[177]. In turn, there are no capital gains tax consequences for the debtor flowing from the waiver or cancellation. RC Williams regards the latter point as important and as I understand it, might be one of the reasons why paragraph 12(5) was inserted into the Eighth Schedule.

One of the most contentious issues is whether paragraph 12(5) also applies to a scenario where the creditor writes off the obligation of the debtor as a bad debt.[178] Also when the debt becomes prescribed (see chapter 1), it might seem as if the creditor has discharged the debt for no consideration.[179] In a liquidation (see chapter 1) scenario, a creditor still has to lodge a claim, even though it is aware that the debtor may not necessarily be able to discharge a debt.[180] Lodging the claim would show that the creditor did not waive or reduce the debt and paragraph 12(5) does not find application.

The SARS CGT guide provides two reasons why this paragraph was legislated.

1. To ensure that the debtor relieved from obligation to pay any amount owing will be subject to CGT on a capital gain equal to the amount discharged..
2. To have symmetry in the tax system by ensuring that there is a matching of capital gains with losses. Meaning, the debtor relieved from the obligation is subject to CGT, while the creditor who waived the debt owed will be able to claim a capital loss in respect of the losses suffered as a consequence of the waiver[181].

I fully agree with the fact that symmetry in the tax system was needed, because the debtor gains some form of a benefit and should be subjected to CGT. In fact, it might even amount to a double benefit. For instance, the debtor acquires a loan to participate in a productive business transaction and gains profit. In addition he is subsequently released from the obligation to pay

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[176] *Supra*

[177] *Supra*

[178] *TE Brinncker, Taxation Principles of Interest and other Financing Transaction March 2009 JJ-9*

[179] *Supra JJ-9*

[180] *Supra JJ-9*

[181] *SARS CGT guide 2007*

the loan. It's a double benefit because, he makes a profit from the business transaction and, is released from his obligation to pay the loan that enables him to transact.

On the other hand, the facts might be different. The debtor might be sinking in debts and although he is being released from one of his obligations to pay, it is not really significant in his financial position and does not really constitute a benefit. SARS will include the amount as a capital gain in the taxpayer's taxable income, but the taxpayer is in an assessed loss position. Ultimately, SARS does not receive anything because of the assessed loss. The debtor cannot pay his debts and there is no hope that he will recover from his insolvent position. The fact that he does not have to also pay tax can hardly be a benefit to him. This illustration goes back to what was said earlier that a benefit has different meanings dependent on individual circumstances.

2.4.3 The treatment of the parties to the waiver

If a debtor is subject to CGT in terms of paragraph 12(5) , the creditor will be entitled to claim a capital loss in terms of paragraph 56(2)(a).[182] This achieves the second reason of matching furnished by SARS for the introduction of this paragraph. If no capital gain arises on the part of the debtor, paragraph 56(2)(a) does not apply and the creditor cannot claim the loss suffered.

Paragraph 12(5) complies with the four building blocks discussed above as follows:

Asset: The Debtor is deemed to have acquired a claim to the debt reduced or discharged.
Base cost: the base cost of the asset is deemed to be nil as nothing is incurred.
Proceeds: The proceeds are determined as follows:

- If the debtor paid nothing -the amount discharged or reduced.
- If the debtor paid something – the difference between the amount paid and the amount discharged or reduced.

Disposal: The claim acquired by the debtor is deemed to be disposed of as the debt is extinguished.

[182] *South Africa 1962. Income Tac Act 58 of 1962*

In short, the debtor will have a capital gain equal to the amount of the debt that has been discharged or reduced less any amount paid to the creditor.[183]

2.5 Paragraph 38 and 56 of the Eighth schedule

Paragraph 38 states that

> *(1) Subject to subparagraph (2) and paragraphs 12 (5) and 67, where a person disposed of an asset by means of a donation or for a consideration not measurable in money or to a person who is a connected person in relation to that person for a consideration which does not reflect an arm's length price—*
>
> *(a)*
> *the person who disposed of that asset must be treated as having dis-posed of that asset for an amount received or accrued equal to the market value of that asset as at the date of that disposal; and*
>
> *[Item (a) substituted by s. 63 (1) (a) of Act No. 32 of 2004.]*
>
> *(b)*
> *the person who acquired that asset must be treated as having acquired that asset at a cost equal to that market value, which cost must be treated as an amount of expenditure actually incurred and paid for the purposes of paragraph 20 (1) (a).*
>
> *[Sub-para. (1) (previously para. 38) amended by s. 87 (1) (a) of Act No. 60 of 2001 and by s. 81 of Act No. 74 of 2002. Item (b) substituted by s. 87 (1) (b) of Act No. 60 of 2001 deemed to have come into operation on 1 October, 2001.]*

Paragraph 38 applies where a person disposes of an asset to a connected person, for a consideration that does not reflect an arms length price. [184] In such a case, the connected person will be deemed to have disposed of the asset for an amount equal to its market value at the time of the disposal. [185]And, the acquirer will be deemed to have acquired the asset at a cost equal to that same market value.[186] A connected person of a trust, for example, is a beneficiary, and a connected person of that beneficiary is his or her relative.[187]

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[183] *SARS CGT Guide 2007*

[184] *M.Stein . Capital Gains Tax 2008 Electronic version Lexisnexis*

[185] *South Africa 1962. Income Tac Act 58 of 1962*

[186] *South Africa 1962. Income Tac Act 58 of 1962*

[187] *Supra*

A relative is defined in section 1 of the Income Tax Act as "*in relationto any person, means the spouse of such person or anybody related to him or his spouse within the third degree of consanguinity, or any spouse of anybody so related, and for the purpose of determining the relationship between any child referred to in the definition of "child" in this section and any other person, such child shall be deemed to be related to its adoptive parent within the first degree of consanguinity*";

Connected persons may only set off capital losses against capital gains made when transacting with the same connected persons. If an asset is sold at a capital loss to a trust, the seller (i.e who is also a beneficiary) may only set off the losses suffered against the capital gains incurred through the sale of another asset to that trust.[188] Further, the loss may only be deducted against the capital gain if the disposals occurred in the same or any later year of assessment as the later transaction that resulted to a capital gain.

Paragraph 38 is made subject to paragraph 12(5), as a result, if paragraph 12(5) applies, section 38 will not find application. Therefore, when the founder waives a trust debt, paragraph 12(5) applies and paragraph 38 will be inapplicable. In consequence, no proceeds will arise and this results to a capital loss for the creditor of the amount waived which they can claim[189] against capital gains even if the debtor and creditor are connected persons.

2.5.1 Donations and Paragraph 38

It must be noted that while a waiver of a trust debt gives rise to capital gains tax, a donation of cash to a trust would not amount to a disposal of an asset leading to proceeds for capital gains tax purposes.[190] This is due to the fact that," cash" is excluded from the definition of an asset in the Eighth Schedule of the ITA.

[188] *Supra*

[189] *Supra*

A donation means a donation in the common law sense of the word.[191]Namely, a transaction under which motivated by liberality, a person makes a disposal completely gratuitously. [192] For the purposes of paragraph 38, the founder's gratuitous waiver of the debt would amount to a donation.[193] Thus, the donor is deemed to have disposed of the debt for an amount received or accrued equal to the market value of the asset as at the date of the disposal.[194]

2.5.2 Paragraph 56

Paragraph 56(1) provides that a creditor waiving the debt owed by a debtor who is his or her connected person must disregard a capital loss determined in consequence of the disposal.[195] A founder and his family trust for example are generally connected persons. Paragraph 56 (1) finds application when the founder creditor disposes of a claim owed by the debtor trust.[196]If the debt waiver amounts to a capital gain in the hands of the debtor in terms of paragraph 12(5), the creditor can claim a capital loss suffered in terms of paragraph 56(2).[197] Paragraph 56(2)(a) has the effect of suspending the application of paragraph 56(1) so that tax equity is achieved.

RC Williams alerts us to an unintended consequence of this paragraph;

> " *should the creditor dispose of a claim against a connected person in relation to that creditor to another person at a loss, and in that other persons hand's a capital gains arises which is included in his or her aggregate capital gain or loss, the creditor may not claim the capital loss that he has suffered.*
>
> *The addition of paragraph 56(d) has the result that where the creditor can prove that the capital gain was brought into account in the determination of the other person's aggregate capital gain or loss, the creditor can claim the capital loss.*[198]

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[191] *Supra*
[192] *Supra*
[193] *Supra*
[194] *South Africa 1962. Income Tac Act 58 of 1962*
[195] *Supra*
[196] *M Stein .Capital gains tax . 2008 Electronic version*
[197] *Supra*
[198] *RC.Williams :Capital Gains Tax a Practitioners Guide,2nd Edition ,2005, 338 - 339*

Since paragraph 56 is discussed, it is necessary to also consider Paragraph 39. Paragraph 39 (1) (a) provides that a person must disregard a capital loss determined on the disposal of an asset to a person who was his connected person immediately before the disposal.[199] A capital loss disregarded in paragraph 39(1) may in terms of paragraph 39(2) be deducted from capital gains made by him on disposals of assets during the same or subsequent years of assessment to the same person to whom the disposal giving rise to the capital loss was made, as long as they are still connected persons at the time of those subsequent disposals.[200] If no further transactions are made with that connected person the loss is forever lost. However, if paragraph 56 applies then set off against other (unconnected) gains can still take place.

2.6 Donations tax, Secondary tax on Companies, Value added Tax and fringe benefits tax

2.6.1 Donations Tax

A further aspect that needs to be considered is a probable donations tax liability in terms of section 54 of the Income Tax Act[201] that may arise as a consequence of debt forgiveness. Donations tax was introduced to limit the avoidance of tax by providing gifts resulting to a reduction of liability for income tax of the donor, while income derived from the donated assets is spread among more taxpayers who may have lower marginal tax rates.[202]

Section 55 defines a donation as any gratuitous disposal of property including any gratuitous waiver or renunciation of a right.[203] In *ITC 1448* the court accepted that;

> *"a adiation by Mrs A was a 'gratuitous disposal of property' and hence a donation as defined in s 55(1)(ii). That it amounted to a disposal of property was common cause. That 'gratuitous', 'gratis' in the Afrikaans text, meant given for nothing, without charge, free, was also not in dispute".*[204]

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[199] *Supra*
[200] *Income Tax Act 58 of 1962*
[201] *Income Tax Act 58 of 1962*
[202] *Silke. South African Income Tax 2009 page para 23.1 Electronic version*
[203] *Income Tax Act 58 of 1962*
[204] *ITC 1448 51 SATC 58 at 63*

Suffice to say, a disposition is gratuitous if it is given for nothing, without charge or for free.[205]In a case of debt waivers, a disposal of a right to claim (the waiver of the debt) by the creditor might constitute a gratuitous disposal. However, SARS has not yet charged donations tax on a creditor who waived a debt. The reason might be that SARS understands the difficulty of proving a "*gratuitous disposal*" and in some cases a waiver is not driven by liberal or generous intentions on the part of the creditor.

A donation in a form of a waiver of a portion of a debt owing to the donor, amounts to a deemed disposal and acquisition for capital gains tax purposes (refer to discussion in paragraph 2.5.1).[206] The debtor is deemed to have acquired a claim to the portion of the debt that was reduced or discharged for no consideration and for a base cost of nil. [207] Further, the debtor is deemed to have disposed of the claim for proceeds equal to the amount that was reduced or discharged.

In Japan, a debt waived by a creditor amounts to a donation to the debtor. However, although the waiver leads to a donation, the creditor cannot deduct the deduction as an expense (see discussion in Chapter 1 paragraph 1.3.3). It appears that Japan and South Africa are in agreement that the waiver of a debt constitutes a donation.

As an alternative to waiving the loan, it is suggested that a debtor repays the debt and subsequently, the creditor donates the payment to the debtor. In essence, this still amounts to a reduction or discharge of the debt but it does not attract capital gains tax due to the fact that there is no disposal of an asset (release of right to claim payment by means of a waiver). However, the donation might, from the creditor's position, trigger donations tax.

This option might not be practical, considering the fact that the debt is being waived because the debtor is unable to repay it and it might not have the funds to settle the debt even though the creditor will eventually donate the payment back to the debtor.

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[205] *ITC no 1448 (1988) 51 SATC 58(C)*
[206] *Paragraph 38 of the Eighth Schedule of the Income Tax Act 58 of 1962*
[207] *Supra*

2.6.2 Secondary tax on companies ("STC")

It is necessary to briefly consider section 64(C) of the ITA in determining whether a waiver of a right can constitute a deemed dividend in the hands of the debtor. Section 64C (2)(b) of the ITA provides that, for the purposes of S 64B[208] , an amount shall be deemed to be a dividend declared by a company to a shareholder, where any shareholder or any connected person in relation to that shareholder is released or relieved from any obligation measurable in money which is owed to that company by that shareholder or connected person., to the extent that the amount so owed was not already deemed to be a dividend declared by that company in terms of paragraph (g) However, section 64(C)(4)(k) of the ITA exempts the debtor from STC if the debtor and the creditor are in the same group of companies. If the debtor and creditor are not part of the same group of companies then there will be an STC liability of 10% of the amount waived.

In the Netherlands a loss arising from the waiver of a loan for business reasons is allowed as a deduction. However if the waiver was not arms length it will be treated as an informal distribution of profit by the lender. The loss will not be deductible and will be subject to the Dutch dividend tax (refer to paragraph 1.3.5)

2.6.3 Value added Tax ("VAT)

A debt reduction might also have Value Added Tax consequences. Section 22(3) of the Value Added Tax Act ("VAT ACT") is similar to section 8(4)(m) of the Income Tax Act. Section 22(3) provides that, where a vendor who accounts for tax on the invoice basis has previously claimed an input tax deduction, but has not paid the full consideration within twelve months from the expiry of the period in which the deduction has been made, he is required to account for output tax in relation to the amount still outstanding. The twelve months is determined from the end of the tax period during which the input tax was claimed, and the vendor is required to account for output tax during the tax period immediately following the twelve month period.

[208] *Section 64B deals with the levy and recovery of Secondary tax on Companies*

Section 22(3) of the VAT Act has a proviso, namely, that where a written contract has been entered into providing that the debtor makes payment on a specific date and the debtor fails to make payment on the agreed date, the debtor becomes liable for output tax within twelve months from the end of the month in which he was liable to make payment.[209]

Amongst other issues, the section affects inter group loan accounts which relate to the taxable supply of goods and services. If the relevant debt is not paid within twelve months, the debtor group entity will have to account for output tax. A corresponding input tax deduction may only be claimed by the debtor once he has made payment.

Although capital gains tax and income tax may not have much impact on a debtor in an assessed loss position as no tax is payable, the physical repayment of the value added tax debt will have an impact on the debtor.[210] For income tax purposes, the debt can only become bad after the payment date has passed.

2.6.4 Seventh Schedule- fringe benefits

Paragraph 2(h) of the Seventh Schedule to the ITA provides that a benefit will arise if an employer pays an amount owing by an employee to a third person, without requiring reimbursement by the employee.[211] A benefit will also arise if the employer releases any employee from the obligation to pay an amount owing by the employee to the employer. The amount to be included in the gross income of the employee is the amount that was owed by the employee.

Section 8 (4)(m) will not find application in circumstances were the employer releases an employee from an obligation to pay. This is due to the fact that generally, the amount borrowed was not used for expenditure incurred in the production of income. Further, if the amount was used to fund such expenditure, that expenditure was not eligible for a section 11 deduction to

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[209] *Supra*
[210] *L Olivier. Reduction or discharge of debts : The Hidden Tax dangers Pg 312*
[211] *TE Brinncker, Taxation Principles of Interest and other Financing Transactions JJ-9 March 2010*

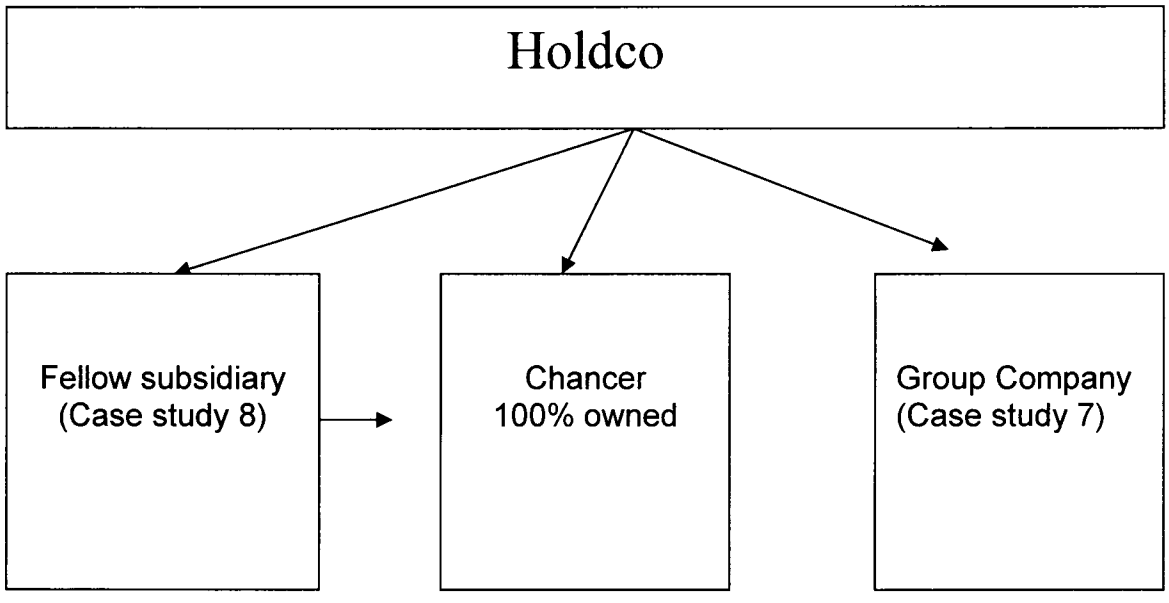
be deducted from the employee's gross income. For this reason it was necessary to include this as a benefit from the employer, to be taxed in the hands of the employee, in terms of the Seventh Schedule.

Chapter 3

3.1 List of Case Studies

In this chapter 6 case studies will be presented illustrating the relevant income tax issues faced by parties to debt reduction transactions. Chapter four will then carefully discuss each case study taking into account the relevant provisions of the Income Tax Act ("ITA") and definitions discussed in the previous chapters.

A diagram illustrating the facts to be used in the case studies is presented below:



Facts

Holdco (Pty) Ltd ("Holdco") holds all the shares in Chancer (Pty) Ltd ("Chancer"). Chancer is in the business of manufacturing cosmetics. At 31 December 2008 (Chancer's financial year-end), the balance sheet was as follows:

Share Capital	1,000,000.00
Shareholders loan	8,500,000.00
Loan from National Development Corporation("NDC")	5,000,000.00
Bank Overdraft	2,200,000.00
Holdco creditor for management fees	500,000.00
ABC Ltd (a third party) for accounting services	50,000.00
Accumulated Losses (also assessed)	**-4,000,000.00**
	13,250,000.00
Trading Stock	5,250,000.00
Building	8,000,000.00
	13,250,000.00

The following other information is relevant:

The loan balances include the following accrued interest: NDC R 300 000, Bank overdraft R 200 000.

The NDC loan stood at R 5 000 000 just before year-end, which included accrued interest of R 1 800 000. An amount of R 1 500 000 was then repaid. The repayment notice did not mention which part of the repayment was interest, neither does the loan agreement stipulate which part of any repayments would be interest or capital. The management fees where of a capital nature.

The building was financed with the R 1 000 000 share capital, R 4 000 000 from the Shareholder's loan and R 3 000 000 from the NDC loan. Income tax allowances of R 450 000 have been claimed on the building.

The following case studies are now presented based on the above facts. For this purpose the five lenders above are collectively referred to as "the creditors":

3.1.1 Case study 1

The creditor (HoldCo) applies for the liquidation of Chancer. HoldCo can expect to receive 60 cents for each Rand as will all the other creditors.

3.1.2 Case study 2

In order to strengthen the balance sheet of Chancer, Holdco agrees to convert R 4 000 000 of the shareholder's loan to ordinary share capital.

3.1.3 Case study 3 compromise

In terms of the agreement with NDC an amount of R 5 000 000 of the loan is automatically released because the South African economy has officially been in recession for more than a year.

3.1.4 Case study 4 debtor's voluntary liquidation

Chancer decides to go into voluntary liquidation. The creditors can expect to receive 60 cents for each Rand.

3.1.5 Case Study 5

Holdco cedes its shareholder's loan and sells its 100% shareholding to a fellow group company.

The Income Tax consequences resulting from the losses incurred in each case study will be examined in Chapter 4.

Chapter 4

4.1 Application and discussion of the Income Tax consequences of the case studies

4.1.1 Case Study 1

Question - The creditor (HoldCo) applies for the liquidation of Chancer. HoldCo can expect to receive 60 cents for each Rand as will all other creditors.

4.1.1.1 Paragraph 12.5

Paragraph 12.5 of the Eighth Schedule applies where a debt owed by a person to a creditor is reduced or discharged for no consideration or for a consideration which is less that the amount by which the face value of the debt has been reduced or discharged. The person is deemed to have disposed of a claim which may be subject to CGT. Paragraph 12(5) does not apply where the debtor and the creditors are members of the same group of companies.

On the basis that HoldCo and Chancer are members of the same group of companies, the above exemption should find application in this scenario. Therefore, no capital gain accrues to Chancer in terms of paragraph 12(5) in respect of the Holdco Loan.

4.1.1.2 Section 20(1)(a)

Section 20(1)(a) of the ITA provides that where a liability owing by a person that is in an assessed loss position has been reduced or extinguished as a result of a concession granted by or a compromise made with any creditors, the balance of that person's assessed loss will be reduced by the amount or value of the benefit received by that person.

4.1.1. 3 Section 8(4)(m)

In terms of section 8(4)(m) of the ITA

a taxable recoupment will arise if:[212]
i) a person is relieved from the obligation to make payment of any expenditure actually incurred;
ii) 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;
iii) if such expenditure was not paid; and
iv) such expenditure or any allowance in relation to such expenditure was allowed as a deduction.

The loan owing by Chancer to HoldCo will be partly extinguished upon liquidation and creditors will only receive 60% of their claims against Chancer, Therefore, requirement (i) of section 8(4)(m) is met as Chancer is relieved from part of its obligation and will only pay 60% of the debts. Moreover, requirement (ii) is also met due to the fact that the relief is a result of creditors waiving or releasing 40% of their debts owed by Chancer.

In applying requirement ii) it is imperative to note that the relief from the obligation to make payment must flow from a cancellation, termination or variation of an agreement or due to the prescription, waiver or release of a claim for payment. In determining whether the dissolution of the loan at hand upon liquidation is due to the waiver of a claim to make payment I will simply refer to the discussion in Chapter 2.

Based on Christie's law of Contract and case law (Ex *Parte Sussens* , *Pretorous v Greyling*) discussed in Chapter 2 it would appear that in the current circumstances, a waiver will only exist if HoldCo deliberately surrenders its rights to claim payment in terms of the loan or commits an unequivocal act with the intention to waive such rights.

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[212] *RH Christie, Law of Contract in South Africa, 5th Edition (2006)Pg Supra 437*

Chancer is placed in creditor's liquidation. The loan (which existed prior to the initiation of the liquidation process) is partly extinguished as a result of the liquidation process and not 'due to a waiver by HoldCo of its claim for payment. This is on the basis that there is no unequivocal act performed by HoldCo with the intention to waive its rights for payment against Chancer in terms of the loan agreement.
Further note the comments of Munnik AJ in the *Union Free State Mining* case[213]

> *" I do not think that a creditor can by the mere exercise of his will terminate the obligation without the concurrence of the debtor because as both Wessels [para 2344A] and Pothier [s578] point out a release, waiver or abandonment is tantamount to making a donation to the debtor of the obligation from which he is to be released and until that donation has been accepted it has not been perfected."*

In application of the above, it appears that, as in the case of a waiver, a release similarly requires the creditor (HoldCo) to perform an act whereby it deliberately surrenders its rights.

Assuming that Chancer has accepted the 40% waiver of the claim from HoldCo, I am of the view that the extinguishing of the loan owing by Chancer constitutes a 'release of a claim for payment by HoldCO. Accordingly requirement ii) of section 8(4)(m) should be met because HoldCo voluntarily submitted Chancer to liquidation and Chancer accepted the offer. HoldCo knew that in a liquidation process, they would get a consideration less than the amounts owed by Chancer. This is a clear indication that HoldCo surrendered its rights to claim full payment from Chancer of the debts owed.

However, Chancer may resist to the applicability of section 8(4)(m) as it not clear from the facts whether or not Chancer has accepted the release. Chancer may find support in the latter quoted decision taken by Munnik AJ in the Union Free State Mining case. But the Commissioner may argue, the fact that Chancer has not repudiated the release of the claim is a clear indication that Chancer accepts the release and is relieved from its obligation to pay the outstanding debt.

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[213] *Union Free State Mining and Finance Gold and Diamond Corpn Ltd 1960 4 SA 547 (W)*

Requirement iii) is also met for the reason that the creditors debts are outstanding (as reflected on the balance sheet) hence all creditors would be only paid 40% of their debts. With regards to requirement iv) section 8(4)(m) only applies where the expenditure giving rise to the loan was either claimed directly as a deduction or indirectly as a capital allowance. The latter requirement is not met to the extent that HoldCo's debt arose from capital expenditure namely the Management fees. The Management fees were not deducted by Chancer as the expenditure was of a capital nature and did not qualify for a deduction.

The same argument will also apply in respect of the other creditors, however as expenditure of R450 000 (building allowances) and R50 000 (accounting services) has been deducted, there would be a section 8(4)(m) recoupment of RR500 000 in respect of the ABC Ltd and NDC loans.

As I said above, paragraph 12(5) will not be applicable in this instance as HoldCo and Chancer are members of the same group of companies (member of the same group are exempt from the application of paragraph 12(5)).

4.1.2 Case Study 2

Question - In order to strengthen the balance sheet of Chancer, Holdco agrees to convert R 4 000 000 of the shareholder's loan to ordinary share capital.

4.1.2.1 Section 20(1)(a)(ii) of the ITA

In terms of section 20, a compromise with any creditor reduces the assessed loss. However not all liabilities reduce an assessed loss.[214] They must be liabilities incurred in the ordinary course of trade. In the facts at hand Chancer claimed an income tax allowance of R 450 000 in respect of a building financed partly by means of a loan from its shareholder. Section 20 applies because the debt arose in the ordinary course of trade (regardless of whether deductions or allowances where claimed) and Chancer has an assessed loss. In some instances, the write off of this type of loan will give rise to a capital gain in the hands of the company in terms of

[214] *Huxmam and Haupt, Notes on South African Income Tax 2009 Pg 261*

paragraph 12(5) of the Eighth Schedule either because the loan waived is greater than the assessed loss or the debt was not incurred in the ordinary course of trade. In this case study however the debtor and the creditor here are part of the same group of companies and therefore paragraph 12(5) cannot apply (paragraph 12(5)(*bb*)).

The relevant case of *CIR v Datakor Engineering (Proprietary) Limited 60 SATC 503* dealt with similar facts where amounts owing by the taxpayer were converted into cumulative redeemable preference shares. The question asked by the court was whether the taxpayer derived a benefit pursuant to the implementation of a scheme of arrangement in terms of section 311 of the Companies Act.[215] The court said;

> *"The court in answering the question whether any benefit had been received by or had accrued to respondent, it was correct 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, must redound to its benefit, the company is discharged from liquidation and its creditors are replaced by a shareholder, who, as the holder of redeemable preference shares, cannot sue the company for repayment of the capital when redemption becomes due.*[216]
>
> *That the provision in question concerns itself with 'any benefit', words of a wide and indeterminate meaning; the benefit, in the words of the Income Tax Act, is to be found in the reduction or extinction of the debt, something which and the extent of which was common cause; indeed, the concession by the creditors (to waive the balance of their exigible 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."*[217]

The court further held that the taxpayer received a benefit equal to the amount of share premium that was created, and that the burden of proof is not on the Commissioner to show that an ascertainable money value existed.[218].

Section 20 is not concerned with the benefit, if any received by a creditor, but whether or not a benefit is received by the taxpayer (the debtor).[219] The court held that the replacement of a creditors claim with preference shares amounts to a concession, as an enforceable compulsion

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[215] *CIR v Datakor Engineering (Proprietary) Limited 60 SATC 503*
[216] *Supra 503*
[217] *Supra 503*
[218] *Supra 504 (head note)*
[219] *Taxation Principles of Interest and other Financing Transactions, March 2009 . JJ-4*

is replaced with something of a completely different nature.[220] The court raised the point that whether or not preference shares are issued or whether existing claims are subordinated, such an arrangement will be for the benefit of the taxpayer.[221]

The *Datakor* case has been criticized as to whether or not a conversion of a loan account into shares will more often than not result in it being seen as a concession granted or a compromise made with at least one creditor (being a holding company).[222] A number of foreign companies that converted their foreign loans to their South African subsidiaries into capital have found that the subsidiaries assessed losses have been reduced by SARS relying on this principle. [223] This is consistent with the approach that if a company issues shares, the interests of existing shareholders are diluted.[224] Should a claim thus be converted into a share, there would clearly be at least a benefit arising from a concession made by the holding company.[225]

The issue is whether the conversion of the loan to shares amounts to a benefit received by Chancer.

Section (20(1)(a)(ii) provides that the taxpayer's assessed loss will be reduced by the value of the amount that reduced or extinguished the taxpayer's liability as a consequence of a compromise or concession with any creditors.
The court in the *Datakor* case concluded that an arrangement between a debtor and creditor to convert the loan into cumulative redeemable preference shares will amount to a benefit to the taxpayer.[226]Respectfully with reference to the *Datakor* case, conversion of the debt to shares will not always amount to a benefit. A benefit for the purposes of section 20(1)(a)(ii), is when a debtor pays less than the amount owed. One cannot be certain that the value of the shares is less than the debt owed until the shares have been valued. The valuation of the shares will supply the true value of the shares and then the value of the shares is compared with the debt owed to

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[220] *Supra JJ-4*
[221] *CIR v Datakor Engineering (Proprietary) Limited 60 SATC 503*
[222] *Taxation Principles of Interest and other Financing Transactions, March 2009 . JJ-5*
[223] *Supra JJ-5*
[224] *Supra JJ-5*
[225] *Supra Jj-5*
[226] *CIR v Datakor Engineering (Proprietary) Limited 60 SATC 503*
283 Silke on South African Income Tax 2009, Electronic version

ascertain whether or not a benefit has been received by the taxpayer. Judge Wunch in *ITC 1613* could not quantify the value of the debt in monetary terms.[227] I agree with him that,

> " *the value of the benefit is not the whole face or amount of the previously existing claims , having regard to the nature of the 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."*[228]

The SARS Practice manual provides that;

> *"The valuation of the shares may in individual cases present some difficulty but generally the value will be the middle market price on the date of the agreement. If the shares are not quoted on the stock exchange, the valuation will be ascertained on the best information available, such as actual sales on or near the date of accrual or, if no sales have taken place, by reference to the present or potential value as reflected in the company's balance sheet. In some cases it may be necessary for lack of information to value the shares at nominal value and leave it to the taxpayer, if the valuation is not acceptable to him, to lodge objection and appeal or show cause why nominal value is not the true value at date of allotment."*[229]

My view is, the Court should have first determined the value of the shares prior to answering the question of "*receiving a benefit* "in section 20(1)(a)(ii). Despite my view, the Datakor decision dictates that the value of the shares is not important. What matters is that the debtor received a benefit as a result of the conversion of the shares and such benefit must be deducted from the debtors assessed loss.

The Dutch case law is of the view that a conversion of a loan to shares is not enough reason to recognize taxable profits in relation to the debt for either the debtor or the lender (refer to discussion in Chapter 1 para 1.3.5)

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[227] *ITC 1613 59 SATC 187 at 196*
[228] *Supra 196*
[229] *SARS Income Tax Practice Manual "Valuations – Shares and options" number 4.Pg A 776 para 4*

In conclusion, the R 4 000 000 loan converted to shares should be set off against the existing assessed loss.

4.1.3 Case study 3

Question - In terms of the agreement with NDC an amount of R 5 000 000 of the loan is automatically released because the South African economy has officially been in recession for more than a year.

As discussed in Chapter 2, when dealing with debt waivers you first have to consider various sections of the Act that are applicable in a sequence i.e first consider section 20(1)(a)(ii) ,section 8(4)(m) and if there is excess available consider paragraph 12(5) of the Eighth Schedule.

4.1.3.1 Section 20(1)(a)(ii)

Section 20(1)(a)(ii) provides the reduction of the assessed loss of a person who benefits from a compromise made with or concession granted by creditors.
In answering the question, I will make use of Silke's formula breaking down the section into the six elements discussed in Chapter 1[230];

- The must be a benefit.
- The benefit must have value or be an amount.
- The benefit must be received by the person concerned or accruing to the debtor.
- The concession must result from a concession granted or a compromise made with creditors.
- The concession or compromise must result in the taxpayer's liabilities to the creditor being reduced or extinguished.
- The liabilities so reduced or extinguished must have arisen in the ordinary course of trade.

[230] *Silke : South African Income Tax 2009 LexisNexis Electronic version*

Chancer has received a benefit. Getting a 5 million write off of a loan owing is definitely a benefit. In the case of *Datakor* it was held that an arrangement between a debtor and creditor to convert the loan into cumulative redeemable preference shares will amount to a benefit for the taxpayer.[231] However, it is worth noting that if a creditor merely writes off the debt as bad or decides not to enforce the debt it does not necessarily amount to a concession or a compromise.[232]

Further section (20(1)(a)(ii) provides that the assessed loss will be reduced by the amount or value of any benefit received by the taxpayer. As a result of an agreement between Chancer and NDC, NDC agreed to reduce Chancer's loan by an amount of R 5 000 000 which is the benefit received by Chancer.

The agreement between Chancer and NDC constitutes a concession because a concession occurs when a creditor waives its rights to claim for a consideration that is of a lesser value and in this case the full amount was waived[233]. In essence Chancer's assessed loss of R 4 000 000 will be wiped out by R 4 000 000 of the R 5 000 000 loan waiver.

In *CIR v Louis Zinn Organisation (Pty) Ltd* 1958 A it was held that the value of the compromise benefit received in one year must reduce any balance of assessed loss incurred at the end of the current year that is carried forward to the year in which the compromise benefit is enjoyed.[234]

The assessed loss was R 4 million and is reduced to nil. There is now an excess of R 1 million to deal with under section 8(4)(m) and paragraph 12(5) of the Eighth Schedule.

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4.1.3.2 Section 8 (4)(m)

In my view, section 8(4)(m) is subject to section 20 and where section 20 finds application, section 8(4)(m) will not apply. Since some authors disagree with the latter view and the fact that it is SARS practice to apply all the relevant sections, I will discuss section 8(4)(m) and paragraph 12(5).

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[231] *CIR v Datakor Engineering (Proprietary) Limited 60 SATC 503*

[232] *TE Brincker,Taxation Principles of Interest and other Financing Transactions, March 2009 .Chapter JJ- 4 para 3.1electonic version from Lexisnexis*

[233] *Silke.South African Income Tax 2009, lexisnexis electronic version, chapter 8.129, June 2009*

[234] *CIR V Louis Zinn Organisation (Py) Ltd 1958 A*

Essentially, since there is a remainder of R 1 000 000 from the amount waived by NDC, it is necessary to test the applicability of section 8(4)(m) to the facts at hand .

Section 8(4)(m) will only find application if;

- A debtor was released or partially released from its obligation to pay any expenditure as a result of a cancellation, termination or a waiver;
- At the time of the relief; the expenditure was not paid and
- The expenditure or allowance in relation to such expenditure was allowed as a deduction in the current or previous year

NDC agreed to reduce Chancer's debt by R 5 000 000. Chancer currently owes NDC an amount of R 5 000 000, of which R 3 000 000 was used to finance the building and income tax allowances amounting to R 450 000 have been claimed on the building.

The main purpose of introducing section 8(4)(m) was to widen the scope of a general recoupment in section 8(4)(a) in circumstances where there was previously a deduction claimed by the taxpayer. Chancer obtained a loan and used part of the loan to purchase the building. Furthermore, Chancer claimed allowances amounting to R 450 000. As provided by section 8(4)(m), Chancer owed NDC a sum of R 5 000 000, obtained allowances for R 450 000 and was relieved from its obligation to repay the R 5 000 000 loan. Therefore, the facts at hand fall into the ambit of section 8(4)(m) and the R 450 000 allowances are recouped by Chancer.

The R 450 000 recoupment is deducted from the R 1 million and there is a balance of R 550 000 of the concession left.

4.1.3.3 Paragraph 12.5 of the Eighth Schedule

The final step is to consider whether the R 550 000 remaining falls into the ambit of paragraph 12(5) of the Eighth Schedule.

The full R 5 000 000 has to be initially considered in terms of paragraph 12(5) but will be reduced by amounts set off under 8(4)(m) and section 20 and therefore only the R 550 000 has to be debated Paragraph 12(5) applies where a debt owed by a person to a creditor is reduced or written off by a creditor. The debtor is as a result of the waiver, deemed to have made a gain on the sale of the creditor's claim for the amount waived and the gain has to be included in his income.

The Eighth Schedule (including paragraph 12(5)) will apply were there is an asset, base cost, proceeds and a disposal as discussed in Chapter 2.[235]

NDC automatically discharged an amount of R 5 000 000 of the loan owed by Chancer. Chancer is deemed to have acquired an asset (which is the NDC claim of R 550 000) at a nil cost. Further, the base cost of an asset is expenditure actually incurred in acquiring the asset including expenditure which was directly related to the improvement and direct costs in respect of its acquisition and disposal and certain holding costs[236]. Therefore, the base cost of this asset is nil because Chancer did not actually incur any expenditure in acquiring the asset. Consequently, Chancer is deemed to have disposed of this asset to itself for proceeds equal to the remainder of the discharged amount of R 550 000.

In conclusion, Chancer's assessed loss is reduced to nil, a section 8(4)(m) recoupment of R450 000 and a taxable capital gain of R275 000 (R550 000 x 50%) is included in taxable income.

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[235] *SARS CGT guide 2007 pg*
[236] *The ABC of Capital Gains Tax for Companies, 4th Issue, June 2008, Page 5*

4.1.4 Case Study 4 – Voluntary Liquidation

Question - Chancer decides to go into voluntary liquidation. The creditors can expect to receive 60 cents for each Rand.

4.1.4.1 Section 20(1)(a)(ii)

Assessed loss is defined as the amount by which the deductions (claimed under section 11 to 19) exceed the income in respect of which these deductions are admissible.[237] As section 11(x) includes all the deductions contained in sections 5 to 37H of the Income Tax Act, there are no deductions from income that are left out when an assessed loss is calculated.[238]

Defining a benefit is really a difficult task, in my view a R 16 250 000 write off of debtors loans definitely seems like a benefit. The Oxford dictionary provides that a benefit is

> " *an advantage or profit gained from something, a payment made by the state or an insurance scheme to someone entitled to receive it e.g an unemployed person.....* "[239]

Huxham makes a comment that, the fact a creditor did not arise from a tax deductible expense is irrelevant. [240]He further states that if the creditor arose in the ordinary course of trade, the assessed loss is reduced.[241] So a loan from the holding company which was used for the day to day business activities is a debt which arises in the ordinary course of trade.[242] This would also apply to the overdraft

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[237] *Huxmam and Haupt, Notes on South African Income Tax 2009 pg 256*
[238] *Supra Pg 256*
[239] *South African Concise Oxford Dictionary, Tenth Edition 1999 Pg 102*
[240] *Huxham and Haupt, Note on South African Income Tax 2009 Pg 261*
[241] *Supra*
[242] *Supra*

4.1.4.2 Liquidation

A company exists as a separate legal entity at the time of incorporation and is terminated by means of the dissolution of the company.[243] During its existence, the company may have acquired rights and incurred liabilities which have to be dealt with before the company is dissolved.[244]

Prior to dissolution, a process called the winding up or liquidation of the company occurs were the company's assets are realised to pay creditors of the company according to their preference and then distributing the residue among shareholders in accordance with their rights.[245]
A company can be wound up in two ways namely by order of court or voluntarily. A voluntary winding up can be either a member's voluntary winding –up or a creditors winding up (refer to Para 1.2.4.2).[246]

For the purposes of this case study the focus will be on a members' voluntary liquidation. A member's liquidation is a procedure that precedes the dissolution of a company which is able to pay its debts.[247] It can only take place where the company is liquidated for some reason other than insolvency. The creditors will not suffer any loss and do not have a say in the winding –up procedure.[248] The winding up process is initiated by a special resolution passed by members. After it has been passed, it is lodged with the Registrar within 28 days and in terms of section 356(2) of the Companies Act, lodges a certified copy thereof with the Master.[249]

The company must, prior to the registration of the resolution, provide security to the satisfaction of the Master, for the payment of the debts of the company within a period not

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[243] *Cilliers & Bernade , Corporate Law, 3rd edition , Butterworths 2000 pg 494*
[244] *Supra 494*
[245] *Supra*
[246] *Supra*
[247] *Supra 495*
[248] *Supra*
[249] *Supra 496*

exceeding twelve months from the commencement of the winding up unless the Master has dispensed with security.[250]

In answering the question at hand, Chancer will not be able to submit itself to voluntary liquidation because it is insolvent as the balance sheet reflects that the liabilities exceed the assets. Section 344(f) of the Companies Act 61 of 1973 provides that a company may be wound up by a court if it is unable to pay its debts. As a result of this provision, Chancer can only be wound up by a court.

In this instance, one will have to wait for the court order and determine if the order resulted to a waiver of the creditors debts. If the court order results to a debt waiver, section 20(1)(a)(ii) will find application. It is to be noted that an individual taxpayer whose estate is voluntarily or compulsory sequestrated cannot from the date of sequestration carry forward any assessed loss incurred prior to that date, unless the sequestration order is set aside.

4.1.4.3 Section 8(4) (m)

In my view, section 8(4)(m) should only find application where the creditors voluntarily capitulate their rights to claim full payment of debts. The creditors had no say in the matter as Chancer submitted itself to voluntary liquidation. There was no positive act on the part of the creditors to show that they surrendered their rights to claim full payment of the debts (as discussed in Chapter 2 paragraph 2.3). Therefore, section 8(4)(m) should not find application because the relief from the obligation was not as a result of cancellation, termination or variation of an agreement or due to the prescription, waiver or release of a claim for payment.(Refer to para 1.2.3 discussion of a waiver in Chapter 1)

4.1.4.4 Paragraph 12(5)

As said earlier, paragraph 12(5) of the Eighth schedule was introduced to deal specifically with cases where a debt owed by a debtor to a creditor has been reduced or discharged by the creditor for no consideration, or consideration which is less than the amount by which the face

[250] *Supra 497*

value of the debt has been reduced or discharged.The debtor is deemed to have acquired a claim equal to the amount of debt that was reduced or discharged for no consideration. Furthermore, there is a deemed disposal of the claim for proceeds equal to the reduction or discharge.[251]If a court order is granted to sequestrate Chancer, paragraph 12(5) will be applicable if the court order results to discharge or reduction of Chancer's obligation to pay the creditors for no consideration or a consideration which is les than the amount owed by Chancer.

Since this case involves liquidation, the creditors still have to lodge a claim, even though they are aware that the debtor may not necessarily be able to discharge their debt. Lodging the claim would show that the creditor did not waive or reduce the debt and paragraph 12(5) does not find application.

4.1.5 Case study 5

Holdco cedes its shareholder's loan and sells its 100% shareholding to a fellow group company.

Paragraph 38 read with paragraph 56 discussed in Chapter 2 are relevant in this case_study due to the fact that HoldCo's claim against Chancer is ceded to a fellow group company. Section 1[252] of the Act provides that a connected person in relation to a company is;

> *(v) any other company if at least 20% of the equity share capital of such company is held by such other company, and no shareholder holds the majority voting rights of such company*
>
> *(vA) any other company if such other company is managed or controlled by*
> *(aa)_ any person who or which is a connected person in relation to such company or*
> *(bb) any person who or which is a connected person contemplated in item (aa)*

HoldCo and the fellow group company are in terms of section 1 connected persons. HoldCo is deemed to have disposed of the shareholders loan for the amount received equal to the market

[251] *Taxation Principles of Interest and other Financing Transactions JJ-8*
[252] *Supra*

value in the cession while the fellow group company is deemed to have acquired that asset at a cost equal to the market value.

Paragraph 56(1) provides that the waiver of the debt (creditor) must disregard a capital loss determined in consequence of the disposal of a debt owed to him by his connected person.[253]

Paragraph 56(2) (a) through (c) further provides that;

Despite paragraph 39, subparagraph (1) of paragraph 56 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 in certain circumstances. In application of paragraph 56, it is common cause that HoldCo disposed of a claim of the shareholders loan by way of cession to a fellow group company. HoldCo must in terms of the section disregard any capital loss determined in consequence of that disposal unless one of the criteria outlined in subparagraph (2)(a) through (c) of paragraph 56(2) is applicable.

Firstly, there can be no inclusion of an aggregate capital gain or aggregate capital loss for the debtor by virtue of paragraph 12(5) arising from this transaction. Chancer's liabilities remain unchanged following the cession. Chancer still has an obligation to pay the shareholders loan to a fellow company in the group. I submit that the cession of the shareholder's loan triggered a disposal by HoldCo of the loan for proceeds equal to the market value of the claim and there is no capital gain or loss.

The cession agreement merely transfers ownership of the claim from HoldCo to a fellow group company. There is no reduction or discharge of debt as contemplated in paragraph 12(5) of the Eighth Schedule.

With respect to subparagraph 56(2)(b), there does not appear to be any reason to suggest that a fellow group company would include any amount in its gross income with regards to the acquisition of the claim. Lastly, subparagraph 56(2)(c) does not find application as there is

[253] *Income Tax Act 58 of 1962*

no amount to be included in the gross income of the debtor, namely Chancer, that is as a result of the cession between HoldCo and the fellow group company.

In conclusion, there has been no waiver of a debt and the capital loss that might be suffered by the fellow group company (being the new creditor) cannot be disregarded.

On the other hand, HoldCo may argue that it and the fellow group company were immediately before the disposal connected persons and paragraph 56 finds application. However, because Holdco sold its shareholding and ceded its shareholders loan at the same time, they were no longer connected persons at the time of the disposal of the shareholding. Therefore, paragraphs 38 and 56 cannot find application and HoldCo will not be deemed to have disposed of the asset for an amount equal to the market value.

Chapter 5

Conclusion

5.1 Introduction

The main purpose of this chapter is to provide a summary of the research paper. It will focus on the main issues discussed and take into account conclusions and views that arose in the discussions.

It will discuss the similarities between South Africa and certain of the countries in dealing with losses on loans or debt waivers. Further, debates dealing with the relevant sections namely, 20(1)(a)(ii) , section 8(4)(m) and paragraph 12(5) of the Eighth Schedule of the Income Tax 50 of 1962 will be highlighted. As said in the introduction, the aim of this paper was not to reach conclusions *per se* but to illustrate the complexity of applying specific income tax sections and certain other relevant tax provisions to situations where a loss in respect of a loan account is incurred.

5.2 International Tax and South Africa in dealing with losses on loans

In South Africa ("SA"), one of the reasons provided for the insertion of paragraph 12(5) in the Eighth Schedule was to enable symmetry in the tax system. A creditor may only be able to claim a capital loss in terms of 56(2)(a) of the Eighth Schedule of the ITA if the provisions of paragraph 12(5) of the Eighth Schedule where applied to the debtor. If no capital gain arises in the hands of the debtor, paragraph 56(2)(a) would not find application. It seems like most of the countries discussed in Chapter 1 also apply some form of consistency in dealing with debt waivers. For instance in Belgium, a waiver of a debt results to a taxable profit in the hands of a debtor and a decrease in the creditor's assets subject to certain conditions.

It appears that Belgium law is lenient towards the debtor and does not focus on cornering the debtor for trying to evade tax or being involved in a tax avoidance scheme. It takes cognizance of the fact that the debtor is in a financial crisis and is unable to pay its debts at

that point in time. However, the debt is not wiped out but postponed by means of a "return to better fortune clause" so as to allow the debtor to pay off its liabilities when it is in a position to do so.

Denmark (just like SA) is very careful when dealing with connected or related persons. For instance, losses on inter-company claims are non-deductible, while South Africa has paragraphs 12(5) and 56 of the Eighth Schedule of the ITA. Paragraph 56 provides that where a debt owed by a debtor who is a connected person has been waived, a capital loss suffered as a result of the debt must be disregarded. However a creditor may claim a loss if the debtor suffered a capital gain as a result of the waiver in terms of paragraph 12(5) of the Eighth Schedule.

5.3 Section 20(1)(a)(ii)

Section 20 (1)(a)(ii) provides for the reduction of assessed losses of a debtor by the amount or value of the benefit received by that debtor as a result of a concession or a compromise granted by its creditors. The amount borrowed must have been used by the debtor to fund trading activities or an asset that was allowed as a deduction in terms of section 11 of the Income Tax Act.

It was determined that the word "benefit" was not defined and this is challenging due to the fact that a benefit for one person might not be a benefit for another. However, courts have interpreted a reduction or extinguishing of a debt to amount to a benefit.[254] Further, that a concession or a compromise resulting to a waiver of the creditor's right to claim payment against the debtor in exchange for redeemable preference shares, translates to a benefit.[255]

This places a heavy burden on the debtor to rebut the presumption that waiver of a debt in exchange for shares amounts to a benefit in the hands of the debtor. In my view, the fact that the creditor has a stake in the company is evidence that the waiver did not amount to a benefit. It received shares in the debtors company in exchange for his right to claim. The creditor will be receiving dividends declared by the company and may also sell those shares

[254] *CIR v Datakor Engineering (Pty) Ltd (1998) 60 SATC 503*
[255] *Supra*

at a profit. Therefore, a waiver of the creditor's right does not result to a total loss as the shares to the debtor's company might amount to a benefit.

The scenario was also discussed where one creditor waives a debt as opposed to a group of creditors coming together and reaching a mutual decision to waive their debts. Ideally, a waiver from a single creditor carries more weight because it comes from a single mind and is voluntary. In a case where the debtor has eight creditors and five agree to a compromise but the remaining three do not approve the decision, despite the minority disapproval the concession will be carried forward. Therefore, even though some of the creditors do not voluntary agree to a concession and compromise yet they will still suffer income tax consequences arising from this concession or compromise.

Lastly, Kevin Burt said that a subordination agreement may be regarded as a concession. I submit, this is incorrect because in a concession, a creditor gives up his right to claim or claims an amount that is less than the debt in dispute. I reiterate, in a novation agreement the debt is substituted but the debtor is still liable to pay according to the new obligation. A concession has an effect of extinguishing or reducing a debt but in a subordination agreement, the company and its creditors agree to terminate old obligations and substitute them with new obligations by means of a novation agreement.

5.4 Section 8(4)(m)

Section 8(4)(m) provides that 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, a debtor is partially relieved from an obligation to pay any expenditure actually incurred. Further, the expenditure was in the current or previous year of assessment allowed as a deduction. The debtor shall be deemed to have recovered or recouped an amount equal to the amount of the obligation that was relieved or partially relieved in the year of assessment the obligation was so relieved.

Applying this section to a typical debt waiver scenario does not seem to produce any anomalies or awkward issues. It tries to strike a balance between the amount of expenditure

incurred and claimed as a deduction in terms of section 11 and the release or partial release of a debtor from an obligation to pay the amount used to fund the latter expenditure.

However, it is worth mentioning that section 8(4)(m) is "subject to" section 20.Further, it would make logical sense to refrain from instituting section 8(4)((m) to amounts that have already been taken into account to reduce the taxpayers assessed loss in terms of section 20(1)(a)(ii). This is so, because, section 8(4)(m) is subject to section 20. If section 20 has already applied to a set of facts, section 8(4)(m) cannot apply to those set of facts. I find support in the case below where the words "subject to" where discussed.[256]:

> *'The words "subject to" can, depending upon the context in which they are used, infer or determine the existence of a condition precedent, or amount to no more than the term of an agreement. Where those words appear in a statutory provision*
>
> *". . . [g]enerally speaking, the words 'subject to' have the effect of introducing a qualification, limitation or condition precedent, thereby curtailing a person's exercise of otherwise unrestricted rights. It does not, in this sense, mean an alternative or optional right without affecting an unfettered original right."*
>
> *'(Per Goldin J in Hickman v The Attorney-General 1980 (2) SA 583 (R) at 585E–F.)*
>
> *'In other statutory provisions, the same words may mean "except as curtailed by"*
>
> . . . .
>
> *'Depending on the context, the same words can prescribe the manner and fashion in which certain powers and duties may, or must be exercised . . . .*
>
> *'The words "subject to" could also constitute a condition precedent, meaning that a test or action must be completed, that something has to take place before the agreement does in fact become binding upon the parties thereto . . . .'*

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[256] *By Hancke J in CIR, Transkei, and another v JALC Holdings (SA) (Pty) Ltd and another 1991 (4) SA 646 (Tk), 54 SATC 7 at 10–11 (on appeal as Moodie v CIR, Transkei, and another; CIR, Transkei, and another v Moodie and another 1993 (2) SA 501 (Tk AD) 55 SATC 164). See the authorities cited there; see also Sentra-Oes Koöperatief Bpk v KBI 1995 (3) SA 197 (A), 57 SATC 109 at 115–6.*

With reference to the above authority, "subject to" in this context means that section 20 precedes section 8(4)(m), therefore if an amount waived was taken into account to reduce the debtor's assessed loss, the remaining amount cannot be used to recoup the expenditure in terms of section 8(4)(m).

5.5 Paragraph 12(5) of the Eighth Schedule

SARS provides the reason why paragraph 12(5) was inserted which was to ensure that a debtor relieved by a waiver was subjected to Capital Gains Tax ("CGT") on the capital gain equal to the amount discharged or waived.[257] Further, SARS wanted to strike an equilibrium in the tax system ensuring that there is a matching of capital gains and losses. [258] To gain the equilibrium, the debtor relieved from the obligation to pay is liable to pay CGT, and the creditor may claim a capital loss suffered as a result of the relief.

The symmetry objective is seemingly achieved when one applies paragraph 12(5) and paragraph 56. Because on the one hand, the debtor is liable for CGT equal to the amount waived, while on the other, the creditor is able to a claim capital loss as a result of the waiver. However, some authors are of the opinion that the symmetry objective is not fully met where a creditor is a non-resident and the debtor is a resident.[259] Paragraph 12(5) will be applied to the debtor even though the creditor is not subject to CGT.[260]If the debtor was a non-resident and the creditor was the resident, the creditor would not be able to claim the capital loss in terms of paragraph 56 if the parties are connected persons.[261] In both instances the symmetry objective is not achieved.

The fundamental objective of paragraph 12(5) to ensure that a debtor relieved from his obligation to pay his debt is taxable on his gain, is criticised. It is said that this paragraph is an anomaly in the Eighth Schedule.[262] The main purpose of the Eighth Schedule is to tax a gain made by the owner of an asset who disposed of its assets at a gain.

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[257] *Comprehensive guide to Capital Gains Tax , Issue 2, para 6.2.5.1*
[258] *Supra*
[259] *The Taxpayer. Volume 58 no 9. September 2009.Page 167*
[260] *Supra*
[261] *Supra*
[262] *Supra*

In the context of the Eighth Schedule, the paragraph might only have relevance by creating fictions that the following acts are deemed to occur:

(a) the debtor is treated as having acquired the creditors claim's to so much of his debt as is discharged for no consideration and therefore has acquired an asset at nil cost[263].

(b) the debtor is treated as having disposed of his claim to himself for proceeds equal to the discharged amount[264].

The paragraph simply caters for disposals which are not actual disposals, but are treated as disposals of assets before being reacquired by the disposer because assets are present in all other cases except for paragraph 12(5).[265]

In conclusion, taxpayers should refrain from debt waiver situations as losses on loans can result to adverse income tax consequences. The underlying reason why losses on loans trigger Section 8(4)(m) and section 20(1)(a)(ii) consequences is generally understood. These two sections provide a sense of matching between the benefit received and the resulting reduction of assessed losses and recoupments. There are circumstances as discussed where these sections might not be easily applied and not all debt waiver situations may result in a benefit.

I agree with Meyerowitz that paragraph 12(5) mainly aims at ensuring that the debtor relieved from his obligation to pay debt is taxable on his gain and this objective defeats the purpose of the Eighth Schedule[266]. The Schedule is designed to tax owners of assets who made a gain from a disposal of those assets.[267] It does not tax the person acquiring the asset until he/she has disposed of that asset for a consideration or deemed consideration if he does so to a connected person[268]. In the instance of debt waivers paragraph 12(5) finds application by creating an asset that does not exist. In my view, this paragraph should not be included in the

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[263] *Supra*
[264] *Supra 10*
[265] *Supra*
[266] *David Meyerowitz. 2009, The Taxpayer, Volume 58 No 9, September 2009 Para 13*
[267] *Supra*
[268] *Supra*

Eighth Schedule because it does not comply with all the building blocks of capital gains tax (it creates an asset that does not exist).

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