

DRAFT INTERPRETATION NOTE

DATE:

ACT : INCOME TAX ACT NO. 58 OF 1962
SECTION : SECTION 19 AND PARAGRAPH 12A OF THE EIGHTH SCHEDULE
SUBJECT : REDUCTION OF DEBT

CONTENTS

	PAGE
Preamble	2
1. Purpose.....	3
2. Background.....	3
3. The law.....	4
4. Application of the law.....	4
4.1 Definitions [section 19(1) and paragraph 12A(1)].....	4
4.1.1 Allowance asset	4
4.1.2 Capital asset.....	4
4.1.3 Debt	4
4.1.4 Reduction amount	5
4.1.5 The time of reduction of an amount of debt	9
(a) Business Rescue.....	9
(b) Compromise	10
(c) Insolvency	10
(d) Liquidation.....	10
4.1.6 Trading stock.....	10
4.2 The application of, and the interaction between, section 19 and paragraph 12A.....	10
4.3 Trading stock held and not disposed of at the time of the reduction of the debt [section 19(3) and (4)]	13
4.4 Operating expenses and trading stock not “held and not disposed of” at the time of the reduction of debt [section 19(5)].....	18
4.5 Allowance assets [section 19(6) and paragraph 12A(3)].....	19
4.6 Non-allowance assets [paragraph 12A(3) and (4)].....	24
4.7 Limitation of deductions and allowances on allowance assets [section 19(7)]	26
4.8 Pre-valuation date assets [paragraph 12A(5)].....	30
4.9 Exclusions from section 19 and paragraph 12A [section 19(8) and paragraph 12A(6)]	32

4.9.1	Estate duty [section 19(8)(a) and paragraph 12A(6)(a)].....	32
4.9.2	Donations tax [section 19(8)(b) and paragraph 12A(6)(b)].....	33
4.9.3	Fringe benefit [section 19(8)(c) and paragraph 12A(6)(c)]	37
4.9.4	Group of companies [paragraph 12A(6)(d)]	38
4.9.5	Companies in liquidation [paragraph 12A(6)(e) and (7)]	40
4.10	Elimination of double recoupment or double reduction of the base cost of an asset	43
4.10.1	Recoupment of amounts allowed to be deducted or set off under certain sections [section 8(4)(a)]	43
4.10.2	Recoupment of expenditure or losses incurred on qualifying shares [section 9C(5) and paragraph 20(3)(a)].....	44
4.10.3	Recoupment of amounts allowed as a deduction from the income of an issuer of an instrument [section 24J(4A)(b)].....	46
4.10.4	Capital gain on the disposal of an asset in a previous year of assessment [paragraph 3(b)(ii)].....	47
4.10.5	Reduction in expenditure incurred under paragraph 20(1)(a) to (g) [paragraph 20(3)(b)]	48
4.10.6	Capital loss on disposal by a creditor of debt owed by a connected person [paragraph 56(1) and 56(2)(a)]	52
4.11	Allocation of payments and debt reductions	52
4.12	Reduction of debt that funded expenditure incurred by persons carrying on mining [section 36(11) – definition of “expenditure”].....	54
4.13	Controlled foreign companies (CFCs) [section 9D(9)(fA)(iv)]	54
5.	Conclusion	54
	Annexure – The law	56

Preamble

In this Note unless the context indicates otherwise –

- “**CGT**” means capital gains tax, being the portion of normal tax attributable to the inclusion in taxable income of a taxable capital gain;
- “**Companies Act**” means the Companies Act No. 71 of 2008;
- “**debt relief**” means the reduction of debt for consideration that is less than the face value of the debt;
- “**Estate Duty Act**” means the Estate Duty Act No. 45 of 1955;
- “**non-allowance asset**” means a “capital asset” as defined in section 19(1) and paragraph 12A(1) on which a deduction or allowance is not allowable under the Act for purposes other than the determination of any capital gain or capital loss;
- “**paragraph**” means a paragraph of the Eighth Schedule;
- “**Schedule**” means a Schedule to the Act;
- “**section**” means a section of the Act;

- “**TA Act**” means the Tax Administration Act No. 28 of 2011;
- “**the Act**” means the Income Tax Act No. 58 of 1962; and
- any other word or expression bears the meaning ascribed to it in the Act.

1. Purpose

This Note provides guidance on the interpretation and application of section 19 and paragraph 12A which deal with the reduction of debt.

2. Background

Debt relief occurs in, for example, insolvency, business rescue, similar statutory proceedings or informal workouts,¹ and can occur within and outside of a group of companies.

The reduction of debt during years of assessment commencing before 1 January 2013 was subject to the following income tax, CGT and donations tax provisions:

- Section 8(4)(m)
- Paragraph (ii) of the proviso to section 20(1)(a)
- Section 54
- Paragraph 2(h) of the Seventh Schedule
- Paragraph 3(b)(ii)
- Paragraph 12(5)
- Paragraph 20(3)(b)

The various taxes imposed upon persons receiving the benefit of debt relief may have effectively undermined the economic benefit of the relief. A new uniform system that provides relief to persons under financial distress in certain circumstances was introduced in the form of section 19 and paragraph 12A with effect from years of assessment commencing on or after 1 January 2013. Section 8(4)(m), paragraph (ii) of the proviso to section 20(1)(a) and paragraph 12(5) which previously dealt with the reduction of debt were simultaneously deleted. The new rules also provide clarity on the ordering of the various provisions and a more explicit set of demarcations between the different provisions.

The new rules are aimed at ensuring that a reduction of debt is not subject to more than one of the following taxes:

- estate duty² (see **4.9.1**)
- donations tax (see **4.9.2**)
- income tax on a fringe benefit received by an employee (see **4.9.3**)
- income tax on income

¹ This is understood to mean an informal process of debt restructuring undertaken by a financially distressed person with creditors outside of any formal insolvency proceedings.

² The value of any debts owed to a deceased person is included in that person’s estate for estate duty purposes under section 3 of the Estate Duty Act.

- CGT

Sections 8(4)(a), 9C(5), 24J(4A)(b) and paragraphs 3(b)(ii), 20(3)(b)(iii) and 56(2)(a) have been amended with effect from years of assessment commencing on or after 1 January 2013 to prevent the recoupment of the same amount, or the reduction of the base cost of an asset, under more than one provision when a debt has been reduced or cancelled. In essence, these provisions ensure that the same reduction amount of a debt does not result in double taxation.

3. The law

The relevant sections and paragraphs are quoted in the **Annexure**.

4. Application of the law

4.1 Definitions [section 19(1) and paragraph 12A(1)]

4.1.1 Allowance asset

An “allowance asset” for purposes of section 19 and paragraph 12A means a “capital asset” (see **4.1.2**) in respect of which a deduction or allowance is allowable under the Act, other than for purposes of determining a capital gain or capital loss. Examples of such deductions or allowances include those granted under section 11(e), 12B or 12C.

Any deduction or allowance that is allowable in the determination of any capital gain or loss must be ignored in determining whether an asset constitutes an “allowance asset” for purposes of section 19 and paragraph 12A. In essence, therefore, the expenditure and the reductions in expenditure referred to in paragraph 20 that are required to be taken into account in the determination of an asset’s base cost must be ignored in determining whether an asset constitutes an “allowance asset”. The deduction of such base cost from proceeds in the determination of a capital gain or loss must similarly be ignored in determining whether the relevant asset is an “allowance asset”.

Section 19(6) and (7) and paragraph 12A(3) contain specific rules that apply when a debt that is owed by a person is reduced by an amount and that amount was used to fund expenditure incurred in respect of an allowance asset (see **4.5** and **4.7**).

4.1.2 Capital asset

A “capital asset” means an “asset” as defined in paragraph 1 that is not trading stock.

An “asset” is defined in paragraph 1 as including –

- “(a) property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum; and
- (b) a right or interest of whatever nature to or in such property;”

4.1.3 Debt

The definition of “debt” excludes a “tax debt” as defined in section 1 of the TA Act but does not elaborate further on the meaning of “debt”. Consideration must therefore be given to its ordinary grammatical meaning taking into account the context in which the word appears and the purpose to which it is directed.

The *Shorter Oxford English Dictionary on Historical Principles* defines the word “debt” as follows:³

“**[D]ebt 1** Something owed or due; something (as money, goods, or service) which one person is under an obligation to pay or render to another. **2** A liability or obligation to pay or render something; the condition of being so liable or obligated...”

In *Joint Liquidators of Glen Anil Development Corporation Ltd (In Liquidation) v Hill Samuel (SA) Ltd* Holmes AJA held that –⁴

“[t]he ordinary meaning of debt is ‘that which is owed or due; anything (as money, goods or services) which one person is under obligation to pay or render to another’. See *Shorter Oxford English Dictionary*. See also *Leviton and Son v De Klerk’s Trustee* 1914 CPD 685 at 691 *in fin*: ‘Whatever is due - *debitum* - from any obligation’ ... It seems to me that it can be said that, in ordinary parlance, a debt is a firm obligation to pay, whether now or later. The notion of a possible or conditional obligation to pay is at variance with this;...”

In *CIR v Datakor Engineering (Pty) Ltd*⁵ the court distinguished the characteristics of debt and shares. Harms JA held that in the case of debt the debtor had an enforceable obligation to effect payment of the debt, whereas in the case of a share the right of redemption rests with the company. Harms JA highlighted a further distinction when noting that in the case of debt all the assets of the company were available to satisfy the claims of creditors, while shares could only be redeemed subject to meeting requirements specified in, at that time, the Companies Act No. 61 of 1973. Under the Companies Act a company may only redeem its shares provided it meets the solvency and liquidity requirements in that Act.

The term “tax debt” is defined in section 1 of the TA Act and means –

“an amount referred to in section 169(1);”

Section 169(1) of the TA Act provides that an amount of tax due or payable in terms of a tax Act is a tax debt due to SARS for the benefit of the National Revenue Fund.

As a result of the exclusion of a tax debt from the definition of “debt” in section 19(1) and paragraph 12A(1), the reduction of a tax debt will not give rise to any income tax or CGT implications. Under certain circumstances⁶ a tax debt owed by a person can be permanently reduced by SARS as a result of a business rescue plan, the liquidation of a company, insolvency of a person, prescription or a compromise.

4.1.4 Reduction amount

A “reduction amount” in relation to a debt owed by a person means any amount by which that debt is reduced, less any amount applied by that person as consideration for that reduction. “That person” is the relevant debtor. The amount applied by the debtor to effect a reduction in the debt may be applied directly, for example, when the payment comes directly from the debtor’s bank account, or indirectly, when a third party pays the creditor on the debtor’s behalf and in return the debtor becomes indebted to the third party for an equal amount. A third party may also pay a creditor

³ A Stevenson 6 ed (2007) Oxford University Press in vol. 2.

⁴ [1982] 1 All SA 105 (A), 1982 (1) SA 103 (A) at 110.

⁵ 1998 (4) SA 1050 (SCA), 60 SATC 503.

⁶ Sections 171, 197 and 198 of the TA Act.

on the debtor's behalf in return for an equal reduction by the debtor of an amount owed to the debtor by the third party.

For example, a payment by a holding company to a creditor of its subsidiary in settlement of a debt due by the subsidiary will qualify as consideration given by the subsidiary for the purposes of the definition of "reduction amount" if the subsidiary becomes indebted to the holding company for the amount so applied.

In contrast, if the subsidiary does not become indebted to the holding company in consequence of the holding company paying the debt owed by the subsidiary, it cannot be said that the subsidiary has applied any amount as consideration for the reduction of the original debt. Since the amount paid by the holding company in these circumstances will not be regarded as consideration applied by the subsidiary in reduction of the original debt, the full amount paid by the holding company to the creditor will constitute a "reduction amount".

Example 1 – Reduction amount

Facts:

Company A holds 100% of the shares in Company B. Company B owed Company C R500 000 for trading stock purchased in the previous year of assessment.

Company B did not have the cash available to pay Company C so Company A paid R500 000 on Company B's behalf with the result that Company B now owes Company A R500 000.

Result:

Company B has indirectly applied R500 000 as consideration for the reduction of the full debt owed by it to Company C because Company B has become indebted to Company A for the amount Company A paid to Company C on Company B's behalf.

Reduction amount = Amount by which the debt is reduced – Amount applied as consideration for that reduction = R500 000 – R500 000 = RNil.

Example 2 – Reduction amount

Facts:

Company A holds 100% of the shares in Company B. Company B owed Company C R500 000 for trading stock purchased in the previous year of assessment.

Company B did not have the cash available to pay Company C so Company A paid R500 000 to Company C on Company B's behalf. Company B was not required to reimburse Company A for the payment made to Company C on its behalf.

Result:

While Company B is no longer indebted to Company C, Company B has not applied any consideration for the reduction of the debt owed by it to Company C because Company B is not required to reimburse Company A for the payment made on its behalf.

Reduction amount = Amount by which the debt is reduced – Amount applied as consideration for that reduction = R500 000 – RNil = R500 000.

As mentioned above, a “reduction amount” is any amount by which the debt owed by a person is reduced, less any *amount* applied by that person as *consideration* for that reduction.

Amount applied as consideration

The *Oxford Dictionaries (online)* defines “consideration” as follows:⁷

“2. A payment or reward...

2.1 *Law* (In a contractual agreement) anything given or promised or forborne by one party in exchange for the promise or undertaking of another.”

In *Ogus v SIR*⁸ “consideration” was held, in the context of donations tax, to mean the *quid pro quo* given under a reciprocal obligation.⁹

The *quid pro quo* received by the creditor in return for the reduction of a debt could be in the form of money or a form other than money, for example, a motor vehicle or the right of use of an asset. The principles established in the *Brummeria* case¹⁰ in relation to the determination of what constituted the accrual of an *amount* for the purposes of the definition of “gross income” are considered relevant here, namely that consideration in a form other than money must be capable of being valued in money and that although the ability to turn that consideration into money may be one of the ways to determine its value in money, it is not essential. The determination of value is an objective, not a subjective test.

Value in money refers to the market value of the consideration in a form other than money. In *Lace Proprietary Mines Ltd v CIR*¹¹ the court held that the true consideration received for the sale of mineral rights was 1 million shares issued to the seller and not the stated purchase price. Further, the true consideration had to be valued and this involved determining the market price of the shares issued. The valuation was not affected by reference to the stated purchase price or the nominal value of the shares allotted by the purchasing company.

Example 3 – Reduction amount

Facts:

X is a retailer specialising in alternative energy solutions. X purchased rechargeable battery lights from Y to sell in X’s business. The total purchase price was R250 000 of which R100 000 was still owing.

X did not have the cash available to pay Y. However X had inherited a vintage car and, being aware that Y was a vintage car collector, offered the car to Y in full and final settlement of the debt. Y accepted X’s offer.

⁷ www.oxforddictionaries.com/definition/english/consideration [Accessed 26 May 2015].

⁸ 1978 (3) SA 67 (T), 40 SATC 100 at 112.

⁹ See also *Grant v Federal Commissioner of Taxation* 7 ATR 1.

¹⁰ *C : SARS v Brummeria Renaissance (Pty) Ltd & Others* 2007 (6) SA 601 (SCA), 69 SATC 205.

¹¹ 1938 AD 267, 9 SATC 349.

The market value of the car was R80 000.

Result:

X applied the value of the car as consideration for the reduction in the debt of R100 000 owed to Y. The amount of the consideration is equal to the market value of the car, namely, R80 000.

Reduction amount = Amount by which the debt is reduced – Amount applied as consideration for that reduction = R100 000 – R80 000 = R20 000.

Issue of shares in reduction of debt

The consideration (subscription price) payable for shares issued by a company directly or indirectly in settlement of a debt, which is frequently encountered in practice, may take the form of money (cash) or a form other than money (such as the discharge of an existing debt). A company may, for example, settle its debt by –

- issuing shares directly in settlement of the debt;
- issuing shares and setting off the subscription price owed by the subscriber against an amount owed by the company;
- converting debt to shares in fulfilment of the conversion rights attaching to the debt (such as convertible debentures); or
- issuing shares to the creditor in exchange for cash and then applying the cash against the debt owed by the company.

In substance all the approaches are the same under company law and in all the scenarios section 40 of the Companies Act applies. Under section 40 of the Companies Act a company may not issue shares, *amongst other conditions*, unless –

- the board has determined that the consideration for the shares is “adequate”; or
- the shares are issued in terms of conversion rights associated with previously issued securities (such as a debenture).

The fact that the consideration for the shares issued must be “adequate” does not imply that the subscription price is necessarily equal to market value. A subscription price which is greater than market value would be an adequate price from a share issue perspective, but would nevertheless give rise to a reduction amount when the market value of the shares issued in discharge of an amount of debt is less than the face value of the debt. In contrast, the issue of shares directly to the creditor in discharge of a debt will not give rise to a reduction amount should the market value of the shares issued to the creditor in discharge of the debt be equal to, or exceed, the face value of the debt. In the latter circumstances the “amount applied by (the company) as consideration for that reduction” is equal to or more than the amount of the debt.

In appropriate circumstances set-off (also referred to as merger or *confusio*) can comprise a valid form of payment that *ipso facto*¹² discharges the relevant debt. Such a situation may arise when a company has issued shares to an existing creditor for

¹² By the fact itself.

an amount payable in cash and the cash payment obligation of the creditor to the company for the shares is set off against the debt obligation of the company to the creditor. Stated differently, the right of the company to claim the cash subscription price from the creditor (an asset of the company in the form of a personal right to claim payment) is set off against a pre-existing debt owed by the company to the creditor. By operation of law (*confusio*), the debt obligation of the creditor and company are *ipso facto* extinguished (reduced).¹³ This situation will not give rise to a reduction amount for purposes of section 19 or paragraph 12A because the amount (market value) of the right of the company to claim payment of the subscription price from the creditor is equal to the amount by which the debt owed by the company to the creditor is reduced.

It may happen that shares are issued in fulfilment of conversion rights which were attached to a debt instrument such as a convertible debenture at the time the debt instrument was issued. As with shares issued directly in discharge of a debt, should the market value of the shares issued in discharge of the conversion obligation be less than the amount (face value) of the debt, a reduction amount will result. This outcome follows from the fact that the amount of consideration (market value of the shares) applied in discharge of the debt is less than the amount of the debt.

Alternatively, a company may issue shares for a subscription price payable in cash and apply the cash proceeds in settlement of a debt owed by it. In these circumstances no reduction amount arises for the purposes of section 19 or paragraph 12A since the cash proceeds applied by the company as consideration for the reduction of the debt will be equal to the amount by which the face value of the debt was reduced. This outcome results irrespective of whether the subscription price was equal to the market value of the shares before or after issue.

The above comments must not be construed as sanctioning a situation in which the issue of shares, whether for cash or by set-off, is simply a sham transaction intended to disguise a waiver of debt. The facts and circumstances of each case will therefore have to be considered before it can be determined whether the issue of shares gives rise to a reduction amount. Furthermore, if the shares issued otherwise than for a cash consideration have a market value immediately after issue which is less than the subscription price, section 24BA may result in a capital gain for the issuing company, unless an exemption applies and section 40CA will result in the base cost of the asset being reduced.

4.1.5 The time of reduction of an amount of debt

For purposes of section 19 and paragraph 12A the time of reduction of the amount of a debt will depend on the facts and circumstances of each case. A debt will generally be reduced when the event giving rise to the debt reduction takes place, for example, when a creditor decides not to enforce payment of a debt and informs the debtor accordingly. However, specific rules apply in the circumstances described below.

(a) Business Rescue

Under business rescue proceedings, creditors may vote to accept less than the face value of the debts owing to them as part of the business rescue plan. The actual amount of a debt that is reduced will in most instances only be determined once the

¹³ F du Bois *et al Wille's Principles of South African Law* 9ed (2007) Juta & Co Ltd at page 831.

assets of the debtor have been disposed of, the agreed costs paid and the final distribution made to the creditors. While the creditors are bound under section 152(4) of the Companies Act by the adopted business rescue plan, the actual amount reduced by a creditor in these circumstances is dependent on the amount of the final distribution which takes place subsequent to the approval and adoption of the business rescue plan. A debt will accordingly only be regarded as having been reduced for purposes of section 19 and paragraph 12A at the time the actual amount of the debt that is reduced is determined, being the date upon which the final distribution is determined and the creditor concerned is notified.

If, however, the amount of debt forgiven is certain at the time the business rescue plan is adopted at the meeting convened under section 151 of the Companies Act, the relevant debt will have been reduced as contemplated in section 19 and paragraph 12A at that time since the adopted business rescue plan is binding on the company and its creditors.¹⁴

(b) Compromise

A compromise between a company and its creditors must be supported by a majority in number representing at least 75% in value of the creditors or class of creditors under section 155(6) of the Companies Act. After the compromise proposal has been so approved it must be sanctioned by the court under section 155(7) of that Act. The time of reduction of the compromised debt will occur when the order of the court sanctioning the compromise is filed under section 155(8)(c) of the same Act.

(c) Insolvency

The time of reduction of a debt as a result of the insolvency of a debtor depends on the facts and circumstances of the case. It will, however, generally occur on the date on which the final liquidation and distribution account is confirmed by the Master of the High Court under section 112 of the Insolvency Act No. 24 of 1936.

(d) Liquidation

The time of reduction of a debt as a result of the liquidation of a company will generally occur on the date on which the liquidator commences with the distribution, which will be after the final liquidation and distribution account has been confirmed by the Master of the High Court under section 408 of the Companies Act No. 61 of 1973.¹⁵

4.1.6 Trading stock

The term “trading stock” is defined in section 1(1) and bears its defined meaning.

4.2 The application of, and the interaction between, section 19 and paragraph 12A

The primary provisions which deal with the consequences of a reduction of debt are section 19 and paragraph 12A.

¹⁴ Section 152(4) of the Companies Act.

¹⁵ Section 408 of the Companies Act No. 61 of 1973 still applies under section 9 of Schedule 5 to the Companies Act.

Section 19 and paragraph 12A will apply if the following requirements are met:

- a debt owed by a person¹⁶ (the debtor) is reduced by an amount;
- the amount of that debt was used, directly or indirectly, to fund certain specified expenditure (see below); and
- the amount of the reduction of the debt exceeds the consideration given by that person (the debtor) for the reduction.

Section 19 will apply if the debt funded expenditure for which a deduction or an allowance was granted under the Act,¹⁷ while paragraph 12A will apply if the debt funded expenditure¹⁸ –

- for which a deduction or an allowance was not granted under the Act (for example, expenditure of a capital nature such as goodwill in respect of which no capital allowance is available under the Act); or
- incurred in respect of an allowance asset.

Generally, therefore, paragraph 12A will not apply when section 19 applies unless the debt reduced had funded expenditure incurred in acquiring an allowance asset, in which event both section 19 and paragraph 12A may apply. For example, section 19 will apply to trading stock and not paragraph 12A. By contrast, both section 19 and paragraph 12A may apply to a machine used in a process of manufacture.

Despite the requirements discussed above having been met, there are limited circumstances discussed later in this section of the Note in which section 19 and paragraph 12A do not apply.

Under both section 19 and paragraph 12A the debt reduced must have funded “expenditure”.

In *C: SARS v Labat Africa Ltd* Harms AP stated the following on the meaning of “expenditure”:¹⁹

“The term ‘expenditure’ is not defined in the Act and since it is an ordinary English word and, unless the context indicates otherwise, this meaning must be attributed to it. Its ordinary meaning refers to the action of spending funds; disbursement or consumption; and hence the amount of money spent.

“The Afrikaans text, in using the term ‘onkoste’, endorses this reading. In the context of the Act it would also include the disbursement of other assets with a monetary value. Expenditure, accordingly, requires a diminution (even if only temporary) or at the very least movement of assets of the person who expends. This does not mean that the taxpayer will, at the end of the day, be poorer because the value of the counter-performance may be the same or even more than the value expended.”

In *Ackermans Ltd v C: SARS*²⁰ it was held that the words “expenditure incurred” mean the undertaking of an obligation to pay or the actual incurring of a liability.

¹⁶ A “person” is defined in section 1(1).

¹⁷ Section 19(2).

¹⁸ Paragraph 12A(2).

¹⁹ 2013 (2) SA 33 (SCA), 74 SATC 1 at 6.

²⁰ 2011 (1) SA 1 (SCA), 73 SATC 1 at 5.

Other court cases have expressed similar views on the meaning of expenditure.²¹

A sufficiently close connection must exist between the debt that is reduced and the particular expenditure incurred in order to conclude that the debt directly or indirectly funded the expenditure. Expenditure is directly funded by an amount of debt if, for example, an asset is purchased on credit from the creditor. Expenditure is indirectly funded by an amount of debt if, for example, a financier advances an amount to a debtor and the debtor uses the amount to finance expenditure incurred in relation to a third person.

As will be evident from the discussion above, the application of section 19 and paragraph 12A depends on the nature of the expenditure incurred that was funded by the debt that is reduced. Specific rules apply to the reduction of debt that funded expenditure incurred in respect of –

- trading stock that is held and not disposed of at the time of the reduction of the debt [section 19(3) and (4)] (see **4.3**);
- goods (other than trading stock held and not disposed of and allowance assets) and services [section 19(5)] (see **4.4**);
- an allowance asset [section 19(6) and (7) and paragraph 12A(3)] (see **4.5** and **4.7**); and
- an asset that is not an allowance asset [paragraph 12A(3) and (4)] (see **4.6**).

Section 19 and paragraph 12A do not apply to any debt owed by a person –

- that is an heir or legatee of a deceased estate to the extent that the debt is owed to, and reduced by, the deceased estate and the amount by which the debt is reduced forms part of the property of the deceased estate for purposes of estate duty under the Estate Duty Act [section 19(8)(a) and paragraph 12A(6)(a)] (see **4.9.1**);
- to the extent that the debt is reduced by way of a “donation”, as defined in section 55(1) or any transaction to which section 58 applies for purposes of donations tax [section 19(8)(b) and paragraph 12A(6)(b)] (see **4.9.2**); or
- to an employer to the extent that the debt is reduced in the circumstances contemplated in paragraph 2(h) of the Seventh Schedule, the so-called fringe benefits tax provisions [section 19(8)(c) and paragraph 12A(6)(c)] (see **4.9.3**).

In addition, paragraph 12A does not apply to any debt owed by a company –

- to another company that forms part of the same “group of companies” as defined in section 41 (often referred to as a domestic group of companies), unless certain provisions apply [paragraph 12A(6)(d)] (see **4.9.4**); or
- to a connected person if the debt is reduced in the course, or in anticipation, of the liquidation, winding up, deregistration or final termination of the existence of that company under specified circumstances [paragraph 12A(6)(e) and (7)] (see **4.9.5**).

²¹ ITC 1783 (2004) 66 SATC 373 (G); *Joffe & Co (Pty) Ltd v CIR* 1946 AD 157, 13 SATC 354; *Allen (HM Inspector of Taxes) v Farquharson Brothers and Co* 17 TC 59; *COT v Rendle* 1965 (1) SA 59 (SRA), 26 SATC 326.

A debtor company forming part of a domestic group of companies and a debtor company in liquidation that is indebted to a connected person are excluded from paragraph 12A because symmetry is achieved in the tax system. On the one hand the debtor company enjoys the benefit of not having to reduce the base cost of its assets or assessed capital loss as a result of the debt reduction while on the other hand the creditor is required to disregard the resulting capital loss under paragraph 56(1).

4.3 Trading stock held and not disposed of at the time of the reduction of the debt [section 19(3) and (4)]

Section 19(3) provides that if a debt owed by a person is reduced and the debt was used, directly or indirectly, to fund expenditure incurred in respect of trading stock that is held and not disposed of by that person at the time of the reduction of the debt, the reduction amount must, to the extent that an amount is taken into account under section 11(a), 22(1) or 22(2) for the year of assessment in which the debt is reduced, be applied to reduce the amount so taken into account.²²

The words “trading stock that is held and not disposed of” are central to the application of section 19, while the word “held” is critical to the application of paragraph 12A. In *Juta’s Tax Library* it is argued in relation to “held” that –²³

“it is therefore considered that a taxpayer holds stock for this purpose where that **stock is owned, and not merely physically held**. The owner, not the possessor, must therefore account for the stock. This view is shared by Meyerowitz (at 9.89). ...” (Emphasis added)

In ITC 1873²⁴ the court was called upon to decide on the meaning of “held and not disposed of” in the context of grapes that had been supplied to a co-operative by a farmer. The farmer’s grapes were crushed and mixed by the co-operative with the grapes and grape juice of other members as part of the initial wine-making process. The issue was whether the farmer still had produce that could be said to be held and not disposed of which could be brought to account as closing stock. Allie J stated the following:

“The word ‘held’ is supplemented and reinforced by the phrase ‘and not disposed of’ because the phrase is conjunctive. The complete phrase ‘held and not disposed of’ makes it patently clear that the produce must have formed part of the farmer’s farming produce and the farmer must still have a legal right to the produce as at the financial year-end;

“It does not mean that the farmer must have had physical possession or control of the produce at the year-end. If that was what the legislature intended, it would have used words that clearly conveyed that meaning.”

It is considered that “held and not disposed of” for purposes of section 19 requires the debtor to have legal ownership of the trading stock at the applicable time, and that mere physical possession will not suffice. Once the trading stock has been sold under an unconditional contract and the taxpayer is accordingly unconditionally entitled to the consideration for the trading stock (that is, the consideration

²² The words “to the extent” make it clear that the amount to be reduced under section 19(3) is limited to an amount taken into account under section 11(a), 22(1) or 22(2).

²³ D Davis *et al* *Jutas Tax Library* [online] (Jutastat e-publications: 2 April 2015) in *Commentary on Income Tax – section 22*.

²⁴ (2014) 77 SATC 93 in [45] and [46].

constitutes gross income in the taxpayer's hands), the trading stock will no longer be considered to be "held and not disposed of" for the purposes of section 22 and section 19. Trading stock disposed of under an instalment credit agreement which provides that ownership will pass only once the whole or a portion of the purchase price has been paid is regarded as having been disposed of and hence must be excluded from closing stock. In these circumstances section 24(1) deems the purchase price to be included in gross income when the agreement is entered into.

As regards the meaning of "held" for purposes of paragraph 12A, it is considered that the same meaning applies, namely, that the debtor must have legal ownership of the relevant asset at the applicable time.

Section 19(3) applies when expenditure incurred in respect of trading stock has been taken into account under –

- section 11(a) and the debt is reduced in the same year of assessment in which the trading stock was acquired;
- section 22(1) when the trading stock is included in closing stock and the debt was reduced during the year of assessment; or
- section 22(2) when the trading stock is included in opening stock and the debt was reduced during the year of assessment.

Depending on the circumstances prevailing when the debt is reduced, section 19(3) may be applied to reduce the amount taken into account under more than one of the sections mentioned above. For example, if the debt is reduced in the same year in which the trading stock was acquired it is necessary to reduce the expenditure allowed under section 11(a) by the reduction amount and, assuming the trading stock is still held and not disposed of at the end of the year of assessment, to reduce the related closing stock amount by the same amount. The reduction of both of the amounts taken into account under section 11(a) and section 22(1) is necessary so as to ensure that an amount that is no longer matched by the corresponding deduction of expenditure incurred on acquisition of the trading stock in that year of assessment is not included in income as part of closing stock. Similarly, if the debt is reduced in a year of assessment following the year in which the trading stock was acquired and it is still held and not disposed of at the end of that year of assessment, both the amounts taken into account under section 22(1) and section 22(2) will need to be reduced.

The amount taken into account as opening stock under section 22(2) for the year of assessment subsequent to the year of assessment in which the debt was reduced, will be the amount included in closing stock at the end of the year of assessment in which the debt was reduced, that is the amount as reduced under section 19(3). If the trading stock is still on hand at the end of that subsequent year, it will need to be accounted for as closing stock under section 22(1). Section 22(1) requires such closing stock to be accounted for at "cost price" less such amount as the Commissioner thinks just and reasonable as representing the amount by which its value has decreased as a result of damage, deterioration, change of fashion, decrease in market value or any other reason satisfactory to the Commissioner. Section 19(3) cannot be applied to reduce the amount taken into account under section 22(2) in these circumstances since it only applies in the year of assessment in which the debt is reduced. However, given that the expenditure originally incurred under section 11(a) on acquisition of the trading stock is required to be reduced by the reduction amount under section 19(3), it is considered that this results in the "cost

price” for purposes of section 22(1) of the trading stock being reduced by such reduction amount. The cost price of the closing stock required to be taken into account under section 22(1) in the year of assessment subsequent to the year of assessment in which the debt was reduced is therefore the “cost price” of the trading stock reduced by the reduction amount that arose in the prior year of assessment.

Section 19(4) also applies when the expenditure was in respect of trading stock that is held and not disposed of by that person at the time of the reduction of the debt. Under section 19(4) if the reduction amount of the debt exceeds the amount applied under section 19(3) to reduce the section 11(a), section 22(1) and section 22(2) amounts as appropriate, then the excess amount is, for the purposes of section 8(4)(a), deemed to be an amount that has been recovered or recouped in the year of assessment in which the debt is reduced. The words “to the extent that a deduction or allowance was granted in terms of the Act” in section 19(4) make it clear that the amount to be brought into account under section 19(3) and 19(4) is limited to the amounts granted as an allowance or deduction under the Act.

Section 19(4) will accordingly apply if the amount of trading stock held and not disposed of at the time of the reduction of a debt is less than the reduction amount of the debt that funded the acquisition of that trading stock. The cost price of trading stock could have been reduced under section 22(1)(a) in a previous year of assessment because of a reduction in its value.

The recoupment of the reduction amount of a debt that was used to fund expenditure incurred in respect of trading stock that was not “held and not disposed of” at the time of the reduction of that debt, is dealt with under section 19(5) (see 4.4).

Any reduction amount must be applied in accordance with the sequence of the subsections of section 19. Thus a debt that funded the acquisition of trading stock and which is partially reduced must first be allocated to trading stock that is held and not disposed of at the time of the debt reduction under section 19(3). Any remaining balance of the debt reduction must then be dealt with as a recoupment under section 19(4) or (5). See Example 4 below.

Example 4 – Reduction of debt that funded the acquisition of trading stock

Facts:

Company A’s year of assessment ends on the last day of February.

During the 2014 year of assessment Company A purchased trading stock from Company B on credit at a cost of R500 000. Of the trading stock so acquired, trading stock with a cost price of R100 000 was sold during the 2014 year of assessment. Company A included the balance of R400 000 in closing stock for the 2014 year of assessment and brought this amount forward as opening stock for the 2015 year of assessment.

On 1 March 2014 Company B cancelled the debt of R500 000 owed by Company A because of Company A’s inability to pay. Trading stock with a cost price of R400 000 was held and not disposed of at the time of reduction of the debt.

Company A's total opening stock for the 2015 year of assessment amounted to R1 million and the closing balance of trading stock at year-end amounted to R800 000. The total closing stock of R800 000 includes the opening stock of R400 000 purchased from Company B.

Result:

Reduction amount = Amount by which the debt is reduced – Amount applied as consideration for that reduction = R500 000 – RNil = R500 000. R400 000 funded trading stock held and not disposed of at the time of the reduction of the debt and R100 000 related to trading stock already sold at that time.

Section 19(3) applies to R400 000 of the reduction amount because the debt directly funded the acquisition of trading stock held and not disposed of amounting to R400 000 at the time of the reduction of the debt. The opening balance of trading stock under section 22(2) is reduced to R600 000 (R1 million – R400 000) and the closing balance of trading stock under section 22(1) is reduced to R400 000 (R800 000 – R400 000).

Section 19(4) does not apply since the full amount of the reduction amount relating to the expenditure incurred in respect of the stock held and not disposed of at the time of the debt reduction (R400 000) was applied to reduce the amounts taken into account as opening and closing stock under section 19(3).

Section 19(5) applies to R100 000 of the reduction amount relating to the trading stock of R100 000 that was disposed of during the 2014 year of assessment. The trading stock of R100 000 was allowed as a deduction under section 11(a) during the 2014 year of assessment. Under section 19(5) this amount is deemed for the purposes of section 8(4)(a) to be an amount that has been recovered or recouped during the 2015 year of assessment (see 4.4).

In the 2016 year of assessment the amount taken into account as opening stock will be the amount included in closing stock at the end of the 2015 year of assessment, that is, R400 000. Assuming the trading stock is still on hand at the end of the 2016 year of assessment, section 22(1) requires it to be accounted for at "cost price" less such amount as the Commissioner thinks just and reasonable as representing the amount by which its value has decreased due to damage, deterioration, change in value, decrease in market value or for any other reason satisfactory to the Commissioner. Section 19(3) cannot be applied to reduce the amount taken into account under section 22(1) since it only applies in the year in which the debt is reduced. However, as the expenditure incurred on acquisition of the trading stock that has been allowed as a deduction under section 11(a) in the 2014 year of assessment is required to have been reduced by the reduction amount that arose in the 2015 year of assessment, it is considered that the "cost price" for purposes of section 22(1) in the 2016 year of assessment must take into account the reduction amount that arose in the 2015 year of assessment.

Note:

If only R50 000 of the debt was cancelled, section 19(3) would be applied to reduce the value of opening stock and closing stock by this amount. Section 19(4) would still not have any application in these circumstances since the full amount of the reduction amount (R50 000) relating to the trading stock on hand and not disposed of would have been applied to reduce the amount taken into account as contemplated in section 19(3), namely, R50 000.

Section 19(5) would not apply because all the trading stock that was funded by the debt reduction was held and not disposed of at the time of the reduction of the debt.

Example 5 – Reduction of debt that funded the acquisition of trading stock*Facts:*

Company C's year of assessment ends on the last day of February.

During the 2014 year of assessment Company C purchased trading stock from Company D on credit at a cost of R300 000. During the same year of assessment Company C sold R200 000 of this stock and included the balance of R100 000 in closing stock. However, as a result of a decline in the value of the closing stock Company C wrote down the value of the stock to R60 000 and brought forward the same amount as opening stock to the 2015 year of assessment.

On 31 March 2014 Company D cancelled the debt of R300 000 owed by Company C because of Company C's inability to pay. The full amount of opening stock of R60 000 was still on hand at the time of the cancellation of the debt and at the end of the year of assessment.

Company C did not have any other trading stock on hand at the end of the year of assessment.

Result:

Reduction amount = Amount by which the debt is reduced – Amount applied as consideration for that reduction = R300 000 – RNil = R300 000. R100 000 funded trading stock held and not disposed of at the time of the reduction of the debt and R200 000 related to trading stock already sold at that time.

Section 19(3) applies to R100 000 of the reduction amount because the debt directly funded the acquisition of trading stock of R100 000 that was held and not disposed of at the time of the reduction of the debt. The opening balance of trading stock under section 22(2) is reduced to nil (R60 000 – R60 000) and the closing balance of trading stock under section 22(1) is also reduced to nil.

Section 19(4) also applies to R100 000 of the reduction amount of the debt that funded the trading stock held and not disposed of at the time of the reduction of the debt, less the amount taken into account under section 19(3) of R60 000. An amount of R40 000 is therefore deemed to be recovered or recouped for purposes of section 8(4)(a).

Section 19(5) applies to the trading stock of R200 000 that was disposed of during the 2014 year of assessment. The trading stock of R200 000 was allowed as a deduction under section 11(a) during the 2014 year of assessment. Under section 19(5) this amount is deemed, for the purposes of section 8(4)(a), to be an amount that has been recovered or recouped during the 2015 year of assessment (see 4.4).

4.4 Operating expenses and trading stock not “held and not disposed of” at the time of the reduction of debt [section 19(5)]

Section 19(5) provides that the reduction amount of any debt that funded specified expenditure (see below), must, *to the extent* that a deduction or allowance was allowed for that expenditure, be deemed, for the purposes of section 8(4)(a), to be an amount that has been recovered or recouped in the year of assessment in which the debt is reduced. The words “to the extent” make it clear that the amount to be brought into account under section 19(5) is limited to the amounts granted as a deduction or an allowance.

The specified expenditure that falls within the ambit of section 19(5) is any expenditure other than –

- expenditure incurred in respect of trading stock that is held and not disposed of at the time of the reduction of the debt (section 19(3) and (4) specifically deal with trading stock held and not disposed of); and
- expenditure incurred in respect of an allowance asset (section 19(6) specifically deals with allowance assets).

Interest that has been capitalised is considered to have been funded by debt since the creditor has in effect extended credit to the debtor in relation to the amount of interest owed by the debtor. Under section 19(5) the reduction amount of the interest portion of a debt would be deemed, for the purposes of section 8(4)(a), to be an amount that has been recovered or recouped to the extent that the relevant interest was allowed as a deduction.

Example 6 – Reduction of a debt that funded expenditure allowed as a deduction

Facts:

Company E borrowed R1 million from Company F and used the funds to finance operating expenses which were allowed as a deduction under section 11(a). Interest of R100 000 was incurred on the loan and allowed as a deduction under section 24J(2). The interest expense was not paid but was added (capitalised) to the outstanding loan balance. Company E’s year of assessment ends on 31 March.

As a result of Company E falling into financial difficulty Company F waived the debt of R1,1 million during the 2015 year of assessment.

Result:

Reduction amount = Amount by which the debt is reduced – Amount applied as consideration for that reduction = R1 100 000 – RNil = R1 100 000.

The debt reduction of R1,1 million funded expenses for which deductions were allowed under the Act. Under section 19(5) the reduction amount of the debt of R1,1 million is deemed, for the purposes of section 8(4)(a), to be an amount that has been recovered or recouped during the 2015 year of assessment.

Example 7 – Reduction of a debt that funded expenditure allowed as a deduction

Facts:

Company E borrowed R1 million from Company F and used the funds to finance the acquisition of a building which did not qualify for any capital allowances under the Act. Interest of R100 000 was incurred on the loan and allowed as a deduction under section 24J(2). The interest expense was not paid but was added (capitalised) to the outstanding loan balance. Company E's year of assessment ends on 31 March.

As a result of Company E falling into financial difficulty, Company F waived the debt of R1,1 million during the 2015 year of assessment.

Result:

Section 19 applies only to debt that was used, directly or indirectly, to fund any expenditure in respect of which a deduction or allowance was granted under the Act. Accordingly, it will apply only to R100 000 of the loan (capitalised interest) since no deduction or allowance was granted in respect of the R1 million that was used to fund the acquisition of the building. A deduction was allowed in respect of the interest of R100 000.

Reduction amount = Amount by which the debt is reduced – Amount applied as consideration for that reduction = R100 000 – RNil = R100 000.

Under section 19(5) the reduction amount of the debt of R100 000 is deemed, for the purposes of section 8(4)(a), to be an amount that has been recovered or recouped during the 2015 year of assessment.

Paragraph 12A(3) or (4) will apply in respect of the debt that financed the acquisition of the building (see 4.6).

See also Example 4 and Example 5 in 4.3 above.

4.5 Allowance assets [section 19(6) and paragraph 12A(3)]

The tax consequences of the reduction of debt used to finance the acquisition of an allowance asset held at the time of such reduction must firstly be considered under paragraph 12A(3) and then under section 19(6).

Paragraph 12A(3) does not apply if the allowance asset is not held by the person whose debt has been reduced at the time of the debt reduction. In contrast, section 19(6) will apply regardless of whether the allowance asset is held at the time of the debt reduction.

Paragraph 12A(3) provides that if a debt owed by a person is reduced and the amount of that debt funded expenditure incurred in respect of an asset that is held by that person at the time of the reduction of the debt, the amount of expenditure

incurred on that asset must, for the purposes of paragraph 20, be reduced by the reduction amount of the debt. The base cost of an asset is calculated for CGT purposes under paragraph 20 and therefore by reducing the expenditure incurred under that paragraph the base cost of the relevant asset is reduced by the reduction amount, or depending on the facts, by an amount which is less than the reduction amount (see Example 8).

Should the reduction amount of the debt exceed the amount of the reduction in the base cost of an allowance asset under paragraph 12A(3), the excess must be brought into account under section 19(6) and must, *to the extent* that a deduction or allowance was granted under the Act, be deemed for the purposes of section 8(4)(a), to be an amount that has been recovered or recouped in the year of assessment in which the debt is reduced. The words “to the extent” make it clear that the amount to be brought into account under section 19(6) must be limited to the amounts previously granted as a deduction or an allowance. Importantly, section 19(6) will apply only once the base cost of the allowance asset has been reduced to nil under paragraph 12A(3), that is, paragraph 12A(3) has been applied to reduce the amount of expenditure incurred by the taxpayer that constitutes the base cost of the relevant allowance asset “to the full extent of that expenditure”.²⁵

The reduction of a debt that funded expenditure incurred in respect of an allowance asset will not result in a capital gain or capital loss for CGT purposes. A capital gain or capital loss can only arise upon actual disposal of the asset.

Example 8 – Reduction of a debt that funded the acquisition of an allowance asset

Facts:

Company A and Company B do not form part of the same group of companies. Company B’s year of assessment ends on the last day of February.

2014 year of assessment

Company B purchased an allowance asset from Company A on credit at a cost of R2 million. Company B claimed a wear-and-tear allowance under section 11(e) of R300 000.

2015 year of assessment

On 1 March 2014 Company B was relieved from payment of the debt of R2 million because of cash-flow problems. The asset was held by Company B at the time of reduction of the debt but was disposed of two weeks later for R1,7 million.

Result:

2015 year of assessment

Reduction amount = Amount by which the debt is reduced – Amount applied as consideration for that reduction = R2 million – RNil = R2 million.

²⁵ Section 19(6)(ii).

The debt of R2 million funded the acquisition of an allowance asset which was still held by the taxpayer when the debt was reduced. As a result, paragraph 12A(3) applies and the base cost of the asset of R1,7 million (R2 million expenditure incurred – R300 000 wear-and-tear allowance previously claimed)²⁶ must be reduced by the reduction amount. The maximum reduction is, however, limited to R1,7 million since expenditure and base cost can only be reduced to nil.

Under section 19(6) to the extent an allowance was granted (that is, R300 000) and paragraph 12A was not applied to the full extent of the expenditure incurred under paragraph 20, a recoupment arises. Even though the reduction amount was R2 million, paragraph 12A only reduced the expenditure by R1,7 million because expenditure of R300 000 had already been reduced under paragraph 20(3)(a)(i) and was therefore not available for reduction under paragraph 12A. The excess of R300 000 (R2 million reduction amount – R1,7 million paragraph 12A reduction) is, for the purposes of section 8(4)(a), deemed under section 19(6) to be an amount that has been recovered or recouped.

The asset was disposed of two weeks into the year of assessment so a partial allowance would be available under section 11(e) for the period of use. However, because of the limitation rules in section 19(7) (see 4.7) no allowance is available under section 11(e) in the 2015 year of assessment.

While the recoupment provisions of section 8(4)(a) have application on the subsequent disposal of the allowance asset, no recoupment is triggered as the selling price of R1,7 million is equal to the tax value of R1,7 million (R2 million cost – R300 000 section 11(e) allowance claimed in 2014).

In addition, the full proceeds of R1,7 million will constitute a capital gain derived by Company B. Base cost is nil under paragraph 20 and 12A (see above) and the proceeds derived by Company B are not reduced by the recoupment of R300 000 that arises under section 19(6). Under paragraph 35(3)(a) proceeds of R1,7 million from the disposal of the asset must be reduced by any amount of those proceeds which must be or was taken into account in the taxpayer's gross income or taxable income, however as reflected above no proceeds from the disposal are required to be so included in Company B's gross income. Paragraph 35(3)(a) does not require a reduction in respect of a previous recoupment under section 19(6) read with section 8(4)(a).

On an overall basis Company B did not pay for the asset because the full amount of the debt was forgiven and when it subsequently sold the asset for R1,7 million those proceeds were subject to CGT. Company B had originally claimed R300 000 as wear and tear in 2014 but this was effectively reversed by the recoupment of R300 000 under section 19(6) in 2015.

²⁶ Under paragraph 20(3)(a)(i) the expenditure incurred as contemplated in paragraph 20(1)(a) to (g) in acquiring an asset must be reduced by any amount which is or was allowable or is deemed to have been allowed as a deduction in determining the taxable income of a person.

Example 9 – Reduction of a debt that funded the acquisition of an allowance asset*Facts:*

Company A and Company B do not form part of the same group of companies. Company B's year of assessment ends on the last day of February.

2014 year of assessment

Company B purchased an allowance asset from Company A on credit at a cost of R2 million. Company B claimed a wear-and-tear allowance under section 11(e) of R300 000.

2015 year of assessment

On 1 March 2014 Company B was relieved from payment of the debt of R2 million because of cash-flow problems. The asset was held by Company B at the time of reduction of the debt but was disposed of two weeks later for R1,8 million.

*Result:**2015 year of assessment*

Reduction amount = Amount by which the debt is reduced – Amount applied as consideration for that reduction = R2 million – RNil = R2 million.

The debt of R2 million funded the acquisition of an allowance asset which was still held by the taxpayer when the debt was reduced. As a result, paragraph 12A(3) applies and the base cost of the asset of R1,7 million (R2 million expenditure incurred – R300 000 wear and tear allowance previously claimed)²⁷ must be reduced by the reduction amount. The maximum reduction is, however, limited to R1,7 million as expenditure and base cost can only be reduced to nil.

Under section 19(6) to the extent an allowance was granted (that is, R300 000) and paragraph 12A was not applied to the full extent of the expenditure incurred under paragraph 20, a recoupment arises. Even though the reduction amount was R2 million, paragraph 12A only reduced the expenditure by R1,7 million because expenditure of R300 000 had already been reduced under paragraph 20(3)(a)(i) and was therefore not available for reduction under paragraph 12A. The excess of R300 000 (R2 million reduction amount – R1,7 million paragraph 12A reduction) is, for the purposes of section 8(4)(a), deemed under section 19(6) to be an amount that has been recovered or recouped.

The asset was disposed of two weeks into the year of assessment so a partial allowance would be available under section 11(e) for the period of use. However, because of the limitation rules in section 19(7), no allowance is available under section 11(e) in the 2015 year of assessment (see **4.7**).

²⁷ Under paragraph 20(3)(a)(i) the expenditure incurred as contemplated in paragraph 20(1)(a) to (g) in acquiring an asset must be reduced by any amount which is or was allowable or is deemed to have been allowed as a deduction in determining the taxable income of a person.

The recoupment provisions of section 8(4)(a) apply on the subsequent disposal of the allowance asset. On the face of it, Company B should suffer a recoupment of R100 000 since the selling price of the allowance asset (R1,8 million) exceeds its tax value of R1,7 million (R2 million cost – R300 000 section 11(e) allowance claimed in 2014) by R100 000. However, paragraph (iii) of the proviso to section 8(4)(a) provides that section 8(4)(a) will not apply to so much of any amount recouped which was previously taken into account under section 19(6). The recoupment of R100 000 was previously included in the deemed recoupment of R300 000 under section 19(6) and accordingly it is not taken into account again on disposal of the asset.

In addition, the full proceeds of R1,8 million will constitute a capital gain derived by Company B. The base cost of the asset is nil under paragraph 20 and 12A (see above) and the proceeds derived by Company B are not reduced by the recoupment of R300 000 that arises under section 19(6). Under paragraph 35(3)(a) proceeds of R1,8 million from the disposal of the asset must be reduced by any amount of those proceeds which must be or was taken into account in the taxpayer's gross income or taxable income. However, as reflected above no proceeds from the disposal are required to be so included. Paragraph 35(3)(a) does not require a reduction in respect of a previous recoupment under section 19(6).

On an overall basis Company B did not pay for the asset because the full amount of the debt was forgiven and when it subsequently sold the asset for R1,8 million those proceeds were subject to CGT. Company B had originally claimed R300 000 as wear and tear in 2014 but this was effectively reversed by the recoupment of R300 000 under section 19(6) in 2015.

Example 10 – Reduction of a debt that funded the acquisition of an allowance asset which was not held at the time of the reduction of the debt

Facts:

Company A and Company B do not form part of the same group of companies. Company B's year of assessment ends on the last day of February.

2014 year of assessment

On 1 March 2013 Company B obtained a loan of R2 million from Company A which Company B used to acquire an allowance asset from a third party at a cost of R2 million. Company B claimed a wear-and-tear allowance of 10% a year on the asset under section 11(e) of R200 000.

2015 year of assessment

Company B sold the allowance asset for R1,7 million on 31 August 2014 to an unconnected third party. Company B claimed a further wear-and-tear allowance of R100 000 ($R200\,000 \times 6 / 12$) on the asset before selling it.

Two weeks later Company A waived the debt of R2 million owed by Company B because of Company B's inability to pay.

*Result:**Disposal of the asset*

No recoupment of the wear-and-tear allowances previously claimed of R300 000 (R200 000 in 2014 and R100 000 in 2015) arises on disposal of the asset under section 8(4)(a) because the proceeds on disposal of R1,7 million do not exceed the tax value of the asset of R1,7 million (R2 million purchase price – R300 000 wear-and-tear allowances).

No capital gain arises on disposal of the asset because the proceeds on disposal of R1,7 million are equal to the base cost of the asset of R1,7 million (R2million cost – R300 000 allowances previously claimed). The base cost of the asset is not reduced by the reduction amount under paragraph 12A(3) because the allowance asset was disposed of before the reduction of the debt and was therefore not held at the time of the reduction of the debt.

Reduction of the debt

Reduction amount = Amount by which the debt is reduced – Amount applied as consideration for that reduction = R2 000 000 – RNil = R2 000 000.

On subsequent forgiveness of the debt of R2 million, section 19(6) applies and the portion of the reduction amount equal to the depreciation of R300 000 previously granted as an allowance under section 11(e) is deemed, for the purposes of section 8(4)(a), to be an amount that is recovered or recouped. The expenditure allowed under section 11(e) is recouped under section 19(6) because –

- a debt owed by a person has been reduced;
- the debt funded allowable expenditure incurred in respect of an allowance asset; and
- the expenditure incurred under paragraph 20 has not been reduced under paragraph 12A to its full extent (in fact, it has not been reduced at all).

Paragraph 20(3)(b) does not apply because the acquisition of the asset was funded indirectly. As a result there is no recoupment of the balance of the reduction amount of R1,7 million.

4.6 Non-allowance assets [paragraph 12A(3) and (4)]

The reduction of a debt that funded expenditure incurred in respect of a non-allowance asset is subject to the application of paragraph 12A(3) (see **4.5**) and paragraph 12A(4).

Paragraph 12A(3) will only apply if the non-allowance asset is held by the person whose debt has been reduced at the time of the reduction of the debt. As mentioned in **4.5**, in these circumstances the expenditure, and therefore the base cost of the asset, is required to be reduced by the reduction amount of the debt. The base cost can only be reduced to nil under paragraph 12A(3) and cannot give rise to a negative base cost.

Should the reduction amount of a debt that has been applied to reduce the base cost of the non-allowance asset under paragraph 12A(3) exceed the base cost of the non-allowance asset, the excess must be applied under paragraph 12A(4)(b)(i) to reduce

any assessed capital loss of the person whose debt has been reduced in the year of assessment in which the reduction of the debt took place. It follows that paragraph 12A(4)(b)(i) will only apply once the base cost of the asset has been reduced to nil under paragraph 12A(3). An “assessed capital loss” is determined under paragraph 9 and in essence refers to the negative balance remaining at the end of the year of assessment after reducing any assessed capital loss from the previous year of assessment by any aggregate capital gain or by increasing it by any aggregate capital loss that arose during the current year of assessment.

While paragraphs 12A(3) and 12A(4)(b)(i) will only apply if the relevant non-allowance asset is held by the person at the time of the debt reduction, paragraph 12A(4)(b)(ii) applies when the relevant asset is no longer held by the person at that time. Should the non-allowance asset not be held by the person whose debt has been reduced at the time of the debt reduction, the full amount of the reduction amount of the debt must be applied under paragraph 12A(4)(b)(ii) to reduce any assessed capital loss of that person for the year of assessment in which the reduction takes place.

The maximum amount of the reduction under section 12A(4)(b) is the amount of the assessed capital loss for the year of assessment.

The reduction of a debt that funded expenditure incurred in respect of a non-allowance asset will not result in a capital gain or capital loss for CGT purposes. A capital gain or capital loss can only arise upon the disposal of the asset.

Example 11 – Reduction of a debt that funded a non-allowance asset

Facts:

In 2009 Company A lent Company B R2 million which Company B used to purchase land on capital account from a third party at a base cost of R2 million. Company A and Company B are not members of the same group of companies. Company B's year of assessment ends on the last day of February.

On 30 June 2013 Company A waived R500 000 of the amount owed by Company B because of Company B's adverse financial position. Company B sold the land on 30 November 2013 for proceeds of R2,2 million.

On 31 March 2014 Company A waived the balance of R1,5 million owing by Company B because of Company B's inability to repay the remaining amount owed to it. At the end of its 2015 year of assessment Company B has an assessed capital loss of R4,5 million before taking into account any debt reduction transactions.

Result:

The CGT implications for Company B are as follows:

2014 year of assessment

Under paragraph 12A(3) the expenditure of R2 million incurred to acquire the land must be reduced by R500 000, being the portion of the debt that was reduced for no consideration. The remaining base cost at this point is thus R1,5 million.

The sale of the land gives rise to a capital gain of R700 000 (proceeds of R2,2 million less base cost of R1,5 million).

2015 year of assessment

Neither paragraph 12A(3) nor paragraph 12A(4)(b)(i) applied when Company A waived the balance of R1,5 million since the non-allowance asset that was funded by the debt was no longer held by Company B at the time of the reduction of the debt. However, under paragraph 12A(4)(b)(ii) Company B's assessed capital loss must be reduced by the amount of the debt reduction of R1,5 million. Company B's assessed capital loss to be carried forward to the 2016 year of assessment will accordingly amount to R3 million [assessed capital loss before debt reduction of R4,5 million less (debt reduction amount of R1,5 million less any amount applied under paragraph 12A(3) in relation to the reduction amount, that is, nil in the example)]. Paragraph 12A(3) was applied to an earlier reduction of the debt but not to the current reduction of R1,5 million.

4.7 Limitation of deductions and allowances on allowance assets [section 19(7)]

Section 19(7) provides that the aggregate amount of deductions and allowances that may be claimed in respect of an allowance asset may not exceed an amount equal to the aggregate of expenditure incurred in the acquisition, creation or improvement of that asset, reduced by an amount equal to the sum of –

- the reduction amount of a debt that funded the expenditure incurred in the acquisition, creation or improvement of that asset; and
- the aggregate amount of deductions and allowances previously allowed to that person in respect of that asset.

The “deductions and allowances” referred to in section 19(7) that are subject to possible limitation include depreciation allowances and a deduction for the loss arising on the alienation, loss or destruction of an asset under section 11(o).

Example 12 – Limitation of deductions and allowances on an allowance asset*Facts:*

Company A acquired second-hand machinery at a cost of R1 million on loan account from Company B on 1 March 2013. Company A and Company B do not form part of the same group of companies. Company A is entitled to an allowance of 20% a year on the cost price of the asset under section 12C(1). On 1 March 2014 Company B waived the outstanding balance on the loan account, which at that stage stood at R500 000, because of Company A's adverse financial position. Company A's year of assessment ends on 28 February.

Result:

Company A was granted allowances under section 12C(1) of R200 000 a year for the 2014 and 2015 years of assessment. At the time of the reduction of the debt, the base cost of the machinery for purposes of paragraph 20 was R600 000 (R1 million – R200 000 for 2014 and R200 000 for 2015).²⁸

²⁸ Under paragraph 20(3)(a)(i) the expenditure of an asset must be reduced by any amount which is or was allowable or is deemed to have been allowed as a deduction in determining the taxable income of a person.

Under paragraph 12A(3) the base cost of the machinery (R600 000) was reduced by R500 000 (the reduction amount of the debt) to R100 000 for purposes of paragraph 20 because of the reduction of the debt by Company B.

Section 19(6) does not apply in these circumstances since the base cost has not been reduced to nil under paragraph 12A(3).

Under section 19(7) the allowances that can be claimed on the machine after the reduction of debt will be limited to R100 000, being the aggregate of the expenditure incurred of R1 million reduced by the reduction amount of the relevant debt (R500 000) plus the aggregate amount of allowances previously granted (R400 000), a total of R900 000. The allowance that may be claimed under section 12C(1) is, therefore, limited to R100 000 for the 2016 year of assessment and no further allowances will be allowed on the asset.

Example 13 – Limitation of deductions and allowances on an allowance asset

Facts:

Company A and Company B do not form part of the same group of companies. Company B's year of assessment ends on the last day of February.

2014 year of assessment

On 1 March 2013 Company B purchased an allowance asset from Company A on credit at a cost of R2 million. Company B claimed a wear-and-tear allowance under section 11(e) on the straight line-basis at a rate of 15% per year, that is, R300 000.

2015 year of assessment

On 1 March 2014 Company B was relieved from payment of the debt of R2 million because of cash-flow problems.

The asset was held by Company B at the time of reduction of the debt but was disposed of on the last day of the year of assessment for R2,1 million.

Result:

2015 year of assessment

Reduction amount = Amount by which the debt is reduced – Amount applied as consideration for that reduction = R2 000 000 – RNil = R2 000 000.

The debt of R2 million funded the acquisition of an allowance asset which was still held by the taxpayer when the debt was reduced. As a result, paragraph 12A(3) applies and the base cost of the asset of R1,7 million (R2 million expenditure incurred – R300 000 wear-and-tear allowance previously claimed)²⁹ must be reduced by the reduction amount. The maximum reduction is, however, limited to R1,7 million since expenditure and base cost can only be reduced to nil.

²⁹ Under paragraph 20(3)(a)(i) the expenditure incurred as contemplated in paragraph 20(1)(a) to (g) in acquiring an asset must be reduced by any amount which is or was allowable or is deemed to have been allowed as a deduction in determining the taxable income of a person.

Under section 19(6) to the extent an allowance was granted (that is, R300 000) and paragraph 12A was not applied to the full extent of the expenditure incurred under paragraph 20, a recoupment arises. Even though the reduction amount was R2 million, paragraph 12A only reduced the expenditure by R1,7 million because expenditure of R300 000 had already been reduced under paragraph 20(3)(a)(i) and was therefore not available for reduction under paragraph 12A. The excess of R300 000 (R2 million reduction amount – R1,7 million paragraph 12A reduction) is, for the purposes of section 8(4)(a), deemed under section 19(6) to be an amount that has been recovered or recouped.

Since the asset was disposed of on the last day of the year of assessment, Company B would, but for the limitation in section 19(7), have been entitled to a deduction under section 11(e) equal to the cost of the asset of R2 million \times 15% = R300 000. However, under section 19(7) the aggregate of the allowances that can be claimed on the asset after the reduction of debt is limited to the aggregate expenditure incurred in acquiring the asset of R2 million reduced by the sum of the reduction amount of R2 million plus the aggregate amount of allowances previously granted of R300 000. This calculation gives a result of negative R300 000 which means that no further allowance under section 11(e) is permitted in 2015.

The recoupment provisions of section 8(4)(a) need to be considered when the asset is disposed of. But for the proviso to section 8(4)(a), Company B would have suffered a recoupment of R300 000 since the selling price of the allowance asset (limited to the original cost of R2 million) exceeded its tax value of R1,7 million [R2 million cost – R300 000 section 11(e) allowance claimed in 2014, no allowance permitted in 2015 under section 19(7)]. However, paragraph (iii) of the proviso to section 8(4)(a) provides that section 8(4)(a) will not apply to so much of any amount recouped which was previously taken into account under section 19(6). R300 000 of the recoupment of R300 000 was previously included as a deemed recoupment under section 19(6) and accordingly it is not taken into account again on disposal of the asset. Therefore, the recoupment on disposal of the allowance asset in these circumstances under section 8(4)(a) is nil.

In addition, the full proceeds of R2,1 million will constitute a capital gain derived by Company B. The base cost of the asset is nil under paragraph 20 and 12A (see above) and the proceeds derived by Company B are not reduced by the recoupment of R300 000 that arises under section 19(6). Under paragraph 35(3)(a) proceeds of R2,1 million from the disposal of the asset must be reduced by any amount of those proceeds that must be or was included in Company B's gross income or that must be or was taken into account in determining its taxable income. However, as noted above, no proceeds from the disposal are required to be so included under section 8(4)(a) on disposal in these circumstances and the full proceeds of R2,1 million must be taken into account in the determination of the capital gain or loss that arises on disposal of the allowance asset. No reduction in respect of a previous recoupment under section 19(6) is required under paragraph 35(3)(a).

Example 14 – Limitation of deductions and allowances on an allowance asset

Facts:

Company A and Company B do not form part of the same group of companies. Company B's year of assessment ends on the last day of February.

2014 year of assessment

Company B purchased an allowance asset from Company A on credit at a cost of R2 million. Company B claimed a wear-and-tear allowance under section 11(e) of R1 million.

2015 year of assessment

On 1 March 2014 Company B was relieved from the payment of R1,5 million of the debt because of cash-flow problems.

The asset was held by Company B at the time of reduction of the debt but was disposed of two weeks later for R800 000.

*Result:**2015 year of assessment*

Reduction amount = Amount by which the debt is reduced – Amount applied as consideration for that reduction = R1,5 million – RNil = R1,5 million.

The debt of R2 million funded the acquisition of an allowance asset which was still held by the taxpayer when the debt was reduced. As a result, paragraph 12A(3) applies and the base cost of the asset of R1 million (R2 million expenditure incurred – R1 million wear-and-tear allowance previously claimed)³⁰ must be reduced by the reduction amount of R1,5 million. The base cost of the asset is accordingly reduced to nil since it is not possible to reduce expenditure to a negative amount.

Under section 19(6) to the extent an allowance was granted (that is, R1 million) and paragraph 12A was not applied to the full extent of the expenditure incurred under paragraph 20, a recoupment arises. Even though the reduction amount was R1,5 million, paragraph 12A only reduced the expenditure by R1 million because expenditure of R1 million had already been reduced under paragraph 20(3)(a)(i) and was therefore not available for reduction under paragraph 12A. The excess of R500 000 (R1,5 million reduction amount – R1 million paragraph 12A reduction) is, for the purposes of section 8(4)(a), deemed under section 19(6) to be an amount that has been recovered or recouped.

A partial section 11(e) allowance is unavailable for the two weeks during which the asset was used in the 2015 year of assessment because of the limitation rules in section 19(7).

³⁰ Under paragraph 20(3)(a)(i) the expenditure incurred as contemplated in paragraph 20(1)(a) to (g) in acquiring an asset must be reduced by any amount which is or was allowable or is deemed to have been allowed as a deduction in determining the taxable income of a person.

Under section 11(o) a deduction for the loss arising on the alienation, loss or destruction of an asset is potentially available, subject to section 19(7), on disposal of the asset because the cost of R2 million exceeds the proceeds of R800 000 and allowances previously claimed of R1 million by R200 000. However, under section 19(7) the aggregate allowances that can be claimed on the asset after the reduction of debt are limited to the aggregate expenditure incurred in acquiring the asset of R2 million reduced by the sum of the reduction amount of R1,5 million plus the aggregate amount of allowances previously granted of R1 million. This gives a result of negative R500 000 which means that no further deduction under section 11(o) is permitted in 2015.

In addition, the full proceeds of R800 000 will constitute a capital gain derived by Company B. The base cost of the asset is nil under paragraph 20 and 12A (see above) and the proceeds derived by Company B are not reduced by the recoupment of R500 000 that arises under section 19(6). Under paragraph 35(3)(a) proceeds of R800 000 from the disposal of the asset must be reduced by any amount of those proceeds that must be or was included in Company B's gross income or that must be or was taken into account in determining its taxable income. However, as noted above, no proceeds from the disposal are required to be so included in gross income or taxable income. No reduction in respect of a previous recoupment under section 19(6) is required under paragraph 35(3)(a).

On an overall basis Company B paid R500 000 for the asset because R1,5 million of the debt of R2 million was forgiven. Company B effectively claimed a deduction for the true cost of R500 000 [originally claimed R1 million as wear and tear in 2014 but part of this (R500 000) was effectively reversed by the recoupment of R500 000 under section 19(6) in 2015 and no further deductions were allowed as a result of section 19(7)]. Accordingly, it is appropriate that when Company B subsequently sold the asset for R800 000 those proceeds were subject to CGT.

4.8 Pre-valuation date assets [paragraph 12A(5)]

Special rules are provided for in paragraph 12A(5) to determine the base cost of a pre-valuation date asset when debt that funded expenditure in relation to such an asset is reduced and paragraph 12A(3) or (4) applies to the reduction. A pre-valuation date asset is defined in paragraph 1 and means an asset acquired before valuation date³¹ by a person and which has not been disposed of by that person before valuation date.

Paragraph 12A(5) provides that, for purposes of determining the date of acquisition of a pre-valuation date asset of a person and the expenditure incurred in respect of that asset, that person must be treated as having –

- disposed of that asset at a time immediately before that debt is reduced for an amount equal to the market value of the asset at the time; and
- immediately reacquired the asset at that time at an expenditure equal to that market value –
 - less any capital gain; and
 - increased by any capital loss,

³¹ The term "valuation date" is defined in paragraph 1 and will generally be 1 October 2001.

that would have been determined had the asset been disposed of at market value at that time.

The market value of an asset on a specified date is determined under paragraph 31. The person is only treated as having disposed of the asset immediately before the reduction of the debt for the purposes of determining the expenditure incurred under paragraph 20. It is not deemed to be an actual disposal of the asset for purposes of the Act as a whole and accordingly does not give rise to a capital gain or loss on the deemed disposal at that point in time.

The expenditure determined under paragraph 12A(5) must be treated as an amount of expenditure actually incurred at a time immediately before the reduction of a debt of a person for purposes of paragraph 20(1)(a).

The aim of this rule is to establish the base cost of a pre-valuation date asset for the purpose of applying the debt reduction rules provided for in paragraphs 12A(3) and 12A(4). The base cost of a pre-valuation date asset is made up of its valuation date value plus any post-valuation date expenditure. The valuation date value may comprise the market value of the asset on valuation date (generally 1 October 2001), the time-apportionment base cost, or 20% of the proceeds after first deducting any post-valuation date expenditure. Since the valuation date value using the time-apportionment and 20% of proceeds methods can only be determined on the date of disposal, it would not be possible to apply paragraph 12A(3) and (4) without first re-establishing the base cost of the asset as an amount of "expenditure", hence the need for this rule.

Example 15 – Determination of the base cost of a pre-valuation date asset

Facts:

Company X acquired land in 1995 at a cost of R500 000. Under paragraph 29 Company X determined the market value of the land on valuation date at R900 000 and adopted this market value as the valuation date value of the land. Improvements of R2 million, funded with a loan from Company Y, were affected to the land in 2003. Company X and Company Y do not form part of the same group of companies. On 1 June 2013 the loan of R2 million was waived because of Company X's adverse economic position. Immediately before the debt cancellation the market value of the land and improvements was R5 million. Company X's year of assessment ends on 31 March.

Result:

The expenditure actually incurred on the asset (land and improvements) is calculated as follows for purposes of paragraph 20(1)(a):

	R
Asset treated as being reacquired at market value	5 000 000
Less: Capital gain had the asset been disposed of (R5 million proceeds – R900 000 market value of land on valuation date – R2 million subsequent expenditure on improvements)	<u>(2 100 000)</u>
Expenditure actually incurred for purposes of paragraph 20(1)(a)	<u>2 900 000</u>

Under paragraph 12A(3) the newly established base cost of the asset is reduced to R900 000 by the amount of the debt reduction (R2,9 million expenditure – R2 million debt reduction).

4.9 Exclusions from section 19 and paragraph 12A [section 19(8) and paragraph 12A(6)]

4.9.1 Estate duty [section 19(8)(a) and paragraph 12A(6)(a)]

Section 19 and paragraph 12A will not apply to any debt owed by a person that is an heir or legatee of a deceased estate, to the extent that –

- the debt is owed to the deceased estate;
- the debt is reduced by the deceased estate; and
- the amount by which the debt is reduced by the deceased estate forms part of the property of the deceased estate for purposes of the Estate Duty Act.

Section 19(8)(a) and paragraph 12A(6)(a) do not require that the reduction amount of the debt has to be subject to estate duty,³² merely that it forms part of the property of the deceased estate for purposes of the Estate Duty Act.

Section 3(1) of the Estate Duty Act provides that the estate of a person shall consist of all property and property which is deemed to be property of that person as at the date of death of the person. Section 3(2) of that Act provides that “property” means any right in or to property, movable or immovable, corporeal or incorporeal and lists certain items which are specifically included in and excluded from “property”. Property which is deemed to be property of a deceased is identified in section 3(3) of the Estate Duty Act. A debt owed to the deceased as at the date of death will generally be regarded as the “property” of the deceased for estate duty purposes even when it is subsequently reduced by the deceased estate.

The amount of a debt that formed part of the property of the deceased estate under section 3 of the Estate Duty Act and which was subsequently reduced by a deceased estate will, therefore, not be subject to the application of section 19 and paragraph 12A in the hands of the debtor.

Example 16 – Non-application of section 19 and paragraph 12A – Debt forming part of the property of a deceased estate

Facts:

Individual A sold shares to a family trust on loan account in 2013. The shares were acquired by the family trust as a capital investment. Individual A passed away on 30 April 2014 and under Individual A’s last will the loan was bequeathed to the trust.

³² Property of a deceased estate may not be subject to estate duty because of deductions allowed under sections 4 and 4A of the Estate Duty Act.

Result:

The deceased discharged the debt for no consideration by operation of law when the liquidation and distribution account of the deceased became final. Under paragraph 12A(6)(a) no reduction in the base cost of the shares must be made because the debt was owed to and reduced by the deceased estate and the amount of the debt formed part of the property of the deceased estate for purposes of the Estate Duty Act. The reduction of the debt is, therefore, not subject to the application of paragraph 12A.

Section 19 does not apply since the debt did not fund any expenditure that was deductible under the Act. Even if it had, section 19(8)(a) provides a similar exclusion in relation to debts forming part of the property of a deceased estate.

4.9.2 Donations tax [section 19(8)(b) and paragraph 12A(6)(b)]

Section 19 and paragraph 12A will not apply to any debt owed by a person to the extent that the debt is reduced by way of –

- a “donation” as defined in section 55(1); or
- any transaction to which section 58 applies, that is, the disposal of property for an inadequate consideration that is deemed to be a donation of such property (see further discussion below).

Importantly, section 19(8)(b) and paragraph 12A(6)(b) do not require that the reduction amount of the debt be subject to donations tax. Thus, while a debt may be reduced by a “donation” as defined in section 55(1) or a deemed donation as contemplated in section 58, the exclusions provided for in section 19(8)(b) and paragraph 12A(6)(b) will apply even when the donation is exempt from donations tax under section 56 or as a result of donations tax not being payable by virtue of section 54 because the donor is a non-resident.

A “donation” as defined in section 55(1)

Under section 19(8)(b) and paragraph 12A(6)(b) a debt reduced by way of a donation as defined in section 55(1) is not subject to the application of section 19 and paragraph 12A.

The terms “donation” and “property” are defined in section 55(1) as follows:

“**[D]onation**’ means any gratuitous disposal of property including any gratuitous waiver or renunciation of a right;

“**[P]roperty**’ means any right in or to property movable or immovable, corporeal or incorporeal, wheresoever situated.”

In *Welch’s Estate v C: SARS Marais JA* stated the following on the meaning of a donation:³³

“The test to be applied at common law to determine whether the disposition of an asset amounts to a donation properly so called (as opposed to a remuneratory donation) is so well-settled that it hardly needs repetition. The test is of course that

³³ 2005 (4) SA 173 (SCA), 66 SATC 303 at 312 and 314.

the disposition must have been motivated by 'pure liberality' or 'disinterested benevolence'.

...

"In my opinion the legislature has not eliminated from the statutory definition the element which the common law regards as essential to a donation, namely, that the disposition be motivated by pure liberality or disinterested benevolence and not by self-interest or the expectation of a quid pro quo of some kind from whatever source it may come.

"If one were to scour the dictionaries to find a single word apt to convey that the disposition should be motivated by pure liberality and not in expectation of any *quid pro quo* of whatever kind, one would not find a better or more appropriate word than 'gratuitous'. The *shorter OED* gives the following meaning to the word:

'1. Freely bestowed or obtained; granted without claim or merit; costing nothing to the recipient; free.

2. Done, made, adopted or assumed without any good ground or reason; uncalled for; unjustifiable.' "

In *Estate Sayle v CIR* the court stated the following:³⁴

"In short, liberality at the expense of another is not a '*donatio*'; to be a '*donatio*' the gift must be liberality at the expense of the donor, an act whereby the donee is enriched and the donor correspondingly impoverished."

In *The Master v Thompson's Estate* the court confirmed that a transaction will not be a donation when something is received in return or when there is some consideration.³⁵

It will be evident that not every reduction of a debt will be motivated by pure liberality or disinterested benevolence. Only the reduction of a debt motivated by pure liberality or disinterested benevolence will be a debt reduced by way of a "donation" as defined in section 55(1).

Any transaction to which section 58 applies

Under section 19(8)(b) and paragraph 12A(6)(b) a debt reduced by way of a transaction to which section 58 applies is not subject to the application of section 19 and paragraph 12A.

Section 58(1) provides as follows

"58. Property disposed of under certain transactions deemed to have been disposed of under a donation.—(1) Where any property has been disposed of for a consideration which, in the opinion of the Commissioner, is not an adequate consideration that property shall for the purposes of this Part be deemed to have been disposed of under a donation: Provided that in the determination of the value of such property a reduction shall be made of an amount equal to the value of the said consideration."

³⁴ 1945 AD 388, 13 SATC 170 at 173.

³⁵ 1961 (2) SA 20 (FC), 24 SATC 157 at 165.

In *Welch's Estate v C: SARS*³⁶ Marais JA held³⁷ that –

“the definition of ‘donation’ in s 55(1) plays no role in interpreting or giving effect to the provision in s 58”.

He continued as follows:³⁸

“It is thus clear, in applying this provision [section 58], that the motive for the disposal is irrelevant; it is simply a question of whether the consideration given for a disposal of property (whatever the motive) was, in the opinion of the Commissioner, adequate.”

In ITC 1599³⁹ Wunsh J explained the history and object of donations tax by quoting the following dicta of Boshoff WRP in *Ogus v SIR*:⁴⁰

“At the outset it is necessary to draw attention to the fact that the donations tax was introduced to make up for loss of revenue by way of income tax and estate duty when certain types of donations are made. The mischief aimed at was that practice by taxpayers of reducing their assets by making donations and thereby reducing the income on which income tax is payable, reducing their assets on which estate duty would be payable at their death, and spreading the assets and the income derived therefrom over several taxpayers.”

Wunsh J stated further that the purpose of section 58 is to combat tax avoidance.⁴¹ He emphasised that the Commissioner’s satisfaction that the consideration is inadequate is only a condition for the coming into force of section 58. When this condition is fulfilled, the fair market value of the property that is disposed of must be compared with the consideration and the difference will be subject to donations tax.⁴²

While Wunsh J confirmed that although the discretion exercised by the Commissioner under section 58(1) is not subject to objection and appeal, he accepted for the purposes of this case that the Commissioner’s determination of the valuation of the property and the consideration given was subject to objection and appeal.⁴³

In SARS’s view the term “adequate consideration” does not necessarily mean “fair market value”. In deciding whether a particular consideration is adequate regard must be had to the circumstances of the case and the objectives of donations tax. One of the objectives of donations tax is to prevent estate duty avoidance. If a donor’s estate is not impoverished by a transaction SARS is less likely to regard a consideration as being inadequate. This situation could occur when a sole holder of shares of a company partially waives an amount owing by the company to such holder of shares. Such a waiver may not result in the holder of shares’ estate being impoverished because the value of the shares may increase by a corresponding amount. A similar situation arises when loans between wholly owned group companies are partially waived. While such a transaction may fall outside the scope of section 58 it may well fall within the ambit of section 19 and paragraph 12A.

³⁶ 2005 (4) SA 173 (SCA), 66 SATC 303.

³⁷ 66 SATC 303 at 315.

³⁸ 66 SATC 303 at 315.

³⁹ 58 SATC 88 at 97.

⁴⁰ 1978 (3) SA 67 (T), 40 SATC 100 at 107.

⁴¹ (1995) 58 SATC 88 (T) at 98.

⁴² At SATC 99.

⁴³ At SATC 96.

Example 17 – Non-application of section 19 – Debt reduced by a donation*Facts:*

Individual X holds 1% of the shares in Company Y, but is not an employee or director of the company. On 1 March 2013 Company Y advanced an interest-free loan of R100 000 to Individual X. On 1 March 2014 Company Y waived the debt of R100 000 because of significant profits derived by the company in the preceding 12 months. The debt of R100 000 funded operating expenses of a business carried on by Individual X, for which deductions were granted in the 2014 year of assessment.

Result:

The cancellation of the debt of R100 000 by Company Y was motivated by pure liberality and is therefore a “donation” as defined in section 55(1). Donations tax is accordingly payable by Company Y on the R100 000 donation. Section 19 does not apply because the debt was reduced by a “donation” as defined in section 55(1) and hence the exclusion in section 19(8)(b)(i) applies.

It is assumed, given Individual X’s 1% shareholding, that the waiver of the loan is unrelated to the rights attaching to the shares held by Individual X and hence is not a dividend *in specie* which would attract dividends tax.

Example 18 – Non-application of paragraph 12A – Debt reduced by a transaction to which section 58 applies*Facts:*

On 1 April 2013 Individual X lent R1 million to the X Family Trust which the trust used to purchase a piece of land from a third party. The land did not qualify for any deductions or allowances under the Act. On 31 March 2014 X waived the loan of R1 million in exchange for payment of R800 000. There was no commercial reason for the reduction of the debt. X did not make any other donations during the 2015 year of assessment.

Result:

The loan of R1 million has been disposed of for a consideration of R800 000 which is not an adequate consideration. Accordingly, under section 58(1) property to the value of R200 000 is deemed to have been disposed of under a donation. The base cost of the capital asset does not have to be reduced under paragraph 12A because the debt was reduced by way of a transaction to which section 58 applies and accordingly paragraph 12A(6)(b)(ii) provides that paragraph 12A does not apply. The waiver of the debt of R200 000 will, however, result in Individual X being liable for donations tax at the rate of 20% × R100 000 (R200 000 deemed donation less exempt portion of R100 000) = R20 000. Despite the fact that only R100 000 of the deemed donation is subject to donations tax, the full amount of R200 000 qualifies for the exclusion in paragraph 12A(6)(b)(ii).

4.9.3 Fringe benefit [section 19(8)(c) and paragraph 12A(6)(c)]

Section 19 and paragraph 12A will not apply to any debt owed by a person to an employer of that person, to the extent that the debt that is reduced falls within the circumstances contemplated in paragraph 2(h) of the Seventh Schedule.

Paragraph 2 of the Seventh Schedule provides that, for the purposes of the Seventh Schedule and paragraph (i) of the definition of “gross income” in section 1(1),⁴⁴ a taxable benefit is deemed to have been granted by an employer to the employer’s employee in respect of the employee’s employment with the employer if –

- as a benefit or advantage of;
- by virtue of such employment; or
- as a reward for services rendered or to be rendered by the employee to the employer,
 - a benefit listed in paragraph 2 of the Seventh Schedule is granted.

Under paragraph 2(h) of the Seventh Schedule a taxable benefit is deemed to have been granted if the employer has –

- directly or indirectly paid any debt owing by an employee to a third person, excluding –
- contributions or payments made directly or indirectly to a medical scheme registered under the Medical Schemes Act No. 131 of 1998 for the benefit of the employee or the employee’s dependants; or
- an amount incurred directly or indirectly in respect of medical, dental and similar services, hospital services, nursing services or medicines provided to the employee or the employee’s spouse, child, relative or dependant,
 - without requiring the employee to reimburse the employer for the amount paid; or
 - released the employee from an obligation to pay any debt owing by the employee to the employer.

Under the proviso to paragraph 2(h) of the Seventh Schedule, if any debt owing by an employee to an employer has been extinguished by prescription,⁴⁵ the employer is deemed to have released the employee from the employee’s obligation to pay the amount of the debt if the employer could have recovered the amount owing or caused the running of the prescription to be interrupted. This proviso will not apply if it is shown to the satisfaction of the Commissioner that the employer’s failure to recover the amount owing or to cause the running of prescription to be interrupted was not due to any intention of the employer to confer a benefit on the employee.

⁴⁴ Under paragraph (i) of the definition of “gross income”, the cash equivalent of the value of a benefit or advantage granted in respect of employment or to the holder of any office, being a “taxable benefit” as defined in the Seventh Schedule, must be included in gross income of the employee.

⁴⁵ Section 11(d) of the Prescription Act No. 68 of 1969 provides that the period of prescription of any debt, other than debt mentioned in section 11(a) to (c) of that Act, is three years.

Example 19 – Non-application of section 19 and paragraph 12A – Debt reduced by an employer that resulted in a fringe benefit*Facts:*

Employer ABC granted a loan of R10 000 to Employee A on 1 April 2010 which funded the acquisition of a computer from Employer ABC. Employee A used the computer to carry on a business after hours and claimed a wear-and-tear allowance of 33,3% a year on the computer. On 1 April 2014 Employer ABC waived the loan.

Result:

Under paragraph 2(h) of the Seventh Schedule the waiver of the loan is deemed to be a taxable benefit granted by Employer ABC to Employee A.

Section 19(8)(c) and paragraph 12A(6)(c) provide that section 19 and paragraph 12A respectively will not apply to a debt owed by a person to that person's employer to the extent that the debt is reduced in the circumstances contemplated in paragraph 2(h) of the Seventh Schedule. The waiver of the loan by Employer ABC to Employee A will accordingly not give rise to any section 19 and paragraph 12A implications.

4.9.4 Group of companies [paragraph 12A(6)(d)]

Paragraph 12A will not apply to any debt owed by a company to another company that forms part of the same "group of companies" as defined in section 41,⁴⁶ unless as part of a transaction, operation or scheme entered into to avoid any tax imposed by the Act –

- that debt, or any debt issued in substitution for that debt, was acquired directly or indirectly from a person who does not form part of that group of companies; or
- that company or the other company became part of the group of companies after that debt, or any debt issued in substitution for that debt, arose.

The exclusion under paragraph 12A(6)(d) will accordingly not be available unless the debtor company and creditor company are resident taxpayers, that is, the relief from paragraph 12A is limited, through the reference to section 41, to situations in which both the debtor company and the creditor company are fully within the South African tax system. While the debtor is absolved in these circumstances from having to reduce the base cost of the asset that was funded by the debt under paragraph 12A(3), and is also not required to reduce any assessed capital loss incurred in relation to the relevant asset under paragraph 12A(4), the creditor company is denied any capital loss on disposal (waiver) of the debt to the debtor company under paragraph 56(1) (see **4.10.6**).

In contrast, section 19 will apply to a debt owed by a company to another company that forms part of the same "group of companies" as defined in section 41.

⁴⁶ See Interpretation Note No. 75 (Issue 2) dated 22 September 2014 "Exclusion of Certain Companies and Shares from a 'Group of Companies' as Defined in Section 41(1)", for a discussion on a "group of companies".

Example 20 – Non-application of paragraph 12A – Debt reduced by a company forming part of the same group of companies as the debtor company

Facts:

Company A acquired land at a cost of R1 million on loan account from Company B on 1 March 2013. Company A and Company B form part of the same group of companies as defined in section 41(1). On 1 March 2014 Company B waived the outstanding balance on the loan account which at that stage stood at R500 000, because of Company A's adverse economic position. Immediately after the reduction of the debt, Company A disposed of the land for R1 million. Company A's year of assessment ends on 28 February.

Result:

Under paragraph 12A(6)(d) Company A is not required to reduce the base cost of its land under paragraph 12A when Company B waives R500 000 of the debt owed by it.

Example 21 – Non-application of paragraph 12A – Debt reduced by a company forming part of the same group of companies as the debtor company

Facts:

Company A acquired second-hand machinery at a cost of R1 million on loan account from Company B on 1 March 2013. Company A and Company B form part of the same group of companies as defined in section 41(1). Company A is entitled to an allowance of 20% a year on the cost price of the machinery under section 12C(1). On 1 March 2014 Company B waived the outstanding balance on the loan account which at that stage stood at R500 000, because of Company A's adverse economic position. Company A's year of assessment ends on 28 February.

Result:

Reduction of debt

Reduction amount = Amount by which the debt is reduced – Amount applied as consideration for that reduction = R500 000 – RNil = R500 000.

Company A was granted allowances under section 12C(1) of R200 000 a year for the 2014 and 2015 years of assessment. At the time of the reduction of the debt, the base cost of the machinery for purposes of paragraph 20 was accordingly R600 000 (R1 million – R400 000).⁴⁷

The base cost of the machinery is not reduced under paragraph 12A(3) because paragraph 12A(6)(d) provides that paragraph 12A must not apply if a debt is reduced by a company forming part of the same group of companies as the debtor company.

⁴⁷ Paragraph 20(3)(a)(i).

Under section 19(6) the reduction amount of the debt that funded the expenditure incurred in respect of the second-hand machinery is deemed, for the purposes of section 8(4)(a), to be an amount that has been recovered or recouped in the 2015 year of assessment, but only to the extent that any allowances have previously been granted under the Act. The recoupment under section 19(6) is accordingly restricted to R400 000.

4.9.5 Companies in liquidation [paragraph 12A(6)(e) and (7)]

Paragraph 12A(6)(e) provides that paragraph 12A does not apply to any debt owed by a company to a connected person⁴⁸ in relation to that company if the debt is reduced in the course, or in anticipation, of the liquidation, winding up, deregistration or final termination of the existence of that company. This exclusion is, however, limited in two respects.

First, under paragraph 12A(6)(e) the provisions of paragraph 12A will not apply only to the extent that the reduction amount of the debt does not, at the time that the debt is reduced, exceed the expenditure contemplated in paragraph 20 incurred in respect of that debt by the connected person. This situation could arise if the creditor acquired the debt from a third party at an expenditure which is less than the face value of the debt.

Secondly, the exclusion provided for under paragraph 12A(6)(e) will not apply, in other words paragraph 12A will apply, if –

- the debt was reduced as part of any transaction, operation or scheme entered into to avoid any tax imposed by the Act and the company became a connected person in relation to the creditor after the debt, or any debt issued in substitution of that debt, arose [paragraph (aa) of the proviso to paragraph 12A(6)(e)]; or
- the company [paragraph (bb) of the proviso to paragraph 12A(6)(e)] –
- has not within 36 months of the date on which the debt is reduced or such further period as the Commissioner may allow, taken the steps contemplated in section 41(4)⁴⁹ to liquidate, wind up, deregister or finally terminate its existence;
- has at any stage withdrawn any step taken to liquidate, wind up, deregister or finally terminate its corporate existence; or
- does anything to invalidate any step contemplated in section 41(4), with the result that the company is or will not be liquidated, wound up, deregistered or finally terminate its existence [paragraph (bb) of the proviso to paragraph 12A(6)(e)].

Any tax that becomes payable as a result of the failure of the debtor company to take the steps contemplated in section 41(4) to liquidate, wind up, deregister or finally terminate its existence must be recovered from the debtor company and the

⁴⁸ See Interpretation Note No. 67 (Issue 2) dated 14 February 2014 “Connected Persons” for a discussion of the definition of “connected person” in section 1(1).

⁴⁹ Specific steps are listed in section 41(4) for the liquidation or winding-up of a company and for the deregistration of a company.

connected person who are jointly and severally liable for the tax [paragraph 12A(7) read with paragraph (bb) of the proviso to paragraph 12A(6)(e)].

Section 19 may, depending on the facts, apply to a debt owed by a company to a connected person in relation to that company if the debt is reduced in the course, or in anticipation, of the liquidation, winding up, deregistration or final termination of the existence of that company because a similar exclusion is unavailable under section 19.

Example 22 – Non-application of paragraph 12A – Debt reduced in anticipation of the liquidation of a company

Facts:

Company Y holds 20% of the shares in Company X. Company X and Company Y are connected persons⁵⁰ in relation to each other but do not form part of the same group of companies. Company Y advanced a loan of R10 million to Company X on 1 April 2009. This loan indirectly funded the acquisition of a fixed property by Company X. On 1 April 2014 Company Y waived the debt of R10 million in anticipation of the liquidation of Company X. Company X's year of assessment ends on 31 March.

Result:

The base cost of Company X's fixed property is not reduced by the reduction amount of the debt of R10 million because paragraph 12A(6)(e) applies. This outcome follows from the fact that –

- the debt owed by Company X is reduced in anticipation of its liquidation;
- the debt is owed by Company X to a connected person (Company Y); and
- the base cost of Company Y's debt (R10 million) does not exceed the reduction amount (R10 million).

Note:

Under paragraph 56(1) Company Y cannot claim the capital loss on disposal of the debt of R10 million because Company X and Company Y are connected persons in relation to each other and paragraph 56(2) does not apply (see **4.10.6**).

⁵⁰ Under paragraph (d)(v) of the definition of "connected person" in section 1(1).

Example 23 – Non-application of paragraph 12A – Debt reduced in anticipation of the liquidation of a company

Facts:

Company Y holds 20% of the shares in Company X. Company X and Company Y are connected persons⁵¹ in relation to each other but do not form part of the same group of companies. Company Y advanced a loan of R10 million to Company X on 1 April 2009. This loan indirectly funded the acquisition of a fixed property by Company X. On 1 April 2014 Company Y waived the debt of R10 million in anticipation of the liquidation of Company X. Company Y is a moneylender and is entitled to claim the loss on cancellation of the loan as a deduction under section 11(a) read with section 23(g). Company X's year of assessment ends on 31 March.

Result:

The base cost of Company Y's debt is nil (R10 million – R10 million)⁵² at the time that the debt is reduced because the loss on disposal of the debt is allowable as a deduction under section 11(a) read with section 23(g).

While –

- the debt owed by Company X is reduced in anticipation of the liquidation of Company X; and
- the debt is owed by Company X to a connected person (Company Y),

the reduction amount (R10 million) exceeds the base cost of Company Y's debt (nil) and the relief under paragraph 12A(6)(e) is accordingly not available to Company X. Consequently, the base cost of Company X's fixed property must, for purposes of paragraph 20, be reduced to nil [R10 million expenditure incurred – R10 million reduction under paragraph 12A(3)].

Example 24 – Non-application of paragraph 12A – Debt reduced in anticipation of the deregistration of a company

Facts:

On 1 July 2010 Individual Y acquired all the shares and a loan account with a face value of R100 000 in Company X from the former holder of shares in Company X. The loan account of R100 000 indirectly financed the acquisition of assets by Company X and was acquired by Individual Y at a discounted value of R80 000. On 1 August 2013 Company X disposed of all its assets. On 1 September 2013 Individual Y waived the loan account in anticipation of the liquidation of Company X. Company X has an assessed capital loss of R30 000. Company X's year of assessment ends on 30 June.

⁵¹ Under paragraph (d)(v) of the definition of "connected person" in section 1(1).

⁵² Under paragraph 20(3)(a)(i) the expenditure incurred by a person on an asset must be reduced by any amount which is or was allowable or is deemed to have been allowed as a deduction in determining the taxable income of that person.

Result:

Individual Y and Company X are connected persons in relation to each other.⁵³

Paragraph 12A(6)(e) provides that paragraph 12A will not apply if the debt owed by a company to a connected person is reduced in anticipation of the liquidation of that company *to the extent* that the reduction amount of the debt (R100 000) does not, at the time of the reduction of the debt, exceed the base cost of the debt of the connected person (R80 000). Since the reduction amount of the debt (R100 000) exceeds the base cost of Individual Y's debt (R80 000) by R20 000, the relief under paragraph 12A(6)(e) applies to the extent that the reduction amount of the debt (R100 000) does not exceed the base cost of the debt (R80 000). Under paragraph 12A(4) the excess of R20 000 will be applied to reduce Company X's assessed capital loss to R10 000 (R30 000 – R20 000).

Note:

Under paragraph 56(2)(a)(i) Individual Y may claim a capital loss on disposal of the debt of R20 000. The balance of the capital loss of R60 000 must be disregarded under paragraph 56(1) (see **4.10.6**).

4.10 Elimination of double recoupment or double reduction of the base cost of an asset

A number of sections and paragraphs have been amended with effect from years of assessment commencing on or after 1 January 2013 to prevent the recoupment of the same amount or the reduction of the base cost of an asset under different provisions when a debt has been reduced.

4.10.1 Recoupment of amounts allowed to be deducted or set off under certain sections [section 8(4)(a)]

Section 8(4)(a) provides for the inclusion in a taxpayer's income of all amounts to be deducted or set off under specific sections of the Act in the current or a previous year of assessment which have been recovered or recouped during the current year of assessment.

Paragraph (ii) of the proviso to section 8(4)(a)

Paragraph (ii) of the proviso to section 8(4)(a), however, provides that section 8(4)(a) shall not apply in respect of an amount recovered or recouped which has been applied to reduce any cost or expenditure incurred by the taxpayer under section 19. Although not stated explicitly, the reference to section 19 in paragraph (ii) of the proviso to section 8(4)(a) is a reference to section 19(3) which deals with the reduction in the cost price of trading stock.

The cost or expenditure relating to trading stock could have been reduced under section 19(3) if amounts were previously taken into account under section 11(a), 22(1) or 22(2) (see **4.3**).

Paragraph (ii) of the proviso to section 8(4)(a) therefore ensures that an amount of any debt reduction which has been applied to reduce the cost price of trading stock

⁵³ Under paragraphs (d)(iv) and (e) of the definition of "connected person" in section 1(1).

under section 19(3) is not recouped again under section 8(4)(a) when the related debt is reduced.

Example 25 – Amounts recovered or recouped under section 8(4)(a) – paragraph (ii) of the proviso to section 8(4)(a)

Facts:

On 1 March 2014 Company B waived a debt of R400 000 owed by Company A because of Company A's adverse financial position. The debt of R400 000 funded the acquisition of trading stock from Company B during the 2014 year of assessment. The trading stock was still held and not disposed of at the end of the 2015 year of assessment. The total opening balance of trading stock for the 2015 year of assessment was R1 million and the total closing balance of trading stock at year-end was R800 000. Company A's year of assessment ends on 28 February.

Result:

Section 19(3) must be applied to reduce the value of opening stock referred to in section 22(2) and closing stock referred to in section 22(1) by R400 000 in the 2015 year of assessment.

Under paragraph (ii) of the proviso to section 8(4)(a) no amount of the debt that was waived falls to be included in the income of Company A under section 8(4)(a) because the cost of trading stock has been reduced under section 19(3). In the absence of paragraph (ii) of the proviso to section 8(4)(a), the amount waived could possibly have been recouped under section 8(4)(a).

Paragraph (iii) of the proviso to section 8(4)(a)

Paragraph (iii) of the proviso to section 8(4)(a) provides that section 8(4)(a) will not apply in respect of an amount recovered or recouped which has been previously taken into account as an amount that is deemed to have been recovered or recouped under section 19(4), (5) or (6). [See 4.3, 4.4 and 4.5 for a discussion of sections 19(4), (5) and (6) respectively].

Paragraph (iii) of the proviso to section 8(4)(a) therefore ensures that an amount that has been taken into account under section 19(4), (5) or (6) as a deemed recoupment under section 8(4)(a) is not again recouped under the substantive provisions of section 8(4)(a). See Example 21 in 4.9.4.

4.10.2 Recoupment of expenditure or losses incurred on qualifying shares [section 9C(5) and paragraph 20(3)(a)]

Any amount (other than a dividend or foreign dividend) that is received by a taxpayer on the disposal of a "qualifying share"⁵⁴ (essentially an equity share held for more than three years) is deemed under section 9C(2) to be of a capital nature.

Since the proceeds derived on disposal of a qualifying share will be of a capital nature, section 9C(5) provides as a general rule that there must be included in a taxpayer's income in the year of assessment in which any qualifying share is disposed of, any expenditure or losses incurred on that qualifying share and allowed

⁵⁴ A "qualifying share" is defined in section 9C(1).

as a deduction from the income of the taxpayer during that or any previous year of assessment under section 11. The amount of the deemed recoupment is made with reference to the amounts previously allowed as a deduction against income and bears no relationship to any amount derived on disposal of the share. Thus, even if a share is disposed of at a capital loss, the recoupment remains unaffected.

Under the proviso to section 9C(5) there will be no recoupment under section 9C(5) of expenditure or losses allowed under section 11 to the extent that the expenditure or losses relating to a qualifying share are taken into account under section 8(4)(a) or section 19 as a result of the reduction of a debt.

The proviso to section 9C(5) therefore prevents the recoupment of the same amount twice.⁵⁵

Paragraph 20(3)(a) provides that the expenditure in paragraph 20(1)(a) to (g), incurred by a person in respect of an asset must be reduced by any amount which –

- is or was allowable or is deemed to have been allowed as a deduction in determining the taxable income of that person; and
- is not included in the taxable income of that person under section 9C(5),

before the inclusion of any taxable capital gain.

Example 26 – Amounts included in income under section 9C(5)

Facts:

On 1 March 2010 Individual A acquired listed shares as trading stock at a cost of R100 000. The acquisition of the shares was funded by a loan from Company B. At the end of Individual A's 2011 year of assessment the value of the shares decreased to R80 000 which Individual A reflected as the value of closing stock under section 22(1)(a). On 1 June 2014 Company B cancelled the debt owing by Individual A because Individual A was unable to pay the amount outstanding. On 30 November 2014 Individual A disposed of the shares for R80 000.

Individual A's year of assessment ends on 28 February.

Result:

As a result of the debt cancellation on 1 June 2014 the value of Individual A's opening stock as at 1 March 2014 is reduced to nil under section 19(3) (R80 000 – R80 000). The excess of the reduction amount of the debt of R20 000 (R100 000 – R80 000) is deemed under section 19(4), for the purposes of section 8(4)(a), to be an amount that has been recovered or recouped.

On 28 February 2014 the shares had been held by Individual A for four continuous years. The proceeds on disposal of the shares on 30 November 2014 will accordingly be treated as being on capital account under section 9C(2) since they comprise qualifying shares.

⁵⁵ See Interpretation Note No. 43 (Issue 5) dated 17 February 2014 "Circumstances in which Certain Amounts Received or Accrued from the Disposal of Shares are Deemed to be of a Capital Nature" for a discussion of section 9C.

As a general rule section 9C(5) provides that a taxpayer must include in income in the year of assessment in which any qualifying share is disposed of any expenditure or losses incurred on that qualifying share and allowed as a deduction from the income of the taxpayer during that or any previous year of assessment under section 11. Individual A claimed expenditure under section 11 of R100 000. In order to prevent double taxation, the proviso to section 9C(5) provides that this general rule does not apply to the extent that the relevant expenditure and losses have been taken into account under section 8(4)(a) or section 19. Since the amount of R100 000 has already been taken into account under section 19(3) and (4), no amount must be included in Individual A's income under section 9C(5).

Notes:

(1) The base cost of the shares has been reduced to nil under paragraph 20(3)(a) because –

- the expenditure of R100 000 was allowed under section 11(a); and
- no amount was included in Individual A's income under section 9C(5).

Individual A will accordingly realise a capital gain on disposal of the shares of R80 000 (proceeds of R80 000 less base cost of nil).

(2) For the 2012 and subsequent years of assessment it is no longer possible for an individual or a trust to write down the value of closing stock of a "financial instrument". A "financial instrument" includes a share.

4.10.3 Recoupment of amounts allowed as a deduction from the income of an issuer of an instrument [section 24J(4A)(b)]

Any adjusted gain on transfer or redemption of an instrument by a person during any year of assessment is deemed to have accrued to such person in such year of assessment under section 24J(4)(a).

Section 24J(4A)(b) in turn provides that when such an adjusted gain on transfer or redemption of an instrument that has been deemed to have accrued to the issuer under section 24J(4)(a) during a year of assessment,

- includes an amount in relation to an instrument representing an accrual amount or an amount determined in accordance with an alternative method, and
- that amount has been allowed as a deduction from the income of the issuer during that year of assessment or any previous year of assessment,
- that amount must, to the extent that the amount is not taken into account under section 19, be included in the income of the issuer during that year of assessment.⁵⁶

Section 24J(4A)(b) therefore ensures that an amount taken into account under section 19 is not again taken into account under section 24J(4).

⁵⁶ The terms "adjusted gain on transfer or redemption of an instrument", "transfer", "redemption", "issuer", "instrument", "accrual amount", and "alternative method" are defined in section 24J(1).

Example 27 – Recoupment of amounts allowed as a deduction from the income of an issuer of an instrument*Facts:*

On 1 December 2010 Company A issued promissory notes to a note holder for R180 000. The maturity date of the contract was 30 November 2014 with a maturity value of R200 000. Company A was obliged under the agreement to pay interest of R88 000 over the period of the loan together with the premium of R20 000 upon maturity of the loan to the note holder, but failed to do so. Under section 24J(2) interest of R108 000 was allowed as a deduction to Company A over the period of the contract (R88 000 + R20 000). On 30 November 2014 the note holder waived the total amount owing under the contract because of the inability of Company A to pay the amounts owing. Company A's year of assessment ends on 31 March.

Result:

Under section 19(5) the reduction amount of the interest debt of R108 000 must, to the extent that a deduction was granted, be deemed to be an amount that has been recovered or recouped under section 8(4)(a) by Company A during its 2015 year of assessment. The full amount of R108 000 that was allowed as a deduction under section 24J(2) is accordingly treated as a recoupment under section 8(4)(a).

The "adjusted gain on transfer or redemption of the instrument" of R288 000 (R180 000 + R88 000 + R20 000 – R0) includes an accrual amount of R108 000 that has been allowed as a deduction under section 24J(2). Under section 24J(4A)(b) the accrual amount of R108 000 must be included in the income of Company A but only to the extent that it has not been taken into account under section 19. Since the full amount of R108 000 is taken into account under section 19(5), no further inclusion under section 24J(4A)(b) is necessary.

4.10.4 Capital gain on the disposal of an asset in a previous year of assessment [paragraph 3(b)(ii)]

Under paragraph 3(b)(ii) a further capital gain will arise in the current year of assessment of a person when any portion of the base cost of an asset⁵⁷ that was disposed of in a previous year of assessment is recovered or recouped in the current year of assessment.

A capital gain is, however, not triggered under paragraph 3(b)(ii) when the base cost of the asset disposed of in a previous year of assessment has been recovered or recouped through the reduction of a debt owed by the taxpayer. This outcome applies irrespective of whether paragraph 12A(3) (reduction of base cost) or (4) (reduction of assessed capital loss) applied to the reduction of the debt (see **4.5** and **4.6**).

⁵⁷ Excluding a pre-valuation date asset.

Example 28 – Capital gain on the disposal of an asset in a previous year of assessment

Facts:

Company B's year of assessment ends on 30 September. In 2010 Company A sold fixed property to Company B on loan account for R10 million. On 31 December 2013 Company B sold the fixed property for R12 million.

On 1 October 2014 Company A cancelled the loan of R10 million owing by Company B because of Company B's adverse financial position. Company B does not have an assessed capital loss as at 30 September 2015.

Result:

2014 Year of Assessment

Company B has derived a capital gain on disposal of the asset of R2 million in its 2014 year of assessment (proceeds of R12 million – base cost of R10 million).

2015 Year of Assessment

While a reduction of debt has occurred in Company B's 2015 year of assessment, paragraph 12A(3) cannot be applied to reduce the base cost of the fixed property because the fixed property was no longer held by Company B at the time of the reduction of the debt. Paragraph 12A(4) can also not be applied because Company B does not have an assessed capital loss. Paragraph 20(3)(b) does not apply because the fixed property was disposed of in the previous year of assessment.

A further capital gain will not arise under paragraph 3(b)(ii) in Company B's 2015 year of assessment when the debt of R10 million is cancelled by Company A because the base cost of the asset was recovered by way of the reduction of a debt.

4.10.5 Reduction in expenditure incurred under paragraph 20(1)(a) to (g) [paragraph 20(3)(b)]

Paragraph 20(3)(b) provides that the expenditure incurred as contemplated in paragraph 20(1)(a) to (g) in respect of an asset must be reduced by any amount which has for any reason been reduced or recovered or become recoverable from or has been paid by any other person (whether before or after the incurral of the expense to which it relates). However, no such reduction in expenditure must be made to the extent the amount is –

- “(i) taken into account as a recoupment under section 8(4)(a) ...;
- (ii) ...; or
- (iii) applied to reduce an amount taken into account in respect of trading stock as contemplated in section 19; or...”.

A taxpayer's capital gain or capital loss is determined for a year of assessment and not at the time of disposal of an asset. Accordingly, adjustments to the base cost of the asset under paragraph 20(3)(b) can be made up to the last day of the year of assessment in which the asset is disposed of. Paragraph 20(3)(b) will therefore apply regardless of whether the reduction of the debt arises before or after disposal of the asset within a year of assessment. However, if the disposal occurred in one year of assessment and the reduction of the debt occurred in a subsequent year of assessment, then paragraph 20(3)(b) would not apply.

Paragraph 20(3)(b) applies when **the expenditure contemplated in paragraph 20(1)(a) to (g) “has for any reason been reduced or recovered or become recoverable from or has been paid by any other person”**. Given that it is the relevant **expenditure**, and not the debt relating to such expenditure that must be reduced or recovered, the view is held that paragraph 20(3)(b) applies only when the debt is incurred with the person from whom the asset is acquired, that is, the amount of the debt was used “directly” to fund the relevant expenditure. It is submitted that paragraph 20(3)(b) does not apply when the person borrows the necessary funds to acquire the asset from a third party, such as a bank, and the third party waives the related debt. The reference to “other person” is interpreted as a reference to someone other than the person who incurred the expenditure that formed part of the base cost of the asset acquired by that person.

It is possible that both section 19 or paragraph 12A and paragraph 20(3)(b) may apply when the amount of the debt was used “directly” to fund the relevant expenditure.

Double taxation could arise should both paragraph 20(3)(b) and section 19 apply to a reduction of debt. In this regard paragraph 20(3)(b) provides that paragraph 20(3)(b) shall **not** apply to the extent that –

- the amount was taken into account as a recoupment under section 8(4)(a)⁵⁸ (it would have if section 19(4) or 19(6) applied); or
- the amount was applied to reduce an amount taken into account in respect of trading stock under section 19⁵⁹ (it would have if section 19(3) applied). This exclusion, therefore, ensures that the base cost of an asset must not be reduced under paragraph 20(3)(b) if section 19 has been applied to reduce an amount taken into account in respect of trading stock.

Double taxation could also arise should both paragraph 12A(3) and paragraph 20(3)(b) apply to a reduction of debt. In this regard, once paragraph 12A(3) has reduced the expenditure contemplated in paragraph 20, that expenditure is simply no longer available to be reduced under paragraph 20(3)(b). Both paragraph 20(3)(b) and paragraph 12A(4) may apply to a reduction of debt when a person whose debt has been reduced has an assessed capital loss and expenditure contemplated in paragraph 20 in respect of a capital asset is available for reduction. In such instances paragraph 12A(4) should be applied in the first instance with any balance of the debt reduction being dealt with under paragraph 20(3)(b).

Example 28 – Application of paragraph 20(3)(b)

Facts:

On 1 March 2010 Company A purchased land (not held as trading stock) from Company B on credit for R1 million. Company A's year of assessment ends on the last day of February. Company A and Company B do not form part of the same group of companies.

⁵⁸ Paragraph 20(3)(b)(i).

⁵⁹ Paragraph 20(3)(b)(iii).

On 31 March 2014 Company A disposed of the asset for proceeds of R1,5 million. On 30 September 2014 Company B waived the debt owed by Company A because of Company A's inability to pay for the land.

Company A did not have an assessed capital loss for the 2015 year of assessment.

Result:

Disposal of asset

The expenditure incurred by Company A in acquiring the land has been reduced or recovered as a result of the reduction of the debt of R1 million by Company B. Company A must accordingly reduce the base cost of the land by the amount of expenditure reduced (R1 million) under paragraph 20(3)(b). The base cost of the land as at the end of the year of assessment is accordingly nil. Company A will therefore realise a capital gain of R1,5 million [R1,5 million (proceeds) – RNil (base cost)] at the end of the 2015 year of assessment.

Reduction of debt

Paragraph 12A(3) and 12A(4)(b)(i) do not apply since the land was not held by Company A at the time the debt owed to Company B was waived.

Paragraph 12A(4)(b)(ii) would also have applied if Company A had an assessed capital loss at the end of its 2015 year of assessment.

Section 19 does not apply since the debt was not used to fund expenditure in respect of which a deduction or allowance was granted under the Act.

Example 29 – Application of paragraph 20(3)(b)

Facts:

On 1 March 2010 Company A purchased land (not held as trading stock) from Company B on credit for R1 million. Company A's year of assessment ends on the last day of February. Company A and Company B do not form part of the same group of companies.

On 31 March 2014 Company B waived the debt owed by Company A because of Company A's inability to pay for the land. On 30 September 2014 Company A disposed of the asset for proceeds of R1,5 million.

Company A did not have an assessed capital loss for the 2015 year of assessment.

Result:

Reduction of debt

Paragraph 12A(3) applies since the land was held by Company A at the time the debt owed to Company B was waived. This means that the expenditure of R1 million as contemplated in paragraph 20 is reduced to nil. The requirements of paragraph 20(3)(b) are also met, however having applied paragraph 12A as the more specific paragraph first, there is simply no expenditure to reduce under paragraph 20(3)(b).

Section 19 does not apply since the debt was not used to fund expenditure in respect of which a deduction or allowance was granted under the Act

Disposal of asset

The expenditure incurred by Company A in acquiring the land has been reduced under paragraph 12A by R1 million to nil. Accordingly, the base cost of the land as at the end of the year of assessment is nil. Company A will therefore realise a capital gain of R1,5 million [R1,5 million (proceeds) – RNil (base cost)] at the end of the 2015 year of assessment.

Example 30 – Reduction of expenditure incurred under paragraph 20(1)(a) to (g)

Facts:

Company A acquired trading stock at a cost of R100 000 during its 2015 year of assessment from Company B on loan account. During the same year of assessment Company B waived the debt of R100 000 because of Company A's inability to repay the loan. Subsequent to the forgiveness of the debt the trading stock was sold for R120 000. Company A's year of assessment ends on 31 March.

Result:

Under section 19(3) the deduction for the cost of acquisition of the trading stock under section 11(a) is reduced to nil, that is, the expenditure incurred (R100 000) is reduced under section 19(3) by the reduction amount of the debt (R100 000).

The full proceeds on disposal of the trading stock of R120 000 are included in Company A's gross income.

Trading stock is an "asset" as defined in paragraph 1 and accordingly also falls to be dealt with under the Eighth Schedule. The capital gain or loss on its disposal is calculated as follows:

	R
Proceeds (R120 000 – R120 000 [paragraph 35(3)(a)]) ⁶⁰	Nil
Less: Base Cost (R100 000 – R100 000 [paragraph 20(3)(a)])	<u>(Nil)</u>
Capital gain	<u>Nil</u>

Under paragraph 20(3)(a) the base cost of the trading stock is reduced by the amount that was allowable as a deduction under section 11(a). While the amount (R100 000) deducted under section 11(a) is required to be reduced by the amount of the reduction of debt (R100 000) under section 19(3), the full R100 000 incurred in respect of the acquisition of the trading stock will still have been "allowable" as contemplated in paragraph 20(3)(a). A further reduction in the base cost of the trading stock is not required under paragraph 20(3)(b) because paragraph 20(3)(b)(iii) excludes a reduction when the amount was applied to reduce an amount taken into account in respect of trading stock as contemplated in section 19.

⁶⁰ Paragraph 35(3)(a) provides that the proceeds from the disposal of an asset must be reduced by any amount of the proceeds that must be or was included in the gross income of that person or that must be or was taken into account when determining the taxable income of that person before the inclusion of any taxable capital gain.

4.10.6 Capital loss on disposal by a creditor of debt owed by a connected person [paragraph 56(1) and 56(2)(a)]

Paragraph 56(1) contains a general prohibition on the claiming of a capital loss by a creditor on disposal of a debt owed by a connected person in relation to that creditor.

However, paragraph 56(2)(a) or (c) permits a creditor to claim a capital loss determined on the disposal of a debt owed by a debtor who is a connected person in relation to the creditor, to the extent that –

- the expenditure on the asset has been reduced under paragraph 12A [this is a reference to paragraph 12A(3)];
- the assessed capital loss of the debtor has been reduced under paragraph 12A [this is a reference to paragraph 12A(4)]; or
- an amount was included in the gross income or income of the debtor, as would have been the case when a reduction amount is deemed under section 19(4), (5) or (6) to be an amount recovered or recouped for purposes of section 8(4)(a).

Example 32 – Capital loss incurred by creditor on disposal of debt owed by a connected person

Facts:

Company A and Company B are connected persons in relation to each other but are not part of the same group of companies. Company B's year of assessment ends on 30 June.

On 1 July 2009 Company A lent Company B R2 million which Company B used to acquire land from Company C with a base cost of R2 million.

On 1 July 2014 Company A waived R500 000 of the debt owed by Company B because of Company B's inability to settle the debt in full. Company B continued to hold the land at the time of the partial debt waiver.

Result:

Since Company B will have to reduce the base cost of its land by R500 000 under paragraph 12A(3), Company A will be entitled to claim the capital loss of R500 000 in relation to the waiver of the debt. This capital loss will not be clogged because paragraph 56(2) applies despite paragraph 39.

4.11 Allocation of payments and debt reductions

In a partial debt reduction of an interest-bearing loan the issue may arise whether it is the interest or the capital element of the loan that is being reduced. In *Standard Bank of South Africa Ltd v Oneanate Investments (Pty) Ltd (In Liquidation)*⁶¹ it was held that debt repayments must first be allocated against interest and then against capital. It would therefore be appropriate to apply this principle in determining in the first instance how the outstanding loan balance is made up and secondly as to whether it is the capital or interest that is being reduced.

⁶¹ 1998 (1) SA 811 (SCA).

It may also happen that debt is used to purchase multiple assets and finance other expenditure. In such circumstances when a partial debt reduction occurs, it will be necessary to determine against which asset or expenditure the debt reduction must be applied. It is considered that the debt reduction must first be allocated to any unpaid interest expense and then proportionately against the remaining expenditure financed by the debt concerned. It would, therefore, be inappropriate for a person to, say, choose to first allocate the debt reduction against a capital asset such as goodwill and then allocate the remainder to trading stock in order to obtain the maximum tax benefit. There may, however, be circumstances that indicate that there is an alternative basis which is more appropriate than a proportional allocation. The onus will be on the taxpayer to justify such an alternative allocation.

Example 33 – Partial reduction of a debt that funded expenditure, a portion of which was deductible and a portion of which was not deductible

Facts:

Company E borrowed R1 million from Company F and used the funds to finance R600 000 of operating expenses which were allowed as a deduction under section 11(a) and R400 000 of expenses which did not qualify as a deduction. Interest of R100 000 was incurred on the loan and allowed as a deduction under section 24J(2). The interest expense was not paid but was added (capitalised) to the outstanding loan balance. Company E's year of assessment ends on 31 March.

As a result of Company E falling into financial difficulty, Company F waived R500 000 of the debt of R1,1 million during the 2015 year of assessment.

Result:

The amount of R500 000 by which the loan was reduced is allocated to –

- interest of R100 000;
- deductible expenditure of R240 000 [(R500 000 – R100 000 allocated to interest) × R600 000 / R1 000 000]; and
- non-deductible expenditure of R160 000 [(R500 000 – R100 000 allocated to interest) × R400 000/R1 000 000].

Section 19 applies only to debt that was used, directly or indirectly, to fund any expenditure in respect of which a deduction or allowance was granted under the Act. Accordingly, it will apply only to R340 000 (R100 000 capitalised interest and R240 000 used to fund deductible expenditure).

Reduction amount = Amount by which the debt is reduced – Amount applied as consideration for that reduction = R340 000 – RNil = R340 000.

Under section 19(5) the reduction amount of the debt of R340 000 is deemed, for the purposes of section 8(4)(a), to be an amount that has been recovered or recouped during the 2015 year of assessment.

Paragraph 12A does not apply since none of the funds were used to finance the acquisition of an asset.

4.12 Reduction of debt that funded expenditure incurred by persons carrying on mining [section 36(11) – definition of “expenditure”]

Section 19 applies to the reduction of debt that funded operating expenses or trading stock of a person carrying on mining operations.

Section 19 does not, however, apply to debt that funded “capital expenditure incurred” as defined in section 36(11) and which was claimed under section 15(a) read with section 36. Such expenditure is specifically excluded from recoupment under section 8(4)(a) and the “recoupment” of such capital expenditure is instead included in “gross income” under paragraph (j) of the definition of that term in section 1(1).

Paragraph 12A applies to the extent that allowance assets or capital assets of a person carrying on mining operations have been funded by debt.

Paragraph 12A does not, however, apply to debt that funded unredeemed capital expenditure, excluding allowance assets and capital assets. The balance of the unredeemed capital expenditure must be reduced by the reduction amount of the debt used to fund it under the definition of “expenditure” in section 36(11) which reads as follows:

“**[E]xpenditure**’ means net expenditure after taking into account any rebates or returns from expenditure, regardless of when such last-mentioned expenditure was incurred.”

The reduction amount of a debt is regarded as a “rebate or return from expenditure” as contemplated in the definition of “expenditure” given the wide import of these words.⁶²

4.13 Controlled foreign companies (CFCs) [section 9D(9)(fA)(iv)]

Special rules apply to CFCs forming part of the same “group of companies” as defined in section 1(1).

Section 9D(9)(fA)(iv) provides⁶³ that in determining the net income of a CFC under section 9D(2A) there must not be taken into account an amount which is attributable to the reduction or discharge by another CFC of a debt owed by that company to that other CFC for no consideration or for consideration less than the amount by which the face value of the debt has been reduced or discharged. This exclusion only applies if the CFCs are companies forming part of the same “group of companies” as defined in section 1(1).

5. Conclusion

Section 19 and paragraph 12A contain ordering rules for dealing with debt relief and replace the previous rules that were contained in section 8(4)(m), the proviso to section 20(1)(a) and paragraph 12(5).

⁶² See *Grootvlei Proprietary Mines Ltd v CIR* 1952 (4) SA 440 (A), 18 SATC 231 at 239.

⁶³ Subject to section 9D(9A) which has specific provisions dealing with an amount which is attributable to a foreign business establishment of a CFC.

The new ordering rules apply to trading stock, other deductible expenditure, allowance assets and capital assets financed by debt which is subsequently reduced. Briefly the rules provide as follows upon a reduction of such debt:

- *Trading stock held and not disposed of* – Any section 11(a) deduction or the value of opening stock as well as any closing stock is reduced by the debt reduction. Any excess is treated as a recoupment for the purposes of section 8(4)(a).
- *Trading stock not held and not disposed of at the time of the reduction of the debt and other deductible expenditure excluding allowance assets* – The debt reduction is treated as a recoupment for the purposes of section 8(4)(a) to the extent that the expenditure was allowed as a deduction.
- *Allowance assets* – The debt reduction first reduces any base cost expenditure after which any excess is treated as a recoupment for the purposes of section 8(4)(a). Future capital allowances will be limited to the cost of the asset less the reduction amount and any previous allowances claimed on the asset.
- *Capital assets that are not allowance assets* – The base cost of the asset is reduced by the reduction amount of the debt. Any excess reduces any assessed capital loss.

A special rule applies to debt that financed the acquisition of a pre-valuation date asset. The effect of the rule is to treat the asset as a post-valuation date asset by re-establishing its base cost as expenditure which can be reduced by the reduction amount of the debt.

The ordering rules do not apply to tax debt or debt that has been reduced by donation, bequest or by an employer. Paragraph 12A contains additional exemptions for debt reduced within a group of companies and debt reduced in the course or in anticipation of liquidation, winding up, deregistration or final termination of a company when the debtor company and the creditor are connected persons in relation to each other.

Consequential amendments to prevent double taxation have been made to sections 8(4)(a), 9C(5), 24J(4A)(b) and paragraphs 3(b)(ii), 20(3)(b)(i) and (iii) and 56(2)(a).

Section 19, paragraph 12A and the consequential amendments referred to above apply to years of assessment commencing on or after 1 January 2013.

Annexure – The law

Section 8(4)(a)

(4) (a) There shall be included in the taxpayer's income all amounts allowed to be deducted or set off under the provisions of sections 11 to 20, inclusive, section 24D, section 24F, section 24G, section 24I, section 24J, section 27(2)(b) and section 37B(2) of this Act, except section 11(k), (p) and (q), section 12(2) or section 12(2) as applied by section 12(3), section 12A(3), section 13(5), or section 13(5), as applied by section 13(8), or section 13bis(7), section 15(a) or section 15A, or under the corresponding provisions of any previous Income Tax Act, whether in the current or any previous year of assessment which have been recovered or recouped during the current year of assessment: Provided that the provisions of this paragraph shall not apply in respect of any such amount so recovered or recouped which has been—

- (i) included in the gross income of such taxpayer in terms of paragraph (jA) of the definition of "gross income";
- (ii) applied to reduce any cost or expenditure incurred by such taxpayer in terms of section 19; or
- (iii) previously taken into account as an amount that is deemed to have been recovered or recouped in terms of section 19(4), (5) or (6).

Section 9C(5)

(5) There shall in the year of assessment in which any qualifying share is disposed of by the taxpayer be included in the taxpayer's income any expenditure or losses incurred in respect of such qualifying share and allowed as a deduction from the income of the taxpayer during that or any previous year of assessment in terms of section 11: Provided that this subsection must not apply in respect of any expenditure or loss to the extent that the amount of that expenditure or loss is taken into account in terms of section 8(4)(a) or section 19.

Section 9D(9)(fA)(iv)

(9) Subject to subsection (9A), in determining the net income of a controlled foreign company in terms of subsection (2A), there must not be taken into account any amount which—

- (fA) is attributable to—
 - (iv) the reduction or discharge by any other controlled foreign company of a debt owed by that company to that other controlled foreign company for no consideration or for consideration less than the amount by which the face value of the debt has been so reduced or discharged,
 where that controlled foreign company and that other controlled foreign company form part of the same group of companies; or

Section 19

19. Reduction of debt.—(1) For the purposes of this section—

“**allowance asset**” means a capital asset in respect of which a deduction or allowance is allowable in terms of this Act for purposes other than the determination of any capital gain or capital loss;

“**capital asset**” means an asset as defined in paragraph 1 of the Eighth Schedule that is not trading stock;

“**debt**” does not include a tax debt as defined in section 1 of the Tax Administration Act;

“**reduction amount**”, in relation to a debt owed by a person, means any amount by which that debt is reduced less any amount applied by that person as consideration for that reduction.

(2) Subject to subsection (8), this section applies where a debt that is owed by a person is reduced by any amount and—

- (a) the amount of that debt was used, directly or indirectly, to fund any expenditure in respect of which a deduction or allowance was granted in terms of this Act; and
- (b) the amount of that reduction exceeds any amount applied by that person as consideration for the reduction.

(3) Where—

- (a) a debt owed by a person is reduced as contemplated in subsection (2); and
- (b) the amount of that debt was used as contemplated in paragraph (a) of that subsection to fund expenditure incurred in respect of trading stock that is held and not disposed of by that person at the time of the reduction of the debt,

the reduction amount in respect of that debt must, to the extent that an amount is taken into account by that person in respect of that trading stock in terms of section 11(a) or 22(1) or (2) for the year of assessment in which the debt is so reduced, be applied to reduce the amount so taken into account in respect of that trading stock.

(4) Where—

- (a) a debt owed by a person is reduced as contemplated in subsection (2);
- (b) the amount of that debt was used as contemplated in paragraph (a) of that subsection to fund expenditure incurred in respect of trading stock that is held and not disposed of by that person at the time of the reduction of the debt; and
- (c) subsection (3) has been applied to reduce an amount taken into account by that person in respect of trading stock as contemplated in that subsection to the full extent of that amount so taken into account,

the reduction amount in respect of that debt must, to the extent that a deduction or allowance was granted in terms of this Act to that person in respect of that expenditure, be deemed, for the purposes of section 8(4)(a), to be an amount that has been recovered or recouped by that person for the year of assessment in which the debt is reduced less any amount of that reduction amount that has been applied to reduce an amount as contemplated in subsection (3).

(5) Where—

- (a) a debt owed by a person is reduced as contemplated in subsection (2); and
- (b) the amount of that debt was used as contemplated in paragraph (a) of that subsection to fund any expenditure other than expenditure incurred—
 - (i) in respect of trading stock that is held and not disposed of by that person at the time of the reduction of the debt; or
 - (ii) in respect of an allowance asset,

the reduction amount in respect of that debt must, to the extent that a deduction or allowance was granted in terms of this Act to that person in respect of that expenditure, be deemed, for the purposes of section 8(4)(a), to be an amount that has been recovered or recouped by that person for the year of assessment in which the debt is reduced.

(6) Where—

- (a) a debt owed by a person is reduced as contemplated in subsection (2); and
- (b) the amount of that debt was used as contemplated in paragraph (a) of that subsection to fund expenditure incurred in respect of an allowance asset,

the reduction amount in respect of that debt must, to the extent that—

- (i) a deduction or allowance was granted in terms of this Act to that person in respect of that expenditure; and

- (ii) paragraph 12A of the Eighth Schedule has not been applied to reduce the amount of expenditure as contemplated in paragraph 20 of that Schedule in respect of that allowance asset to the full extent of that expenditure,

be deemed, for the purposes of section 8(4)(a), to be an amount that has been recovered or recouped by that person for the year of assessment in which the debt is reduced.

(7) Where a debt owed by a person that was used to fund expenditure incurred in respect of the acquisition, creation or improvement of an allowance asset is reduced, the aggregate amount of the deductions and allowances allowable to that person in respect of that allowance asset may not exceed an amount equal to the aggregate of the expenditure incurred in the acquisition of that allowance asset, reduced by an amount equal to the sum of—

- (a) the reduction amount in respect of that debt; and
- (b) the aggregate amount of all deductions and allowances previously allowed to that person in respect of that allowance asset.

(8) This section must not apply to any debt owed by a person—

- (a) that is an heir or legatee of a deceased estate, to the extent that—
 - (i) the debt is owed to that deceased estate;
 - (ii) the debt is reduced by the deceased estate; and
 - (iii) the amount by which the debt is reduced by the deceased estate forms part of the property of the deceased estate for the purposes of the Estate Duty Act;
- (b) to the extent that the debt is reduced by way of—
 - (i) a donation as defined in section 55 (1); or
 - (ii) any transaction to which section 58 applies; or
- (c) to an employer of that person, to the extent that the debt is reduced in the circumstances contemplated in paragraph 2(h) of the Seventh Schedule.

Section 24J(4A)(b)

(4A) Where in the case of any—

- (b) issuer of an instrument any adjusted gain on transfer or redemption which has been deemed to have been accrued to such issuer in terms of subsection (4)(a) during any year of assessment, includes an amount in relation to such instrument representing an—
 - (i) accrual amount; or
 - (ii) amount determined in accordance with an alternative method,

which amount has been allowed as a deduction from the income of such issuer during such year of assessment or any previous year of assessment, to the extent that such amount is not taken into account in terms of section 19, such amount shall be included in the income of such issuer during such year of assessment.

The Eighth Schedule

Paragraph 3(b)(ii)

3. Capital gain.—A person's capital gain for a year of assessment, in respect of the disposal of an asset—

- (b) in a previous year of assessment, is equal to—
 - (ii) so much of the base cost of that asset that has been taken into account in determining the capital gain or capital loss in respect of that disposal as has been recovered or recouped during the current year of assessment, otherwise than by way of any reduction of any debt owed by that person, and which has not been taken into account in the redetermination of the capital gain or capital loss in terms of paragraph 25(2); or

Paragraph 12A

12A. Reduction of debt.—(1) For the purposes of this paragraph—

“**allowance asset**” means a capital asset in respect of which a deduction or allowance is allowable in terms of this Act for purposes other than the determination of any capital gain or capital loss;

“**capital asset**” means an asset that is not trading stock;

“**debt**” does not include a tax debt as defined in section 1 of the Tax Administration Act;

“**reduction amount**”, in relation to a debt owed by a person, means any amount by which that debt is reduced less any amount applied by that person as consideration for that reduction.

(2) Subject to subparagraph (6), this paragraph applies where a debt that is owed by a person is reduced by any amount and—

- (a) the amount of that debt was used, directly or indirectly, to fund any expenditure—
 - (i) other than expenditure in respect of which a deduction or allowance was granted in terms of this Act; or
 - (ii) incurred in respect of an allowance asset; and
- (b) the amount of that reduction exceeds any amount applied by that person as consideration for that reduction.

(3) Where—

- (a) a debt owed by a person is reduced as contemplated in subparagraph (2); and
- (b) the amount of that debt was used as contemplated in item (a) of that subparagraph to fund expenditure incurred in respect of an asset that is held by that person at the time of the reduction of the debt,

the amount of expenditure so incurred in respect of that asset must, for the purposes of paragraph 20, be reduced by the reduction amount in respect of that debt.

(4) Where—

- (a) a debt owed by a person is reduced as contemplated in subparagraph (2); and
- (b) the amount of that debt was used as contemplated in item (a) of that subparagraph to fund expenditure incurred in the acquisition, creation or improvement of an asset (other than an allowance asset) that is—
 - (i) held by that person at the time of the reduction of the debt, and subparagraph (3) has been applied to reduce any expenditure in respect of that asset to the full extent of that expenditure; or
 - (ii) no longer held by that person at the time of the reduction of that debt,

the reduction amount in respect of that debt, less any amount that has been applied to reduce any amount of expenditure as contemplated in subparagraph (3), must be applied to reduce any assessed capital loss of that person for the year of assessment in which the reduction takes place.

(5) Where subparagraph (3) or (4) applies in respect of a debt that was used to fund expenditure in respect of a pre-valuation date asset of a person, for the purposes of determining the date of acquisition of that asset and the expenditure incurred in respect of that asset, that person must be treated as having—

- (a) disposed of that asset at a time immediately before that debt is reduced as contemplated in subparagraph (3)(a) or (4)(a), as the case may be, for an amount equal to the market value of that asset at that time; and
- (b) immediately reacquired that asset at that time at an expenditure equal to that market value—
 - (i) less any capital gain, and
 - (ii) increased by any capital loss,that would have been determined had the asset been disposed of at market value at that time,

which expenditure must be treated as an amount of expenditure actually incurred at that time for the purposes of paragraph 20(1)(a).

(6) This paragraph must not apply to any debt owed by a person—

- (a) that is an heir or legatee of a deceased estate, to the extent that—
 - (i) the debt is owed to that deceased estate;
 - (ii) the debt is reduced by the deceased estate; and
 - (iii) the amount by which the debt is reduced by the deceased estate forms part of the property of the deceased estate for the purposes of the Estate Duty Act, 1955 (Act No. 45 of 1955);
- (b) to the extent that the debt is reduced by way of—
 - (i) donation as defined in section 55 (1); or
 - (ii) any transaction to which section 58 applies;
- (c) to an employer of that person, to the extent that the debt is reduced in the circumstances contemplated in paragraph 2(h) of the Seventh Schedule;
- (d) to another person where that person and that other person are companies that form part of the same group of companies as defined in section 41, unless, as part of any transaction, operation or scheme entered into to avoid any tax imposed by this Act—
 - (i) that debt (or any debt issued in substitution for that debt) was acquired directly or indirectly from a person who does not form part of that group of companies; or
 - (ii) that company or that other company became part of that group of companies after that debt (or any debt issued in substitution for that debt) arose; or
- (e) that is a company, where—
 - (i) that debt is reduced in the course, or in anticipation, of the liquidation, winding up, deregistration or final termination of the existence of that company; and
 - (ii) the person to whom the debt is owed is a connected person in relation to that company,

to the extent that reduction amount in respect of that debt does not, at the time that the debt is reduced, exceed the amount of expenditure contemplated in paragraph 20 incurred in respect of that debt by the connected person: Provided that this subitem must not apply—

(aa) if—

- (A) the debt was reduced as part of any transaction, operation or scheme entered into to avoid any tax imposed by this Act; and
- (B) that company became a connected person in relation to the person to whom the debt is owed after the debt (or any debt issued in substitution of that debt) arose; or

(bb) if that company—

- (A) has not, within 36 months of the date on which the debt is reduced or such further period as the Commissioner may allow, taken the steps contemplated in section 41(4) to liquidate, wind up, deregister or finally terminate its existence;
- (B) has at any stage withdrawn any step taken to liquidate, wind up deregister or finally terminate its corporate existence; or
- (C) does anything to invalidate any step contemplated in subparagraph (A), with the result that the company is or will not be liquidated, wound up, deregistered or finally terminate its existence.

(7) Any tax which becomes payable as a result of the application of paragraph (bb) of the proviso to subparagraph (6)(e) must be recovered from the company and the connected person contemplated in that subparagraph who must be jointly and severally liable for that tax.

Paragraph 20(3)(a)

(3) The expenditure contemplated in subparagraph (1)(a) to (g), incurred by a person in respect of an asset must be reduced by any amount which—

- (a) (i) is or was allowable or is deemed to have been allowed as a deduction in determining the taxable income of that person; and
- (ii) is not included in the taxable income of that person in terms of section 9C (5), before the inclusion of any taxable capital gain; or

Paragraph 20(3)(b)(i) and (iii)

(3) The expenditure contemplated in subparagraph (1)(a) to (g), incurred by a person in respect of an asset must be reduced by any amount which—

- (b) has for any reason been reduced or recovered or become recoverable from or has been paid by any other person (whether prior to or after the incurral of the expense to which it relates), to the extent that such amount is not—
 - (i) taken into account as a recoupment in terms of section 8(4)(a) or paragraph (j) of the definition of “gross income”;
 - (ii) ...
 - (iii) applied to reduce an amount taken into account in respect of trading stock as contemplated in section 19; or

Paragraphs 56(1) and (2)(a)

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

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

- (a) an amount which is applied to reduce—
 - (i) the expenditure in respect of an asset of the debtor in terms of paragraph 12A; or
 - (ii) any assessed capital loss of the debtor in terms of paragraph 12A;
- (b) ...
- (c) an amount that must be or was included in the gross income or income of the debtor or taken into account in the determination of the balance of assessed loss of the debtor in terms of section 20 (1)(a); or