

INTERPRETATION NOTE: NO. 91

DATE: 21 October 2016

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

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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;
- “**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;
- “**VAT**” means Value-Added Tax;
- “**VAT Act**” means the Value-Added Tax Act No. 89 of 1991; and
- any other word or expression bears the meaning ascribed to it in the Act.

All guides and interpretation notes referred to in this Note are available on the SARS website at www.sars.gov.za.

All amounts in examples exclude VAT except for those identified in **4.15**.

1. Purpose

This Note provides guidance on the interpretation and application of section 19 and paragraph 12A which deal with the reduction of debt. The Note does not address section 22 of the VAT Act dealing with irrecoverable 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)

Under the previous legislation listed above, 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

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.

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 subject to only 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
- 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. 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.

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**).

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.

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 “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 *Electricity Supply Commission v Stewarts and Lloyds of SA (Pty) Ltd*⁴ the court held that the word “debt” should be given the meaning ascribed to it in the *Shorter Oxford English Dictionary*.

In *Joint Liquidators of Glen Anil Development Corporation Ltd (In Liquidation) v Hill Samuel (SA) Ltd* Holmes AJA referred to the *Electricity Supply Commission*⁵ case with approval and held that –⁶

“[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’.

The foregoing were cited by this Court in *Electricity Supply Commission v Stewarts & Lloyds of SA (Pty) Ltd* 1981 (3) SA 340 (A) at 344F. ... 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;...”

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

⁴ 1981 (3) SA 340 (A) at 344F.

⁵ 1981 (3) SA 340 (A) at 344F.

⁶ [1982] 1 All SA 105 (A), 1982 (1) SA 103 at 110.

In *Desai NO v Desai and Others*⁷ the same court (the Appellate Division, now the Supreme Court of Appeal) appeared to expand the meaning of “debt” in holding as follows as regards the meaning of “debt” in the context of the Prescription Act –⁸

“The term ‘debt’ is not defined in the Act but in the context of section 10(1) (of the Prescription Act) it has a wide meaning and general meaning, and includes *an obligation to do something or refrain from doing something.*” (Emphasis added.)

The Constitutional Court subsequently considered the broader meaning of debt as adopted in the *Desai* case in *Makate v Vodacom (Pty) Ltd*⁹ but held that –

“(t)o the extent that *Desai* went beyond what was said in *Escom*¹⁰ it was decided in error. There is nothing in *Escom* that remotely suggests that ‘debt’ includes every obligation to do something or refrain from doing something, apart from payment or delivery...(and) so broad a construction of the word ‘debt’ is...inconsistent with earlier decisions of the same court that gave the word a more circumscribed meaning.”

In *CIR v Datakor Engineering (Pty) Ltd*¹¹ the court distinguished the characteristics of debt and shares. Harms JA held that with debt the debtor had an enforceable obligation to effect payment of the debt, while with a share the right of redemption rests with the company. Harms JA highlighted a further distinction when noting that with debt all the assets of the company were available to satisfy the claims of creditors, while shares could be redeemed only subject to meeting requirements specified in, at that time, the Companies Act No. 61 of 1973. Under the Companies Act a company may redeem its shares provided it meets the solvency and liquidity requirements in that Act.

The *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2012*¹² stated that the term “debt” bears its ordinary meaning and it means an amount owed by one person (the debtor) to another (the creditor). Debt includes, for example, a loan, advance, note, bond, debenture, bank deposit or any other claim of money requiring repayment.

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 circumstances¹³ 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.

⁷ 1996 (1) SA 141 (A) at 146.

⁸ Act No. 68 of 1969.

⁹ 2016 (4) SA 121 (CC).

¹⁰ *Electricity Supply Commission v Stewarts and Lloyds of SA (Pty) Ltd* 1981 (3) SA 340 (A).

¹¹ 1998 (4) SA 1050 (SCA), 60 SATC 503.

¹² In paragraph 2.3.

¹³ Sections 171, 197 and 198 of the TA Act.

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. The reference to “that person” in the definition of “reduction amount” is a reference to the debtor.

The starting point is to determine if the debt has been “reduced”. A debt is reduced if the contractual obligation attaching to the debt is discharged. It is trite law that a contractual obligation is discharged by performance of the obligation (most often payment), or by merger (*confusio*), set-off (*compensatio*), release (*acceptilatio*),¹⁴ notice, novation, impossibility of performance, prescription, or insolvency. As noted, a debt owed by a debtor to a creditor is a contractual obligation and, depending on the facts, any one of these methods of discharging an obligation could be used to discharge a debt. The discharge of an amount owed by a taxpayer to a creditor (a debt) using an applicable legal method will result in a reduction of “a debt owed by a person” as contemplated in the definition of “reduction amount”. Waiver, merger and set-off are discussed in more detail below.

The amount applied by the debtor as consideration for a reduction of 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 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. Should the debt owing by the subsidiary to the holding company subsequently be reduced, section 19 or paragraph 12A or both these provisions may apply since the debt indirectly funded the expenditure concerned (see 4.2 for a discussion of indirect funding of expenditure).

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 sold the trading stock in the year it was acquired.

¹⁴ “Release” includes, for example, abandonment, relinquishment and waiver.

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 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 *less* amount applied as consideration for that reduction = R500 000 – R500 000 = RNil.

Note:

Should the debt owing by Company B to Company A subsequently be reduced, section 19(5) will apply since the debt indirectly funded the acquisition of the trading stock which was sold before the reduction of the debt.

See 4.2 for a discussion of indirect funding of expenditure and 4.4 for a discussion of section 19(5).

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 *less* 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* defines “consideration” as follows:¹⁵

“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*¹⁶ “consideration” was held, in the context of donations tax, to mean the *quid pro quo* given under a reciprocal obligation.¹⁷

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.¹⁸ The principles established in the *Brummeria* case¹⁹ 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. The “value in money” of consideration in a form other than money refers to the market value of such consideration, that is, the market value of the thing (goods or services) given by the debtor to the creditor that extinguishes the debt in whole or in part.

In *Lace Proprietary Mines Ltd v CIR*²⁰ the appellant company sold mineral rights to another company. The purchase price for the mineral rights was stated to be paid and satisfied by the allotment and issue to the seller of 1 million shares of 5 shillings each in the capital of the purchaser credited as fully paid-up. The Commissioner placed a valuation of 12 shillings per share on the said shares. Stratford CJ held²¹ that the true intention of the parties was that the true consideration for the sale of the mineral rights was 1 million shares and not the stated purchase price. No cash consideration could be demanded from the purchaser of the mineral rights which was entitled and obliged to deliver these shares in fulfilment of its obligation to pay for the assets bought. Stratford CJ held further that the consideration for the shares had to be valued and such valuation cannot be affected by reference to the stated purchase price or the nominal value of the shares.

¹⁵ www.oxforddictionaries.com/definition/english/consideration [Accessed 14 September 2016].

¹⁶ 1978 (3) SA 67 (T), 40 SATC 100 at 112.

¹⁷ See also *Grant v Federal Commissioner of Taxation* 7 ATR 1.

¹⁸ Depending on the facts, in addition to considering the potential income tax and CGT consequences of a reduction of debt, the debtor may need to consider the income tax and CGT consequences of the disposal of the asset given as consideration for the debt reduction. This Note does not deal with the income tax and CGT consequences of the disposal of an asset by the debtor in these circumstances.

¹⁹ *C: SARS v Brummeria Renaissance (Pty) Ltd & Others* 2007 (6) SA 601 (SCA), 69 SATC 205.

²⁰ 1938 AD 267, 9 SATC 349.

²¹ At SATC 361.

Example 3 – Reduction amount

Facts:

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

Individual X did not have the cash or other assets available to pay Individual Y the amount still due of R100 000. However, Individual X had inherited a vintage car and, being aware that Individual Y was a vintage car collector, offered the car to Individual Y in full and final settlement of the debt. Individual X and Individual Y agreed that the market value of the car was R80 000.

Individual Y accepted Individual X's offer to give an asset with a market value of R80 000 in full and final settlement of the debt of R100 000, recognising that effectively this meant that R20 000 of the total debt was being waived (debt of R100 000 – consideration of R80 000).

Result:

Individual X applied the car as consideration for the reduction of the debt of R100 000 owed to Individual Y. Since the consideration was in a form other than money, its value in money, namely, market value, had to be determined. The amount of the consideration was therefore equal to the market value of the car, namely, R80 000.

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

Issue of shares and the reduction of debt

The consideration (subscription price) payable for shares issued by a company 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, reduce its debt by –

- issuing shares directly to a creditor in full and final settlement of the debt;
- issuing shares for an amount payable in cash 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.

These approaches are discussed below. 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 under 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.

Issuing shares directly to a creditor in full and final settlement of a debt

The issuing of shares directly to a creditor in full and final settlement of a debt constitutes consideration in a form other than money. The value in money, namely the market value of the shares, must therefore be determined. A subscription price which is greater than the market value of the shares 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 a creditor in full and final settlement 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.

Issuing shares for an amount payable in cash and setting off the subscription price owed by the subscriber against an amount owed by the company

In appropriate circumstances set-off (also referred to as merger or *confusio*) can comprise a valid form of payment that *ipso facto*²² discharges the relevant debt. Such a situation may arise when a company has issued shares to an existing creditor for 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).²³ This situation will not give rise to a reduction amount for purposes of section 19 or paragraph 12A if 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. Under these circumstances the market value of the shares is irrelevant, since the consideration for the reduction of the debt is in the form of money (cash), which is set off against the amount owing. See also “Debt discharged through set-off (*compensatio*)” below.

Converting debt to shares in fulfilment of the conversion rights attaching to the debt (such as convertible debentures)

It may happen that shares are issued in fulfilment of conversion rights which were attached to a debt instrument, such as, for example, a convertible debenture, at the time the debt instrument was issued. A debt instrument with convertible rights is essentially a type of hybrid debt instrument that is convertible into equity of the issuing company on the occurrence of a specified event by the holder, or, in certain circumstances, the company issuing the debt instrument. As with shares issued

²² By the fact itself.

²³ F du Bois *et al Wille's Principles of South African Law* 9ed (2007) Juta & Co Ltd at page 831.

directly to a creditor in full and final settlement of a debt, the market value of the shares must be determined, since “consideration for the reduction” is in a form other than money. 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.

Issuing shares to the creditor in exchange for cash and then applying the cash against the debt owed by the company.

A company may issue shares for a subscription price payable in cash and apply the cash proceeds in full settlement of a debt owed by it. In these circumstances no reduction amount arises for the purposes of section 19 or paragraph 12A if the cash proceeds applied by the company as consideration for the reduction of the debt are 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 market value of the shares is irrelevant, since the consideration for the reduction of the debt is in the form of money (cash).

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 must be considered before it can be determined whether the issue of shares gives rise to a reduction amount. Also, 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. See paragraphs 8.40 and 8.41 of the *Comprehensive Guide to Capital Gains Tax* (Issue 5) for a discussion of sections 24BA and 40CA.

Debt discharged through waiver

In *Alfred McAlpine & Son (Pty) Ltd v Transvaal Provincial Administration*²⁴ it was held that for a right to be waived, the person holding the right must have knowledge of such right and must have deliberately abandoned the right, expressly or by conduct which is clearly inconsistent with an intention to enforce it. There must therefore be an intention to waive the right.

The impairment of a debt in a creditor’s accounting records or the claiming of a doubtful debt allowance for tax purposes does not generally indicate an intention by the creditor to abandon its rights against the debtor or an actual abandonment. In many cases the creditor still intends to enforce payment of the debt and its rights against the debtor remain valid and in existence even though the debt was impaired for accounting purposes or a doubtful debt allowance was claimed for income tax purposes.

In *Malone & another v FX Africa Foreign Exchange (Pty) Ltd & others*²⁵ the applicant argued that a respondent creditor had abandoned a debt because it had written the debt off in its financial statements. A Chartered Accountant submitted an affidavit to

²⁴ [1977] 4 All SA 262 (T), 1977 (4) SA 310 at 323 and 324.

²⁵ Case NO. 1056/2014, Western Cape Division, 27 June 2014, unreported. See also N van Vuuren “Impairment is not Abandonment” (November 2014) *Werksmans Legal Brief* 042009.

the court that "impairment" or "writing-off" of a loan receivable does not, in accounting terms, amount to its abandonment (that is, discharge). The accountant explained that the management of FX Africa can and often does continue to try and recover a debt subsequent to treating it as being fully impaired. If any portion of the debt is recovered, the amount recovered is written back and recognised as profit or income in the year in which the recovery is made. After weighing up the evidence, the court concluded that the relevant debt was still valid and had not been abandoned (discharged).

In the context of section 19 and paragraph 12A, a debt that is impaired in the creditor's books of account or the claiming of a doubtful debt allowance for income tax purposes would not, therefore, generally constitute a reduction of the debt as contemplated in the definition of "reduction amount" in section 19 and paragraph 12A since the debt has not been waived.

Debt discharged through merger (confusio)

A debt will generally be discharged by merger (*confusio*) if the debtor acquires the debt from the creditor. The leading case dealing with *confusio* is *Grootchwaing Salt Works Ltd v Van Tonder* in which Innes CJ stated the following:²⁶

"Now *confusio* in the sense with which we are here concerned is the concurrence of two qualities or capacities in the same person, which mutually destroy one another. In regard to contractual obligations it is the concurrence of the debtor and creditor in the same person and in respect of the same obligation. (Pothier *Verbintenissen*, par 641; *Opzomer*, Vol. 7, para. 1472; *Van der Linden* (1.18, para. 5). The typical example of *confusio* and the one mainly dealt with in the books is the case of a creditor becoming heir to his debtor or vice versa. But the same position is established whenever the creditor steps into the shoes of his debtor by any title which renders him subject to his debt (Pothier *Verb*, para. 642) and it is common cause that *confusio* takes place as between lessor and lessee when the latter acquires the leased property. As to the consequences of *confusio* there can be no doubt that speaking generally it destroys the obligations in respect of which it operates. Pothier (para. 643) is clear upon the point. A person, he says, can neither be his own creditor nor his own debtor. And if there is no other debtor then the debt is extinguished. *Non potest esse obligatio sine persona obligata*. (See also Voet, 46.3.19; Cens. For, Pt. 1.4.38, para. 1; *Van der Linden*, 1.18, sec. 5, etc.), but the obligation is only destroyed to the extent to which the concurrence of the opposing capacities renders it impossible to exist."

While the debt may be extinguished in full by *confusio*, it is still necessary for purposes of section 19 and paragraph 12A to determine whether the debt has been discharged for full consideration. Otherwise stated, it is necessary to determine the value of consideration given by the debtor for the acquisition of its own debt, since that is also the consideration given for the reduction of the debt and impacts on whether there is a reduction amount.

The issue of a negotiable instrument (for example, a debenture or promissory note) in relation to a debt does not necessarily result in the discharge (reduction) of the debt. In essence the holder acquires an alternative right against the debtor which may be disposed of to another party for consideration (the so-called holder in due course). However, discharge of the debt or negotiable instrument evidencing the debt results in the discharge of the other. Should a debtor acquire a negotiable instrument evidencing an underlying debt in respect of which it is the debtor, on acquisition that

²⁶ 1920 AD 492 at 497.

debtor in essence steps into the shoes of the creditor and normally the debt would be discharged by merger. However, the law relating to negotiable instruments is governed by the Bills of Exchange Act No. 34 of 1964. Under that Act, if an issuer (debtor) also becomes the holder of the negotiable instrument before maturity of the instrument, neither the underlying debt nor instrument is discharged and both may be re-issued by the issuer under section 35 of that Act. The debt is accordingly not discharged.²⁷ It follows that while under common law merger may take place, common law merger is suspended by operation of a statutory provision and the debt will not, in these circumstances, have been “reduced” for purposes of section 19 or paragraph 12A. By contrast, under section 59 of that Act, when an issuer becomes the holder of the negotiable instrument at, or after, maturity, the instrument (and by extension the underlying debt) is discharged and the underlying debt is therefore “reduced” for purposes of section 19 and paragraph 12A. Should a debtor, therefore, repurchase a debenture issued by the debtor on or after maturity of the debenture, the debt will have been reduced by merger under section 59 of the Bills of Exchange Act.

Example 4 – Reduction amount – Debt discharged by merger (*confusio*)

Facts:

Company A holds 100% of the shares in Company B. Company A acquired trading stock from Company B on credit at a cost of R1 million. As a result of Company A's inability to pay, the debt of R1 million remained unpaid. The estimated present market value of the debt owed by Company A to Company B is R200 000.

Company B distributed the debt of R1 million to Company A as a dividend *in specie* and Company A and Company B accepted that the distribution was in full and final settlement of the amount owed by Company A.

Result:

The debt owed by Company A has been discharged in full by *confusio*, since Company A cannot be debtor and creditor in respect of the same amount. The “amount applied by that person (Company A) as consideration for that reduction” is the market value of the debt distributed as a dividend *in specie* by Company B to Company A. Since the market value of the debt acquired by Company A amounts to only R200 000, a debt reduction of R800 000 has occurred with attendant consequences for Company A under section 19.

Reduction amount = Amount by which the debt is reduced *less* amount applied as consideration for that reduction = R1 000 000 – R200 000 = R800 000.

²⁷ FR Malan, JT Pretorius & SF du Toit “Discharge of Instrument” Chapter 14 *Malan on Bills of Exchange, Cheques and Promissory Notes in South African Law* [online] (My LexisNexis: 2009) in paragraph 180.

Debt discharged through set-off (compensatio)

In *Wille's Principles of South African Law* it is noted that as in the case of merger (*confusio*), set-off (*compensatio*) results in the –²⁸

“extinction *pro tanto* of debts owed reciprocally to each other by two persons. If the debts are equal both are discharged; if unequal the smaller is discharged, the larger remaining in force for the balance or excess only. Set-off is equivalent to payment and it consequently operates *ipso facto* and *ipso jure*, automatically, as a discharge total or partial, of the debts in question, the moment four conditions or sets of facts occur.”

Wille notes that the four conditions that must be met before set-off will operate automatically are that both debts must be (a) of the same nature, (b) liquidated, (c) due and (d) payable by the same persons in the same capacities.

Example 5 – Reduction amount – Debt discharged by set-off*Facts:*

Individual X purchased trading stock of R100 000 from Company A on credit on 1 April.

Company A hired Individual X to paint Company A's premises. The cost of R250 000 was payable on completion of the job. The job was completed on 31 May.

Result:

The four conditions for set-off are met on 31 May because the debts are –

- of the same nature – both are payable in money;
- liquidated – the amount of both debts is certain;
- fully due – both debts are due on 31 May; and
- payable by, and to, the same persons in the same capacities – Individual X and Company A are the creditor and debtor in their own names.

Therefore, on 31 May Individual X's debt of R100 000 owing to Company A is discharged by set-off and Company A's debt to the extent of R100 000 owing to Individual X is discharged by set-off. The balance of Company A's debt of R150 000 (R250 000 debt *less* R100 000 discharged) owing to Individual X remains due and payable.

Company A's reduction amount = Amount by which the debt is reduced *less* amount applied as consideration for that reduction = R100 000 – R100 000 = RNil.

Individual X's reduction amount = Amount by which the debt is reduced *less* amount applied as consideration for that reduction = R100 000 – R100 000 = RNil.

²⁸ F du Bois *et al Wille's Principles of South African Law* 9 ed (2007) Juta & Co Ltd at page 832.

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.

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 be determined only once the 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 be regarded as having been reduced for purposes of section 19 and paragraph 12A only 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.²⁹

(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 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. Any potential tax liability resulting from the application of section 19 or paragraph 12A or both these provisions must be taken into account in the final liquidation and distribution account.

²⁹ Section 152(4) of the Companies Act.

(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 1973.³⁰ Any potential tax liability resulting from the application of section 19 or paragraph 12A or both these provisions must be taken into account in the final liquidation and distribution account.

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.

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

- A debt owed by a person³¹ (the debtor) is reduced by an amount.
- The amount of that debt was used, directly or indirectly, to fund certain specified expenditure (see below).
- 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,³² while paragraph 12A will apply if the debt funded expenditure –³³

- 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.

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 (an allowance asset) 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 (see **4.9**).

³⁰ Section 408 of the Companies Act No. 61 of 1973 still applies as provided for by item 9 of Schedule 5 to the Companies Act.

³¹ The term “person” is defined in section 1(1).

³² Section 19(2).

³³ Paragraph 12A(2).

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”.³⁴

“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.”

Section 19 does not apply to all amounts that qualify for a deduction under the Act. For example, section 19 does not apply to recoup foreign exchange losses that qualified for deduction from income under section 24I(3) on a foreign currency-denominated loan which is subsequently waived without consideration. Section 19 does not apply because the foreign exchange loss does not constitute “expenditure” contemplated in section 19(2). Section 8(4)(a) may, however, apply (see **4.10.1** and **4.14**).

Although section 19(2)(a) does not specifically require that the expenditure funded by the relevant debt must be “incurred” or “actually incurred”, given that the expenditure must have been allowed as a deduction or allowance under the Act, it can be accepted that, practically speaking, the “expenditure” referred to in section 19(2)(a) must not only constitute “expenditure” as judicially defined, but must also have been “incurred” because generally the Act requires expenditure to have been incurred before it can qualify as a deduction or allowance. In addition, “incurred” is important because section 19(3), (4), (5) and (6) refer to “expenditure incurred” in relation to trading stock, other expenses and allowance assets. Similarly, paragraph 12A(2)(a)(i) refers to a deduction or allowance being granted and paragraph 12A(2)(a)(ii), 12A(3) and 12A(4) refer to “expenditure incurred”.

The meaning of “expenditure ... *actually incurred*”, which is useful in determining the meaning of “incurred”, has been considered by our courts on a number of occasions. Its meaning was best summarised by Corbett JA (as he then was) in *Edgars Stores Ltd v CIR* in which he stated the following:³⁵

“Thus it is clear that only expenditure (otherwise qualifying for deduction) in respect of which the taxpayer has incurred an unconditional legal obligation during the year of assessment in question may be deducted in terms of s 11(a) from income returned for that year. The obligation may be unconditional (*ab initio*) though initially conditional, may become unconditional by fulfilment of the conditions during the year of assessment; in either case the relative expenditure is deductible in that year.”

³⁴ 2013 (2) SA 33 (SCA), 74 SATC 1 at 6.

³⁵ 1988 (3) SA 876 (A), 50 SATC 81 at 90.

To that Nicholas AJA (as he then was) added the following:³⁶

“Actually incurred does not mean ‘actually paid’, but means all expenditure actually incurred during the year, whether the liability has been discharged during that year or not.”

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. For example, A bought an allowance asset from B on credit and borrowed money from C to pay B in full. A subsequently borrowed money from D to pay C in full. The original debt from B constituted direct funding of expenditure, while the debts incurred in relation to C and D constitute indirect funding of expenditure. Section 19 and paragraph 12A may apply if the amount owing by A to D is reduced. The applicability of section 19 and paragraph 12A to any reduction in the amount owed by A to D is supported by the established principle that when a loan is repaid by a second loan, the purpose of the second loan is derived from the first loan.³⁷

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

³⁶ At SATC 95.

³⁷ See ITC 1020 (1962) 25 SATC 414 (T) at 415; *CIR v General Motors SA (Pty) Ltd* 1982 (1) SA 196 (T), 43 SATC 249 at 256 and ITC 1553 (1989) 55 SATC 105 (T) at 112 and 113.

- 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 (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**).

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).

There is a risk that symmetry will not be achieved if a similar rule was included in section 19. For example, a debtor company whose debt to a group company is waived may suffer an effective income inclusion with a tax effect of 28%, while the creditor group company may have a capital loss on waiver of the debt with a lower tax effect as a result of the lower inclusion rate applicable to a net capital gain. Also, capital losses may be set off only against capital gains and are unavailable for set-off against taxable income.

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.³⁸

Meaning of “held and not disposed of”

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 (see **4.5** and **4.6**). In relation to the meaning of “held”, *Juta’s Tax Library* states the following.³⁹

“[I]t 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,

³⁸ 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).

³⁹ D Davis *et al* *Jutas Tax Library* [online] (Jutastat e-publications: 2 April 2015) in *Commentary on Income Tax – section 22*.

must therefore account for the stock. This view is shared by Meyerowitz (at 9.89).”

(Emphasis added)

In ITC 1873⁴⁰ 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.”

On appeal in *Avenant v C: SARS*⁴¹ the SCA held that “produce on hand and not disposed of” includes the fractional ownership of pooled produce and therefore included the taxpayer’s undivided share in the grapes that had been crushed and merged with the grapes of other farmers. As regards the issue of ownership and possession, the court concluded that –⁴²

“in the present case where ownership is retained by the appellant [the taxpayer] but possession is not, the produce is clearly ‘held’ for the purposes of para 2 of the First Schedule”.

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 no longer has legal ownership of it but is unconditionally entitled to the consideration for it (that is, the consideration 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 (see **4.5** and **4.6**).

⁴⁰ (2014) 77 SATC 93 (WC) at 103.

⁴¹ Case No. 367/2015 [2016] ZASCA 90, 1 June 2016, unreported.

⁴² See above in paragraphs 25 and 28.

Application of section 19(3)

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 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 applies only 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.

Application of section 19(4)

Section 19(4) also applies when the debt funded expenditure that was incurred in respect of trading stock that is held and not disposed of at the time of the reduction of the debt. Section 19(4) provides that 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 must, for the purposes of section 8(4)(a), be 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 (4) is limited to the amounts granted as an allowance or deduction under the Act.

Section 19(4) will therefore 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. See Example 7.

Application of section 19(5)

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).

Sequence of the application of the subsections of section 19

Any reduction amount in respect of trading stock 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 6.

Example 6 – Reduction of debt that funded the acquisition of trading stock*Facts:*

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

2015 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 year of assessment. Company A included the difference of R400 000 in closing stock at year-end. The closing balance of trading stock at year end was R1 million.

2016 year of assessment

On 1 March 2015 Company B cancelled the debt of R500 000 owed by Company A because of Company A's inability to pay. The trading stock acquired during the 2015 year of assessment with a cost price of R400 000 was held and not disposed of at the time of the reduction of the debt.

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

Result:

2016 year of assessment

Reduction amount = Amount by which the debt is reduced *less* 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.

Application of section 19(3)

Section 19(3) applies to R400 000 of the reduction amount because the debt directly funded the acquisition of trading stock amounting to R400 000 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 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).

Application of section 19(4)

Section 19(4) does not apply since the full amount of the reduction amount relating to the expenditure incurred in respect of the trading 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).

Application of section 19(5)

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 2015 year of assessment. The trading stock of R100 000 was allowed as a deduction under section 11(a) during the 2015 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 2016 year of assessment (see 4.4).

2017 year of assessment

Opening balance of trading stock

The amount taken into account as opening stock will be the amount included in closing stock at the end of the 2016 year of assessment, that is, R400 000.

Closing balance of trading stock

Assuming the trading stock is still on hand at the end of the 2017 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 applies only in the year of assessment 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 2015 year of assessment is required to have been reduced by the reduction amount that arose in the 2016 year of assessment, it is considered that the “cost price” for purposes of section 22(1) in the 2017 year of assessment must take into account the reduction amount that arose in the 2016 year of assessment.

Notes:

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 held 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 7 – Reduction of debt that funded the acquisition of trading stock*Facts:*

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

2015 year of assessment

Company C purchased trading stock from Company D on credit at a cost of R300 000. During the year of assessment Company C sold R200 000 of this trading 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 its value to R60 000.

2016 year of assessment

On 31 March 2015 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 (see above), 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:**2016 year of assessment*

Reduction amount = Amount by which the debt is reduced *less* 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.

Application of section 19(3)

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 RNil (R60 000 – R60 000) and the closing balance of trading stock under section 22(1) is also reduced to RNil.

Application of section 19(4)

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 have been recovered or recouped for purposes of section 8(4)(a).

Application of section 19(5)

Section 19(5) applies to the trading stock of R200 000 that was disposed of during the 2015 year of assessment. The trading stock of R200 000 was allowed as a deduction under section 11(a) during the 2015 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 2016 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 to a loan account 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 must 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. See 4.11 for the allocation of payments and debt reductions.

Example 8 – Reduction of a debt that funded expenditure allowed as a deduction

Facts:

Company E's year of assessment ends on 31 March.

2016 year of assessment

Company E borrowed R1 million from Company F and used the funds to finance operating expenses that 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.

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

Result:

2016 year of assessment

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

Application of section 19(5)

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 2016 year of assessment.

Example 9 – Reduction of a debt that funded expenditure allowed as a deduction

Facts:

Company E's year of assessment ends on 31 March.

2016 year of assessment

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.

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

Result:**2016 year of assessment**

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

Application of section 19(5)

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 for the interest of 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 2016 year of assessment.

Note:

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

See also Examples 6 and 7 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.

Having regard to the meaning of “held”, the debtor must have legal ownership of the relevant asset at the time that a debt is reduced (see 4.3 for a discussion of the meaning of “held”).

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 10).

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 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”.⁴³

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 arise only upon actual disposal of the asset.

Example 10 – 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.

2015 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.

2016 year of assessment

On 1 March 2015 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:

2016 year of assessment

Reduction of the debt

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

Application of paragraph 12A(3)

The debt of R2 million funded the acquisition of an allowance asset which was still held by Company B 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)⁴⁴ must be reduced by the reduction amount. The reduction is, however, limited to R1,7 million, since expenditure and base cost can be reduced only to nil.

⁴³ Section 19(6)(ii).

⁴⁴ 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.

Application of section 19(6)

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(3) reduced the expenditure by R1,7 million only 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 less R1,7 million paragraph 12A(3) 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.

Application of section 19(7)

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 2016 year of assessment.

*Disposal of the asset**Application of section 8(4)(a)*

While the recoupment provisions of section 8(4)(a) have application on the subsequent disposal of the allowance asset, no recoupment is triggered, since 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 2015).

Determination of capital gain

The full proceeds of R1,7 million will constitute a capital gain derived by Company B. Base cost is RNil under paragraph 20 and 12A(3) (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).

Company B effectively did not pay for the asset because the full amount of the debt was forgiven. When Company B subsequently sold the asset for R1,7 million, the full amount of the proceeds constituted a capital gain.

Note:

Company B originally claimed R300 000 as wear and tear in 2015 but this was reversed by the recoupment of R300 000 under section 19(6) in 2016.

Example 11 – 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.

2015 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.

2016 year of assessment

On 1 March 2015 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:

2016 year of assessment

Reduction of the debt

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

Application of paragraph 12A(3)

The debt of R2 million funded the acquisition of an allowance asset which was still held by Company B 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)⁴⁵ must be reduced by the reduction amount. The reduction is, however, limited to R1,7 million, since expenditure and base cost cannot be reduced below nil.

Application of section 19(6)

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(3) reduced the expenditure by only 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 *less* R1,7 million paragraph 12A(3) 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.

⁴⁵ Paragraph 20(3)(a)(i).

Application of sections 11(e) and 19(7)

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 2016 year of assessment (see 4.7).

*Disposal of the asset**Application of section 8(4)(a)*

The recoupment provisions of section 8(4)(a) apply to the subsequent disposal of the allowance asset. 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 2015) 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 it is therefore not taken into account again on disposal of the asset.

Determination of capital gain

The full proceeds of R1,8 million will constitute a capital gain derived by Company B on disposal of the asset. The base cost of the asset is RNil under paragraph 20 and 12A(3) (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).

Company B effectively did not pay for the asset because the full amount of the debt was forgiven. When Company B subsequently sold the asset for R1,8 million the full amount of the proceeds constituted a capital gain.

Note:

Company B originally claimed R300 000 as wear and tear in 2015 but this was effectively reversed by the recoupment of R300 000 under section 19(6) in 2016.

Example 12 – Reduction of a debt that funded the acquisition of an allowance asset 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.

2015 year of assessment

On 1 March 2014 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.

2016 year of assessment

Company B sold the allowance asset for R1,7 million on 31 August 2015 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:**2016 year of assessment**Disposal of the asset**Application of section 8(4)(a)*

No recoupment of the wear-and-tear allowances previously claimed of R300 000 (R200 000 in 2015 and R100 000 in 2016) 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).

Determination of capital gain

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 (R2 million cost – R300 000 allowances previously claimed). The base cost of the asset was 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 *less* amount applied as consideration for that reduction = R2 000 000 – RNil = R2 000 000.

Application of section 19(6)

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 has been 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).

Note:

Paragraph 20(3)(b) does not apply because the acquisition of the asset was funded indirectly. As a result there is no reduction in the base cost of the asset. The balance of the reduction amount of R1,7 million [R2 million – R300 000 deemed to be recouped under section 19(6)] is not applied under either paragraph 12A or paragraph 20(3)(b). Company B did not therefore suffer any tax consequences on the reduction amount of R1,7 million (see 4.10.5).

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 apply only 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 cannot be reduced below nil under paragraph 12A(3) so as to give rise to a negative amount.

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 that 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 debt is reduced. Therefore, paragraph 12A(4)(b)(i) will apply only 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 apply only 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 debt is reduced.

The maximum amount of the reduction under paragraph 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 arise only upon the subsequent disposal of the asset.

Example 13 – Reduction of a debt that funded a non-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.

2011 year of assessment

Company A lent Company B R2 million which Company B used to purchase land on capital account from a third party at a cost of R2 million.

2015 year of assessment

On 30 June 2014 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 2014 for proceeds of R2,2 million.

2016 year of assessment

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

*Result:**2015 year of assessment**Reduction of the debt*

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

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

Disposal of the asset

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).

*2016 year of assessment**Reduction of the debt*

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

Neither paragraph 12A(3) nor paragraph 12A(4)(b)(i) applied when Company A waived the balance of the debt of R1,5 million, since the non-allowance asset 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 2017 year of assessment will accordingly be R3 million (assessed capital loss before debt reduction of R4,5 million less debt reduction amount 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 respect of the acquisition of that asset, reduced by an amount equal to the sum of –

- the reduction amount of a debt that funded the expenditure incurred in respect 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 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 A's year of assessment ends on the last day of February.

2015 year of assessment

Company A acquired second-hand machinery at a cost of R1 million on loan account from Company B on 1 March 2014. Company A is entitled to an allowance of 20% a year on the cost price of the asset under section 12C(1).

2016 year of assessment

On 1 March 2015 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.

Result:

2016 year of assessment

Reduction of the debt

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

Application of paragraph 12A(3)

Company A was granted allowances under section 12C(1) of R200 000 a year for the 2015 and 2016 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 purchase price – R400 000 wear-and-tear allowances claimed).⁴⁶

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 the asset was held by Company A at the time of the reduction of the debt.

Application of section 19(6)

Section 19(6) does not apply in these circumstances, since the base cost of the asset of R600 000 exceeded the reduction amount and therefore paragraph 12A(3) applied to the full reduction amount.

Application of section 19(7)

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 R900 000 (the reduction amount of the debt of R500 000 plus the aggregate amount of allowances previously granted of R400 000). The allowance that may be claimed under section 12C(1) is, therefore, limited to R100 000 for the 2017 year of assessment and no further allowances will be allowed on the asset.

Example 15 – 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.

2015 year of assessment

On 1 March 2014 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% a year, that is, R300 000.

2016 year of assessment

On 1 March 2015 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.

⁴⁶ Paragraph 20(3)(a)(i).

*Result:**2016 year of assessment**Reduction of the debt*

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

Application of paragraph 12A(3)

The debt of R2 million funded the acquisition of an allowance asset that was held by Company B 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 *less* R300 000 wear-and-tear allowance previously claimed)⁴⁷ must be reduced by the reduction amount. The reduction is, however, limited to R1,7 million, since expenditure and base cost cannot be reduced below nil.

Application of section 19(6)

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(3) reduced the expenditure by only 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(3). The excess of R300 000 [R2 million reduction amount *less* R1,7 million applied under paragraph 12A(3)] is, for the purposes of section 8(4)(a), deemed under section 19(6) to be an amount that has been recovered or recouped.

Application of sections 11(e) and 19(7)

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 amount 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 and the aggregate amount of allowances previously granted of R300 000. This calculation gives a negative result of (R300 000) which means that no further allowance under section 11(e) is permitted in 2016.

⁴⁷ Paragraph 20(3)(a)(i).

*Disposal of the asset**Application of section 8(4)(a)*

The recoupment provisions of section 8(4)(a) must 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 less R300 000 section 11(e) allowance claimed in 2015). 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). An amount of R300 000 was previously included as a deemed recoupment under section 19(6) and it is, therefore, not taken into account again on disposal of the asset. The recoupment on disposal of the allowance asset in these circumstances under section 8(4)(a) is therefore RNil.

Determination of capital gain

The full proceeds of R2,1 million will constitute a capital gain derived by Company B on disposal of the asset. The base cost of the asset is RNil under paragraph 20 and 12A(3) (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 of the asset are required to be so included under section 8(4)(a).

Example 16 – 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. The asset qualified to be written off on the straight-line basis over four years.

2015 year of assessment

By the end of the 2015 year of assessment, Company B had claimed wear-and-tear allowances under section 11(e) of R1 million (R2 million \times 2 / 4).

2016 year of assessment

On 1 March 2015 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:**2016 year of assessment**Reduction of the debt*

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

Application of paragraph 12A(3)

The debt of R2 million funded the acquisition of an allowance asset which was still held by Company B 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 *less* R1 million wear-and-tear allowance claimed)⁴⁸ must be reduced by the reduction amount of R1,5 million. The base cost of the asset is reduced to RNil, since expenditure cannot be reduced to a negative amount.

Application of section 19(6)

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(3) reduced the expenditure by only R1 million because expenditure of R1 million had already been reduced under paragraph 20(3)(a)(i) and was therefore unavailable for reduction under paragraph 12A(3). The excess of R500 000 (R1,5 million reduction amount *less* R1 million paragraph 12A(3) 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.

*Disposal of the asset**Application of sections 11(e), 11(o) and 19(7)*

A partial section 11(e) allowance is unavailable for the two weeks during which the asset was used in the 2016 year of assessment because of the limitation rules in section 19(7).

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 amount of 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 and the aggregate amount of allowances previously granted of R1 million. This gives a negative result of (R500 000) which means that no deduction under section 11(o) is permitted in 2016.

⁴⁸ Paragraph 20(3)(a)(i).

Determination of capital gain

The full proceeds of R800 000 constitute a capital gain derived by Company B on disposal of the asset. The base cost of the asset is RNil under paragraph 20 and 12A(3) (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).

Company B effectively paid R500 000 for the asset because R1,5 million of the debt of R2 million was forgiven. Company B claimed deductions for the true cost of R500 000 [R1 million claimed as a wear and tear allowance in 2015 of which R500 000 was recouped under section 19(6) in 2016 and no further deductions were allowed as a result of section 19(7)].

It is therefore appropriate that when Company B subsequently sold the asset for R800 000, the full amount constituted a capital gain.

Example 17 – 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.

2015 year of assessment

Company B purchased a new manufacturing machine from Company A on credit at a cost of R800 000. Company B claimed an allowance under section 12C of R320 000 (40% × R800 000).

2016 year of assessment

Company B claimed an allowance under section 12C of R160 000 (20% × R800 000). On 1 June 2015 Company B was relieved from the payment of R100 000 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 R25 000.

*Result:**2016 year of assessment**Reduction of the debt*

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

Application of paragraph 12A(3)

The debt of R800 000 funded the acquisition of an allowance asset that was held by Company B when the debt was reduced. As a result, paragraph 12A(3) applies and the base cost of the asset of R320 000 (R800 000 expenditure incurred *less* R480 000 allowances previously claimed)⁴⁹ must be reduced by the reduction amount of R100 000. The base cost of the asset is accordingly reduced to R220 000.

*Disposal of the asset**Application of sections 11(o) and 19(7)*

Under section 11(o) a deduction of R295 000 for the loss arising on disposal of the asset is potentially available, subject to section 19(7), because the cost of R800 000 exceeds the proceeds of R25 000 and allowances previously claimed of R480 000 by R295 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 R800 000 reduced by the sum of the reduction amount of R100 000 and the aggregate amount of allowances granted. The deduction under section 11(o) is therefore limited to R220 000 (R800 000 cost – R100 000 reduction amount – R480 000 section 12C allowances).

Determination of capital gain

Company B derived proceeds of R25 000 on disposal of the asset. While the original base cost of the asset (R800 000) is reduced to R220 000 under paragraph 20(3)(a)(i) and 12A(3), the base cost of R220 000 is further reduced by the amount of the allowance claimed under section 11(o) of R220 000 [paragraph 20(3)(a)(i)], resulting in a base cost of RNil. A capital gain of R25 000 is therefore derived by Company B on disposal of the asset (proceeds of R25 000 – base cost of RNil).

Company B effectively paid R700 000 for the asset because R100 000 of the debt of R800 000 was forgiven. Company B claimed deductions for the true cost of R700 000 (allowances under section 12C of R480 000 plus the section 11(o) allowance of R220 000).

It is therefore appropriate that when Company B subsequently sold the asset for R25 000, the full amount constituted a capital gain.

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

Special rules in paragraph 12A(5) determine the base cost of a pre-valuation date asset when debt that funded expenditure in relation to that asset is reduced and paragraph 12A(3) or (4) applies. A pre-valuation date asset is defined in paragraph 1 and means an asset acquired before valuation date⁵⁰ by a person and which has not been disposed of by that person before valuation date.

⁴⁹ Paragraph 20(3)(a)(i).

⁵⁰ The term "valuation date" is defined in paragraph 1 and will generally be 1 October 2001.

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,

that would have been determined had the asset been disposed of at market value⁵¹ at that time.

A person is treated as having disposed of the asset immediately before the reduction of the debt only for the purposes of determining the expenditure incurred under paragraph 20. The disposal is not deemed to be an actual disposal of the asset for purposes of the remaining provisions of the Act and therefore does not give rise to a capital gain or loss on the deemed disposal.

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 paragraph 12A(3) and (4). The base cost of a pre-valuation date asset is made up of its valuation date value plus any expenditure incurred on or after the valuation date. 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 expenditure incurred on or after the valuation date. Since the valuation date value using the time-apportionment and 20% of proceeds methods can be determined only 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 18 – Determination of the base cost of a pre-valuation date asset

Facts:

Company X and Company Y do not form part of the same group of companies. Company X's year of assessment ends on 31 March.

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.

⁵¹ The market value of an asset on a specified date is determined under paragraph 31.

On 1 June 2015 the loan of R2 million was waived because of Company X's adverse economic position. Immediately before the debt reduction the market value of the land and improvements was R5 million.

Result:

2016 year of assessment

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

Application of paragraph 12A(5) to establish the base cost of the pre-valuation date asset

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 improvements)	<u>(2 100 000)</u>
Expenditure actually incurred for purposes of paragraph 20(1)(a)	<u>2 900 000</u>

Application of paragraph 12A(3)

Under paragraph 12A(3) the newly established base cost of the asset is reduced to R900 000 by the reduction amount (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 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 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,⁵² 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”.

⁵² 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.

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

Facts:

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

Individual A sold shares to Family Trust A on loan account in 2013. The shares were acquired by the trust as a capital investment.

Individual A passed away on 30 April 2015 and under Individual A’s last will the loan was bequeathed to the trust.

Result:

2016 year of assessment

Application of section 19 and paragraph 12A

The deceased (Individual A) 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 do 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).

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 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.

Meaning of “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:⁵³

“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 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:⁵⁴

“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.⁵⁵

⁵³ 2005 (4) SA 173 (SCA), 66 SATC 303 at 312 and 314.

⁵⁴ 1945 AD 388, 13 SATC 170 at 173.

⁵⁵ 1961 (2) SA 20 (FC), 24 SATC 157 at 165.

Not every reduction of a debt is 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.”

In *Welch’s Estate v C: SARS*⁵⁶ Marais JA held⁵⁷ 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:⁵⁸

“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 1599⁵⁹ Wunsh J explained the history and object of donations tax by quoting the following dicta of Boshoff WRP in *Ogus v SIR*:⁶⁰

“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.⁶¹ 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.⁶²

⁵⁶ 2005 (4) SA 173 (SCA), 66 SATC 303.

⁵⁷ At SATC 315.

⁵⁸ At SATC 315.

⁵⁹ (1995) 58 SATC 88 (T) at 97.

⁶⁰ 1978 (3) SA 67 (T), 40 SATC 100 at 107.

⁶¹ At SATC 98.

⁶² At SATC 99.

While Wunsh J confirmed that 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.⁶³

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.

Example 20 – Non-application of section 19 – Debt reduced by a donation

Facts:

Individual X's year of assessment ends on the last day of February.

Individual X holds 1% of the shares in Company Y, but is not an employee or director of the company. On 1 March 2014 Company Y advanced an interest-free loan of R100 000 to Individual X.

On 1 March 2015 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 2015 year of assessment.

Result:

2016 year of assessment

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

Application of section 19(5)

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(5) 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.

⁶³ At SATC 96.

Note:

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

Individual X's year of assessment ends on the last day of February.

2015 year of assessment

On 1 April 2014 Individual X lent R1 million to The X Family Trust which the trust used to purchase a piece of land from a third party. No deductions or allowances in respect of the land could be claimed by The X Family Trust under the Act.

2016 year of assessment

On 31 March 2015 Individual 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. Individual X did not make any other donations during the 2016 year of assessment.

*Result:**2016 year of assessment*

Reduction amount = Amount by which the debt is reduced *less* amount applied as consideration for that reduction = R1 000 000 *less* R800 000 = R200 000.

Application of paragraph 12A(3)

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 must not be reduced under paragraph 12A(3) because the debt was reduced by way of a transaction to which section 58 applies. Under these circumstances 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),⁶⁴ 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 debt⁶⁵ owing by an employee to a third person without requiring the employee to reimburse the employer for the amount paid by the employer or the employee is released from paying the employer an amount owed by the employee.

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,⁶⁶ 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 does not apply if 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.

Example 22 – Non-application of section 19 and paragraph 12A – Debt reduced by an employer resulting in a fringe benefit

Facts:

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

Employer ABC granted a loan of R10 000 to Employee A on 1 April 2013 which funded the acquisition of a computer from Employer ABC.

⁶⁴ 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.

⁶⁵ Excluding amounts in respect of which paragraph 2(i) or paragraph 2(j) of the Seventh Schedule apply.

⁶⁶ 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.

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 2015 Employer ABC waived the loan. The computer was still held and not disposed of by Employee A at the time of the reduction of the debt.

Result:

2016 year of assessment

Reduction amount = Amount by which the debt is reduced *less* amount applied as consideration for that reduction = R10 000 *less* RNil = R10 000.

Application of section 19 and paragraph 12A

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 do 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 does not therefore give rise to any section 19 and paragraph 12A implications.

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

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 41,⁶⁷ 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 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**).

⁶⁷ 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".

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.

Example 23 – 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 and Company B form part of the same group of companies as defined in section 41(1). Company A’s year of assessment ends on the last day of February.

Company A acquired land at a cost of R1 million on loan account from Company B on 1 March 2014. On 1 March 2015 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.

Result:

2016 year of assessment

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

Application of paragraph 12A(3)

Paragraph 12A(6)(d) provides that Company A must not reduce the base cost of the land under paragraph 12A(3) by the reduction amount of R500 000, since Company A and Company B form part of the same group of companies.

Note:

Company B is denied a capital loss on the waiver of the debt under paragraph 56(1) (see 4.10.6).

Example 24 – 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 and Company B form part of the same group of companies as defined in section 41(1). Company A’s year of assessment ends on the last day of February.

Company A acquired second-hand machinery at a cost of R1 million on loan account from Company B on 1 March 2014. 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 2015 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.

Result:

2016 year of assessment

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

Application of paragraph 12A(3)

Company A was granted allowances under section 12C(1) of R200 000 a year for the 2015 and 2016 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 – R400 000).⁶⁸

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.

Application of section 19(6)

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 2016 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.

Note:

Company B is allowed a partial capital loss of R400 000 but is denied a capital loss of R100 000 on the waiver of the debt under paragraph 56(1) read with paragraph 56(2)(c) (see 4.10.6).

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 person⁶⁹ 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 (the debtor). This exclusion is, however, limited in two respects.

First, under paragraph 12A(6)(e) paragraph 12A does not apply 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 by the connected person in respect of that debt. 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 under paragraph 12A(6)(e) does not apply, in other words paragraph 12A does 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

⁶⁸ Paragraph 20(3)(a)(i).

⁶⁹ See Interpretation Note No. 67 (Issue 2) dated 14 February 2014 “Connected Persons” on the definition of “connected person” in section 1(1).

- the company –
 - 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)⁷⁰ 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 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 (the debtor) because an exclusion similar to the one in paragraph 12A(6)(e) is not available under section 19.

Example 25 – Non-application of paragraph 12A – Debt reduced in anticipation of the liquidation of a debtor company

Facts:

Company Y holds 20% of the shares in Company X. Company X and Company Y are connected persons⁷¹ in relation to each other but do not form part of the same group of companies. Company X's year of assessment ends on 31 March.

Company Y advanced a loan of R10 million to Company X on 1 April 2010. This loan indirectly funded the acquisition of a fixed property by Company X. On 1 April 2015 Company Y waived the debt of R10 million in anticipation of the liquidation of Company X.

Result:

2016 year of assessment

Reduction amount = Amount by which the debt is reduced *less* amount applied as consideration for that reduction = R10 million *less* RNil = R10 million.

⁷⁰ Specific steps are listed in section 41(4) for the liquidation or winding-up of a company and for the deregistration of a company.

⁷¹ Under paragraph (d)(v) of the definition of "connected person" in section 1(1).

Application of paragraph 12A(3)

The base cost of Company X's fixed property is not reduced by the reduction amount of the debt of R10 million under paragraph 12A(3) 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).

Example 26 – Non-application of paragraph 12A – Debt reduced in anticipation of the liquidation of a debtor company*Facts:*

Company Y holds 20% of the shares in Company X. Company X and Company Y are connected persons⁷² in relation to each other but do not form part of the same group of companies. Company X's year of assessment ends on 31 March.

Company Y advanced a loan of R10 million to Company X on 1 April 2010. This loan indirectly funded the acquisition of a fixed property by Company X.

On 1 April 2015 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).

*Result:**2016 year of assessment*

Reduction amount = Amount by which the debt is reduced *less* amount applied as consideration for that reduction = R10 million *less* RNil = R10 million.

Application of paragraph 12A(3)

The base cost of Company Y's debt was RNil (R10 million – R10 million)⁷³ when the debt was reduced because the loss on disposal of the debt was allowable as a deduction under section 11(a) read with section 23(g).

⁷² Under paragraph (d)(v) of the definition of "connected person" in section 1(1).

⁷³ 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.

While –

- the debt owed by Company X is reduced in anticipation of its liquidation; 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 (RNil) and the relief under paragraph 12A(6)(e) is therefore not available to Company X.

Consequently, the base cost of Company X's fixed property must, for purposes of paragraph 20, be reduced to RNil under paragraph 12A(3) (R10 million expenditure incurred less R10 million reduction amount).

Example 27 – Non-application of paragraph 12A – Debt reduced in anticipation of the liquidation of a debtor company

Facts:

Company X's year of assessment ends on 30 June.

2013 year of assessment

On 1 July 2012 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.

2016 year of assessment

On 1 August 2015 Company X disposed of all its assets. On 1 September 2015 Individual Y waived the loan account in anticipation of the liquidation of Company X. Company X has an assessed capital loss of R30 000 at the end of the year of assessment before taking into account any reduction amounts.

Result:

2016 year of assessment

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

Application of paragraph 12A(4)

Individual Y and Company X are connected persons in relation to each other.⁷⁴ 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).

⁷⁴ Under paragraphs (d)(iv) and (e) of the definition of "connected person" in section 1(1).

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)(ii) Individual Y may claim a capital loss on disposal of the debt of R20 000. The balance of the capital loss of R60 000 (R80 000 – R20 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 allowed 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.

The reduction amount of a debt that funded or gave rise to expenses, allowances or losses for which deductions were claimed may, subject to paragraphs (ii) and (iii) of the proviso to section 8(4)(a) (see below), be recouped under section 8(4)(a). *Wunsh J* held as follows in ITC 1634:⁷⁵

“The cancellation or reduction of a liability which has been incurred by a taxpayer in the production of its income, is not of a capital nature and has been allowed as a deduction in computing its taxable income[,] is an amount which accrues to the taxpayer and, in any event, whether or not it is of a capital nature, represents a recoupment by it of the deduction for the purpose of s 8(4)(a) of the Act. There is no difficulty in identifying the ‘amount’ – it is the face value of the liability which is cancelled or the amount by which it is reduced. Amounts of reduced or extinguished liabilities of which the taxpayer derives the benefit in the course of carrying on its business and arise from the business or are incidents of it accrue to it.”

In *Omnia Fertilizer Ltd v C: SARS*⁷⁶ Howie P found that the conclusion of the Special Court in ITC 1634 that recoupment had occurred was correct.⁷⁷

⁷⁵ (1997) 60 SATC 235 (T) at 258.

⁷⁶ 2003 (4) SA 513 (SCA), 65 SATC 159.

⁷⁷ At SATC 164.

He stated that –⁷⁸

“the legislature wished to ensure that if the deduction of expenditure was once allowed a taxpayer should not escape taxation if alleged expenditure was not to be expenditure after all, whether or not liability was legally terminated”.

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

Paragraph (ii) of the proviso to section 8(4)(a) 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 taken into account under sections 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 under section 19(3) is not recouped again under section 8(4)(a) when the relevant debt is reduced.

Example 28 – Amounts recovered or recouped under section 8(4)(a) – Paragraph (ii) of the proviso to section 8(4)(a)

Facts:

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

On 1 March 2015 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 2015 year of assessment.

The trading stock of R400 000 acquired during the 2015 year of assessment was still held and not disposed of at the end of Company A's 2016 year of assessment. The opening balance of trading stock for the 2016 year of assessment was R1 million and the closing balance R800 000.

Result:

2016 year of assessment

Reduction amount = Amount by which the debt is reduced *less* amount applied as consideration for that reduction = R400 000 *less* RNil = R400 000.

Application of section 19(3)

Section 19(3) must be applied to reduce the cost price of opening stock taken into account under section 22(2) and closing stock taken into account under section 22(1), by the reduction amount of R400 000.

⁷⁸ At SATC 163.

Application of paragraph (ii) of the proviso to section 8(4)(a)

Under paragraph (ii) of the proviso to section 8(4)(a) no amount of the debt that was waived must 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 to 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 section 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 recovery or recoupment for purposes of section 8(4)(a) is not again recouped under section 8(4)(a). See Examples 11 and 15.

4.10.2 Recoupment of expenditure or losses incurred on equity shares held for at least three years [section 9C(5) and paragraph 20(3)(a)]

Any amount received or accrued (other than a dividend or foreign dividend) or any expenditure incurred in respect of an equity share⁷⁹ must be deemed under section 9C(2) to be of a capital nature if the equity share had, at the time of the receipt or accrual of that amount or incurral of that expenditure, been held for a period of at least three years.

Since the proceeds derived on disposal of an equity share held for at least three years 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 that equity share is disposed of, any expenditure or losses incurred on that share and allowed 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 determined 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. Therefore, even if a share is disposed of at a capital loss, the amounts previously allowed as a deduction must be included in income.

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 an equity share referred to 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.⁸⁰

⁷⁹ The term "equity share" is defined in section 9C(1).

⁸⁰ 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" on section 9C.

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

Facts:

Individual A's year of assessment ends on the last day of February.

2011 year of assessment

On 1 March 2010 Individual A acquired listed shares as trading stock at a cost of R100 000 and claimed this amount as a deduction under section 11(a). The acquisition of the shares was funded by a loan from Company B. At the end of the 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).

2016 year of assessment

On 1 June 2015 Company B cancelled the debt owing by Individual A because Individual A was unable to pay the amount outstanding. On 30 November 2015 Individual A disposed of the shares for R80 000.

Result:

2016 year of assessment

Reduction of the debt

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

Application of section 19(3) and (4)

As a result of the debt cancellation on 1 June 2015 the value of Individual A's opening stock as at 1 March 2015 is reduced to RNil 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.

Disposal of the shares

Application of section 9C(2) and (5)

On 28 February 2015 the shares had been held by Individual A for five continuous years. The proceeds on disposal of the shares on 30 November 2015 will be treated as being of a capital nature under section 9C(2), since they comprise equity shares held for at least three years.

Section 9C(5), subject to its proviso, stipulates that a taxpayer must include in income in the year of assessment in which any equity share, held for at least three years, 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 of R100 000 under section 11(a).

However, since the amount of R100 000 has already been taken into account under section 19(3) and (4) when the debt was reduced, no amount must be included in Individual A's income under section 9C(5) by virtue of the proviso to section 9C(5).

Notes:

- (1) The base cost of the shares has been reduced to RNil under paragraph 20(3)(a) because the expenditure of R100 000 was allowed as a deduction under section 11(a) and no amount was included in Individual A's income under section 9C(5). Individual A will therefore realise a capital gain on disposal of the shares of R80 000 (proceeds of R80 000 less base cost of RNil).
- (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" under section 22(1)(a). A "financial instrument" includes a share.⁸¹

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.⁸²

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).

⁸¹ Paragraph (a) of the definition of "financial instrument" in section 1(1).

⁸² 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 30 – Recoupment of amounts allowed as a deduction from the income of an issuer of an instrument

Facts:

Company A's year of assessment ends on 31 March.

On 1 December 2011 Company A issued promissory notes to a note holder for R180 000. The maturity date of the contract was 30 November 2015 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 2015 the note holder waived the total amount owing under the contract because of the inability of Company A to pay the amounts owing.

Result:

2016 year of assessment

Reduction amount = Amount by which the debt is reduced /less amount applied as consideration for that reduction = R108 000 /less RNil = R108 000.

Application of section 19(5)

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 for the purposes of section 8(4)(a) by Company A. The full amount of R108 000 that was allowed as a deduction under section 24J(2) is accordingly treated as a recoupment under section 19(5) for purposes of section 8(4)(a).

Application of section 24J(4A)(b)

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 Company A's income 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) must be made.

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 asset⁸³ that was disposed of in a previous year of assessment is recovered or recouped in the current year of assessment.

⁸³ Excluding a pre-valuation date asset.

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 paragraph 12A(4) (reduction of assessed capital loss) applied to the reduction of the debt (see 4.5 and 4.6).

Example 31 – 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 2011 Company B acquired fixed property from Company A on loan account for R10 million. On 31 December 2014 Company B sold the fixed property for R12 million.

On 1 October 2015 Company A cancelled the loan of R10 million owing by Company B because of Company B's adverse financial position. Company B did not have an assessed capital loss as at 30 September 2016.

Result:

2015 year of assessment

Disposal of the asset

Company B derived a capital gain on disposal of the asset of R2 million (proceeds of R12 million less base cost of R10 million).

2016 year of assessment

Reduction of the debt

Reduction amount = Amount by which the debt is reduced less amount applied as consideration for that reduction = R10 million less RNil = R10 million.

Paragraph 12A(3) cannot be applied to reduce the base cost of the fixed property by the reduction amount 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 (see 4.10.5).

A further capital gain will not arise under paragraph 3(b)(ii) because this paragraph does not apply when the base cost of an asset was recovered or recouped 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 an 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 occurs 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 in respect 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 section 19 and paragraph 20(3)(b) apply to a reduction of debt. In this regard 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)⁸⁴ (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 19⁸⁵ (it would have if section 19(3) applied). This exclusion, therefore, ensures that the base cost of an asset must not be

⁸⁴ Paragraph 20(3)(b)(i).

⁸⁵ Paragraph 20(3)(b)(iii).

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 12A(4) and paragraph 20(3)(b) 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 32 – Disposal of an asset and the reduction of debt during the same year of assessment

Facts:

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

On 1 March 2011 Company A purchased land (not held as trading stock) from Company B on credit for R1 million.

On 31 March 2015 Company A disposed of the asset for proceeds of R1,5 million.

On 30 September 2015 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 2016 year of assessment.

Result:

2016 year of assessment

Reduction of the debt

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

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 have applied if Company A had an assessed capital loss at the end of its 2016 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.

Disposal of the 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 of R1 million 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 therefore RNil.

Company A will realise a capital gain of R1,5 million [R1,5 million (proceeds) less RNil (base cost)] at the end of the year of assessment.

Example 33 – Reduction of debt and the disposal of an asset during the same year of assessment*Facts:*

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

On 1 March 2011 Company A purchased land (not held as trading stock) from Company B on credit for R1 million.

On 31 March 2015 Company B waived the debt owed by Company A because of Company A's inability to pay for the land.

On 30 September 2015 Company A disposed of the asset for proceeds of R1,5 million.

Company A did not have an assessed capital loss for the 2016 year of assessment.

*Result:**2016 year of assessment**Reduction of the debt*

Paragraph 12A(3) applies, since the land was held by Company A at the time the debt owed to Company B was waived. The expenditure of R1 million as contemplated in paragraph 20 is therefore reduced to RNil.

The requirements of paragraph 20(3)(b) are also met. However, having applied paragraph 12A(3) as the more specific paragraph first, there is 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 the asset

The expenditure incurred by Company A in acquiring the land has been reduced under paragraph 12A(3) by R1 million to RNil. Accordingly, the base cost of the land as at the end of the year of assessment is RNil.

Company A therefore realised a capital gain of R1,5 million [R1,5 million (proceeds) less RNil (base cost)] at the end of the year of assessment.

Example 34 – Reduction of debt and the subsequent disposal of trading stock*Facts:*

Company A's year of assessment ends on 31 March.

Company A acquired trading stock at a cost of R100 000 during its 2016 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.

*Result:**2016 year of assessment**Reduction of the debt*

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

Disposal of the asset

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:

Proceeds (R120 000 – R120 000 [paragraph 35(3)(a)]) ⁸⁶	R Nil
Less: Base Cost (R100 000 – R100 000 [paragraph 20(3)(a)])	(Nil)
Capital gain	<u>Nil</u>

Note:

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.

⁸⁶ 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 35 – Capital loss incurred by a 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 do not form part of the same group of companies. Company B's year of assessment ends on 30 June.

On 1 July 2010 Company A lent Company B R2 million which Company B used to acquire land from Company C at a cost of R2 million.

On 1 July 2015 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:

2016 year of assessment

Since Company B must reduce the base cost of its land by R500 000 under paragraph 12A(3), Company A may 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 39.⁸⁷

⁸⁷ See the *Comprehensive Guide to Capital Gains Tax* (Issue 5) in paragraph 9.5 for a discussion of 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 Oeanate Investments (Pty) Ltd (In Liquidation)*⁸⁸ 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, whether it is the capital or interest that is being reduced.

It may also happen that a single item of 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. In ITC 1020⁸⁹ a loan was used for two purposes. The interest in relation to the portion of the loan used for the one purpose was deductible and the interest related to the other purpose was not deductible. The loan was repaid in fixed instalments. In determining the amount of interest that was deductible under the Act, the court approved a proportional allocation of the repayments between the two purposes and denied an allocation to the one purpose ahead of the other. Although this case dealt with the allocation of actual repayments the principles are considered to be applicable in the context of debt reduction.

Money is fungible and generally there is no justification for isolating portions of an indivisible sum which has funded the purchase of a number of different assets. It would, therefore, generally 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. Such an allocation may comprise an impermissible tax avoidance arrangement under Part IIA of the Act or a sham arrangement that should be ignored.

There may, however, be exceptional 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.⁹⁰

Example 36 – 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's year of assessment ends on 31 March.

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 were not incurred in the production of income and hence not allowed as a deduction.

⁸⁸ 1998 (1) SA 811 (SCA).

⁸⁹ (1962) 25 SATC 414 (T).

⁹⁰ The onus is on the taxpayer under section 102(1) of the TA Act.

Interest of R100 000 was incurred on the loan and 60% of this amount was allowed as a deduction under section 24J(2). The interest expense was not paid but was added (capitalised) to the outstanding loan balance.

As a result of Company E falling into financial difficulty, Company F waived R500 000 of the debt of R1,1 million during the 2016 year of assessment.

Result:

The loan reduction of R500 000 is allocated to –

- interest of R100 000 of which R60 000 was deductible and R40 000 was not;
- deductible expenditure of R240 000 [(R500 000 less R100 000 allocated to interest) × R600 000 / R1 000 000]; and
- non-deductible expenditure of R160 000 [(R500 000 less 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 R300 000 (R60 000 deductible capitalised interest and R240 000 used to fund deductible expenditure).

Reduction amount = Amount by which the debt is reduced less amount applied as consideration for that reduction = R300 000 less RNil = R300 000.

Under section 19(5) the reduction amount of the debt of R300 000 is deemed, for the purposes of section 8(4)(a), to be an amount that has been recovered or recouped during the 2016 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.⁹¹

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) provides⁹² 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 applies only if the CFCs are companies forming part of the same “group of companies” as defined in section 1(1).

4.14 Determination of the reduction amount of a debt denominated in a currency other than the currency of the Republic (section 25D) and the recoupment of foreign exchange losses [section 8(4)(a)]

The definitions of “reduction amount” in section 19(1) and paragraph 12A(1) do not indicate how the reduction amount of a debt that is denominated in a currency other than the currency of the Republic must be determined. This determination should therefore be made under section 25D. Section 25D applies to, amongst others, amounts received by or accrued to a person and the reduction amount is the amount of the benefit which the debtor has received.

The reduction amount of a debt that is denominated in a currency other than the currency of the Republic must be translated to the currency of the Republic (the rand) on the date on which the debt is reduced by applying either the spot rate or the average exchange rate under section 25D, whichever is applicable, since the taxable income of a person is determined in rand.⁹³

The reduction amount of a debt denominated in a currency other than the currency of the Republic may therefore include amounts of foreign exchange gains or losses that were included in or deducted from income under section 24I(3)(a). Foreign exchange losses claimed as a deduction under section 24I(3)(a) in one or more earlier years of

⁹¹ See *Grootvlei Proprietary Mines Ltd v CIR* 1952 (4) SA 440 (A), 18 SATC 231 at 239.

⁹² Subject to section 9D(9A) which has specific provisions dealing with an amount which is attributable to a foreign business establishment of a CFC.

⁹³ See Interpretation Note No. 63 (Issue 2) dated 12 August 2015 “Rules for the Translation of Amounts Measured in Foreign Currencies other than Exchange Differences Governed by Section 24I and The Eighth Schedule” on section 25D.

assessment upon annual translation of the outstanding debt to rand or upon realisation of the debt in the current year of assessment cannot be recouped under section 19(5), since these losses are not “expenditure” as contemplated in section 19(2) (see 4.2). These foreign exchange losses must, however, be recouped under section 8(4)(a) when the debt is reduced (see 4.10.1). Foreign exchange gains included in the income of a debtor before the reduction of debt or as a result of such reduction remain taxable.

Example 37 – Debt reduction of an amount denominated in a currency other than the currency of the Republic – Debt funding acquisition of an allowance asset

Facts:

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

On 1 April 2015 Company A purchased a second-hand machine for \$100 000 from Company B on credit. Company A claimed a capital allowance of R200 000 (20% × R1 million) under section 12C(1) for the 2016 year of assessment.

The debt was payable on 31 May 2015 but remained unpaid and was eventually waived by Company B on 31 January 2016 because of Company A’s inability to pay.

The machine was held and not disposed of by Company A on 31 January 2016.

The ruling exchange rates are as follows:

	R / \$
Date:	Spot rate
1 April 2015 (transaction date)	10,0000
31 January 2016 (realisation date)	12,0000

Result:

2016 year of assessment

Capital allowance claimed

Under section 25D(1) the expenditure incurred by Company A on acquisition of the machine is translated to rand by applying the spot rate on date of acquisition.

The cost price of the machine on date of acquisition therefore amounts to R1 million (\$100 000 × R10,0000).

Company A claimed a capital allowance of R200 000 (R1 million × 20%) under section 12C(1).

Determination of exchange difference on realisation date

The debt was realised by Company A on 31 January 2016, since it was waived by Company B on that date. The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and realisation date, as follows:

	R
Exchange difference [\$100 000 × (10,0000 – 12,0000)]	(200 000)

An exchange difference of R200 000 was determined on realisation date representing a foreign exchange loss that must be deducted from Company A's income under section 24I(3)(a).

Reduction of the debt [Application of paragraph 12A(3) and sections 8(4)(a) and 19(6)]

The reduction of the debt by Company B on 31 January 2016 results in the application of paragraph 12A(3) and sections 8(4)(a) and 19(6).

The reduction amount of a debt that is denominated in a currency other than the currency of the Republic must be translated by Company A to the currency of the Republic (the rand) on the date on which the debt is reduced by applying the spot rate under section 25D(1).

Reduction amount = Amount by which the debt is reduced less amount applied as consideration for that reduction = \$100 000 less \$Nil = \$100 000.

Therefore, reduction amount = Amount by which the debt is reduced less amount applied as consideration for that reduction = R1,2 million less RNil = R1,2 million.

On 31 January 2016 the reduction amount was therefore R1,2 million (\$100 000 × R12,0000).

The reduction amount of R1,2 million is reconciled as follows:

	R
Rand amount of debt incurred on 1 April 2015 that funded the acquisition of an allowance asset	(1 000 000)
Increase in rand value of debt owing to exchange movement	<u>(200 000)</u>
Rand amount of debt on 31 January 2016	<u>(1 200 000)</u>

Application of paragraph 12A(3)

Since R1 000 000 of the debt of R1 200 000 funded the expenditure incurred on acquisition of the machine (R1 000 000), the amount of the expenditure incurred on acquisition of the machine must for purposes of paragraph 20 (base cost) be reduced by the reduction amount relating to that expenditure, namely R1 000 000.

However, since the base cost of the machine has already been reduced by the capital allowance claimed under paragraph 20(3)(a)(i) of R200 000, it is only the remaining base cost of R800 000 that must be reduced under paragraph 12A(3). The base cost of the machine is therefore reduced to RNil (R800 000 base cost – R800 000 reduction amount).

Application of section 19(6)

Under section 19(6) the reduction amount is, to the extent to which paragraph 12A did not apply, deemed to be an amount that has been recovered or recouped for the purposes of section 8(4)(a). The amount deemed to have been recouped for purposes of section 8(4)(a) is R200 000 (R1 000 000 – R800 000). This amount is the same as the amount that was claimed as a capital allowance under section 12C(1).

Application of section 8(4)(a)

Under section 8(4)(a) the excess reduction amount of R200 000 [reduction amount of R1,2 million less R800 000 applied under paragraph 12A(3), less R200 000 applied under section 19(6)] is recouped under section 8(4)(a). In this regard the waiver of the debt triggers a recoupment under section 8(4)(a), since the foreign exchange loss of R200 000 was allowed as a deduction under section 24I(3)(a) [see 4.10.1 on the application of section 8(4)(a) when a debt is reduced].

Example 38 – Debt reduction of an amount denominated in a currency other than the currency of the Republic – Debt funding the acquisition of an allowance asset

Facts:

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

On 1 April 2015 Company A purchased a second-hand machine for \$100 000 from Company B on credit. Company A claimed a capital allowance of R200 000 (R1 million × 20%) under section 12C(1) for the 2016 year of assessment. The debt was payable on 31 May 2015 but remained unpaid and was eventually waived by Company B on 31 January 2016 because of Company A's inability to pay.

The machine was held and not disposed of by Company A on 31 January 2016.

The ruling exchange rates are as follows:

	R / \$
Date:	Spot rate
1 April 2015 (transaction date)	10,0000
31 January 2016 (realisation date)	8,0000

Result:

2016 year of assessment

Capital allowance claimed

Under section 25D(1) the expenditure incurred by Company A on acquisition of the machine is translated to rand by applying the spot rate on date of acquisition. The cost price of the machine on date of acquisition therefore amounts to R1 million (\$100 000 × R10,0000). Company A claimed a capital allowance of R200 000 (R1 million × 20%) under section 12C(1).

Determination of exchange difference on realisation date

The debt was realised by Company A on 31 January 2016, since it was waived on that date by Company B. The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and realisation date, as follows:

	R
Exchange difference [\$100 000 × (10,0000 – 8,0000)]	200 000

An exchange difference of R200 000 was determined on realisation date representing a foreign exchange gain that must be included in Company A's income under section 24I(3)(a).

Reduction of the debt [Application of paragraph 12A(3) and section 19(6)]

The reduction of the debt by Company B on 31 January 2016 resulted in the application of paragraph 12A(3) and section 19(6).

The reduction amount of a debt that is denominated in a currency other than the currency of the Republic must be translated by Company A to the currency of the Republic (the rand) on the date on which the debt is reduced by applying the spot rate under section 25D(1).

Reduction amount = Amount by which the debt is reduced *less* amount applied as consideration for that reduction = \$100 000 *less* \$Nil = \$100 000.

Therefore, reduction amount = Amount by which the debt is reduced *less* amount applied as consideration for that reduction = R800 000 *less* RNil = R800 000.

On 31 January 2016 the reduction amount was therefore R800 000 (\$100 000 × R8,0000).

The reduction amount of R800 000 is reconciled as follows:

	R
Rand amount of debt incurred on 1 April 2015 that funded the acquisition of an allowance asset	(1 000 000)
<i>Less:</i> Decrease in rand value of debt owing to exchange movement	<u>(200 000)</u>
Rand amount of debt on 31 January 2016	<u>(800 000)</u>

Reduction amount = Amount by which the debt is reduced *less* amount applied as consideration for that reduction = R800 000 *less* RNil = R800 000.

Application of paragraph 12A(3)

Since the full amount of the reduction amount of the debt (R800 000) funded the expenditure incurred on acquisition of the machine (R1 000 000), the amount of the expenditure incurred on acquisition of the machine must for purposes of paragraph 20 (base cost) be reduced by R800 000. However, since the base cost of the machine has already been reduced by the capital allowance claimed under paragraph 20(3)(a)(i) of R200 000, it is only the remaining base cost of R800 000 that must be reduced under paragraph 12A(3). The base cost of the machine is therefore reduced to RNil (R800 000 base cost – R800 000 reduction amount).

Application of section 19(6)

Section 19(6) does not apply, since the reduction amount of R800 000 has been used in full to reduce the amount of expenditure incurred on acquisition of the machine under paragraph 12A(3).

The foreign exchange gain

The foreign exchange gain of R200 000 that is included in Company A's income under section 24I(3)(a) is not impacted by the reduction amount and remains taxable.

Example 39 – Debt reduction of an amount denominated in a currency other than the currency of the Republic – Debt funding the acquisition of trading stock

Facts:

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

On 1 April 2015 Company A purchased trading stock of \$500 000 from Company B on credit. The debt was payable on 31 May 2015 but remained unpaid and was eventually waived by Company B on 31 March 2016 because of Company A's inability to pay.

The trading stock was held and not disposed of by Company A on 31 March 2016, but was sold in April 2016.

The ruling exchange rates are as follows:

Date:	R / \$ Spot rate
1 April 2015 (transaction date)	12,1000
29 February 2016 (translation date)	15,6000
31 March 2016 (realisation date)	15,1000

Result:

2016 year of assessment

Income tax treatment of trading stock

The amount of trading stock acquired of R6 050 000 ($\$500\,000 \times 12,1000$) is deductible under section 11(a). The rand amount of the expenditure is determined under section 25D(1) for Company A by multiplying the amount of the expenditure incurred by the spot rate on the date on which the expenditure was incurred.

The cost price of the trading stock of R6 050 000 is included in closing stock under section 22(1) read with section 22(3)(a)(i).⁹⁴

Determination of exchange difference on translation date:

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and translation date, as follows:

	R
Exchange difference [$\$500\,000 \times (12,1000 - 15,6000)$]	(1 750 000)

An exchange difference of R1 750 000 determined on translation date representing a foreign exchange loss is deductible from income under section 24l(3)(a).

⁹⁴ Under section 22(3)(a)(i) the cost price at any date of any trading stock in relation to any person shall exclude any exchange difference relating to the acquisition of the trading stock.

*2017 year of assessment**Income tax treatment of trading stock*

The cost price of trading stock held and not disposed of on 1 March 2016 of R 6 050 000 is included in opening stock under section 22(2) read with section 22(3)(a)(i).

Determination of exchange difference on realisation date

The debt was realised by Company A on 31 March 2016, since it was waived on that date by Company B. The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on translation date and realisation date, as follows:

	R
Exchange difference [$\$500\,000 \times (15,6000 - 15,1000)$]	250 000

An exchange difference of R250 000 determined on realisation date representing a foreign exchange gain must be included in Company A's income under section 24(3)(a).

Reduction of the debt [Application of sections 8(4)(a) and 19(3)]

The reduction of the debt by Company B on 31 March 2016 results in the application of section 19(3). The debt funded the acquisition of trading stock that was held and not disposed of at the time of the reduction of the debt.

The reduction amount of a debt that is denominated in a currency other than the currency of the Republic must be translated by Company A to the currency of the Republic (the rand) on the date on which the debt is reduced by applying the spot rate under section 25D(1).

Reduction amount = Amount by which the debt is reduced *less* amount applied as consideration for that reduction = \$500 000 *less* \$Nil = \$500 000.

Therefore, reduction amount = Amount by which the debt is reduced *less* amount applied as consideration for that reduction = R7 550 000 *less* RNil = R7 550 000.

On 31 March 2016 the reduction amount of the debt was therefore R7 550 000 ($\$500\,000 \times 15,1000$).

The reduction amount of the debt of R7 550 000 is reconciled as follows:

	R
Rand amount of debt incurred on 1 April 2015 that funded the acquisition of trading stock allowed as a deduction under section 11(a)	(6 050 000)
Increase in rand value of debt owing to exchange movement	(1 750 000)
Decrease in rand value of debt owing to exchange movement	<u>250 000</u>
Rand amount of debt on 31 March 2016	<u>(7 550 000)</u>

Application of section 19(3)

The opening balance of trading stock is reduced to RNil (R6 050 000 expenditure incurred on acquisition of the trading stock *less* R6 050 000 reduction amount) under section 19(3).

Application of section 8(4)(a)

The remaining reduction amount of R1 500 000 (R7 550 000 – R6 050 000), represents the net amount of exchange differences (foreign exchange loss of R1 750 000 less foreign exchange gain of R250 000).

Under section 8(4)(a) the foreign exchange loss of R1 750 000 must be recouped, since this amount was allowed as a deduction under section 24l(3)(a). The amount of the recoupment is, however, limited to R1 500 000 [reduction amount of R7 550 000 less R6 050 000 already applied under section 19(3)].

The foreign exchange gain

The foreign exchange gain of R250 000 that is included in Company A's income under section 24l(3)(a) is not impacted by the reduction amount and remains taxable.

4.15 Reduction amount and expenditure inclusive of VAT

Section 23C(1) provides that when applying any provision of the Act, a taxpayer that is a vendor⁹⁵ and is or was in any previous year of assessment entitled to a deduction of input tax⁹⁶ under section 16(3) of the VAT Act, must exclude the amount of that input tax from the cost or market value of an asset acquired or the amount of expenditure incurred by that taxpayer.

A taxpayer that is not a vendor must not exclude the input tax referred to above from the cost or market value of an asset acquired or the amount of expenditure incurred, since the taxpayer is not entitled to a deduction for input tax under section 16(3) of the VAT Act.

The amount of expenditure contemplated in section 19(2) or paragraph 12A(2) that was funded by a debt that is reduced must therefore be determined –

- exclusive of VAT by a debtor that is a vendor and is or was entitled to a deduction of input tax under section 16(3) of the VAT Act; and
- inclusive of VAT by a debtor that is not a vendor.

Example 40 – Reduction of a debt that funded expenditure allowed as a deduction – Reduction amount and expenditure inclusive of VAT – Debtor is a vendor*Facts:*

Company A and Company B are vendors for VAT purposes. Company A's year of assessment ends on 31 March.

⁹⁵ As defined in section 1(1) of the VAT Act.

⁹⁶ As defined in section 1(1) of the VAT Act.

Company A borrowed R114 000 from Company B and used the funds to finance operating expenses incurred on 1 February 2015 which attracted VAT at 14%. Company A was allowed a deduction under section 11(a) for operating expenses of R100 000 ($R114\,000 \times 100 / 114$). The balance of the expenditure of R14 000 was disallowed as a deduction under section 23C(1) because Company A claimed R14 000 ($R114\,000 \times 14 / 114$) as an input tax deduction under section 16(3) of the VAT Act.

As a result of Company A falling into financial difficulty, Company B waived the debt of R114 000 on 1 June 2015.

Result:

2016 year of assessment

Reduction amount = Amount by which the debt is reduced less amount applied as consideration for that reduction = R114 000 – RNil = R114 000.

The debt reduction of R114 000 funded tax-deductible expenses of R100 000 and VAT of R14 000. Under section 23C(1) the VAT component of the expenditure incurred of R114 000, namely, R14 000, was not allowed as a deduction under section 11(a), since Company A was entitled to an input tax deduction of the VAT incurred of R14 000 under section 16(3) of the VAT Act. A deduction of R100 000 was granted under section 11(a).

Although the full amount of the debt of R114 000 was waived, section 19 applies only to the portion of the debt of R100 000 that funded expenditure for which a deduction was granted under the Act.⁹⁷ The reduction amount for purposes of section 19 is therefore R100 000. Under section 19(5) R100 000 is deemed, for the purposes of section 8(4)(a), to be an amount that has been recovered or recouped during Company A's 2016 year of assessment.

Example 41 – Reduction of a debt that funded expenditure allowed as a deduction – Reduction amount and expenditure inclusive of VAT – Debtor not a vendor

Facts:

Company A is not a vendor for VAT purposes, but Company B is a vendor. Company A's year of assessment ends on 31 March.

Company A borrowed R114 000 from Company B and used the funds to finance operating expenses inclusive of VAT which were incurred on 1 February 2015 and allowed as a deduction under section 11(a).

Company A did not claim an input tax deduction under section 16(3) of the VAT Act and was therefore entitled to claim the amount of R114 000 (inclusive of VAT) as a deduction under section 11(a).

As a result of Company A falling into financial difficulty, Company B waived the debt of R114 000 on 1 June 2015.

⁹⁷ Section 19(2).

Result:**2016 year of assessment**

Reduction amount = Amount by which the debt is reduced /less amount applied as consideration for that reduction = R114 000 – RNil = R114 000.

The debt reduction of R114 000 funded tax-deductible expenses of R114 000.

Under section 19(5) an amount of R114 000 is deemed, for the purposes of section 8(4)(a), to be an amount that has been recovered or recouped during Company A's 2016 year of assessment.

5. Conclusion

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

The new ordering rules apply to trading stock, other deductible expenditure, allowance assets and capital assets financed by debt that 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 under section 22(2) as well as any closing stock under section 22(1) is reduced by the reduction amount of a debt under section 19(3). Any excess reduction amount is treated under section 19(4) 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 reduction amount of a debt is deemed to be a recoupment under section 19(5) for the purposes of section 8(4)(a) to the extent that the expenditure that was funded by the debt was allowed as a deduction.
- *Allowance assets* – The reduction amount of a debt first reduces any base cost expenditure under paragraph 12A(3) after which any excess is deemed to be a recoupment under section 19(6) 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, under section 19(7).
- *Capital assets that are not allowance assets* – The base cost of the asset is reduced by the reduction amount of the debt under paragraph 12A(3). Any excess reduction amount reduces an assessed capital loss under paragraph 12A(4).

A special rule applies to debt that financed the acquisition of a pre-valuation date asset. The effect of the rule in paragraph 12A(5) 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 [section 19(8) and paragraph 12A(6)(a), (b) and (c)]. Paragraph 12A(6)(d) and (e) contain 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.

The reduction amount of a debt that is denominated in a currency other than the currency of the Republic must be translated to the currency of the Republic (the rand) on the date on which the debt is reduced by applying the applicable exchange rate under section 25D.

A foreign exchange loss may have been claimed as a deduction under section 24I(3)(a) in one or more earlier years of assessment upon annual translation of the outstanding debt to rand or upon realisation of the debt in the current year of assessment. These losses must be recouped under section 8(4)(a) when the debt is reduced (see **4.10.1**). Foreign exchange gains included in the income of a debtor before the reduction of debt or as a result of such reduction remain taxable.

The amount of expenditure contemplated in section 19(2) or paragraph 12A(2) that was funded by a debt that is reduced must be determined –

- exclusive of VAT for a debtor that is a vendor and that is or was entitled to a deduction of input tax under section 16(3) of the VAT Act; and
- inclusive of VAT for a debtor that is not a vendor.

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 equity share held for a period of at least three years is disposed of by the taxpayer be included in the taxpayer's income any expenditure or losses incurred in respect of such equity 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 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 23C(1)

23C. Reduction of cost or market value of certain assets.—(1) Where for the purposes of applying any provision of this Act regard is to be had to the cost to the taxpayer or the market value of any asset acquired by him or to the amount of any expenditure incurred by him, and—

- (a) the taxpayer is a vendor as defined in section 1 of the Value-Added Tax Act; and
- (b) the taxpayer is or was in any previous year of assessment entitled under section 16(3) of the last-mentioned Act to a deduction of input tax as defined in section 1 of that Act,

the amount of such input tax shall be excluded from the cost or the market value of such asset or the amount of such expenditure: Provided that in the case of any lease as contemplated in paragraph (b) of the definition of “instalment credit agreement” in section 1 of that Act, there shall be excluded by the lessee from each rental payment made by him in respect of such lease, an amount which bears to such input tax the same ratio as such rental payment bears to the sum of all rental payments in connection with such lease.

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, other than a disposal contemplated in subparagraph (c), is equal to—
- (i) ...
 - (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
 - (iii) ...

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 respect 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;
- (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

Paragraph 56(1) and paragraph 56(2)(a) and (c)

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