DRAFT

South African Revenue Service

DRAFT INTERPRETATION NOTE: 91 (ISSUE 2)

DATE:

ACT : INCOME TAX ACT 58 OF 1962

SECTION : SECTION 19 AND PARAGRAPH 12A OF THE EIGHTH SCHEDULE

SUBJECT : CONCESSION OR COMPROMISE OF A 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 71 of 2008;
- **"Estate Duty Act"** means the Estate Duty Act 45 of 1955;
- **"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 28 of 2011;
- **"the Act"** means the Income Tax Act 58 of 1962;
- **"VAT"** means Value-Added Tax;
- **"VAT Act"** means the Value-Added Tax Act 89 of 1991;
- **"year 1"**, **"year 2"** etc in any of the examples means the respective calendar year; 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.** Unless indicated otherwise, the latest issues of these documents should be consulted.

All amounts in examples exclude VAT except for those identified in **4.17**.

1. Purpose

This Note provides guidance on the interpretation and application of section 19 and paragraph 12A which deal with the concession or compromise of debt in respect of years of assessment commencing on or after 1 January 2018.

The information in this Note is based on the income tax and tax administration legislation (as amended) as at the time of publishing and includes the following:

- The Taxation Laws Amendment Act 34 of 2019 which was promulgated on 15 January 2020 (as per *Government Gazette* 42951).
- The Tax Administration Laws Amendment Act 33 of 2019 which was promulgated on 15 January 2020 (as per *Government Gazette* 42952).
- The Rates and Monetary Amounts and Amendment of Revenue Laws Act 32 of 2019 which was promulgated on 15 January 2020 (as per *Government Gazette* 42950).

Issue 1 of this Note should be consulted for a comprehensive discussion of the debt reduction provisions applicable for years of assessment commencing before 1 January 2018.

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.

Before 1 January 2013 various taxes were imposed upon persons receiving the benefit of debt relief that may have effectively undermined the economic benefit of the relief. A 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.

The new rules aim to ensure that debt relief is subject to only one of the following taxes:

- Estate duty[2] (see **4.11.1**)
- Donations tax (see **4.11.2**)
- Income tax on a fringe benefit received by an employee (see **4.11.3**)
- Income tax on income
- CGT

Section 19 and paragraph 12A were subsequently amended by the 2017, 2018 and 2019 Taxation Laws Amendment Acts.[3]

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

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

3 Acts 17 of 2017, 23 of 2018 and 34 of 2019.

Section 19 and paragraph 12A were substituted by sections 32 and 70 of the Taxation Laws Amendment Act 17 of 2017. Further amendments were made by sections 36 and 77 of the Taxation Laws Amendment Act 23 of 2018 most of which, barring two mentioned below, were backdated to 1 January 2018. These backdated amendments were largely aimed at lessening the impact of the debt relief rules which could have had harsh consequences, for example, as a result of the terms of a loan being changed.

Further amendments to section 19(8)(*b*) and paragraph 12A(4) and (6)(*b*) and the introduction of section 19(6A) by the Taxation Laws Amendment Act 23 of 2018 came into effect for years of assessment commencing on or after 1 January 2019.[4] The introduction of section 19(6A) and the amendments to paragraph 12A(4) deal with a debt benefit that arises in a year of assessment subsequent to that in which the asset was disposed of. Previously the only consequence for a debtor under the latter circumstances was a reduction in an assessed capital loss. However, with effect from years of assessment commencing on or after 1 January 2019, a recoupment or capital gain may occur in the year of assessment in which the debt benefit arises. The amendments to section 19(8)(*b*) and paragraph 12A(6)(*b*) deal with the exclusion of a debt benefit arising by donation which now applies only in respect of the portion of the donation on which donations tax is payable. Section 19 or paragraph 12A will therefore apply *to the extent* that the debt benefit arises by means of a donation which qualifies for exemption from donations tax under, for example, the annual donations tax exemption of R100 000.[5]

Section 54 of the Taxation Laws Amendment Act 34 of 2019 deleted two obsolete definitions (allowance asset and capital asset) from paragraph 12A(1).

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 [section 19(1)]

An "allowance asset" for purposes of section 19 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.

Section 19(6), (6A) and (7) and paragraph 12A(3), (4) and (5) contain the rules that apply when a debt benefit arises in respect of a debt owed by a person and the amount of that debt was owed in respect of or used to fund expenditure incurred in respect of an allowance asset (see **4.5**, **4.6**, **4.7** and **4.10**).

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4 Sections 36(1)(*j*), 77(1)(*g*), 77(1)(*h*) and 36(1)(*i*) of the Taxation Laws Amendment Act 23 of 2018.

5 Section 56(2)(*b*).

4.1.2 Capital asset [section 19(1)]

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

The definition of "asset" in paragraph 1 includes –

> "(*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 Concession or compromise

"Concession or compromise" is widely defined and is fundamental to the application of section 19 and paragraph 12A. This definition is divided into two paragraphs and contemplates five possible forms of concession or compromise. Paragraph (*a*) applies to all persons while paragraph (*b*) applies only to a debtor company when the settlement of the debt is done through a so-called "debt-capitalisation".

Under paragraph (*a*) of the definition, a "concession or compromise" means any arrangement under which a debt is –

- cancelled or waived; or
- extinguished by –
  - redemption of the claim in respect of that debt by the person owing that debt or by any person that is a connected person in relation to that person; or
  - merger by reason of the acquisition by the person owing that debt of the claim in respect of that debt,

otherwise than as a result of or by reason of the implementation of an arrangement described in paragraph (*b*) of the definition.

Under paragraph (*b*) of the definition, "concession or compromise" means any arrangement under which a debt owed by a company is settled, directly or indirectly –

- by being converted to or exchanged for shares in that company; or
- by applying the proceeds from shares issued by that company.

Not every "concession or compromise" will result in the application of section 19 or paragraph 12A. Section 19 or paragraph 12A will have no practical effect if, for example, no debt benefit is determined.

(a) Debt cancelled or waived (paragraph (a)(i) of the definition of "concession or compromise")

Cancellation of a debt

The cancellation of a debt or part thereof constitutes a concession or compromise of the debt under paragraph (*a*)(*i*) of the definition of "concession or compromise".

Lexico.com defines "cancel" as follows:[6]

> "1.2 Abolish or make void (a financial obligation)
>
> I intend to cancel your debt to me."

A debt that is rendered void with no legal force or validity through, for example, prescription or insolvency falls within the ambit of "cancellation of a debt".

There is some debate regarding whether a debt discharged or extinguished through set-off (*compensatio*) falls within the ambit of "cancellation of a debt" or whether it constitutes a redemption of the claim in respect of the debt by the debtor as envisaged under paragraph (*a*)(ii)(*aa*) of the definition of "concession or compromise" [see **4.1.3(b)**].

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 –[7]

> "extinction *pro tanto*[8] 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*[9] and *ipso jure*,[10] 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.

LAWSA describes set-off as meaning that one debt is cancelled by another and essentially agrees with that stated in *Wille*.[11] Arguably therefore a debt settled through set-off falls under paragraph (*a*)(i) of the definition of "concession or compromise". However, in the context of section 19 and paragraph 12A, because set-off is equivalent to payment, set-off will be regarded as falling under paragraph (a)(ii)(*aa*) of the definition of "concession or compromise", unless it falls under paragraph (*b*) of the definition. When calculating the debt benefit [see **4.1.5(b)**] in this instance the debt asset which is set-off against the debt owing will be taken into account as expenditure incurred in redemption of the debt.

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6 **www.lexico.com/en/definition/cancel** [Accessed 7 December 2020].

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

8 For so much; for as much as one is able; as far as it can go.

9 By the fact itself.

10 By the act of the law itself, or by mere operation of law.

11 See also LTC Harms "Termination of Obligations – Set-off" 19 (Second Edition Replacement) *LAWSA* [online] (My LexisNexis: 29 February 2006) in paragraphs 244 - 246.

Waiver of a debt

The waiver of a debt constitutes a concession or compromise under paragraph (*a*)(*i*) of the definition of "concession or compromise".

Waiver is a form of contract in which one party deliberately surrenders that party's rights. There is a presumption against waiver and the burden of proof, which is not easily discharged, is on the party asserting it. The intention to waive must be communicated to the debtor and until then the creditor may change his or her mind.

In *Alfred McAlpine & Son (Pty) Ltd v Transvaal Provincial Administration*[12] 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*[13] 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 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 the respondent 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).

The impairment of a debt in the creditor's books of account or the claiming of a doubtful debt allowance for income tax purposes would thus not generally constitute a concession or compromise for purposes of section 19 and paragraph 12A since the debt has not unequivocally been waived.

(b) Debt extinguished by redemption of the claim in respect of the debt (paragraph (*a*)(ii)(*aa*) of the definition of "concession or compromise")

The extinguishment of a debt by redemption of the claim in respect of that debt by the person owing that debt or by any person that is a connected person in relation to that person, otherwise than as a result of or by reason of the implementation of an arrangement described in paragraph (*b*) of the definition of "concession or compromise" [see **4.1.3(d)** and **4.1.3(e)**]**,** is a concession or compromise**.**

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12 [1977] 4 All SA 262 (T), 1977 (4) SA 310 at 323 and 324.

13 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.

Lexico.com[14] defines "redemption" as follows:

> "2 The action of regaining or gaining possession of something in exchange for payment, or clearing a debt."

The redemption of a debt as envisaged in paragraph (*a*)(*ii*)(*aa*) of the definition of "concession or compromise" is very wide. A debt owed by a debtor to a creditor is a contractual obligation and one of the most common methods of discharging that obligation is through payment in cash or kind. A redemption by the person owing the debt includes settlement by the debtor and settlement by someone else on instruction of the debtor.

In the context of section 19 and paragraph 12A, because set-off is equivalent to payment, set-off will be regarded as falling under paragraph (a)(*ii*)(*aa*) of the definition of "concession or compromise", unless it falls under paragraph (*b*) of the definition [see **4.1.3(a)**].

Repayment of a debt in full by the debtor, or a connected person in relation to the debtor, results in the debt being extinguished through redemption, thereby constituting a "concession or compromise" under paragraph (*a*)(ii)(*aa*) of the definition of that term. However, as noted above not every concession or compromise will result in the application of the section 19 or paragraph 12A (see **4.2**). The facts of the specific case must be considered.

(c) Debt extinguished by merger (paragraph (a)(*ii*)(bb) of the definition of "concession or compromise")

The extinguishment of a debt by merger by reason of the debtor acquiring the claim to the debt, otherwise than as a result of or by reason of the implementation of an arrangement described in paragraph (*b*) of the definition of "concession or compromise" [see **4.1.3(d)** and **4.1.3(e)**]**,** is a concession or compromise**.**

A debt will generally be extinguished by merger (confusio) if the debtor acquires the debt from the creditor. Merger or confusio is the union in the same person of the characters of creditor and debtor in respect of the same debt. The leading case dealing with confusio is Grootchwaing Salt Works Ltd v Van Tonder in which Innes CJ stated the following:[15]

> "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

[14] **www.lexico.com/definition/redemption** [Accessed 7 December 2020].

[15] 1920 AD 492 at 497.

> 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."

Examples of how merger may occur include the purchase on the open market of a listed debenture by the issuer, the distribution by a trust to a beneficiary of an amount owed by the beneficiary, or the distribution *in specie* by a subsidiary to its holding company of a debt owed by the holding company.

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 or extinction 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 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 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.[16] 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 "extinguished" for purposes of section 19 and 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 "extinguished" 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 extinguished by merger under section 59 of the Bills of Exchange Act.

(d) Debt owed by a company is settled, directly or indirectly, by conversion to or in exchange for shares issued by that company (paragraph (*b*)(i) of the definition of "concession or compromise")

A company may, for example, settle its debt by –

- issuing shares directly to a creditor in full and final settlement of the debt; or
- converting debt to shares in fulfilment of the conversion rights attaching to the debt (such as convertible debentures).

The settlement of a debt by the issue or conversion of shares, as listed above, constitutes a concession or compromise under paragraph (*b*)(i) of the definition of that term.

16 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.

(e) Debt owed by a company is settled, directly or indirectly, by applying the proceeds from shares issued by that company (paragraph (b)(*ii*) of the definition of "concession or compromise")

A company may, for example, settle its debt by –

- 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; or
- issuing shares to the creditor in exchange for cash and then applying the cash against the debt owed by the company.

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

As stated in **4.1.3(a)** and **4.1.3(b),** debt may be discharged or extinguished through set-off. A debt discharged through set-off will generally fall under paragraph (*a*)(ii)(aa) of the definition of "concession or compromise". However, if the set-off relates to the settlement of a debt owed by a company which is directly or indirectly settled by applying proceeds from a share issue, the set-off falls under paragraph (*b*)(ii) of the definition. This is important as it has an impact of the determination of the possible debt benefit (see below).

Set-off in the context of a share issue 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).[17]

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.

4.1.4 Debt

"Debt" means any amount that is owed by a person in respect of –

- expenditure incurred by that person (paragraph (*a*) of the definition); or
- a loan, advance or credit that was used, directly or indirectly, to fund any expenditure incurred by that person (paragraph (*b*) of the definition).

The definition of "debt" excludes a "tax debt" as defined in section 1 of the TA Act.

Paragraph (*a*) of the definition of "debt" refers to a situation where, for example, an asset is acquired on credit from a supplier.

Paragraph (*b*) of the definition of "debt" would apply, for example, if a person borrowed money from a bank and used those funds to purchase an asset from a supplier.

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

In *CIR v Datakor Engineering (Pty) Ltd*[18] 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 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 definition of "tax debt" in section 1 of the TA Act is –

> "an amount referred to in section 169(1);".

Section 169(1) of the TA Act provides that an amount of tax due or payable under 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 circumstances[19] a tax debt owed by a person can be permanently reduced by SARS because of a business rescue plan, the liquidation of a company, insolvency of a person, prescription or a compromise.

4.1.5 Debt benefit

The debt benefit in respect of a debt owed by a person to another person is determined, based on the type of arrangement contemplated in the definition of "concession or compromise" in section 19(1) and paragraph 12A(1).

(a) Debt benefit in respect of a debt cancelled or waived (paragraph (a) of the definition of "debt benefit")

The debt benefit in respect of a debt that is cancelled or waived, is the amount cancelled or waived.

Example 1 – Debt benefit – Debt waived

Facts:

Company X lent Company Y R100 000 at an interest rate of 10% a year, repayable in five years' time. As a result of cash-flow difficulties experienced by Company Y, Company X agreed to waive R30 000 of the loan.

Result:

Debt benefit

Debt benefit = Amount waived = R30 000.

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18 1998 (4) SA 1050 (SCA), 60 SATC 503.

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

(b) Debt benefit in respect of the extinction of a debt by redemption of the claim in respect of the debt or merger by reason of the acquisition of the claim in respect of the debt (paragraph (*b*) of the definition of "debt benefit")

The debt benefit in the case of the extinction of a debt by means of the redemption of the claim or merger as envisaged in paragraph (*b*) of this definition is the amount by which the face value of the claim in respect of that debt held by the person to whom the debt is owed prior to the entering into that arrangement exceeds the expenditure incurred in respect of –

- the redemption of that debt; or
- the acquisition of the claim in respect of that debt.

Expenditure incurred in respect of redemption or the acquisition of the claim in respect of the debt

Paragraph (*b*) of the definition of "debt benefit" provides that "expenditure incurred" must be taken into account in determining the amount of a debt benefit in respect of the extinction of a debt.

In *C: SARS v Labat Africa Ltd* Harms AP stated the following on the meaning of "expenditure":[20]

> "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."

The use of the word "expenditure" requires that the debtor give up cash or assets in extinguishing the debt. Expenditure incurred in respect of the extinction of a debt could therefore be in the form of money or a form other than money, for example, a motor vehicle, the right of use of an asset, the right to or in an asset or the right to claim payment of a claim owing to the debtor.[21]

The principles established in the *Brummeria* case[22] 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 and not a subjective test. The "value in money" of consideration in a form other than money refers

[20] 2013 (2) SA 33 (SCA), 74 SATC 1 at 6.

[21] Depending on the facts, in addition to considering the potential income tax and CGT consequences of debt relief, the debtor may need to consider the income tax and CGT consequences of the disposal of the asset for purposes of redemption of the debt. This Note does not deal with the income tax and CGT consequences of the disposal of an asset by the debtor in these circumstances.

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

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.

Expenditure incurred in respect of the redemption of the debt may be incurred directly, for example, when the payment comes from the debtor's bank account, or indirectly, when a connected person pays the creditor on the debtor's behalf and the debtor must reimburse the connected person. Although the legislation does not stipulate in words that the expenditure must be directly or indirectly incurred by the debtor, from the context and purpose of the legislation it is apparent that one must consider the extent to which the debtor is impoverished in this regard and therefore the expenditure must have been incurred by the debtor.

Example 2 – Debt benefit – Debt extinguished by redemption

Facts:

Individual A owes R100 000 to Company B in respect of trading stock purchased. At the end of the year of assessment, Individual A pays the full amount owing to Company B in cash.

Result:

Debt benefit

Debt benefit = Face value of the claim in respect of the debt *less* expenditure incurred by individual A in respect of redemption of the debt:

= R100 000 − R100 000

= RNil

Example 3 – Debt benefit – Debt extinguished by redemption

Facts:

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

Year of assessment ending on 28 February year 2

On 1 March year 1 Company A issued 100 debentures at face value of R100 000 each. The debentures were redeemable at the option of Company A after five years based on their market value at the time of redemption.

Year of assessment ending on 28 February year 8

On 30 April year 7 Company A redeemed one of the debentures at its market value of R90 000. The market value of the debentures had fallen as a result of an increase in prevailing interest rates.

Result:

Year of assessment ending on 28 February year 8

Debt benefit

Debt benefit = Face value of the claim in respect of the debt *less* expenditure incurred by Company A in respect of redemption of the debt:

= R100 000 − R90 000 (expenditure incurred by Company A to redeem the debenture at current market value)

= R10 000

Example 4 – Debt benefit – Debt extinguished by redemption

Facts:

Company A and Company B are connected persons in relation to each other. 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, but Company A paid R500 000 on Company B's behalf with the result that Company B now owes Company A R500 000.

Result:

Debt benefit

Debt benefit = Face value of the claim in respect of the debt *less* expenditure incurred by Company B in respect of redemption of the debt:

= R500 000 – R500 000

= RNil

Example 5 – Debt benefit – Debt extinguished by redemption

Facts:

Company A and Company B are not connected persons in relation to each other. Company B owed Company C R500 000 for trading stock purchased in the previous year of assessment.

Since Company B did not have the cash available to pay Company C, it requested Company A to pay R500 000 to Company C on its behalf and in return it would repay Company A in the future. Company B now owes Company A R500 000.

Result:

Debt benefit

Debt benefit = Face value of the claim in respect of the debt *less* expenditure incurred by Company B in respect of redemption of the debt:

= R500 000 − R500 000

= RNil

Example 6 – Debt benefit – Debt extinguished by redemption

Facts:

Company A and Company B are connected persons in relation to each other. 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, but 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:

Debt benefit

Debt benefit = Face value of the claim in respect of the debt *less* expenditure incurred by Company B in respect of redemption of the debt:

= R500 000 − Rnil

= R500 000

Example 7 – Debt benefit – Debt extinguished by *set-off* (redemption of the claim)

Facts:

Individual X and Company A's years of assessment end on the last day of February.

Year of assessment ending on 28 February year 2

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

Result:

Year of assessment ending on 28 February year 2

The four conditions for set-off are met on 31 May year 1 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 year 1; 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 year 1 Individual X's debt of R100 000 owing to Company A is extinguished by set-off and Company A's debt *to the extent* of R100 000 owing to Individual X is extinguished by set-off. The balance of Company A's debt of R150 000 (R250 000 debt − R100 000 discharged) owing to Individual X remains due and payable.

Debt benefit – Company A

Debt benefit = Face value of the claim in respect of the debt extinguished *less* expenditure incurred in respect of redemption of the debt:

= R100 000 − R100 000 = RNil.

Debt benefit – Individual X

Debt benefit = Face value of the claim in respect of the debt extinguished *less* expenditure incurred in respect of redemption of the debt:

= R100 000 − R100 000

= RNil

Example 8 – Debt benefit – Debt waived and extinguished by redemption

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.

Result:

Debt benefit

Individual X incurred expenditure of R80 000 in respect of the redemption of the debt. Since the expenditure was in a form other than money, its value in money, namely, market value, had to be determined. The amount of the expenditure incurred was therefore equal to the market value of the car, namely, R80 000.

Debt benefit in respect of the debt that was extinguished by settlement = Face value of the claim in respect of the debt *less* expenditure incurred in respect of the redemption of the debt:

= R100 000 − R80 000

= R20 000

Example 9 – Debt benefit – Debt extinguised 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 market value of the debt owed by Company A to Company B is R200 000.

Company B distributed the debt to Company A as a dividend *in specie.*

Result:

Debt benefit

The debt owed by Company A has been extinguished by *confusio,* since Company A cannot be debtor and creditor in respect of the same amount. The expenditure incurred in respect of the acquisition of the claim in respect of the debt is the market value of the right to the dividend *in specie* of R200 000.

Debt benefit = Face value of the claim in respect of the debt *less* expenditure incurred in respect of the acquisition of the claim in respect of the debt:

= R1 million − R200 000

= R800 000

Example 10 – Debt benefit – Debt extinguised by merger (*confusio)*

Facts:

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

Year of assessment ending on 28 February year 2

On 1 April year 1 Company X issued 1 000 debentures on the Johannesburg Stock Exchange at an issue price of R10 000 each.

Year of assessment ending on 28 February year 5

On 30 April year 4 Company X purchased 100 of those debentures on the open market when the listed price was R8 000 each owing to an increase in prevailing interest rates.

Result:

Year of assessment ending on 28 February year 5

Debt benefit

Upon acquisition of the debentures on 30 April year 4 the debt owing by Company X will be extinguished by merger because Company X cannot be both debtor and creditor in respect of the same debentures.

Debt benefit = Face value of the claim in respect of the debt *less* expenditure incurred in respect of the acquisition of the claim in respect of the debt:

= R1 million (100 × R10 000) − R800 000 (100 × R8 000)

= R200 000

Example 11 – Debt benefit – Debt extinguised by merger (*confusio)*

Facts:

Trust A is a discretionary trust which has several beneficiaries. Over the years the trust had advanced R100 000 to Beneficiary X on loan account. Beneficiary X was in a dire financial position and the trustees estimated that no more than R10 000 of the loan was recoverable. They accordingly resolved to distribute the loan to Beneficiary X out of the trust capital.

Result:

Debt Benefit

Debt benefit = Face value of the claim in respect of the debt *less* expenditure incurred in respect of the acquisition of the claim in respect of the debt:

= R100 000 − R10 000

= R90 000

Note:

Expenditure incurred in respect of the acquisition of the claim in respect of the debt is the market value of the right to the distribution of R10 000.

(c) Debt benefit in respect of settlement of debt by being converted or exchanged for shares or by applying the proceeds from shares issued (paragraphs (*c*) and (*d*) of the definition of "debt benefit")

The calculation of a debt benefit in the case of the settlement of debt by being converted or exchanged for shares or by applying the proceeds from shares issued[23] depends on whether the person who acquired shares in a company under a concession or compromise held an effective interest (see below) in the shares of that company prior to the entering into of that arrangement.

"Debt benefit" means –

- if that person did not hold an effective interest in the shares of that company prior to entering into the concession or compromise, the amount by which –
    - ➢ the face value of the claim held in respect of that debt prior to the entering into the concession or compromise, exceeds
    - ➢ the market value of the shares acquired by reason or as a result of the implementation of that arrangement (paragraph (*c*) of the definition of "debt benefit"); or
- if that person held an effective interest in the shares of that company prior to entering into the concession or compromise, the amount by which –
    - ➢ the face value of the claim held in respect of that debt prior to the entering into of that arrangement, exceeds
    - ➢ the amount by which the market value of any effective interest held by that person in the shares of that company immediately after the implementation of that arrangement exceeds, solely as a result of the implementation of that arrangement, the market value of the effective

[23] That is, an arrangement described in paragraph (*b*) of the definition of "concession or compromise".

interest held by that person in the shares of that company immediately prior to the entering into of that arrangement (paragraph (*d*) the definition of "debt benefit").

The "face value of the claim" referred to above is not necessarily the whole debt but only that part that is subject to the concession or compromise, namely, the part that is converted or exchanged for shares or settled by applying the proceeds from shares issued. The principle is that only *to the extent* that the creditor does not derive value from the share issue in comparison to the face value of the debt that is settled, will there be a debt benefit to the debtor company.

Even though a debt benefit may arise under paragraph (*c*) or (*d*) of the definition of "debt benefit", section 19 and paragraph 12A contain exclusions which, if applicable, provide that the section or paragraph do not apply to a debt benefit. Therefore, while a debt benefit may arise when debt is settled by being converted or exchanged for shares or by applying the proceeds from shares issued, it will not have a practical effect –

- *to the extent* the debt does not consist of interest [see **4.11.7** dealing with the exclusion in section 19(8)(*f*) and paragraph 12A(6)(*g*)]; or
- if the debtor and creditor are part of the same "group of companies" as defined in section 41(1) (see **4.1.7**) and specific requirements are met [see **4.11.6** dealing with the exclusion in section 19(8)(*e*) and paragraph 12A(6)(*f*)].

Meaning of "effective interest" in shares

Paragraphs (*c*) and (*d*) of the definition of "debt benefit" refer to the creditor holding or not holding an effective interest in the debtor company. An effective interest refers to direct and indirect interests in the shares of a company. For example, A holds 60% of the shares in B and B holds 40% of the shares in C. A's 60% direct interest in the shares of B means A has an effective interest of 60% in B and B's 40% direct interest in the shares of C means B has an effective interest of 40% in C. A's indirect interest in the shares of C through its holding of shares in B means A also has an indirect effective interest of 24% (60% × 40%) in C. If A also holds 5% of the shares in C directly, A's effective interest in C would be 29% (24% + 5%).

The settlement of a debt by issuing shares can cause an increase in the market value of the shares in another company that holds shares in the debtor company. For example, this situation could occur when the creditor (A) holds shares in a company (B) that holds shares in the debtor company (C). In this scenario, the settlement of debt by the issuing of shares by C to A may result in an increase in the market value of the effective interest of the creditor (A) in the shares of the debtor company (C). See also **Example 15**.

Market value

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 is considered by the board to be "adequate" does not require that the subscription price be equal to the market value of the shares. There could be a difference between "adequate consideration" and "market value".

The appropriate method for determining the market value of the shares will depend on the facts of the particular case.

Example 12 – Debt benefit – Debt settled by issue of shares by debtor company – Creditor not holding an effective interest in the shares of the debtor company prior to the concession or compromise

Facts:

Individual A is the sole holder of shares in Company B, holding 100 000 shares which were acquired on formation of the company at a subscription price of R100 000. Individual B lent R1 million to Company B interest free some years ago. It was agreed to recapitalise Company B by issuing 200 000 shares to Individual B in partial discharge of R200 000 of the loan. The balance sheet of Company B before and after the arrangement appeared as follows:

	Before	After
	R	R
Share capital	100 000	300 000
Accumulated losses	(200 000)	(200 000)
	(100 000)	100 000
Land at cost (same as market value)	1 000 000	1 000 000
Less: Current liabilities	(100 000)	(100 000)
Less: Loan – Individual B	(1 000 000)	(800 000)
	(100 000)	100 000

Assume that the appropriate method for determining the market value of the shares is the "net asset value" basis. The market value of the land at the time the debt benefit arose was equal to its cost price.

Result:

Debt benefit

The market value of Individual B's shares after the arrangement is R66 667 [R100 000 × (200 000 / 300 000)].

Debt benefit = Face value of the claim in respect of the debt subject to the concession or compromise prior to entering into the arrangement *less* the market value of the shares acquired:

= R200 000 − R66 667

= R133 333

Note:

The debt benefit is not subject to section 19 or paragraph 12A because of the exclusion in section 19(8)(*f*) and paragraph 12A(6)(*g*) (see **4.11.7**).

Example 13 – Debt benefit – Debt settled by issue of shares by debtor company – Creditor holding an effective interest in the shares of the debtor company prior to the concession or compromise

Facts:

Company B's year of assessment ends on 31 December.

Year of assessment ending on 31 December year 1

Individual A holds 100% of the equity shares in Company B. Company B purchased land from Individual A interest free on loan account for R1 million on 1 March year 1.

Year of assessment ending on 31 December year 3

On 30 April year 3 Company B and Individual A agreed that Company B could settle R200 000 of the loan, which still stood at R1 million, through the issue of equity shares of R200 000 to Individual A.

The balance sheet of Company B appeared as follows before and after the issue of the new shares:

	Before R	After R
Share capital	100 000	300 000
Accumulated losses	(200 000)	(200 000)
	(100 000)	100 000
Land at cost (same as market value)	1 000 000	1 000 000
Less: Current liabilities	(100 000)	(100 000)
Less: Loan – Individual A	(1 000 000)	(800 000)
	(100 000)	100 000

Assume the appropriate method for determining the market value of the shares is the "net asset value" basis and that the market value of Individual A's shares in Company B prior to the issue of the shares was RNil. The market value of the land at the time the debt benefit arose was equal to its cost price.

Result:

Year of assessment ending on 31 December year 3

Debt benefit

The market value of Individual A's shares in Company B prior to the issue of the shares in settlement of R200 000 of the debt was RNil and after the arrangement was R100 000.

Debt benefit = Face value of the claim in respect of the debt subject to the concession or compromise before entering into the arrangement *less* the difference between the market value of all Individual A's shares after and prior to the arrangement:

= R200 000 − R100 000 (R100 000 − RNil)

= R100 000

Note:

The debt benefit is not subject to section 19 or paragraph 12A because of the exclusion in section 19(8)(*f*) and paragraph 12A(6)(*g*) (see **4.11.7**).

Example 14 – Debt benefit – Debt settled by issue of shares by debtor company – Creditor holding an effective interest in the shares of the debtor company prior to the concession or compromise

Facts:

Company B's year of assessment ends on 31 December.

Year of assessment ending on 31 December year 1

Individual A holds 10% of the equity shares in Company B. Individual A also holds 100% of the equity shares in Company C which holds the remaining 90% of the equity shares in Company B. Company B purchased land from Individual A on an interest-free loan account for R50 000 on 1 March year 1.

Year of assessment ending on 31 December year 5

On 30 April year 5 Company B and Individual A agreed that Company B could settle R20 000 of the loan, which still stood at R50 000, through the issue of 20 000 equity shares of R20 000.

The balance sheet of Company B appeared as follows before and after the issue of the new shares:

	Before	After
	R	R
Share capital	100 000	120 000
Accumulated losses	(20 000)	(20 000)
	80 000	100 000
Land at cost (same as market value)	50 000	50 000
Other assets	80 000	80 000
Less: Loan – Individual A	(50 000)	(30 000)
	80 000	100 000

Assume the appropriate method for determining the market value of the shares are valued on the "net asset value" basis. The market value of the land at the time the debt benefit arose was equal to its cost price.

Result:

Year of assessment ending on 31 December year 5

Debt benefit

Prior to the arrangement Individual A held 10% of the shares in Company B directly. Individual A also had an indirect interest of 90% (100% × 90%) in Company B through Company C. Therefore, Individual A's effective interest in Company B was 100% (10% + 90%).

The market value of a 100% effective interest in Company B prior to the arrangement was R80 000 and after the arrangement was R100 000.

Debt benefit = Face value of the claim in respect of the debt subject to the concession or compromise before entering into the arrangement *less* the difference between the market value of Individual A's effective interest after and before the arrangement:

= R20 000 − R20 000 (R100 000 − R80 000)

= RNil

Note:

If there had been a debt benefit it would not have been subject to section 19 or paragraph 12A because of the exclusion in section 19(8)(*f*) and paragraph 12A(6)(*g*) (see **4.11.7**).

Example 15 – Debt benefit – Debt settled by issue of shares by debtor company – Creditor holding an effective interest in the shares of the debtor company prior to the concession or compromise

Facts:

Company B's year of assessment ends on 31 December.

Year of assessment ending on 31 December year 1

Individual A holds 10% of the equity shares in Company B. Individual A also holds 50% of the equity shares in Company C which holds the remaining 90% of the equity shares in Company B. Company B purchased land from Individual A as a capital asset on an interest-bearing loan account for R100 000 on 1 March year 1. The interest element of the loan qualified for deductions under section 24J(2).

Year of assessment ending on 31 December year 5

On 30 April year 5 Individual A waived the loan, which stood at R140 000, representing capital of R100 000 and capitalised interest of R40 000, through the issue of 70 000 equity shares of R140 000. The loan was waived because of Company B's adverse financial position.

The market value of Individual A's effective interest in Company B prior to the arrangement was R40 000 and after the arrangement was R70 000. Individual A's effective interest in Company B increased by 10% after the arrangement.

Result:

Year of assessment ending on 31 December year 5

Debt benefit

Prior to the arrangement Individual A held 10% of the shares in Company B directly. Individual A also had an indirect interest of 45% (50% × 90%) in Company B through Company C. Therefore, Individual A's effective interest in Company B was 55% (10% + 45%). After the arrangement, Individual A's effective interest increased to 65%

Debt benefit = Face value of the claim in respect of the debt subject to the concession or compromise before entering into the arrangement *less* the difference between the market value of Individual A's effective interest after and before the arrangement:

= R140 000 − R30 000 (R70 000 − R40 000)

= R110 000

R40 000 of the debt benefit is allocated to interest and the difference of R70 000 is allocated to the capital amount of the loan (see **4.13** for allocation of a debt benefit between interest and the capital element of a loan).

The debt benefit of R40 000 is subject to section 19(5), which means that it is deemed to be recovered or recouped for purposes of section 8(4)(*a*) (see **4.4**).

The debt benefit of R70 000 is not subject to paragraph 12A because of the exclusion in paragraph 12A(6)(*g*) (see **4.11.7**).

4.1.6 The time that a debt benefit arises[24]

For purposes of section 19 and paragraph 12A the time when a debt benefit in respect of a debt owed by a person arises by reason of a concession or compromise in that year of assessment will depend on the facts and circumstances of each case. A debt benefit will generally arise when the event giving rise to a concession or compromise 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.

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 benefit 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 of a debt benefit 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 benefit will accordingly arise for purposes of section 19 and paragraph 12A only at the time the actual amount of the debt that is subject to a concession or compromise 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 benefit will arise at that time, since the adopted business rescue plan is binding on the company and its creditors.[25]

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 when a debt benefit in respect of the compromised debt arises is when the order of the court sanctioning the compromise is filed under section 155(8)(*c*) of the same Act.

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[24] The "time that a debt benefit arises" is not a defined term, however, the determination when a debt benefit arises is relevant in a number of the provisions discussed below.

[25] Section 152(4) of the Companies Act.

Insolvency

The time that a debt benefit arises 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 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.

Liquidation

The time that a debt benefit arises as a result of the liquidation of an insolvent company will generally be 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 61 of 1973.[26] 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.

4.1.7 Group of companies

A group of companies means a "group of companies" as defined in section 41(1).

The definition of "group of companies" in section 41(1) begins with the wider definition of the term in section 1(1) but then provides for certain exclusions. These are, amongst others, a company incorporated under foreign law which is not effectively managed in South Africa, a company effectively managed outside South Africa and a variety of exempt or partially exempt bodies such as a public benefit organisation and a recreational club.[27]

This definition is crucial having regard to the exclusions in section 19(8)(*d*) and (*e*) and paragraph 12A(6)(*d*) and (*f*) which apply to the cancellation, waiver or extinction of intra-group debt and the settlement of debt through the issue of shares respectively.

4.1.8 Market value

The definition of "market value" in section 19(1) and paragraph 12A(1) applies to shares held or acquired by reason or as a result of a concession or compromise. It means, in relation to shares acquired or held by reason or as a result of implementing a concession or compromise in respect of a debt, the market value of those shares immediately after the implementation of that concession or compromise.

The definition of "market value" in section 19(1) and paragraph 12A(1) modifies the definition of "market value" in paragraph 1 which in turn refers to paragraph 31 containing the detailed rules for determining market value. The definition of "market value" in section 19(1) and paragraph 12A(1) is used in paragraphs (*c*) and (*d*) of the definition of "debt benefit" when debt is settled through the issue of shares. This definition is also used in paragraph 12A(5) which applies when debt is used to finance the acquisition of a pre-valuation date asset.

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26 Section 408 of the Companies Act 61 of 1973 still applies as provided for by item 9 of Schedule 5 to the Companies Act.

27 See Interpretation Note 75 "Exclusion of Certain Companies and Shares from a 'Group of Companies' as Defined in Section 41(1)".

For shares listed on a recognised exchange and for which a price is quoted on that exchange, paragraph 31(1)(*a*) provides that the market value is the ruling price in respect of that share on that recognised exchange at close of business on the last business day before the specified date. That rule is in conflict with the definition of "market value" in section 19(1) and paragraph 12A(1) which requires the market value to be determined immediately after the concession or compromise. Therefore, depending on the facts, it may be appropriate to use the ruling price at close of business on the date of the concession or compromise.

Paragraph 31(3) provides that the market value for unlisted shares is the price which could have been obtained upon a sale of the asset between a willing buyer and a willing seller dealing at arm's length in an open market, disregarding any provision restricting the transferability of the shares or which specifies how the value of the shares is to be determined. A special rule applies when a company is being wound up. Again, this market value must be determined immediately after the concession or compromise.

4.1.9 Trading stock [section 1(1)]

"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

Section 19 and paragraph 12A are the primary provisions dealing with the consequences of a concession or compromise.

These provisions apply if all of the following requirements are met:

- A debt benefit in respect of a debt owed by a person[28] (the debtor) arises in respect of a year of assessment.
- The amount of that debt was owed by that person in respect of or was used, directly or indirectly, to fund certain specified expenditure (see below).

Section 19 applies if the debt funded expenditure for which a deduction or an allowance was granted under the Act[29] while paragraph 12A applies if the debt funded any expenditure in respect of an asset[30] other than in respect of trading stock for which a deduction or allowance was granted under the Act.[31]

Trading stock generally qualifies for a deduction under section 11(*a*) or 22(2). However, not all acquisitions of trading stock will necessarily qualify for these deductions. For example, section 23F(1) prohibits the deduction under section 11(*a*) in respect of trading stock acquired during a year of assessment which is neither disposed of during such year nor held at the end of such year. Paragraph 12A(3) will apply in these limited circumstances when a debt benefit arises in respect of debt owed which funded the acquisition of such trading stock for which no deduction or allowance was granted, to reduce the expenditure incurred for purposes of base cost of trading stock with the amount of the debt benefit.

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28 Definition of "person" in section 1(1).

29 Section 19(2).

30 Section 19(2) does not include "in respect of an asset", however in the operative paragraphs which follow it is clear that section 19 has a practical impact if the expenditure is "in respect of an asset", namely, trading stock or an allowance asset.

31 Paragraph 12A(2).

Paragraph 12A does not apply when section 19 applies, unless the debt benefit arises in respect of debt that funded expenditure incurred in acquiring an allowance asset, in which event both section 19 and paragraph 12A may apply.

Both section 19 and paragraph 12A require that the debt that is subject to a concession or compromise must have been owed in respect of or have funded "expenditure". See **4.1.5** for a discussion on the meaning of "expenditure".

Section 19 does not apply to all amounts that qualify for a deduction or allowance under the Act. It applies if the debt directly or indirectly funded expenditure for which a deduction or allowance was granted 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*) or section 24I(4) may, however, apply (see **4.12.1** and **4.16**).

Although section 19(2)(*b*) does not specifically require that the expenditure funded by the relevant debt must be "incurred" or "actually incurred", it can be argued that the "expenditure" referred to in the section must not only constitute "expenditure" as judicially defined, but must also have been "incurred". The Act generally 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), (6), (6A) and (7) refer to "expenditure incurred" in relation to trading stock, other expenses and allowance assets. Similarly paragraph 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:[32]

> "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."

To that Nicholas AJA (as he then was) added the following:[33]

> "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 subject to a concession or compromise and the particular expenditure incurred in order to conclude that the debt was owed in respect of or 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,

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32 1988 (3) SA 876 (A), 50 SATC 81 at 90.

33 At SATC 95.

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 cancelled, waived, extinguished or settled. The applicability of section 19 and paragraph 12A to any debt benefit in respect of an 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.[34]

It is evident from the discussion above that the application of section 19 and paragraph 12A depends on the nature of the expenditure that was funded by the debt. Specific rules apply to a debt benefit relating to debt owed in respect of or that was used to fund expenditure incurred in respect of –

- trading stock that is held and not disposed of at the time the debt benefit arises [section 19(3) and (4)] (see **4.3**);
- operating expenses (*other than* trading stock held and not disposed of and allowance assets) [section 19(5)] (see **4.4**);
- an allowance asset [section 19(6), (6A) and (7) and paragraph 12A(3), (4) and (5)] (see **4.5**, **4.6**, **4.7** and **4.10**); and
- any other asset [paragraph 12A(3), (4) and (5)] (see **4.8**, **4.9** and **4.10**).

Despite the requirements discussed above having been met, there are circumstances in which section 19 and paragraph 12A do not apply (see **4.11**). Briefly, section 19 and paragraph 12A do not apply to a debt benefit in respect of 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 **4.11.1**);
- *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 in respect of which donations tax is payable [section 19(8)(*b*) and paragraph 12A(6)(*b*)] (see **4.11.2**);
- 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 **4.11.3**);
- to another company forming part of the same domestic group of companies and the debtor company did not carry on a trade during the year of assessment in which the debt benefit arises and during the immediately preceding year of assessment, unless certain provisions apply [section 19(8)(*d*) and paragraph 12A(6)(*d*)] (see **4.11.4**);
- to another company forming part of the same domestic group of companies and reduces or settles the debt directly or indirectly by means of shares issued by the debtor company, unless certain provisions apply [section 19(8)(*e*) and paragraph 12A(6)(*f*)] (see **4.11.6**); or

34 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 the extent* that the debt owed is settled, directly or indirectly, by being converted to or exchanged for shares in the debtor company or by applying the proceeds from shares issued by that company and does not consist of or represent an amount owed in respect of interest incurred by that person during any year of assessment [section 19(8)(*f*) and paragraph 12A(6)(*g*)] (see **4.11.7**).

Paragraph 12A further does not apply to any debt owed by a company 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 **4.11.5**).

A debtor company in liquidation that is indebted to a connected person is 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 as a result of the debt benefit 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 connected person 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 a debt benefit arises [section 19(3) and (4)]

Section 19(3) applies to a debt benefit relating to a debt owed in respect of or that was used to fund, directly or indirectly, expenditure incurred for trading stock that is held and not disposed of at the time the debt benefit arises. The debt benefit 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 benefit arises, be applied to reduce the amount so taken into account.[35]

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. In relation to the meaning of "held", *Juta's Tax Library* states the following:[36]

> "[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, must therefore account for the stock. This view is shared by Meyerowitz (at 9.89). … ."

(Emphasis added)

[35] 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).

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

In ITC 1873[37] 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*[38] 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 –[39]

> "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".

"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.

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 benefit arises 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 benefit arose during the year of assessment; or

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37 (2014) 77 SATC 93 (WC) at 103.
38 [2016] ZASCA 90, 78 SATC 343 (A) at 356.
39 See above in paragraphs 25 and 28.

- section 22(2) when the trading stock is included in opening stock and the debt benefit arose during the year of assessment.

Depending on the circumstances prevailing when the debt benefit arises, 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 amount of the debt benefit 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 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 benefit arises 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 benefit arose, will be the amount included in closing stock at the end of the year of assessment in which the debt benefit arose, 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 benefit arose. However, given that the expenditure originally incurred under section 11(*a*) on acquisition of the trading stock is required to be reduced by the amount of the debt benefit 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 debt benefit 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 benefit arose is therefore the "cost price" of the trading stock reduced by the amount of the debt benefit 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 the debt benefit arises. Section 19(4) provides that if the amount of the debt benefit exceeds the amount applied under section 19(3) to reduce the section 11(*a*), section 22(1) and section 22(2) amounts as appropriate, 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 benefit arises. 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 the debt benefit arises is less than the amount of the debt benefit in respect 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 17)**.

Application of section 19(5)

The recoupment of the amount of a debt benefit relating to debt owed in respect of or that was used to fund expenditure incurred in respect of trading stock that was not "held and not disposed of" at the time the debt benefit arises, is dealt with under section 19(5) (see **4.4**).

Sequence of the application of the subsections of section 19

Any amount of a debt benefit in respect of trading stock for which a deduction or allowance was granted must be applied in accordance with the sequence of the subsections of section 19. Thus, a debt that was owed in respect of or that was used to fund the acquisition of trading stock and which is partially cancelled, waived, extinguished or settled must first be allocated to trading stock that is held and not disposed of at the time the debt benefit arises under section 19(3). Any remaining balance of the amount of the debt benefit must then be dealt with as a recoupment under section 19(4) or (5) (see **Examples 16 and 17**).

Example 16 – Debt benefit in respect of debt owed that funded the acquisition of trading stock

Facts:

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

Year of assessment ending on 28 February year 2

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.

Year of assessment ending on 28 February year 3

On 1 March year 2 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 previous year of assessment with a cost price of R400 000 was held and not disposed of at the time the debt benefit arose.

Company A's opening balance of trading stock amounted to R1 million and the closing balance of trading stock at year end amounted to R700 000. The opening and closing balances of trading stock included the trading stock of R400 000 purchased from Company B during the previous year of assessment.

None of the exclusions in section 19(8) apply.

Result:

Year of assessment ending on 28 February year 3

Debt benefit

Debt benefit = Amount cancelled = R500 000.

R400 000 funded trading stock held and not disposed of at the time the debt benefit arose 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 amount of the debt benefit because the debt directly funded the acquisition of trading stock amounting to R400 000 held and not disposed of at the time the debt benefit arose. 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 R300 000 (R700 000 − R400 000).

Application of section 19(4)

Section 19(4) does not apply since the full amount of the debt benefit relating to the expenditure incurred in respect of the trading stock held and not disposed of at the time the debt benefit arose (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 amount of the debt benefit relating to the trading stock of R100 000 that was disposed of during the year of assessment ending on 28 February year 2. The trading stock of R100 000 was allowed as a deduction under section 11(*a*) during that 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 year of assessment ending on 28 February year 3 (see **4.4**).

Year of assessment ending on 28 February year 4

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 year of assessment ending on 28 February year 3, that is, R300 000.

Closing balance of trading stock

Assuming the trading stock is still on hand at the end of the year of assessment ending on 28 February year 4, 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 benefit arose. However, as the expenditure incurred on acquisition of the trading stock that has been allowed as a deduction under section 11(*a*) in the year of assessment ending on 28 February year 2 is required to have been reduced by the amount of the debt benefit that arose in the year of assessment ending on 28 February year 3, it is considered that the "cost price" for purposes of section 22(1) in the year of assessment ending on 28 February year 4 must take into account the amount of the debt benefit that arose in the previous year of assessment. Therefore, closing stock is R300 000.

Notes:

(1) 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.

(2) Section 19(4) would still not have any application in these circumstances, since the full amount of the debt benefit (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.

(3) Section 19(5) would not apply because the trading stock of R50 000, that was funded by the debt in respect of which the debt benefit arose, was held and not disposed of at the time the debt benefit arose.

Example 17 – Debt benefit in respect of debt owed that funded the acquisition of trading stock

Facts:

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

Year of assessment ending on 28 February *year 2*

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.

Year of assessment ending on 28 February year 3

On 31 March year 2 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.

None of the exclusions in section 19(8) apply.

Result:

Year of assessment ending on 28 February year 3

Debt benefit

Debt benefit = Amount cancelled = R300 000.

R100 000 funded trading stock held and not disposed of at the time the debt benefit arose 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 amount of the debt benefit because the debt directly funded the acquisition of trading stock of R100 000 that was held and not disposed of at the time the debt benefit arose. 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 amount of the debt benefit in respect of the debt that funded the trading stock held and not disposed of at the time the debt benefit arose, *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 year of assessment ending on 28 February year 2. The trading stock of R200 000 was allowed as a deduction under section 11(*a*) during that 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 year of assessment ending on 28 February year 3 (see **4.4**).

4.4 Operating expenses and trading stock not "held and not disposed of" at the time a debt benefit arises [section 19(5)]

Section 19(5) provides that the amount of a debt benefit which arises in respect of a debt owed in respect of or which was used to fund 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 benefit arises. 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 the debt benefit arises (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), (6A) and (7) specifically deal 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 amount of a debt benefit in respect 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 **4.13** for the allocation of payments and debt benefits between the interest and capital element of a loan.

Example 18 – Debt benefit in respect of a debt owed that funded expenditure allowed as a deduction

Facts:

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

Year of assessment ending on 31 March year 2

On 1 April year 1 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.

None of the exclusions in section 19(8) apply.

Result:

Year of assessment ending on 31 March year 2

Debt benefit

Debt benefit = Amount waived = R1,1 million.

Application of section 19(5)

The debt benefit in respect of the debt owed of R1,1 million funded expenses for which deductions were allowed under the Act. Under section 19(5) the amount of the debt benefit 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 year of assessment ending on 31 March year 2.

Example 19 – Debt benefit in respect of a debt owed that funded expenditure allowed as a deduction

Facts:

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

Year of assessment ending on 31 March year 2

On 1 April year 1 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. The building was not disposed of in a prior year of assessment.

None of the exclusions in section 19(8) or paragraph 12A(6) apply.

Result:

Year of assessment ending on 31 March year 2

Debt benefit in respect of the interest portion of the debt

Debt benefit in respect of the interest portion of the debt = Amount waived = 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 amount of the debt benefit 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 year of assessment ending on 31 March year 2.

Note:

Paragraph 12A(3) will apply to the debt benefit of R1 million in respect of the debt that financed the acquisition of the building (see **4.8**).

4.5 Allowance assets not disposed of in a prior year of assessment [section 19(6) and paragraph 12A(3)]

The tax consequences of a debt benefit in respect of debt owed in respect of or which was used to finance the acquisition of an allowance asset not disposed of in a prior year of assessment must firstly be considered under paragraph 12A(3) and then under section 19(6).

Paragraph 12A(3) provides that if a debt benefit arises in a year of assessment in respect of a debt owed by a person and the amount of that debt was owed in respect of or was used to fund expenditure incurred in respect of an asset that was not disposed of in a prior year of assessment, the amount of expenditure incurred on that asset must, for the purposes of paragraph 20, be reduced by the amount of the debt benefit.

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 amount of the debt benefit, or depending on the facts, by an amount which is less than that amount (see **Example 20**). Paragraph 12A(3) must be considered together with paragraph 20(3)(*a*)(i) which deals with the reduction of the base cost of an asset for amounts allowed as a deduction (see **Example 20**). The base cost of an asset cannot be reduced below RNil.

Should the amount of a debt benefit 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 benefit arises. 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 RNil under paragraph 12A(3), that is, section 19(6) will apply to the amount of a debt benefit *to the extent* that paragraph 12A was not applied to reduce the amount of expenditure incurred (base cost of the allowance asset).[40]

Example 20 – Debt benefit in respect of debt owed that funded the acquisition of an allowance asset not disposed of in a prior year of assessment

Facts:

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

Year of assessment ending on 28 February year 2

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.

Year of assessment ending on 28 February year 3

On 1 March year 2 Company B was relieved from payment of the debt of R2 million because of its inability to pay. The asset was disposed of two weeks later for R1,7 million.

None of the exclusions in section 19(8) or paragraph 12A(6) applies.

Result:

Year of assessment ending on 28 February year 3

Debt benefit

Debt benefit = Amount waived = R2 million.

Application of paragraph 12A(3)

The debt of R2 million funded the acquisition of an allowance asset which was not disposed of in a prior year of assessment. As a result, paragraph 12A(3) applies and the base cost of the asset of R1,7 million (R2 million cost − R300 000 wear-and-tear allowance previously claimed) [41] must be reduced by the amount of the debt benefit. The reduction in base cost is, however, limited to R1,7 million, since expenditure contemplated in paragraph 20 (base cost) cannot be reduced below RNil.

Application of section 19(6)

Under section 19(6) *to the extent* an allowance was granted (that is, R300 000) and the debt benefit was not applied under paragraph 12A to reduce the expenditure incurred under paragraph 20, a recoupment arises. Even though the amount of the debt benefit was R2 million, paragraph 12A(3) reduced the expenditure by R1,7 million only because expenditure of R300 000, which was allowed as a deduction under section 11(*e*) had already been reduced under paragraph 20(3)(*a*)(i) and was therefore not available for reduction under paragraph 12A(3).

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40 Section 19(6)(ii).

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

Under section 19(6) the excess of R300 000 (R2 million debt benefit − R1,7 million paragraph 12A(3) reduction) is deemed, for the purposes of section 8(4)(*a*), to be an amount that has been recovered or recouped.

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) (see **4.7**) no allowance is available under section 11(*e*) in the year of assessment ending on 28 February year 3.

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).

Capital gain on disposal of the asset

The full proceeds of R1,7 million will constitute a capital gain derived by Company B on disposal of the asset. 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, since the selling price of the asset equalled its tax value. Paragraph 35(3)(*a*) does not require a reduction in proceeds in respect of a previous recoupment under section 19(6) read with section 8(4)(*a*). The base cost of the asset is RNil under paragraphs 20 and 12A(3) (see above).

Company B effectively did not pay for the asset because the full amount of the debt was waived. 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 a wear and tear allowance but this was reversed by the recoupment of R300 000 under section 19(6).

Example 21 – Debt benefit in respect of debt owed that funded the acquisition of an allowance asset not disposed of in a prior year of assessment

Facts:

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

Year of assessment ending on 28 February year 2

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.

Year of assessment ending on 28 February year 3

On 1 March year 2 Company B was relieved from payment of the debt of R2 million because of cash-flow problems. The asset was disposed of two weeks later for R1,8 million.

None of the exclusions in section 19(8) or paragraph 12A(6) applies.

Result:

Year of assessment ending on 28 February year 3

Debt benefit

Debt benefit = Amount waived = R2 million.

Application of paragraph 12A(3)

The debt of R2 million funded the acquisition of an allowance asset which was not disposed of in a prior year of assessment. As a result, paragraph 12A(3) applies and the base cost of the asset of R1,7 million (R2 million cost – R300 000 wear-and-tear allowance previously claimed) [42] must be reduced by the amount of the debt benefit. The reduction in base cost is, however, limited to R1,7 million, since expenditure contemplated in paragraph 20 (base cost) cannot be reduced below RNil.

Application of section 19(6)

Under section 19(6) *to the extent* an allowance was granted (that is, R300 000) and the debt benefit was not applied under paragraph 12A to reduce the expenditure incurred under paragraph 20, a recoupment arises. Even though the amount of the debt benefit was R2 million, paragraph 12A(3) reduced the expenditure by only R1,7 million because expenditure of R300 000, which was allowed as a deduction under section 11(*e*) had already been reduced under paragraph 20(3)(*a*)(i) and was therefore not available for reduction under paragraph 12A(3).

Under section 19(6) the excess of R300 000 (R2 million debt benefit − R1,7 million paragraph 12A(3) reduction) is deemed, for the purposes of section 8(4)(*a*), to be an amount that has been recovered or recouped.

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) (see **4.7**), no allowance is available under section 11(*e*) in the year of assessment ending on 28 February year 3.

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[42] Base cost reduced under paragraph 20(3)(*a*)(i).

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) by R100 000. However, paragraph (iii) of the proviso to section 8(4)(*a*) (see **4.12.1**) 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) for purposes of section 8(4)(*a*) and it is therefore not taken into account again on disposal of the asset.

Capital gain on disposal of the asset

The full proceeds of R1,8 million will constitute a capital gain derived by Company B on disposal of the asset. 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 (see "*Application of section 8(4)(a)*") no proceeds from the disposal are required to be so included. Paragraph 35(3)(*a*) does not require a reduction in proceeds in respect of a previous recoupment under section 19(6) read with section 8(4)(*a*). The base cost of the asset is RNil under paragraphs 20 and 12A(3) (see above).

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 a wear and tear allowance but this was reversed by the recoupment of R300 000 under section 19(6).

Example 22 – Debt benefit in respect of debt owed that funded the acquisition of an allowance asset not disposed of in a prior year of assessment

Facts:

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

Year of assessment ending on 28 February year 2

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.

Year of assessment ending on 28 February year 3

On 1 March year 2 Company B was relieved from payment of R1,8 million because of cash-flow problems. The asset was disposed of two weeks later for R1,9 million.

None of the exclusions in section 19(8) or paragraph 12A(6) applies.

Result:

Year of assessment ending on 28 February year 3

Debt benefit

Debt benefit = Amount waived = R1,8 million.

Application of paragraph 12A(3)

The debt of R2 million funded the acquisition of an allowance asset which was not disposed of in a prior year of assessment. As a result, paragraph 12A(3) applies and the base cost of the asset of R1,7 million (R2 million cost − R300 000 wear-and-tear allowance previously claimed) [43] must be reduced by the amount of the debt benefit. The reduction in base cost is, however, limited to R1,7 million, since expenditure contemplated in paragraph 20 (base cost) cannot be reduced below RNil.

Application of section 19(6)

Under section 19(6) *to the extent* an allowance was granted (that is, R300 000) and the debt benefit was not applied under paragraph 12A to reduce the expenditure incurred under paragraph 20, a recoupment arises. Even though the amount of the debt benefit was R1,8 million, paragraph 12A(3) reduced the expenditure by only R1,7 million because expenditure of R300 000, which was allowed as a deduction under section 11(*e*), had already been reduced under paragraph 20(3)(*a*)(i) and was therefore not available for reduction under paragraph 12A(3).

Under section 19(6) the excess of R100 000 (R1,8 million debt benefit − R1,7 million paragraph 12A(3) reduction) is deemed, for the purposes of section 8(4)(*a*), to be an amount that has been recovered or recouped.

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) (see **4.7**), no allowance is available under section 11(*e*) in the year of assessment ending on 28 February year 3.

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 R200 000, since the selling price of the allowance asset (R1,9 million) exceeds its tax value of R1,7 million (R2 million cost − R300 000 section 11(*e*) allowance) by R200 000. However, paragraph (iii) of the proviso to section 8(4)(*a*) (see **4.12.1**) 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). R100 000 was previously recouped under section 19(6) for purposes of section 8(4)(*a*). Recoupment of R100 000 (R200 000 − R100 000) is taken into account under section 8(4)(*a*) on disposal of the asset.

[43] Base cost reduced under paragraph 20(3)(*a*)(i).

Capital gain on disposal of the asset

Proceeds of R1,8 million [proceeds of R1,9 million − recoupment of R100 000 under section 8(4)(*a*)] will constitute a capital gain derived by Company B on disposal of the asset. The proceeds derived by Company B are not reduced by the recoupment of R100 000 that arises under section 19(6). Under paragraph 35(3)(*a*) proceeds of R1,9 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. Proceeds from disposal of the asset of R100 000 are required to be so included, since it was taken into account under section 8(4)(*a*) on disposal of the asset. The base cost of the asset is RNil under paragraphs 20 and 12A(3) (see above).

Company B effectively paid R200 000 for the asset because R1,8 million of the debt was forgiven. When Company B subsequently sold the asset for R1,9 million, proceeds of R1,8 million constituted a capital gain and overall there was a net “deduction” from income of R100 000. Company B originally claimed R300 000 as a wear and tear allowance but R100 000 was recouped under section 19(6) and R100 000 under section 8(4)(*a*).

Example 23 – Debt benefit in respect of debt owed that funded the acquisition of an allowance asset disposed of during the year of assessment

Facts:

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

Year of assessment ending on 28 February year 2

On 1 March year 1 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.

Year of assessment ending on 28 February year 3

Company B sold the allowance asset for R1,7 million on 31 August year 2 to an unconnected third party. Company B claimed a further wear-and-tear allowance of R100 000 (R200 000 × 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.

None of the exclusions in section 19(8) or paragraph 12A(6) applies.

Result:

Year of assessment ending on 28 February year 3

Since the disposal of the asset and the debt benefit arose during the same year of assessment, paragraph 12A is applied first. The application of paragraph 12A is not prohibited, since the asset was not disposed of in a prior year of assessment. Since tax is an annual event, all transactions are considered at the end of the year of assessment.

Debt benefit

Debt benefit = Amount waived = R2 million.

Application of paragraph 12A(3)

The debt of R2 million funded the acquisition of an allowance asset which was not disposed of in a prior year of assessment. As a result, paragraph 12A(3) applies and the base cost of the asset of R1,7 million (R2 million cost − R300 000 wear-and-tear allowances previously claimed) [44] must be reduced by the amount of the debt benefit. The reduction in base cost is, however, limited to R1,7 million, since expenditure contemplated in paragraph 20 (base cost) cannot be reduced below RNil.

Application of section 19(6)

Under section 19(6) *to the extent* allowances were granted (that is, R300 000) and the debt benefit was not applied under paragraph 12A to reduce the expenditure incurred under paragraph 20, a recoupment arises. Even though the amount of the debt benefit was R2 million, paragraph 12A(3) reduced the expenditure by R1,7 million only, because expenditure of R300 000, which was allowed as a deduction under section 11(*e*) had already been reduced under paragraph 20(3)(*a*)(i) and was therefore not available for reduction under paragraph 12A(3).

Under section 19(6) the excess of R300 000 (R2 million debt benefit − R1,7 million paragraph 12A(3) reduction) is deemed, for the purposes of section 8(4)(*a*), to be an amount that has been recovered or recouped.

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

The asset was disposed of six months into the year of assessment so a partial allowance of R100 000 (R200 000 × 6 / 12) would be available under section 11(*e*) for the period of use. The limitation rules in section 19(7) (see **4.7**) do not limit the allowance as the waiver only occurred after Company B was entitled to the allowance under section 11(*e*).

Disposal of the asset

Application of section 8(4)(a)

While the recoupment provisions of section 8(4)(*a*) have application on the 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*) allowances claimed).

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.

Capital gain on disposal of the asset

The full proceeds of R1,7 million will constitute a capital gain derived by Company B on disposal of the asset. 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, since the selling price of the asset equalled its tax value. Paragraph 35(3)(*a*) does not require a reduction in proceeds in respect of a previous recoupment under section 19(6) read with section 8(4)(*a*). The base cost of the asset is RNil under paragraphs 20 and 12A(3) (see above).

Company B effectively did not pay for the asset because the full amount of the debt was waived. When Company B 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 allowances but this was reversed by the recoupment of R300 000 under section 19(6).

4.6 Allowance assets disposed of in a prior year [section 19(6A) and paragraph 12A(4)]

For years of assessment commencing on or after 1 January 2019, section 19(6A) stipulates that when a debt benefit arises during any year of assessment in respect of a debt owed by a person and the amount of that debt is owed in respect of or was used to fund expenditure incurred in respect of an allowance asset that was disposed of in a year of assessment prior to that in which that debt benefit arises, that person must, if the amount determined in respect of that disposal as a recovery or recoupment of a deduction or allowance is less than *the amount that would have been so determined* had that debt benefit been taken into account in the year of assessment in which the disposal occurred, treat the amount of that difference as an amount recovered or recouped for purposes of section 8(4)(*a*) in the year of assessment in which the debt benefit arises.

"*The amount that would have been so determined*" includes the amount which would have been deemed a recovery or recoupment for purposes of section 8(4)(*a*) under section 19(6) and the amount of the recoupment under section 8(4)(*a*) on disposal of the asset when the recalculation is performed – see the Examples below.

Paragraph 12A(4) may also apply under the abovementioned circumstances. It must be determined whether the capital gain or capital loss that arose in the prior year of assessment on disposal of the asset would have differed from the capital gain or capital loss determined assuming that the debt benefit was taken into account in that prior year of assessment. The absolute difference must be treated as a capital gain in the year of assessment in which the debt benefit arises. See also **4.9**.

Example 24 – Debt benefit in respect of debt owed that funded the acquisition of an allowance asset disposed of in a prior year of assessment

Facts:

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

Year of assessment ending on 28 February year 2

On 1 March year 1 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 of R300 000 on the asset under section 11(*e*).

Company B sold the allowance asset for R1,7 million on 28 February year 2 to an unconnected third party.

Year of assessment ending on 28 February year 3

On 1 March year 2 Company A waived the debt of R2 million owed by Company B because of Company B's inability to pay.

None of the exclusions in section 19(8) or paragraph 12A(6) applies.

Result:

Year of assessment ending on 28 February year 2

Disposal of the asset

Recoupment under section 8(4)(a)

There is no recoupment under section 8(4)(*a*) on disposal of the asset, since the selling price of R1,7 million was equal to the asset's tax value of R1,7 million (cost of R2 million − wear and tear allowance of R300 000).

Capital gain

Company B made a capital gain of RNil [proceeds of R1,7 million − base cost of R1,7 million (cost of R2 million − section 11(*e*) allowance of R300 000[45])] on disposal of the asset.

Year of assessment ending on 28 February year 3

Debt benefit

Debt benefit = Amount waived = R2 million.

The debt was used to fund an allowance asset disposed of in a prior year of assessment. The recoupment of RNil and capital gain of RNil which arose in the prior year of assessment must be re-determined as if the debt benefit had arisen in the year of assessment ending on 28 February year 2.

45 Base cost reduced under paragraph 20(3)(*a*)(i).

Re-determined capital gain on disposal of the asset under paragraph 12A(4)

As a result of the debt waiver, the base cost of the allowance asset must be reduced to RNil (cost of R2 million − wear and tear allowance of R300 000 – debt benefit under paragraph 12A(3), limited to R1,7 million). The re-determined capital gain on disposal of the asset is R1,7 million [(proceeds of R1,7 million − re-determined recoupment under section 8(4)(*a*) (see below) of RNil) − base cost of RNil].

The amount to be treated as a capital gain in the year of assessment ending on 28 February year 3 is the absolute difference between R1,7 million (re-determined capital gain for the year of assessment ending on 28 February year 2) and RNil (capital gain determined for the year of assessment ending on 28 February year 2) = R1,7 million.

Re-determined amount of recoupment under section 19(6A)

As a result of the debt waiver, an amount of R300 000 (debt benefit of R2 million − amount of R1,7 million that was applied under paragraph 12A(3) to reduce the base cost of the asset) would have been determined as an amount that had to be recovered or recouped under section 19(6) for purposes of section 8(4)(*a*).

The re-determined recoupment under section 8(4)(*a*) on disposal of the asset is RNil [selling price of R1 700 000, limited to the cost of R2 million − tax value of R1 700 000 (cost of R2 million − wear and tear allowance of R300 000)].

Under section 19(6A), if the amount determined as a recovery or recoupment of a deduction or allowance on disposal of the asset (RNil) is less than the amount that would have been so determined had that debt benefit been taken into account in the year of assessment in which the disposal occurred [R300 000 under section 19(6) and RNil under section 8(4)(*a*)], the amount of the difference (R300 000) must be treated as an amount recovered or recouped for purposes of section 8(4)(*a*) in the year of assessment in which that debt benefit arises, namely, the year of assessment ending on 28 February year 3.

Note:

The same result is achieved as in **Example 18**, in which case the asset was disposed of in the same year of assessment in which the debt benefit arose.

Example 25 – Debt benefit in respect of debt owed that funded the acquisition of an allowance asset disposed of in a prior year of assessment

Facts:

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

Year of assessment ending on 28 February year 2

On 1 March year 1 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 of R300 000 on the asset under section 11(*e*).

Company B sold the allowance asset for R1,8 million on 28 February year 2 to an unconnected third party.

Year of assessment ending on 28 February year 3

On 1 March year 2 Company A waived the debt of R2 million owed by Company B because of Company B's inability to pay.

None of the exclusions in section 19(8) or paragraph 12A(6) applies.

Result:

Year of assessment ending on 28 February year 2

Disposal of the asset

Recoupment under section 8(4)(a)

There is a recoupment of R100 000 under section 8(4)(*a*) on disposal of the asset, since the selling price of R1,8 million exceeded the asset's tax value of R1,7 million (cost of R2 million − wear and tear allowance of R300 000).

Capital gain

Company B made a capital gain of RNil [proceeds of R1,7 million [proceeds of R1 800 000 – amount recovered or recouped of R100 000 which is included in gross income under section 8(4)(*a*)] − base cost of R1,7 million [(cost of R2 million − section 11(*e*) allowance of R300 000[46])] on disposal of the asset.

Year of assessment ending on 28 February year 3

Debt benefit

Debt benefit = Amount waived = R2 million.

The debt was used to fund an allowance asset disposed of in a prior year of assessment. The recoupment of R100 000 and capital gain of RNil which arose in the prior year of assessment must be re-determined as if the debt benefit had arisen in the year of assessment ending on 28 February year 2.

Re-determined capital gain on disposal of the asset under paragraph 12A(4)

As a result of the debt waiver, the base cost of the allowance asset must be reduced to RNil (cost of R2 million – wear and tear allowance of R300 000 − debt benefit under paragraph 12A(3), limited to R1,7 million). The re-determined capital gain on disposal of the asset is R1,8 million (proceeds of R1,8 million − base cost of RNil).

The amount to be treated as a capital gain in the year of assessment ending on 28 February year 3 is the absolute difference between R1,8 million (re-determined capital gain for the year of assessment ending on 28 February year 2) and RNil (capital gain determined for the year of assessment ending on 28 February year 2) = R1,8 million.

Re-determined amount of recoupment under section 19(6A)

As a result of the debt waiver, an amount of R300 000 (debt benefit of R2 million − amount of R1,7 million that was applied under paragraph 12A(3) to reduce the base cost of the asset) would have been determined as an amount that had to be recovered or recouped under section 19(6) for purposes of section 8(4)(*a*).

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46 Base cost reduced under paragraph 20(3)(*a*)(i).

On disposal of the asset a recoupment of R100 000 would have arisen [selling price of R1,8 million − tax value of R1,7 million (cost of R2 million − wear and tear allowance of R300 000)]. However, this would have been reduced to RNil under paragraph (iii) of the proviso to section 8(4)(*a*) because the amount is already taken into account under section 19(6).

Under section 19(6A), if the amount determined as a recovery or recoupment of a deduction or allowance on disposal of the asset (R100 000) is less than the amount that would have been so determined had that debt benefit been taken into account in the year of assessment in which the disposal occurred [R300 000 under section 19(6) and RNil under section 8(4)(*a*)], the amount of the difference (R200 000) must be treated as an amount recovered or recouped for purposes of section 8(4)(*a*) in the year of assessment in which that debt benefit arises, namely, the year of assessment ending on 28 February year 3. Therefore, R200 000 is a recoupment for purposes of section 8(4)(*a*).

Note:

The same result is achieved as in **Example 19**, in which case the asset was disposed of in the same year of assessment in which the debt benefit arose.

Example 26 – Debt benefit in respect of debt owed that funded the acquisition of an allowance asset disposed of in a prior year of assessment

Facts:

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

Year of assessment ending on 28 February year 2

On 1 March year 1 Company B purchased an allowance asset from Company A on credit at a cost of R1 million. Company B claimed a wear-and-tear allowance of 20% a year on the asset under section 11(*e*) of R200 000.

Company B sold the allowance asset for R800 000 on 28 February year 2 to an unconnected third party.

Year of assessment ending on 28 February year 3

On 1 March year 2 Company A waived the debt of R1 million owed by Company B because of Company B's inability to pay.

None of the exclusions in section 19(8) or paragraph 12A(6) applies.

Result:

Year of assessment ending on 28 February year 2

Disposal of the asset

Recoupment under section 8(4)(a)

There is no recoupment under section 8(4)(*a*) on disposal of the asset, since the selling price of R800 000 was equal to the asset's tax value of R800 000 (cost of R1 million − wear and tear allowance of R200 000).

Capital gain

Company B made a capital gain of RNil [proceeds of R800 000 − base cost of R800 000 (cost of R1 million − section 11(*e*) allowance of R200 000[47])] on disposal of the asset.

Year of assessment ending on 28 February year 3

Debt benefit

Debt benefit = Amount waived = R1 million.

The debt was used to fund an allowance asset disposed of in a prior year of assessment. The recoupment of RNil and capital gain of RNil which arose in the prior year of assessment must be re-determined as if the debt benefit had arisen in the year of assessment ending on 28 February year 2.

Re-determined capital gain on disposal of the asset under paragraph 12A(4)

As a result of the debt waiver, the base cost of the allowance asset must be reduced to RNil (cost of R1 million − wear and tear allowance of R200 000 − debt benefit under paragraph 12A(3), limited to R800 000). The re-determined capital gain on disposal of the asset is R800 000 [(proceeds of R800 000 − re-determined recoupment under section 8(4)(a) (see below) of RNil) − base cost of RNil].

The amount to be treated as a capital gain in the year of assessment ending on 28 February year 3 is the absolute difference between R800 000 (re-determined capital gain for the year of assessment ending on 28 February year 2) and RNil (capital gain determined for the year of assessment ending on 28 February year 2) = R800 000.

Re-determined amount of recoupment under section 19(6A)

As a result of the debt waiver, an amount of R200 000 (debt benefit of R1 million − amount of R800 000 that was applied under paragraph 12A(3) to reduce the base cost of the asset) would have been determined as an amount that had to be recovered or recouped under section 19(6) for purposes of section 8(4)(*a*).

The re-determined recoupment under section 8(4)(*a*) on disposal of the asset is RNil [selling price of R800 000, limited to the cost of R1 million − tax value of R800 000 (cost of R1 million − wear and tear allowance of R200 000)].

Under section 19(6A), if the amount determined as a recovery or recoupment of a deduction or allowance on disposal of the asset (RNil) is less than the amount that would have been so determined had that debt benefit been taken into account in the year of assessment in which the disposal occurred [R200 000 under section 19(6) and RNil under section 8(4)(*a*)], the amount of the difference (R200 000) must be treated as an amount recovered or recouped for purposes of section 8(4)(*a*) in the year of assessment in which that debt benefit arises, namely, the year of assessment ending on 28 February year 3. Therefore, R200 000 is a recoupment for purposes of section 8(4)(*a*).

[47] Base cost reduced under paragraph 20(3)(*a*)(i).

Example 27 – Debt benefit in respect of debt owed that funded the acquisition of an allowance asset disposed of in a prior year of assessment

Facts:

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

Year of assessment ending on 28 February year 2

On 1 March year 1 Company B purchased an allowance asset from Company A on credit at a cost of R1 million. Company B claimed a wear-and-tear allowance of 20% a year on the asset under section 11(*e*) of R200 000.

Company B sold the allowance asset for R1,2 million on 28 February year 2 to an unconnected third party.

Year of assessment ending on 28 February year 3

On 1 March year 2 Company A waived R900 000 of the debt owed by Company B because of Company B's inability to pay.

None of the exclusions in section 19(8) or paragraph 12A(6) applies.

Result:

Year of assessment ending on 28 February year 2

Disposal of the asset

Recoupment under section 8(4)(a)

There is recoupment under section 8(4)(*a*) on disposal of the asset of R200 000 [selling price of R1,2 million, limited to the cost price of R1 million − tax value of R800 000 (cost of R1 million − wear and tear allowance of R200 000)].

Capital gain

Company B made a capital gain of R200 000 [proceeds of R1 million (R1 200 000 selling price − recoupment of R200 000[48]) − base cost of R800 000 (R1 million cost − section 11(*e*) allowance of R200 000[49])] on disposal of the asset.

Year of assessment ending on 28 February year 3

Debt benefit

Debt benefit = Amount waived = R900 000.

The debt was used to fund an allowance asset disposed of in a prior year of assessment. The recoupment of R200 000 and capital gain of R200 000 which arose in the prior year of assessment must therefore be re-determined as if the debt benefit had arisen in the year of assessment ending on 28 February year 2.

[48] Proceeds reduced under paragraph 35(3)(*a*).

[49] Base cost reduced under paragraph 20(3)(*a*)(i).

Re-determined capital gain on disposal of the asset under paragraph 12A(4)

As a result of the debt waiver, the base cost of the allowance asset must be reduced to RNil (cost of R1 million − wear and tear allowance of R200 000[50] − debt benefit under paragraph 12A(3), limited to R800 000). The re-determined capital gain on disposal of the asset is R1,1 million [proceeds of R1,1 million [proceeds of R1,2 million − recoupment on disposal of the asset of R100 000 under section 8(4)(*a*) (see below)] − base cost of RNil)].

The amount to be treated as a capital gain in the year of assessment ending on 28 February year 3 is the absolute difference between R1,1 million (re-determined capital gain for the year of assessment ending on 28 February year 2) and R200 000 (capital gain determined for the year of assessment ending on 28 February year 2) = R900 000.

Re-determined amount of recoupment under section 19(6A)

As a result of the debt waiver, an amount of R100 000 (debt benefit of R900 000 − amount of R800 000 that was applied under paragraph 12A(3) to reduce the base cost of the asset) would have been determined as an amount that had to be recovered or recouped under section 19(6) for purposes of section 8(4)(*a*).

The re-determined recoupment under section 8(4)(*a*) on disposal of the asset is R200 000 [selling price of R1,2 million, limited to the cost price of R1 million − tax value of R800 000 (cost of R1 million − wear and tear allowance of R200 000)]. The recoupment of R200 000 is reduced to R100 000 [R200 000 recoupment − R100 000 accounted for under section 19(6) (see above) under paragraph (iii) of the proviso to section 8(4)(*a*)].

Under section 19(6A) if the amount determined as a recovery or recoupment of a deduction or allowance on disposal of the asset (R200 000) is less than the amount that would have been so determined had that debt benefit been taken into account in the year of assessment in which the disposal occurred (R100 000 under section 19(6) + R100 000 under section 8(4)(*a*) on disposal), the amount of the difference must be treated as an amount recovered or recouped for purposes of section 8(4)(*a*) in the year of assessment in which that debt benefit arises, namely, the year of assessment ending on 28 February year 3. Since the amount of the re-determined recoupment on disposal (R100 000) equals the amount originally determined, there is no amount that must be accounted for under section 19(6A).

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 debt benefit in respect 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.

[50] Base cost reduced under paragraph 20(3)(*a*)(i).

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 28 – Limitation of deductions and allowances on an allowance asset

Facts:

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

Year of assessment ending on 28 February year 2

Company A acquired second-hand machinery at a cost of R1 million on loan account from Company B on 1 March year 1. Company A is entitled to an allowance of 20% a year on the cost price of the asset under section 12C(1), namely, R200 000.

Year of assessment ending on 28 February year 3

On 1 March year 2 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.

None of the exclusions in section 19(8) or paragraph 12A(6) apply.

Result:

Year of assessment ending on 28 February year 3

Debt benefit

Debt benefit = Amount waived = R500 000.

Application of paragraph 12A(3)

Company A was granted allowances under section 12C(1) of R200 000 a year for the years of assessment ending on 28 February year 2 and year 3. At the time the debt benefit arose, the base cost of the machinery for purposes of paragraph 20 was R600 000 (R1 million cost − R400 000 wear-and-tear allowances claimed).[51]

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

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 amount of the debt benefit and therefore paragraph 12A(3) applied to the full amount of the debt waived.

[51] Base cost reduced under paragraph 20(3)(*a*)(i).

Application of section 12C and 19(7)

Company A used the asset during the year of assessment and therefore is entitled to an allowance of 20% a year on the cost price of the asset under section 12C(1), namely, R200 000. The section 12C allowance for the year of assessment ending on 28 February year 3 is not limited by section 19(7) as Company A's entitlement to the allowance arose before Company B waived the debt.

Under section 19(7) the allowances that can be claimed on the machine after the debt benefit arose will be limited to R100 000, being the aggregate of the expenditure incurred of R1 million reduced by R900 000 (the amount of the debt benefit of R500 000 plus the aggregate amount of allowances previously granted in years of assessment ending on 28 February year 2 and year 3 of R400 000). The allowance that may be claimed under section 12C(1) is, therefore, limited to R100 000 for the year of assessment ending on 28 February year 4 and no further allowances will be allowed on the asset.

Example 29 – Limitation of deductions and allowances on an allowance asset

Facts:

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

Year of assessment ending on 28 February year 2

On 1 March year 1 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.

Year of assessment ending on 28 February year 3

On 31 August year 2 Company B was relieved from payment of the debt of R2 million because of cash-flow problems.

None of the exclusions in section 19(8) or paragraph 12A(6) apply.

Result:

Year of assessment ending on 28 February year 3

Debt benefit

Debt benefit = Amount waived = R2 million.

Application of paragraph 12A(3)

Company B was granted allowances under section 11(*e*) of R300 000 and R150 000 (R300 000 × 6 / 12) for the years of assessment ending on 28 February year 2 and year 3. At the time the debt benefit arose, the base cost of the machinery for purposes of paragraph 20 was R1 550 000 (R2 million cost − R450 000 wear-and-tear allowances claimed).[52]

Under paragraph 12A(3) the base cost of the machinery (R1 550 000) was reduced by R1 550 000 to R Nil for purposes of paragraph 20.

52 Base cost reduced under paragraph 20(3)(*a*)(i).

Application of section 19(6)

Section 19(6) applies in these circumstances, since paragraph 12A(3) did not apply to the full amount of the debt waived. R450 000 (debt benefit of R2 million − amount applied under paragraph 12A(3) of R1 550 000) is deemed to be an amount recovered or recouped under section 19(6) for purposes of section 8(4)(*a*).

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

Company B used the machine during the year of assessment before the debt was waived on 31 August year 2 and therefore is entitled to an allowance for that period under section 11(e) of R150 000 (15% x R2 000 000 x 6 / 12).

The allowance available for the six months in year of assessment ending 28 February year 3 after the debt was waived and future years of assessment is potentially limited under section 19(7). Under section 19(7) the allowances that can be claimed on the machine after the debt benefit arose will be limited to RNil, being the aggregate of the expenditure incurred of R2 million reduced by R2 450 000 (the amount of the debt benefit of R2 million plus the aggregate amount of allowances previously granted in years of assessment ending on 28 February year 2 and year 3 of R300 000 and R150 000) but limited to RNil. Therefore no allowance may be claimed under section 11(*e*) for the period 1 September year 2 − 28 February year 3 for the year of assessment ending on 28 February year 3 or in future years of assessment.

Example 30 – Limitation of deductions and allowances on an allowance asset

Facts:

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

Year of assessment ending on 28 February year 2

On 1 March year 1 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.

Year of assessment ending on 28 February year 3

On 1 March year 2 Company B was relieved from payment of the debt of R2 million because of cash-flow problems. The asset was disposed of on 28 February year 3 for R2,1 million.

None of the exclusions in section 19(8) or paragraph 12A(6) apply.

Result:

Year of assessment ending on 28 February year 3

Debt benefit

Debt benefit = Amount waived = R2 million.

Application of paragraph 12A(3)

The debt of R2 million funded the acquisition of an allowance asset that was not disposed of in a prior year. As a result, paragraph 12A(3) applies and the base cost of the asset of R1,7 million (R2 million cost − R300 000 wear-and-tear allowance previously claimed)[53] must be reduced by the amount of the debt benefit. The reduction of base cost is, however, limited to R1,7 million, since expenditure and base cost cannot be reduced below RNil.

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 amount of the debt benefit 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 amount of the debt benefit − R1,7 million applied under paragraph 12A(3)] is, deemed under section 19(6) to be an amount that has been recovered or recouped for purposes of section 8(4)(*a*).

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*) of R300 000 (R2 million × 15%). However, under section 19(7) the aggregate amount of the allowances that can be claimed on the asset after the debt benefit arose is limited to the aggregate expenditure incurred in acquiring the asset of R2 million reduced by the sum of the debt benefit 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 allowance under section 11(*e*) is permitted in the year of assessment ending on 28 February year 3.

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 − R300 000 section 11(*e*) allowance claimed).

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) (see **4.12.1**). 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.

[53] Base cost reduced under paragraph 20(3)(*a*)(i).

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). 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*), because of paragraph (iii) of the proviso to section 8(4)(*a*).

Example 31 – Limitation of deductions and allowances on an allowance asset

Facts:

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

Year of assessment ending on 28 February year 2

On 1 March year 1 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.

Year of assessment ending on 28 February year 3

By the end of the year of assessment ending on 28 February year 3, Company B had claimed wear-and-tear allowances under section 11(*e*) of R1 million (R2 million × 2 / 4).

Year of assessment ending on 28 February year 4

On 1 March year 3 Company B was relieved from the payment of R1,5 million of the debt because of cash-flow problems. The asset was disposed of on 15 March year 3 for R800 000.

None of the exclusions in section 19(8) or paragraph 12A(6) apply.

Result:

Year of assessment ending on 28 February year 4

Debt benefit

Debt benefit = Amount waived = R1,5 million.

Application of paragraph 12A(3)

The debt of R2 million funded the acquisition of an allowance asset which was not disposed of in a prior year. As a result, paragraph 12A(3) applies and the base cost of the asset of R1 million (R2 million cost − R1 million wear-and-tear allowance claimed)[54] must be reduced by the amount of the debt benefit of R1,5 million. The base cost of the asset is reduced to RNil, since expenditure cannot be reduced below RNil.

[54] Base cost reduced under paragraph 20(3)(*a*)(i).

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 amount of the debt benefit 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 debt benefit − R1 million paragraph 12A(3) reduction) is, deemed under section 19(6) to be an amount that has been recovered or recouped for the purposes of section 8(4)(*a*).

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 year of assessment ending on 28 February year 4 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 debt benefit arose are limited to the aggregate expenditure incurred in acquiring the asset of R2 million reduced by the sum of the amount of the debt benefit 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 the year of assessment ending on 28 February year 4.

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). The proceeds derived by Company B of R800 000 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. The proceeds on disposal of the asset of R800 000 was less than the asset's tax value of R1 million. 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 waived. Company B claimed deductions for the true cost of R500 000 [R1 million claimed as a wear and tear allowances of which R500 000 was recouped under section 19(6) 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 32 – Limitation of deductions and allowances on an allowance asset

Facts:

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

Year of assessment ending on 28 February year 2

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).

Year of assessment ending on 28 February year 3

Company B claimed an allowance under section 12C of R160 000 (20% × R800 000). On 1 June year 2 Company B was relieved from the payment of R100 000 of the debt because of cash-flow problems. The asset was disposed of on 15 June year 2 for R25 000.

None of the exclusions in section 19(8) or paragraph 12A(6) apply.

Result:

Year of assessment ending on 28 February year 3

Debt benefit

Debt benefit = Amount waived = R100 000.

Application of paragraph 12A(3)

The debt of R800 000 funded the acquisition of an allowance asset that was not disposed of in a prior year. As a result, paragraph 12A(3) applies and the base cost of the asset of R320 000 (R800 000 cost − R480 000 allowances previously claimed)[55] must be reduced by the amount of the debt benefit of R100 000. The base cost of the asset is accordingly reduced to R220 000.

Application of sections 12C and 19(7)

Company B used the machine during the year of assessment and therefore is entitled to an allowance of 20% a year on the cost price of the asset under section 12C(1), namely, R160 000. The section 12C allowance for the year of assessment ending on 28 February year 3 is not limited by section 19(7) as Company B's entitlement to the allowance arose *before* Company A waived the debt on 1 June year 2.

55 Base cost reduced under paragraph 20(3)(*a*)(i).

If Company B had not sold the machine, the section 12C allowances that could have been claimed on the machine *after* the debt benefit arose in future years of assessment would have been limited under section 19(7) to R220 000, being the aggregate of the expenditure incurred of R800 000 reduced by R580 000 (the amount of the debt benefit of R100 000 plus the aggregate amount of allowances previously granted in years of assessment ending on 28 February year 2 and year 3 of R480 000 (R320 000 + R160 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 debt benefit arose are limited to the aggregate expenditure incurred in acquiring the asset of R800 000 reduced by the sum of the amount of the debt benefit 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 debt benefit amount − R480 000 section 12C allowances).

Determination of capital gain

Company B derived proceeds of R25 000 on disposal of the asset. The base cost of the asset of R800 000 is reduced by R580 000 (allowances claimed under section 12C of R480 000 + debt benefit of R100 000) under paragraphs 20(3)(*a*)(*i*) and 12A(3) to R220 000. Under paragraph 20(3)(*a*)(*i*) the base cost is further reduced by the amount of the scrapping allowance claimed under section 11(*o*) of R220 000 , 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 waived. 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 Other assets not disposed of in a prior year of assessment [paragraph 12A(3)]

A person must reduce the expenditure contemplated in paragraph 20 in respect of an asset by the amount of any debt benefit when –

- that debt benefit in respect of a debt owed by a person arises in respect of a year of assessment by reason or as a result of a concession or compromise in respect of that debt during that year of assessment; and

- the amount of that debt is owed by that person in respect of or was used by that person to fund, directly or indirectly, any expenditure in respect of an asset (other than trading stock for which a deduction or allowance was granted under the Act)[56] that was not disposed of by that person in a year of assessment prior to that in which that debt benefit arises.

The base cost of an asset cannot be reduced below RNil under paragraph 12A(3) to give rise to a negative amount.

Example 33 – Debt benefit – Asset not disposed of in a prior year of assessment

Facts:

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

Year of assessment ending on 29 February year 2

On 1 March year 1 Company A acquired land on loan account from Company B for R1 million.

Year of assessment ending on 28 February year 4

On 1 February year 4 Company B waived R600 000 of the debt because of Company A's inability to pay.

Year of assessment ending on 29 February year 6

On 1 March year 5 Company A disposed of the land for R1 200 000.

None of the exclusions in paragraph 12A(6) applies.

Result:

Year of assessment ending on 28 February year 4

Debt benefit

Debt benefit = Amount waived = R600 000.

Under paragraph 12A(3) the base cost of the land must be reduced by R600 000.

Year of assessment ending on 29 February year 6

Capital gain on disposal of the land

	R
Proceeds	1 200 000
Less: Base cost [R1 million cost − R600 000 reduction in base cost under paragraph 12A(3)]	(400 000)
Capital gain	800 000

[56] Paragraph 12A(2)(*b*).

Example 34 – Debt benefit – Trading stock for which a deduction was not allowed under section 11(*a*)

Facts:

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

Year of assessment ending on 31 March year 2

On 1 April year 1 Company A ordered trading stock at a cost of R100 000 from Company B on loan account and incurred the liability to pay for it. A deduction for the acquisition of the trading stock was not allowed under section 11(*a*) read with section 23F(1), since the trading stock was neither disposed of nor held during the year of assessment. On 30 September year 1 Company B waived the debt of R100 000 because the resale value of the trading stock declined significantly.

None of the exclusions in paragraph 12A(6) apply.

Result:

Year of assessment ending on 31 March year 2

Debt benefit

Debt benefit = Amount waived = R100 000.

Under paragraph 12A(3) the base cost of the trading stock is reduced to RNil (expenditure incurred of R100 000 − amount of the debt benefit of R100 000).

Note:

Section 19 does not apply, since the acquisition of the trading stock did not qualify for a deduction under section 11(*a*), because of the application of section 23F(1) (see **4.2**).

4.9 Other assets disposed of in a prior year of assessment [paragraph 12A(4)]

From years of assessment commencing on or after 1 January 2019, paragraph 12A(4) applies when –

- a debt benefit in respect of a debt owed by a person arises in respect of a year of assessment by reason or as a result of a concession or compromise in respect of that debt during that year of assessment; and
- the amount of that debt is owed in respect of or was used by that person to fund, directly or indirectly, any expenditure incurred in respect of an asset (other than trading stock for which a deduction or allowance was granted under the Act)[57] that was disposed of in a year of assessment prior to that in which that debt benefit arises.

It is necessary to determine whether the capital gain or capital loss that arose in the prior year of assessment on disposal of the asset would have differed from the capital gain or capital loss determined assuming that the debt benefit was taken into account in that prior year of assessment.

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[57] Paragraph 12A(2)(*b*).

The absolute difference between the prior year capital gain or capital loss and the re-determined capital gain or capital loss must be determined. The absolute difference is the distance between two real numbers (negative, zero or positive) on the "real line". For example, the absolute difference between - 2 and + 3 is 2 + 3 = 5, while the absolute difference between two negative or two positive numbers is the difference between their absolute values (for example, the absolute difference between -2 and -5 is 3 and between 3 and 7 is 4).

Thus, for example, if a capital loss of R20 arose on disposal of the asset in a prior year of assessment and the re-determined amount is a capital gain of R80, the absolute difference is R100 (R20 + R80).

The absolute difference must be treated as a capital gain in the year of assessment in which the debt benefit arises.

When multiple debt benefits have arisen in respect of an asset over more than one prior year of assessment, any duplication in the amount of the capital gain to be brought to account must be eliminated.[58]

Example 35 – Debt benefit – Asset disposed of in a prior year of assessment

Facts:

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

Year of assessment ending on 28 February year 2

On 1 March year 1 Individual A lent R1 million to Company B. Company B used the funds to acquire vacant land at a cost of R1 million. On 28 February year 2 Company B sold the land for R1,2 million and reflected a capital gain of R200 000 for the year of assessment.

Year of assessment ending on 28 February year 3

On 30 April year 2 Individual A waived the loan of R1 million because of Company B's inability to pay.

None of the exclusions in paragraph 12A(6) apply.

Result:

Year of assessment ending on 28 February year 3

Debt benefit

Debt benefit = Amount waived = R1 million.

The debt was used to fund an asset disposed of in a prior year of assessment. The capital gain of R200 000 which arose in the year of assessment ending on 28 February year 2 must therefore be re-determined as if the debt benefit had arisen in that year of assessment.

[58] The proviso to paragraph 12A(4).

Re-determined capital gain on disposal of the asset under paragraph 12A(4)

As a result of the debt waiver, the base cost of the vacant land must be reduced to RNil (cost of R1 million − debt benefit of R1 million) under paragraph 12A(3). The re-determined capital gain on disposal of the asset is R1,2 million (proceeds of R1,2 million − base cost of RNil).

The amount to be treated as a capital gain in the year of assessment ending on 28 February year 3 under paragraph 12A(4) is the absolute difference between R1,2 million (re-determined capital gain for the year of assessment ending on 28 February year 2) and R200 000 (capital gain determined for the year of assessment ending on 28 February year 2) = R1 million.

Example 36 – Debt benefit – Asset disposed of in a prior year of assessment – Multiple debt benefits

Facts:

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

Year of assessment ending on 29 February year 2

Company A acquired vacant land on 1 March year 1 for R1 million which was financed through an interest-free loan from the bank.

Year of assessment ending on 28 February year 5

Company A disposed of the land on 28 February year 5 for R1,2 million.

Years of assessment ending on the last day of February year 6, 7 and 8

Company A began to experience cash-flow difficulties and the bank waived portions of the loan over the next three years: R100 000 on 1 March year 5, R300 000 on 1 March year 6 and R600 000 on 1 March year 7.

None of the exclusions in paragraph 12A(6) apply.

Result:

Year of assessment ending on 28 February year 5

Capital gain on disposal of the land

	R
Proceeds	1 200 000
Less: Base cost	(1 000 000)
Capital gain	200 000

Years of assessment ending on the last day of February years 6, 7 and 8

Debt benefits arose in each of the years of assessment ending on the last day of February year 6, 7 and 8 in respect of the amounts of debt waived, namely, R100 000, R300 000 and R600 000 respectively.

Paragraph 12A(4) stipulates that the capital gain determined for the year of assessment ending on 28 February year 5 in respect of the asset disposed of, must be re-determined for each of the years of assessment in respect of which a debt benefit arose, taking into account the proviso to paragraph 12A(4).

Year of assessment ending on 29 February year 6

	R
Proceeds	1 200 000
Less: Base cost [R1 million – R100 000 (paragraph 12A(3)]	(900 000)
Re-determined capital gain – year of assessment ending on 28 February year 5	300 000
Less: Capital gain determined – year of assessment ending on 28 February year 5	(200 000)
Amount treated as capital gain – year of assessment ending on 29 February year 6	100 000

Year of assessment ending on 28 February year 7

Proceeds	1 200 000
Less: Base cost [R1 million – R100 000 – R300 000 (paragraph 12A(3)]	(600 000)
Re-determined capital gain – year of assessment ending on 28 February year 5	600 000
Less: Capital gain determined – year of assessment ending on 28 February year 5	(200 000)
Less: Capital gain determined – year of assessment ending on 29 February year 6	(100 000)
Amount treated as capital gain – year of assessment ending on 28 February year 7	300 000

Year of assessment ending on 28 February year 8

	R
Proceeds	1 200 000
Less: Base cost [R1 million – R100 000 – R300 000 – R600 000 (paragraph 12A(3)]	(0)
Re-determined capital gain – year of assessment ending on 28 February year 5	1 200 000
Less: Capital gain determined – year of assessment ending on 28 February year 5	(200 000)
Less: Capital gain determined – year of assessment ending on 29 February year 6	(100 000)
Less: Capital gain determined – year of assessment ending on 28 February year 7	(300 000)
Amount treated as capital gain – year of assessment ending on 28 February year 8	600 000

Example 37 – Debt benefit – Asset disposed of in a prior year of assessment

Facts:

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

Year of assessment ending on 29 February year 2

Company A acquired a piece of vacant land on 1 March year 1 for R1 million which was funded by an interest-free loan from Company B.

Year of assessment ending on 28 February year 5

Company A sold the land on 28 February year 5 for R800 000.

Year of assessment ending on 29 February year 6

On 1 March year 5 Company B waived the loan because of Company A's inability to pay.

None of the exclusions in paragraph 12A(6) apply.

Result:

Year of assessment ending on 28 February year 5

Capital loss on disposal of the land

	R
Proceeds	800 000
Less: Base cost	(1 000 000)
Capital loss	(200 000)

Year of assessment ending on 29 February year 6

Debt benefit

Debt benefit = Amount waived = R1 million.

The debt was used to fund an asset disposed of in a prior year of assessment. The capital loss of R200 000 which arose in the year of assessment ending on 28 February year 5 must therefore be re-determined as if the debt benefit had arisen in that year of assessment.

Re-determined capital gain on disposal of the asset under paragraph 12A(4)

As a result of the debt waiver, the base cost of the vacant land must be reduced to RNil (cost of R1 million − debt benefit of R1 million) under paragraph 12A(3). The re-determined capital gain on disposal of the asset is R800 000 (proceeds of R800 000 − base cost of RNil).

The amount to be treated as a capital gain for the year of assessment ending on 29 February year 6 is the absolute difference between R800 000 (re-determined capital gain for the year of assessment ending on 28 February year 5) and R200 000 (capital loss determined for the year of assessment ending on 28 February year 5) = R1 million.

Example 38 – Debt benefit – Asset disposed of in a prior year of assessment

Facts:

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

Year of assessment ending on 29 February year 2

Company A acquired a piece of vacant land on 1 March year 1 for R1 million which was funded by an interest-free loan from Company B.

Year of assessment ending on 28 February year 5

Company A sold the land on 28 February year 5 for R300 000.

Year of assessment ending on 29 February year 6

On 1 March year 5 Company B waived R100 000 of the loan because of Company A's inability to pay.

None of the exclusions in paragraph 12A(6) apply.

Result:

Year of assessment ending on 28 February year 5

Capital loss on disposal of the land

	R
Proceeds	300 000
Less: Base cost	(1 000 000)
Capital loss	(700 000)

Year of assessment ending on 29 February year 6

Debt benefit

Debt benefit = Amount waived = R100 000.

The debt was used to fund an asset disposed of in a prior year of assessment. The capital loss of R700 000 which arose in the year of assessment ending on 28 February year 5 must therefore be re-determined as if the debt benefit had arisen in that year of assessment.

Re-determined capital gain on disposal of the asset under paragraph 12A(4)

As a result of the debt waiver, the base cost of the land must be reduced to R900 000 (cost of R1 million − debt benefit of R100 000) under paragraph 12A(3). The re-determined capital loss is R600 000 (proceeds of R300 000 − base cost of R900 000).

The amount to be treated as a capital gain for the year of assessment ending on 29 February year 6 is the absolute difference between R600 000 (re-determined capital loss for the year of assessment ending on 28 February year 5) and R700 000 (capital loss determined for the year of assessment ending on 28 February year 5) = R100 000.

Example 39 – Debt benefit – Asset disposed of in a prior year of assessment

Facts:

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

Year of assessment ending on 29 February year 2

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.

Year of assessment ending on 28 February year 5

On 30 June year 4 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 year 4 for proceeds of R2,2 million.

Year of assessment ending on 29 February year 6

On 31 March year 5 Company A waived the balance of R1,5 million because of Company B's inability to repay the remaining amount.

None of the exclusions in paragraph 12A(6) apply.

Result:

Year of assessment ending on 28 February year 5

Debt benefit

Debt benefit = Amount waived = R500 000.

Under paragraph 12A(3) the expenditure of R2 million incurred to acquire the land must be reduced by the debt benefit of R500 000. 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 − base cost of R1,5 million).

Year of assessment ending on 29 February year 6

Debt benefit

Debt benefit = Amount waived = R1,5 million.

The debt was used to fund an asset which was disposed of in a prior year of assessment. The capital gain of R700 000 which arose in the year of assessment ending on 28 February year 5 must therefore be re-determined as if the debt benefit had arisen in that year of assessment.

Re-determined capital gain on disposal of the asset under paragraph 12A(4)

As a result of the debt waiver, the base cost of the land must be reduced to RNil (cost of R2 million − amounts applied under paragraph 12A(3) of R500 000 and R1,5 million, respectively). The re-determined capital gain is R2,2 million (proceeds of R2,2 million − base cost of RNil).

The amount to be treated as a capital gain in the year of assessment ending on 29 February year 6 is the absolute difference between R2,2 million (re-determined capital gain for the year of assessment ending on 28 February year 5) and R700 000 (capital gain determined for the year of assessment ending on 28 February year 5) = R1,5 million.

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

Special rules in paragraph 12A(5) determine the base cost of a pre-valuation date asset when a debt benefit arises in respect of debt that funded expenditure in relation to that asset and paragraph 12A(3) or (4) applies. A pre-valuation date asset is defined in paragraph 1 and means an asset acquired before valuation date[59] by a person and which has not been disposed of by that person before valuation date.

[59] Definition of "valuation date" in paragraph 1. Valuation date 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 a debt benefit arose 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 value[60] at that time.

A person is treated as having disposed of an asset immediately before a debt benefit arose 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 capital 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 debt benefit arose 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 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 40 – Determination of the base cost of a pre-valuation date asset

Facts:

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

Year of assessment ending on 31 March year 2

Company X acquired land (before 1 October 2001) at a cost of R500 000. Under paragraph 29 Company X determined the market value of the land on valuation date (1 October 2001) at R900 000 and adopted this market value as the valuation date value of the land.

Year of assessment ending on 31 March year 11

Improvements of R2 million, funded with a loan from Company Y, were affected to the land (after 1 October 2001).

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

Year of assessment ending on 31 March year 16

On 1 June year 15 the loan of R2 million was waived because of Company X's adverse economic position. Immediately before the debt benefit arose the market value of the land and improvements was R5 million.

None of the exclusions in paragraph 12A(6) apply.

Result:

Year of assessment ending on 31 March year 16

Debt benefit

Debt benefit = Amount waived = 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)	(2 100 000)
Expenditure actually incurred for purposes of paragraph 20(1)(*a*)	2 900 000

Application of paragraph 12A(3)

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

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

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

Section 19 and paragraph 12A do not apply to a debt benefit in respect of 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 amount of the debt benefit has to be subject to estate duty,[61] merely that it forms part of the property of the deceased estate for purposes of the Estate Duty Act.

61 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.

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

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

Example 41 – 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.

Year of assessment ending on 28 February year 2

Individual A sold shares to Family Trust A for R1 million on loan account on 1 March year 1. The shares were acquired by the trust as a capital investment.

Year of assessment ending on 28 February year 4

Individual A passed away on 30 April year 3 and under Individual A's last will the loan of R1 million was bequeathed to the trust.

Result:

Year of assessment ending on 28 February year 4

Debt benefit

Debt benefit = Amount extinguished = R1 million.

Application of section 19 and paragraph 12A

The debt was discharged for no consideration by operation of law when the liquidation and distribution account of the deceased became final and the loan was awarded to the trust. Under paragraph 12A(6)(*a*) no reduction in the base cost of the shares must be made by the trust 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 debt benefit of R1 million 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.

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

Section 19 and paragraph 12A do not apply to a debt benefit in respect of 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); and
- in respect of which donations tax is payable.

The exclusions under section 19(8)(*b*) and paragraph 12A(6)(*b*) apply only *to the extent* that donations tax is payable on the debt benefit. Thus, if a debt is 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 not apply *to the extent* that the donation is exempt from donations tax under section 56 or if donations tax is not payable by virtue of section 54 because the donor is a non-resident.

Meaning of "donation" as defined in section 55(1)

The definitions "donation" and "property" in section 55(1) read 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:[62]

> "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.' "

[62] 2005 (4) SA 173 (SCA), 66 SATC 303 at 312 and 314.

In *Estate Sayle v CIR* the court stated the following:[63]

> "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.[64]

Not every reduction or concession or compromise 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

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*[65] Marais JA held[66] 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:[67]

> "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 1599[68] Wunsh J explained the history and object of donations tax by quoting the following dicta of Boshoff WRP in *Ogus v SIR*:[69]

> " '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.' "

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63 1945 AD 388, 13 SATC 170 at 173.
64 1961 (2) SA 20 (FC), 24 SATC 157 at 165.
65 2005 (4) SA 173 (SCA), 66 SATC 303.
66 At SATC 315.
67 At SATC 315.
68 (1995) 58 SATC 88 (T) at 97.
69 1978 (3) SA 67 (T), 40 SATC 100 at 107.

Wunsh J stated further that the purpose of section 58 is to combat tax avoidance.[70] 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.[71]

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.[72]

In SARS's view "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 42 – Non-application of section 19 – Debt reduced by a donation – Years of assessment commencing on or after 1 January 2019

Facts:

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

Year of assessment ending on 28 February year 2

Individual X holds 1% of the shares in Company Y, a resident company. Individual X is not an employee or director of the company. On 1 March year 1 Company Y advanced an interest-free loan of R100 000 to Individual X. The debt of R100 000 funded operating expenses of a business carried on by Individual X, for which deductions were granted.

Year of assessment ending on 28 February year 3

On 1 March year 2 Company Y waived the debt of R100 000 because of significant profits derived by the company in the preceding 12 months

None of the exemptions from donations tax in section 56 apply.

70 At SATC 98.
71 At SATC 99.
72 At SATC 96.

Result:

Year of assessment ending on 28 February year 3

Debt benefit

Debt benefit = Amount waived = 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) on which donations tax is payable and hence the exclusion in section 19(8)(*b*)(i) applies.

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 43 – Partial-application of paragraph 12A – Debt reduced by a donation – Years of assessment commencing on or after 1 January 2019

Facts:

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

Year of assessment ending on 29 February year 2

On 1 March year 1 Individual A advanced a loan of R1 million to Trust B, of which her two children are the only beneficiaries. Trust B used the funds to acquire a property at a cost of R1 million from which it derived rental income.

Year of assessment ending on 29 February year 6

On 1 March year 5 Individual A waived R150 000 of the loan. No other donations were made.

The property was not disposed of in a prior year of assessment.

Result:

Year of assessment ending on 29 February year 6

Debt benefit

Debt benefit = Amount waived = R150 000.

Application of paragraph 12A(3)

The waiver of the debt of R150 000 by Individual A was motivated by pure liberality and is therefore a "donation" as defined in section 55(1). Under section 56(2)(*b*) R100 000 of the donation is exempt from donations tax. Donations tax is accordingly payable by Individual A on the donation of R50 000 (R150 000 − R100 000).

The exclusion under paragraph 12A(6)(*b*) will therefore apply only *to the extent* of R50 000 which is subject to donations tax. The base cost of Trust B's property must be reduced by the amount of the debt benefit not subject to donations tax (R100 000) under paragraph 12A(3).

Example 44 – Partial-application of paragraph 12A – Debt reduced by a transaction to which section 58 applies – Years of assessment commencing on or after 1 January 2019

Facts:

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

Year of assessment ending on 28 February year 2

On 1 April year 1 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.

Year of assessment ending on 28 February year 3

On 31 March year 2 Individual X agreed to accept R700 000 in full and final settlement of the loan of R1 million. There was no commercial reason for the concession or compromise of the debt. Individual X did not make any other donations during the year of assessment.

The land was not disposed of in a prior year of assessment.

Result:

Year of assessment ending on 28 February year 3

Debt benefit

Debt benefit = Amount extinguished by settlement:

= Face value of the claim of R1 million *less* expenditure incurred in respect of redemption of the debt of R700 000

= R300 000

Application of section 58(1) and paragraph 12A(3)

The loan of R1 million has been disposed of for a consideration of R700 000 which is not an adequate consideration. Accordingly, under section 58(1) property to the value of R300 000 is deemed to have been disposed of under a donation.

The deemed donation of R300 000 will result in Individual X being liable for donations tax on R200 000 [R300 000 deemed donation − R100 000 exempt portion under section 56(2)(*b*)]. Since only R200 000 of the deemed donation is subject to donations tax, only that amount qualifies for the exclusion in paragraph 12A(6)(*b*)(ii).

The base cost of the land must be reduced by R100 000 under paragraph 12A(3), since this portion of the debt benefit is not subject to donations tax.

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

Section 19 and paragraph 12A will not apply to a debt benefit in respect of 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),[73] a taxable benefit is deemed to have been granted by an employer to the employer's employee in respect of the employee's employment with the employer if –

- as a benefit or advantage of;
- by virtue of such employment; or
- as a reward for services rendered or to be rendered by the employee to the employer,

a benefit listed in paragraph 2 of the Seventh Schedule is granted.

Under paragraph 2(*h*) of the Seventh Schedule a taxable benefit is deemed to have been granted if the employer has directly or indirectly paid any debt[74] 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,[75] 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.

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73 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.

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

75 Section 11(*d*) of the Prescription Act 68 of 1969 provides that the period of prescription of any debt, other than debt mentioned in section 11(*a*) to (*c*) of that Act, is three years.

Example 45 – 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.

Year of assessment ending on 28 February year 2

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

Year of assessment ending on 28 February year 4

On 1 April year 3 Employer ABC waived the loan. The computer was not disposed of in a prior year of assessment.

Result:

Year of assessment ending on 28 February year 4

Debt benefit

Debt benefit = Amount waived = 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 benefit in respect of 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.

4.11.4 Group of companies [section 19(8)(*d*) and paragraph 12A(6)(*d*)]

Section 19 and paragraph 12A do not apply to a debt benefit in respect of any debt owed by a company to another company when during the year of assessment during which that debt benefit arises and the immediately preceding year of assessment –

- both the debtor and creditor form part of the same "group of companies" as defined in section 41(1),[76] and
- the debtor company has not carried on any trade.

[76] See Interpretation Note 75 "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".

The exclusion in section 19(8)(*d*) and paragraph 12A(6)(*d*) does not apply in respect of any debt –[77]

- incurred, directly or indirectly, by the debtor company to fund expenditure incurred in respect of any asset that was subsequently disposed of by that company by way of an asset-for-share, intra-group or amalgamation transaction or a liquidation distribution in respect of which section 42, 44, 45 or 47, as the case may be, applied; or
- incurred or assumed by the debtor company to settle, take over, refinance or renew, directly or indirectly, any debt incurred by –
  - any other company that forms part of the same group of companies; or
  - any company that is a controlled foreign company[78] in relation to any company that forms part of the same group of companies.

The exclusion uses the definition of "group of companies" in section 19(1) and paragraph 12A(1), which in turn refers to the restricted definition of the same term in section 41(1) rather than the wider definition in section 1(1). The relief under section 19(8)(*d*) and paragraph 12A(6)(*d*) is therefore limited to situations in which both the debtor company and the creditor company are fully within the tax system. If the exclusion applies, the debtor is not subject to the tax consequences under section 19 and paragraph 12A but this is matched by the denial of a capital loss on disposal of the debt for the creditor under paragraph 56(1).

Example 46 – Non-application of paragraph 12A – Debt benefit in respect of a debt owed by a company forming part of the same group of companies as the creditor 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.

Year of assessment ending on 28 February year 2

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

Year of assessment ending on 28 February year 3

On 1 March year 2 Company B waived the outstanding balance on the loan account, which at that stage stood at R500 000, because of Company A's adverse economic position.

Company A has not carried on any trade since acquisition of the land.

Result:

Year of assessment ending on 28 February year 3

Debt benefit

Debt benefit = Amount waived = R500 000.

77 The proviso to section 19(8)(*d*) and paragraph 12A(6)(*d*).
78 Definition of "controlled foreign company" in section 1(1).

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 amount of the debt benefit of R500 000, since Company A and Company B form part of the same group of companies and Company A did not carry on a trade during the current and previous years of assessment.

Note:

Company B is denied a capital loss on the waiver of the debt under paragraph 56(1) (see **4.12.6**).

Example 47 – Non-application of paragraph 12A – Debt benefit in respect of a debt owed by a company forming part of the same group of companies as the creditor 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.

Years of assessment ending on the last day of February year 2 and 3

Company A acquired second-hand machinery at a cost of R1 million on loan account from Company B on 1 March year 1. Company A claimed an allowance of 20% a year on the cost price of the machinery under section 12C(1) for the years of assessment ending on 28 February year 2 and year 3.

Year of assessment ending on 28 February year 4

Company A claimed an allowance of 20% a year on the cost price of the machinery under section 12C(1) for the year of assessment ending on 28 February year 4. Company A ceased trading during this year of assessment.

Year of assessment ending on 29 February year 6

On 1 March year 5 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:

Year of assessment ending on 29 February year 6

Debt benefit

Debt benefit = Amount waived = R500 000.

Application of section 19(6) and paragraph 12A(3)

Company A was granted allowances under section 12C(1) of R200 000 a year for the years of assessment ending on 28 February year 2, year 3 and year 4. At the time the debt benefit arose, the base cost of the machinery for purposes of paragraph 20 was R400 000 (cost of R1 million – allowances of R600 000).[79]

[79] Base cost reduced under paragraph 20(3)(*a*)(i).

> The base cost of the machinery is not reduced under paragraph 12A(3) and no recoupment arises under section 19(6) because section 19(8)(*d*) and paragraph 12A(6)(*d*) provide that section 19 and paragraph 12A must not apply if a debt benefit arises in respect of a debt owed by a company to another company forming part of the same group of companies as the debtor company and the debtor company did not carry on a trade during the current and previous years of assessment.
>
> **Note:**
>
> Company B is denied a capital loss of R500 000 on the waiver of the debt under paragraph 56(1) (see **4.12.6**).

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

Paragraph 12A(6)(*e*) provides that paragraph 12A does not apply to a debt benefit in respect of any debt owed by a company to a connected person[80] 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, discussed below.

First, under paragraph 12A(6)(*e*) paragraph 12A does not apply *to the extent* that the debt benefit in respect of the debt does not, at the time that the debt benefit arises, exceed the expenditure contemplated in paragraph 20 incurred by the connected person (the creditor) in respect of that debt, for example, when the creditor acquired the debt from a third party at an expenditure which is less than the face value of the debt. *To the extent* that the debt benefit exceeds the expenditure contemplated in paragraph 20 incurred by the connected person (the creditor), paragraph 12A will apply.

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 debtor company became a connected person in relation to the creditor after the debt, or any debt issued in substitution of that debt, arose [paragraph (*a*) of the proviso to paragraph 12A(6)(*e*)]; or
- the debtor 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)[81] 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,

[80] See Interpretation Note 67 "Connected Persons" on the definition of "connected person" in section 1(1).

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

deregistered or finally terminate its existence [paragraph (*b*) 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 (*b*) of the proviso to paragraph 12A(6)(*e*)].

Section 19 may, depending on the facts, apply to a debt owed by a debtor 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 48 – 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 persons[82] 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.

Year of assessment ending on 31 March year 2

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

Year of assessment ending on 31 March year 6

On 1 April year 5 Company Y waived the debt of R10 million in anticipation of the liquidation of Company X.

The fixed property was not disposed of in a prior year of assessment.

Result:

Year of assessment ending on 31 March year 6

Debt benefit

Debt benefit = Amount waived = R10 million.

Application of paragraph 12A(3)

The base cost of Company X's fixed property is not reduced by the amount of the debt benefit 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 to a connected person (Company Y); and
- the amount of the debt benefit of R10 million does not exceed the base cost of Company Y's asset (the debt) of R10 million.

[82] Under paragraph (*d*)(v) of the definition of "connected person" in section 1(1).

Expenditure contemplated in paragraph 20 incurred by Company Y (the creditor) in respect of the debt is R10 million. The exclusion in paragraph 12A(6)(*e*) applies to the full debt benefit of R10 million because it does not exceed the cost of Company Y's expenditure of R10 million for the debt.

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 **4.12.6**).

Example 49 – 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 persons[83] 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.

Year of assessment ending on 31 March year 2

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

Year of assessment ending on 31 March year 6

On 1 April year 5 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*).

The fixed property was not disposed of in a prior year of assessment.

Result:

Year of assessment ending on 31 March year 6

Debt benefit

Debt benefit = Amount waived = R10 million.

Application of paragraph 12A(3)

The base cost of Company Y's asset (the debt) was RNil (cost of R10 million − loss claimed under section 11(*a*) read with section 23(*g*) of R10 million)[84] when the debt was reduced.

[83] Under paragraph (*d*)(v) of the definition of "connected person" in section 1(1).

[84] 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 amount of the debt benefit (R10 million) exceeds the base cost of Company Y's asset (the debt) of 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 (R10 million cost − R10 million amount of the debt benefit) under paragraph 12A(3).

Example 50 – 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.

Year of assessment ending on 30 June year 2

On 1 July year 1 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 vacant land by Company X and was acquired by Individual Y at a discounted value of R80 000.

Year of assessment ending on 30 June year 5

On 1 August year 4 Company X disposed of all its assets. On 1 September year 4 Individual Y waived the loan account in anticipation of the liquidation of Company X.

Result:

Year of assessment ending on 30 June year 5

Debt benefit

Debt benefit = Amount waived = R100 000.

Application of paragraph 12A(3)

Individual Y and Company X are connected persons in relation to each other.[85] 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 amount of the debt benefit (R100 000) does not, at the time the debt benefit arises, exceed the base cost of the asset (the debt) of the connected person (R80 000).

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

The amount of the debt benefit of R100 000 exceeds the base cost of Individual Y's asset (the debt) of R80 000 by R20 000. The relief under paragraph 12A(6)(*e*) applies *to the extent* that the amount of the debt benefit (R100 000) does not exceed the base cost of the debt (R80 000), that is, the relief applies to R80 000 of the debt. The relief does not apply to R20 000 of the debt benefit and therefore under paragraph 12A(3) the excess of R20 000 will be applied to reduce the base cost of the land to R80 000 (cost of R100 000 − debt benefit of R20 000).

Notes:

(1) Paragraph 12A(3) is applied since the asset was not disposed of in a prior year of assessment. Although the asset was disposed of before the debt benefit arose, paragraph 12A is applied first.

(2) The capital loss on disposal of the debt of R80 000 must be disregarded under paragraph 56(1) (see **4.12.6**).

4.11.6 Debtor company issuing shares to creditor company forming part of the same group of companies [section 19(8)(*e*) and paragraph 12A(6)(*f*)]

Section 19 and paragraph 12A do not apply to a debt benefit in respect of any debt owed by a company to another company when –

- the debtor and creditor companies form part of the same "group of companies" as defined in section 41(1); and
- the debtor company reduces or settles that debt, directly or indirectly, by means of shares issued by it.

However, the exclusion in section 19(8)(*e*) and paragraph 12A(6)(*f*) do not apply in respect of any debt that was incurred or assumed by that debtor company in order to settle, take over, refinance or renew, directly or indirectly, any debt incurred by another (third) company which –

- did not form part of that same group of companies at the time that the debtor company incurred that debt; or
- does not form part of that same group of companies at the time that the debtor company reduces or settles that debt, directly or indirectly, by means of shares issued by it.

Example 51 – Non-application of section 19 and paragraph 12A – Issue of shares to creditor forming part of the same group of companies

Facts:

Company A and Company B's years of assessment end on the last day of February. Company A holds 100% of the equity shares in Company B.

Year of assessment ending on 28 February year 2

Company B purchased listed shares from Company A on loan account for R900 000 on 1 March year 1.

Year of assessment ending on 28 February year 7

The loan had increased by R100 000 as a result of accumulated interest. On 30 April year 6 Company B and Company A agreed that Company B could settle R200 000 of the loan (including all accumulated interest) through the issue of equity shares of R200 000 because Company B had accumulated losses and needed to be recapitalised.

On the "net asset valuation" method the market value of the shares held by Company A in Company B before the issue of the shares in settlement of R200 000 of the debt was RNil and after the issue was R100 000.

Result:

Year of assessment ending on 28 February year 7

Company B (Debtor)

Debt benefit

There has been a concession or compromise under paragraph (*b*)(i) of the definition of that term in section 19(1) and paragraph 12A(1) because a portion of the debt owed by Company B has been settled by being converted to or exchanged for shares in that company.

Debt benefit = Face value of the claim in respect of the portion of the debt subject to the concession or compromise before entering into the arrangement *less* the difference between the market value of Company A's shares after and before the arrangement:

= R200 000 − R100 000 (R100 000 − RNil)

= R100 000

Application of paragraph 12A(6)(f)

The base cost of the listed shares is R933 333 [cost of R900 000 + R33 333 (one-third of interest of R100 000 under paragraph 20(1)(*g*) (see **4.11.7** for an explanation of paragraph 20(1)(*g*))].

Under paragraph 12A(6)(*f*) Company B is not required to reduce the base cost of the listed shares by the debt benefit of R100 000 because Company B and Company A are companies forming part of the same "group of companies" as defined in section 41(1). The exclusion in paragraph 12A(6)(*f*) includes accumulated capitalised interest, unlike paragraph 12A(6)(*g*) (see **4.11.7**).

Notes:

(1) The debt benefit is determined under paragraph (*d*) of the definition of "debt benefit" in section 19(1) and paragraph 12A(1).

(2) The balance of the accumulated interest of R66 667 (R100 000 − R33 333) would not have qualified as a deduction under section 11(*a*) by reason of section 23(*f*)[86] and is therefore not subject to recoupment under section 19(5) for purposes of section 8(4)(*a*).

[86] Section 23(*f*) disallows expenses incurred in respect of amounts received or accrued, in this case dividends, which do not constitute income.

Company A (Creditor)

Under paragraph 56(1) Company A will not be entitled to claim a capital loss on disposal of the loan in exchange for the shares, since Company B has not suffered any of the consequences listed in paragraph 56(2).

4.11.7 Debtor company issuing shares to creditor – Debt not including interest [section 19(8)(*f*) and paragraph 12A(6)(*g*)]

Section 19 and paragraph 12A do not apply to a debt benefit in respect of any debt owed by a person *to the extent* that the debt so owed –

- is settled by means of an arrangement described in paragraph (*b*) of the definition of “concession or compromise”; and
- does not consist of or represent an amount owed by that person in respect of any interest incurred by that person during any year of assessment.

Paragraph (*b*) of the definition of “concession or compromise” deals with the situation in which a debt owed by a company is settled directly or indirectly –

- by being converted to or exchanged for shares in that company; or
- by applying the proceeds from shares issued by that company.

Therefore, if a debt benefit arises in respect of a debt comprising principal debt and capitalised interest, the principal debt amount is not subject to section 19 and paragraph 12A because of the exclusions under section 19(8)(*f*) and paragraph 12A(6)(*g*).The interest portion is, however, not excluded and is subject to section 19 and paragraph 12A.

However, when a debt benefit arises in respect of accumulated interest, there are relatively few situations in which it will result in the reduction in the base cost of an asset. This outcome follows from paragraph 20(2)(*a*) which prohibits the inclusion in the base cost of an asset of any borrowing costs, including any interest as contemplated in section 24J or raising fees. The only exception to this rule is in paragraph 20(1)(*g*) which allows one-third of the interest on money borrowed to finance the cost of acquisition or improvement or enhancement in the value of a share listed on a recognised exchange or a participatory interest in a portfolio of a collective investment scheme (including money borrowed to refinance those borrowings). Depending on the facts, if the interest was deductible there may be a recoupment under section 19(5), for purposes of section 8(4)(*a*).

In a partial settlement of an interest-bearing loan, the issue may arise whether it is the interest or the capital element of the loan that is being settled. It has to be determined 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. See **4.13** dealing with the allocation of payments and debt benefits.

Example 52 – Non-application of section 19 and paragraph 12A – Non-interest bearing debt discharged through issue of shares

Facts:

Company A is 100% owned by Individual B. In order to return Company A to solvency, Individual B agreed to the issue of shares in settlement of the loan account which stood at R200 000. No portion of the loan account represented accumulated capitalised interest.

Before the issue of the additional shares, the previously held shares had a market value of RNil and after the share issue all the shares are worth R100.

Result:

Debt benefit

There has been a concession or compromise under paragraph (*b*)(i) of the definition of that term in section 19(1) and paragraph 12A(1) because the debt owed by Company A has been settled by being converted to or exchanged for shares in that company.

Debt benefit = Face value of the claim in respect of the debt subject to the concession or compromise before entering into the arrangement *less* the difference between the market value of Company A's shares after and before the arrangement:

= R200 000 − R100 (R100 − RNil)

= R199 900

Application of section 19(8)(f) and paragraph 12A(6)(g)

There are no consequences under section 19 and paragraph 12A because of the exclusion in section 19(8)(*f*) and paragraph 12A(6)(*g*), since no portion of the loan comprised accumulated interest.

Notes:

(1) The debt benefit is determined under paragraph (*d*) of the definition of "debt benefit" in section 19(1) and paragraph 12A(1).

(2) Individual B is denied a capital loss of R200 000 on the settlement of the debt under paragraph 56(1) (see **4.12.6**).

Example 53 – Partial application of paragraph 12A – Debt discharged through issue of shares

Facts:

Company A is 100% owned by Individual B. In order to return Company A to solvency, Individual B agreed to the issue of shares in settlement of R100 000 of the loan account which stood at R200 000. The portion of the loan so settled included accumulated capitalised interest owing of R60 000. The loan was used to finance the acquisition of listed shares of R100 100.

Before the issue of the additional shares, the previously held shares had a market value of RNil and after the share issue all the shares are worth R100.

Result:

Debt benefit

There has been a concession or compromise under paragraph (*b*)(i) of the definition of that term in section 19(1) and paragraph 12A(1) because a portion of the debt owed by Company A has been settled by being converted to or exchanged for shares in that company.

Debt benefit = Face value of the claim in respect of the portion of the debt subject to the concession or compromise before entering into the arrangement *less* the difference between the market value of Company A's shares after and before the arrangement:

= R100 000 − R100 (R100 − RNil)

= R99 900

Application of section 19(8)(f) and paragraph 12A(6)(g)

Of the debt benefit amount, R39 900 (debt benefit of R99 900 − accumulated interest of R60 000) is excluded under section 19(8)(*f*) and paragraph 12A(6)(*g*), since this portion of the debt benefit does not relate to a debt owed in respect of interest. The portion of the debt benefit relating to accumulated interest of R60 000 is *not* excluded under section 19(8)(*f*) and paragraph 12A(6)(*g*).

Application of section 19(5) and paragraph 12A(3)

The base cost of the listed shares amounts to R120 100 [cost of R100 100 + one-third of interest of R20 000 (R60 000 / 3) (**Note 2**)].

Under paragraph 12A(3) Company A must reduce the base cost of the listed shares by R20 000, which is the one-third portion of the interest included in the base cost of the shares.

The balance of the debt benefit relating to accumulated interest of R40 000 (R60 000 − R20 000) relating to interest incurred does not have any consequences under section 19(5), since it would not have qualified for a deduction under section 11(*a*) read with section 23(*f*), being in the production of exempt dividend income.

Notes:

(1) The debt benefit is determined under paragraph (*d*) of the definition of "debt benefit" in section 19(1) and paragraph 12A(1).

(2) One-third of interest is included in the base cost of listed shares under paragraph 20(1)(*g*).

(3) Individual B is denied a capital loss of R80 000 (R100 000 – R20 000 reduction in base cost of Company A's shares) on the settlement of the debt under paragraph 56(1) (see **4.12.6**).

4.12 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.

4.12.1 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 in the current or a previous year of assessment which have been recovered or recouped during the current year of assessment.

The amount of a debt benefit in respect of a debt owed 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:[87]

> "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*[88] Howie P found that the conclusion of the Special Court in ITC 1634 that recoupment had occurred was correct.[89]

He stated that –[90]

> "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**).

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87 (1997) 60 SATC 235 (T) at 258.
88 2003 (4) SA 513 (SCA), 65 SATC 159.
89 At SATC 164.
90 At SATC 163.

Paragraph (ii) of the proviso to section 8(4)(*a*) therefore ensures that an amount of any debt benefit 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 benefit arises.

Example 54 – 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.

Year of assessment ending on 28 February year 2

Company A incurred debt of R400 000 which funded the acquisition of trading stock from Company B.

Year of assessment ending on 28 February year 3

On 1 March year 2 Company B waived the debt of R400 000 because of Company A's adverse financial position. The trading stock of R400 000 was still held and not disposed of at the end of the year of assessment. The opening balance of trading stock for the year of assessment ending on 28 February year 3 was R1 million and the closing balance R800 000.

None of the exclusions in section 19(8) apply.

Result:

Year of assessment ending on 28 February year 3

Debt benefit

Debt benefit = Amount waived = 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 amount of the debt benefit of R400 000.

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 21** and **30**).

4.12.2 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 share[91] 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 paragraph (*a*) of 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.

Paragraph (*a*) of the proviso to section 9C(5) therefore prevents the recoupment of the same amount twice.[92]

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.

[91] Definition of "equity share" in section 9C(1).

[92] See Interpretation Note 43 "Circumstances in which Certain Amounts Received or Accrued from the Disposal of Shares are Deemed to be of a Capital Nature" on section 9C.

Example 55 – Amounts included in income under section 9C(5)

Facts:

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

Year of assessment ending on 29 February year 2

On 1 March year 1 Company 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 year of assessment the value of the shares decreased to R80 000 which Company A reflected as the value of closing stock under section 22(1)(*a*).

Year of assessment ending on 28 February year 7

On 1 June year 6 Company B cancelled the debt owing by Company A because it was unable to pay the amount outstanding. On 30 November year 6 Company A disposed of the shares for R80 000.

None of the exclusions in section 19(8) apply.

Result:

Year of assessment ending on 28 February year 7

Debt benefit

Debt benefit = Amount cancelled = R100 000.

Application of section 19(3) and (4)

As a result of the debt cancellation on 1 June year 6 the value of Company A's opening stock as at 1 March year 6 is reduced to RNil under section 19(3) (R80 000 – R80 000). The excess of the amount of the debt benefit of R20 000 (R100 000 – R80 000) is deemed under section 19(4) to be an amount that has been recovered or recouped for the purposes of section 8(4)(*a*).

Disposal of the shares

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

On 29 February year 6 the shares had been held by Company A for five continuous years. The proceeds on disposal of the shares 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 provisos, 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. Company 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 cancelled, no amount must be included in Company A's income under section 9C(5) because of paragraph (*a*) of the proviso to section 9C(5).

> **Note:**
>
> 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 Company A's income under section 9C(5). Company A will therefore realise a capital gain on disposal of the shares of R80 000 (proceeds of R80 000 − base cost of RNil).

4.12.3 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.[93]

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).

> **Example 56 – 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.
>
> *Year of assessment ending on 31 March year 2*
>
> On 1 December year 1 Company A issued promissory notes to a note holder for R180 000. The maturity date of the contract was 30 November year 5 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).
>
> *Year of assessment ending on 31 March year 6*
>
> On 30 November year 5 the note holder waived the total amount owing under the contract because of the inability of Company A to pay the amounts owing.

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93 Definitions of "adjusted gain on transfer or redemption of an instrument", "transfer", redemption", "issuer", "instrument", "accrual amount" and "alternative method" in section 24J(1).

None of the exclusions in section 19(8) apply.

Result:

Year of assessment ending on 31 March year 6

Debt benefit

Debt benefit = Amount waived = R108 000.

Application of section 19(5)

Under section 19(5) the amount of the debt benefit in respect 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.

4.12.4 Capital gain on the disposal of an asset in a prior 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 asset[94] that was disposed of in a prior year of assessment is recovered or recouped in the current year of assessment.

A capital gain is, however, not triggered under paragraph 3(*b*)(ii) when the base cost of the asset disposed of in a prior year of assessment has been recovered or recouped through the reduction of a debt owed by the taxpayer. The recovery or recoupment of base cost of an asset disposed of in a prior year of assessment by way of debt reduction is dealt with under paragraph 12A(4) (redetermination of capital gain or capital loss) (see **4.6** and **4.9**).

94 Excluding a pre-valuation date asset.

Example 57 – Capital gain on disposal of an asset in a prior year of assessment

Facts:

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

Year of assessment ending on 28 February year 2

On 1 March year 1 Individual A lent R1 million to Company B which Company B used to acquire vacant land at a cost of R1 million. On 28 February year 2 Company B sold the land for R1,2 million and reflected a capital gain of R200 000.

Year of assessment ending on 28 February year 3

On 30 April year 2 Individual A waived the loan of R1 million because of Company B's inability to pay.

None of the exclusions in paragraph 12A(6) apply.

Result:

Year of assessment ending on 28 February year 3

Debt benefit

Debt benefit = Amount waived = R1 million.

The debt was used to fund an asset disposed of in a prior year of assessment. The capital gain of R200 000 which arose in the year of assessment ending on 28 February year 2 must therefore be re-determined as if the debt benefit had arisen in that year of assessment.

Re-determined capital gain on disposal of the asset under paragraph 12A(4)

As a result of the debt waiver, the base cost of the land must be reduced to RNil (cost of R1 million − debt benefit of R1 million) under paragraph 12A(3). The re-determined capital gain on disposal of the asset is R1,2 million (proceeds of R1,2 million − base cost of RNil).

The amount to be treated as a capital gain in the year of assessment ending on 28 February year 3 is the absolute difference between R1,2 million (re-determined capital gain for the year of assessment ending on 28 February year 2) and R200 000 (capital gain determined for the year of assessment ending on 28 February year 2) = R1 million.

Application of paragraph 3(b)(ii)

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.

4.12.5 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*) or paragraph (*j*) of the definition of "gross income";
>
> (ii) …; or
>
> (iii) applied to reduce an amount of expenditure incurred in respect of—
>
> (*aa*) trading stock as contemplated in section 19(3); or
>
> (*bb*) any other asset as contemplated in paragraph 12A(3); 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 a concession or compromise of a 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 concession or compromise of the debt occurred in a subsequent year of assessment, paragraph 20(3)(*b*) would not apply. Paragraph 12A(4) will apply under these circumstances (see **4.6** and **4.9**).

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 or paragraph 12A and paragraph 20(3)(*b*) apply to a concession or compromise of a debt. In this regard paragraph 20(3)(*b*) shall **not** apply *to the extent* that –

- the amount of a debt benefit was taken into account as a recoupment under section 8(4)(*a*) or paragraph (*j*) of the definition of "gross income"[95] (it would have if section 19(4), 19(6), 19(6A) or 36(7EA) applied);
- the amount of a debt benefit was applied to reduce an amount taken into account in respect of trading stock under section 19[96] (it would have if section 19(3) applied). This exclusion, therefore, ensures that the base cost of an asset must not be reduced under paragraph 20(3)(*b*) if section 19 has been applied to reduce an amount taken into account in respect of trading stock; or
- the amount of a debt benefit was applied to reduce the base cost of an asset under paragraph 12A(3).[97]

If section 19(3), 19(4), 19(6), 19(6A) or paragraph 12A(3) would, absent one of the exclusions in section 19(8) or paragraph 12A(6) (see **4.11**), have applied, such that paragraph 20(3)(*b*) would not have applied as indicated above, then notwithstanding that section 19 and paragraph 12A do not apply to the debt benefit because of an applicable exclusion, paragraph 20(3)(*b*) will not apply to reduce the asset's base cost.[98]

Example 58 – Disposal of an asset and debt benefit arising during the same year of assessment

Facts:

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

Year of assessment ending on 29 February year 2

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

Year of assessment ending on 29 February year 6

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

None of the exclusions in paragraph 12A(6) apply.

Result:

Year of assessment ending on 29 February year 6

Debt benefit

Debt benefit = Amount waived = R1 million.

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95 Paragraph 20(3)(*b*)(i).

96 Paragraph 20(3)(*b*)(iii)(*aa*).

97 Paragraph 20(3)(*b*)(iii)(*bb*).

98 See Binding Private Ruling 334 dated 21 November 2019 "Waiver of Loan Claims by Settlor of a Trust".

Paragraph 12A(3) applies, since the land was not disposed of in a prior year of assessment. The base cost of the asset is reduced to RNil (cost of R1 million − debt benefit of R1 million).

Paragraph 20(3)(*b*) is not applied, since the base cost of the asset was reduced to RNil under paragraph 12A(3). Paragraph 20(3)(*b*)(iii)(*bb*) prohibits the application of paragraph 20(3)(*b*).

Disposal of the asset

Company A realised a capital gain of R1,5 million (proceeds of R1,5 million − base cost of RNil) on disposal of the asset.

Example 59 – Disposal of an asset and debt benefit arising during the same year of assessment

Facts:

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

Year of assessment ending on 29 February year 2

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

Year of assessment ending on 29 February year 6

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

None of the exclusions in paragraph 12A(6) apply.

Result:

Year of assessment ending on 29 February year 6

Debt benefit

Debt benefit = Amount waived = R1 million.

Paragraph 12A(3) applies, since the land was not disposed of in a prior year of assessment. The expenditure of R1 million as contemplated in paragraph 20 is reduced to RNil (cost of R1 million − debt benefit of R1 million).

Paragraph 20(3)(*b*) is not applied, since the base cost of the asset is reduced to RNil under paragraph 12A(3). Paragraph 20(3)(*b*)(iii)(*bb*) prohibits the application of paragraph 20(3)(*b*).

Disposal of the asset

Company A realised a capital gain of R1,5 million (proceeds of R1,5 million − base cost of RNil) on disposal of the asset.

Example 60 – Disposal of trading stock and debt benefit arising during the same year of assessment

Facts:

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

Year of assessment ending on 31 March year 2

On 1 April year 1 Company A acquired trading stock at a cost of R100 000 from Company B on loan account. On 1 September year 1 Company B waived the debt of R100 000 because of Company A's inability to repay the loan. Subsequent to the waiver of the debt the trading stock was sold for R120 000.

None of the exclusions in section 19(8) apply.

Result:

Year of assessment ending on 31 March year 2

Debt benefit

Debt benefit = Amount waived = R100 000.

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

Disposal of the asset

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

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

	R
Proceeds (R120 000 – R120 000 [paragraph 35(3)(*a*)])[99]	Nil
Less: Base Cost (R100 000 – R100 000 [paragraph 20(3)(*a*)])	(Nil)
Capital gain	Nil

Notes:

(1) 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 deducted under section 11(*a*) of R100 000 is required to be reduced by the amount of the debt benefit of 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 a deduction as contemplated in paragraph 20(3)(*a*).

[99] 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.

(2) 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)(*aa*) 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.

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

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 section 19(3) or paragraph 12A(3);
- the amount of the debt disposed of represents an amount which must be taken into account by the debtor as a capital gain under paragraph 12A(4); or
- an amount must be or was included in the gross income or income of the debtor, as would have been the case when a debt benefit amount is deemed under section 19(4), (5), (6) or (6A) to be an amount recovered or recouped for purposes of section 8(4)(*a*).

Example 61 – 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.

Year of assessment ending on 30 June year 2

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

Year of assessment ending on 30 June year 6

On 1 July year 5 Company A waived R500 000 of the debt owed by Company B because of Company B's inability to settle the debt in full. The land was not disposed of in a prior year of assessment.

None of the exclusions in paragraph 12A(6) apply.

Result:

Year of assessment ending on 30 June year 6

Debt benefit

Debt benefit = Amount waived = R500 000.

> 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)(*a*)(i) applies despite paragraph 39.[100]

4.13 Debt benefit in respect of debt owed which funded deductible and non-deductible expenditure or which comprised an interest and capital element

In a partial concession or compromise of an interest-bearing loan, the issue may arise whether it is the interest or the capital element of the loan that is being cancelled, waived, extinguished or settled. In *Standard Bank of South Africa Ltd v Oneanate Investments (Pty) Ltd (In Liquidation)*[101] 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 concession or compromise occurs it will be necessary to determine against which asset or expenditure the debt benefit must be applied. It is considered that the debt benefit must first be allocated to any unpaid interest expense and then proportionately against the remaining expenditure financed by the debt concerned. In ITC 1020[102] 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 a concession or compromise arrangement.

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 benefit 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.[103]

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[100] See the *Comprehensive Guide to Capital Gains Tax* for a discussion of paragraph 39.
[101] [1998] 1 All SA 413 (A), 1998 (1) SA 811.
[102] (1962) 25 SATC 414 (T).
[103] The onus is on the taxpayer under section 102(1) of the TA Act.

Example 62 – Debt benefit in respect of a debt owed that funded deductible and non-deductible expenditure

Facts:

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

Year of assessment ending on 31 March year 2

On 1 April year 1 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.

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.

Year of assessment ending on 31 March year 3

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

None of the exclusions in section 19(8) apply.

Result:

Debt benefit

Debt benefit = Amount waived = R500 000

The debt benefit 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 − R100 000 allocated to interest) × R600 000 / R1 million]; and
- non-deductible expenditure of R160 000 [(R500 000 − R100 000 allocated to interest) × R400 000 / R1 million].

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).

Under section 19(5) the amount of the debt benefit 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 year of assessment.

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

4.14 Debt benefit in respect of debt that funded expenditure incurred by persons carrying on mining [section 36(7EA)]

Operating expenses or trading stock

Section 19 applies to a debt benefit in respect of debt owed that funded operating expenses or trading stock of a person carrying on mining operations.

Allowance assets and capital assets [excluding "capital expenditure incurred" as defined in section 36(11)]

Paragraph 12A applies *to the extent* that allowance assets or capital assets of a person carrying on mining operations have been funded by debt. Section 19 may apply to a debt benefit in respect of debt owed that funded allowance assets.

"Capital expenditure incurred" as defined in section 36(11)

From years of assessment commencing on or after 1 January 2018, section 36(7EA) stipulates that subject to paragraph 12A(6)(*a*) to (*d*) and (*f*), when a debt benefit arises in respect of a debt that is owed by a person and that debt was used directly or indirectly to fund any amount of capital expenditure incurred, the debt benefit in respect of that debt must be applied to reduce any amount of capital expenditure incurred in the year of assessment that the debt benefit arises.

The proviso to section 36(7EA) stipulates that any amount of the debt benefit that exceeds the capital expenditure incurred in the year of assessment that the debt benefit arises, must be treated as an amount received by or accrued to that person carrying on mining operations during that year of assessment in respect of a disposal of assets the cost of which has been included in capital expenditure incurred in respect of the mine to which that capital expenditure relates.

The *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2017*[104] provides the following summary of the special tax regime for mining companies:

> "….mining companies have a special tax regime and are required in terms of section 36 of the Act to account for their capital expenditure in respect of capital or allowance assets differently from companies in other sectors.
>
> Over and above the normally available deductions for operating expenses, mining companies benefit from a preferential tax treatment of their capital expenditure. Mining companies are allowed a hundred per cent upfront deduction of the capital expenditure incurred albeit that this 100 per cent upfront deduction can only be claimed against income derived from mining operations ("mining income"). Any capital expenditure incurred that exceeds the mining income of a mining company in any given year (referred to as unredeemed capital expenditure) is then ring-fenced and carried over to the subsequent years to be applied against the mining income generated by the mining company in those subsequent years. Upon disposal of any capital or allowance asset the cost of which constituted capital expenditure incurred by a mining company, the full proceeds of the disposal of that asset is in the case of certain gold mining companies deducted from capital expenditure and in any other case included in the gross income of the mining company (under paragraph (j) of the definition of "gross income"). The policy rationale for this inclusion in gross income of the full proceeds is that those assets of the mining company benefited from the preferential tax treatment of a hundred per cent upfront deduction of its cost."

[104] In paragraph 2.1.

The following explanation is provided in the abovementioned *Explanatory Memorandum* on the application of section 36(7EA):[105]

> "a. The amount of debt that is reduced, cancelled, waived, forgiven or discharged during a year of assessment must reduce any amount of capital expenditure incurred that has not yet been deducted (i.e. the balance of the unredeemed capital expenditure of the previous year of assessment that is deemed to have been incurred in the current year as well as capital expenditure actually incurred in the current year).
>
> b. To the extent that the debt that is reduced, cancelled, waived, forgiven or discharged exceeds the capital expenditure incurred in previous years of assessment and the capital expenditure incurred during the year of assessment any excess amount must be treated as an amount received by or accrued to that person carrying on mining operations during the year of assessment that the debt that is reduced, cancelled, waived, forgiven or discharged in respect of a disposal of assets the cost of which has been included in capital expenditure incurred. As a result, the excess amount will be subject to inclusion in the gross income of the mining company in terms of paragraph (*j*) of the definition of gross income.
>
> …the proposed rules dealing with the tax treatment of capital expenditure of mining companies will also be subject to the exclusions provided for under paragraph 12A of the Eighth Schedule."

It should be noted that section 36(7EA) is currently not subject to paragraph 12A(6)(*e*) and (*g*).

4.15 Controlled foreign companies (CFCs) [section 9D(9)(*f*A)(iv)]

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

Section 9D(9)(*f*A)(iv) provides[106] 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).

4.16 Determination of the amount of a debt benefit in respect of a debt denominated in a currency other than the currency of the Republic (section 25D) and the recoupment of foreign exchange losses or the deduction from income of foreign exchange gains [sections 8(4)(*a*) and 24I(4)]

The definition of "debt benefit" in section 19(1) and paragraph 12A(1) do not indicate how the amount of a debt benefit in respect 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 debt benefit is the amount of the benefit which the debtor has received.

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[105] In paragraph 2.1.

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

The amount of a debt benefit in respect 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 benefit arises 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.[107]

The amount of a debt benefit in respect 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 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**). Foreign exchange losses and foreign exchange gains must, however, with effect from years of assessment commencing on or after 1 January 2019, be dealt with under section 24I(4) when a debt benefit arises. Before years of assessment commencing on or after 1 January 2019, such recoupment of foreign exchange losses were dealt with under section 8(4)(*a*).

Section 24I(4) stipulates that subject to section 11, in determining the taxable income of any person contemplated in section 24I(2) in respect of a debt[108] owing to that person *to the extent* that on realisation the debt was irrecoverable by reason of becoming bad or the realisation of the debt resulted in a loss determined in the foreign currency due to a decline in the market value of that debt, the amount of –

- any foreign exchange gain, relating to that debt, that is or was included in the income of that person in the current or any previous year of assessment must be deducted from the income of that person; and
- the amount of any foreign exchange loss, relating to that debt, that is or was deducted from the income of that person in the current or any previous year of assessment must be included in the income of that person.

Example 63 – Debt benefit in respect of a debt denominated in a currency other than the currency of the Republic – Debt funding acquisition of an allowance asset

Facts:

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

Year of assessment ending on 28 February year 2

On 1 April year 1 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 year of assessment.

The debt was payable on 31 May year 1 but remained unpaid and was eventually waived by Company B on 31 January year 2 because of Company A's inability to pay. The machine was not disposed of in a prior year of assessment.

[107] See Interpretation Note 63 "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.

[108] A debt contemplated in paragraph (*b*) of the definition of "exchange item".

None of the exclusions in section 19(8) or section 12A(6) apply.

The ruling exchange rates are as follows:

Date:	**R / $ Spot rate**
1 April year 1 (transaction date)	10,0000
31 January year 2 (realisation date)	12,0000

Result:

Year of assessment ending on 28 February year 2

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 year 2, 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*).

Debt benefit

Debt benefit = Amount waived = $100 000.

The amount of a debt benefit in respect 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 benefit arises by applying the spot rate under section 25D(1):

= R1,2 million ($100 000 × R12,0000).

The amount of the debt benefit of R1,2 million is reconciled as follows:

	R
Rand amount of debt incurred on 1 April year 1 that funded the acquisition of an allowance asset	1 000 000
Increase in rand value of debt because of exchange movement	200 000
Rand amount of debt on 31 January year 2	1 200 000

Application of paragraph 12A(3)

Since R1 million of the debt of R1,2 million funded the expenditure incurred on acquisition of the machine (R1 million), the amount of the expenditure incurred on acquisition of the machine must for purposes of paragraph 20 be reduced by the amount of the debt benefit relating to that expenditure, namely, R1 million.

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 debt benefit).

Application of section 19(6)

Under section 19(6) the amount of the debt benefit 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*) = R200 000 (debt benefit relating to the acquisition of the machine of R1 million − amount applied under paragraph 12A(3) of R800 000). This amount (R200 000) is the same as the amount that was claimed as a capital allowance under section 12C(1).

Application of section 24I(4)(a)(ii)

Under section 24I(4)(*a*)(ii) the excess amount of the debt benefit of R200 000 [debt benefit of R1,2 million − R800 000 applied under paragraph 12A(3) − R200 000 applied under section 19(6)] is included in income. In this regard the waiver of the debt triggers an inclusion in income under section 24I(4)(*a*)(ii), since the foreign exchange loss of R200 000 was allowed as a deduction under section 24I(3)(*a*).

Example 64 – Debt benefit in respect of a debt denominated in a currency other than the currency of the Republic – Debt funding the acquisition of an allowance asset

Facts:

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

Year of assessment ending on 28 February year 2

On 1 April year 1 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 year of assessment. The debt was payable on 31 May year 1 but remained unpaid and was eventually waived by Company B on 31 January year 2 because of Company A's inability to pay. The machine was not disposed of in a prior year of assessment.

None of the exclusions in section 19(8) or paragraph 12A(6) apply.

The ruling exchange rates are as follows:

Date:	**R / $ Spot rate**
1 April year 1 (transaction date)	10,0000
31 January year 2 (realisation date)	8,0000

Result:

Year of assessment ending on 28 February year 2

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 year 2, 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*).

Debt benefit

Debt benefit = Amount waived = $100 000.

The amount of a debt benefit in respect 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 benefit arises by applying the spot rate under section 25D(1):

= R800 000 ($100 000 × R8,0000).

The amount of the debt benefit of R800 000 is reconciled as follows:

	R
Rand amount of debt incurred on 1 April year 1 that funded the acquisition of an allowance asset	1 000 000
Less: Decrease in rand value of debt because of exchange movement	(200 000)
Rand amount of debt on 31 January year 2	800 000

Application of paragraph 12A(3)

Since the full amount of the amount of the debt benefit (R800 000) funded the expenditure incurred on acquisition of the machine (R1 million), the amount of the expenditure incurred on acquisition of the machine must for purposes of paragraph 20 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 amount of debt benefit).

Application of section 19(6)

Section 19(6) does not apply, since the amount of the debt benefit of R800 000 has been applied 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*) must be deducted from income under section 24I(4)(*a*)(i).

Example 65 – Debt benefit in respect of a debt 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.

Year of assessment ending on 28 February year 2

On 1 April year 1 Company A purchased trading stock of $500 000 from Company B on credit. The debt was payable on 31 May year 1.

Year of assessment ending on 28 February year 3

The debt was waived by Company B on 31 March year 2 because of Company A's inability to pay. The trading stock was sold in April year 2.

None of the exclusions in section 19(8) apply.

The ruling exchange rates are as follows:

Date:	**R / $** **Spot rate**
1 April year 1 (transaction date)	12,1000
28 February year 2 (translation date)	15,6000
31 March year 2 (realisation date)	15,1000

Result:

Year of assessment ending on 28 February year 2

Income tax treatment of trading stock

The amount of trading stock acquired of R6 050 000 ($500 000 × 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).[109]

[109] 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.

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 × (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 24I(3)(*a*).

Year of assessment ending on 28 February year 3

Income tax treatment of trading stock

The cost price of trading stock held and not disposed of on 1 March year 2 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 year 2, 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 × (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 24I(3)(*a*).

Debt benefit

Debt benefit = Amount waived = $500 000

The amount of a debt benefit in respect 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 benefit arises by applying the spot rate under section 25D(1):

= R7 550 000 ($500 000 × 15,1000).

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

	R
Rand amount of debt incurred on 1 April year 1 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	(250 000)
Rand amount of debt on 31 March year 2	7 550 000

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 − R6 050 000 amount of debt benefit) under section 19(3).

Application of section 24I(4)(a)(ii)

The remaining amount of the debt benefit of R1,5 million (R7 550 000 − R6 050 000), represents the net amount of exchange differences (foreign exchange loss of R1 750 000 − foreign exchange gain of R250 000).

Under section 24I(4)(*a*)(ii) the foreign exchange loss of R1 750 000 must be included in income, since this amount was allowed as a deduction under section 24I(3)(*a*). The foreign exchange gain of R250 000 that is included in Company A's income under section 24I(3)(*a*) must be deducted from income under section 24I(4)(*a*)(i).

4.17 Debt benefit – Expenditure inclusive or exclusive of VAT

Section 23C(1) provides that when applying any provision of the Act, a taxpayer that is a vendor[110] and is or was in any previous year of assessment entitled to a deduction of input tax[111] 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 cancelled, waived, extinguished or settled 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 66 – Debt benefit in respect of a debt that funded expenditure allowed as a deduction – Debt benefit 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.

Year of assessment ending on 31 March year 1

Company A borrowed R115 000 from Company B and used the funds to finance operating expenses incurred on 1 February year 1 which attracted VAT at 15%. Company A was allowed a deduction under section 11(*a*) for operating expenses of R100 000 (R115 000 × 100 / 115). The balance of the expenditure of R15 000 was disallowed as a deduction under section 23C(1) because Company A claimed R15 000 (R115 000 × 15 / 115) as an input tax deduction under section 16(3) of the VAT Act.

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

Year of assessment ending on 31 March year 2

As a result of Company A falling into financial difficulty, Company B waived the debt of R115 000 on 1 June year 1.

None of the exclusions in section 19(8) apply.

Result:

Year of assessment ending on 31 March year 2

Debt benefit

Debt benefit = Amount waived = R115 000.

The debt benefit in respect of the debt owed funded tax-deductible expenses of R100 000 and VAT of R15 000. Under section 23C(1) the VAT component of the expenditure incurred of R115 000, namely, R15 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 R15 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 R115 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.[112] The amount of the debt benefit for purposes of section 19 is therefore R100 000.

Application of section 19(5)

Under section 19(5) R100 000 is deemed to be an amount that has been recovered or recouped for the purposes of section 8(4)(*a*) during Company A's year of assessment ending on 31 March year 2.

Example 67 – Debt benefit in respect of a debt that funded expenditure allowed as a deduction – Debt benefit 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.

Year of assessment ending on 31 March year 1

Company A borrowed R115 000 from Company B and used the funds to finance operating expenses inclusive of VAT which were incurred on 1 February year 1 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 R115 000 (inclusive of VAT) as a deduction under section 11(*a*).

[112] Section 19(2).

Year of assessment ending on 31 March year 2

As a result of Company A falling into financial difficulty, Company B waived the debt of R115 000 on 1 June year 1.

None of the exclusions in section 19(8) apply.

Result:

Year of assessment ending on 31 March year 2

Debt benefit

Debt benefit = Amount waived = R115 000.

The debt benefit in respect of the debt owed funded tax-deductible expenses of R115 000.

Application of section 19(5)

Under section 19(5) an amount of R115 000 is deemed to be an amount that has been recovered or recouped for the purposes of section 8(4)(*a*) during Company A's year of assessment ending on 31 March year 2.

5. Conclusion

Section 19 and paragraph 12A deal with the concession or compromise of a debt. These provisions apply to trading stock, deductible expenditure, allowance assets and capital assets financed by debt that is subsequently cancelled, waived, extinguished or settled, in the case of a company, by being converted to or exchanged for shares in that company or applying the proceeds from shares issued by the company.

The application of section 19 and paragraph 12A depends on the nature of the expenditure that was funded by the debt. Specific ordering rules apply to a debt benefit in respect of debt owed in respect of or that was used to fund expenditure incurred in respect of the following assets:

- Trading stock that is held and not disposed of at the time the debt benefit arises

  Any deduction under section 11(*a*) or the value of opening stock or closing stock is reduced by the debt benefit under section 19(3). Any excess amount is deemed under section 19(4) to be an amount recovered or recouped for purposes of section 8(4)(*a*) (see **4.3**).

- Trading stock disposed of and other deductible expenditure excluding allowance assets

  The debt benefit is deemed under section 19(5) to be an amount recovered or recouped for purposes of section 8(4)(*a*)] (see **4.4**).

- Assets not disposed of in a year of assessment prior to that in which the debt benefit arises

  The base cost of the asset is reduced under paragraph 12A(3) by the amount of the debt benefit. After the base cost of an allowance asset has been reduced to RNil, any excess amount is deemed under section 19(6) to be an amount recovered or recouped for purposes of section 8(4)(*a*). Future capital allowances are limited under section 19(7) to the cost of the asset *less* the amount of the debt benefit and any previous allowances claimed on the asset (see **4.5**, **4.7** and **4.8**).

- Assets disposed of in a year of assessment prior to that in which the debt benefit arises

  Under section 19(6A) and paragraph 12A(4) respectively, the debt benefit triggers a re-determination of the recoupment of allowances or the capital gain or loss recognised in that earlier year of assessment. The difference between the re-determined recoupment and the amount of recoupment in the earlier year of assessment is treated as an amount recovered or recouped for purposes of section 8(4)(*a*) in the year of assessment in which the debt benefit arises. The absolute difference between the re-determined capital gain or loss and the capital gain or loss determined in the earlier year of assessment is treated as a capital gain in the year of assessment in which the debt benefit arises (see **4.6** and **4.9**).

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 amount of a debt benefit (see **4.10**).

Special rules apply to a debt benefit in respect of a debt that funded expenditure incurred by persons carrying on mining (see **4.14**).

Section 19 and paragraph 12A do not apply to a debt benefit in respect of 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 **4.11.1**);
- *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, in respect of which donations tax is payable [section 19(8)(*b*) and paragraph 12A(6)(*b*)] (see **4.11.2**);
- 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 **4.11.3**);
- to another company forming part of the same domestic group of companies and the debtor company did not carry on a trade during the year of assessment in which the debt benefit arises and during the immediately preceding year of assessment, unless certain provisions apply [section 19(8)(*d*) and paragraph 12A(6)(*d*)] (see **4.11.4**);
- to another company forming part of the same domestic group of companies and the debtor company reduces or settles the debt directly or indirectly by means of issuing shares, unless certain provisions apply [section 19(8)(*e*) and paragraph 12A(6)(*f*)] (see **4.11.6**); or

- *to the extent* that the debt so owed is settled, directly or indirectly, by being converted to or exchanged for shares in the debtor company or by applying the proceeds from shares issued by that company and does not consist of or represent an amount owed in respect of interest incurred by that person during any year of assessment [section 18(8)(*f*) and paragraph 12A(6)(*g*)] (see **4.11.7**).

In addition, paragraph 12A does not apply to any debt owed by a company 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 **4.11.5**).

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*) (see **4.12**).

The amount of a debt benefit in respect 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 benefit arises by applying the applicable exchange rate under section 25D (see **4.16**).

A foreign exchange loss may have been claimed as a deduction under section 24I(3)(*a*) and a foreign exchange gain included in income 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. Foreign exchange losses must be included in income under section 24I(4)(*a*)(ii) when a debt benefit arises. Foreign exchange gains included in the income of a debtor before the debt benefit arises must be deducted from income under section 24I(4)(*a*)(i) (see **4.16**).

The amount of expenditure contemplated in section 19(2) or paragraph 12A(2) that was funded by a debt that is cancelled, waived, extinguished or settled 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 (see **4.17**).

Leveraged Legal Products
SOUTH AFRICAN REVENUE SERVICE
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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*), 11(*n*), 11(*p*) and (*q*), section 11F, 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 13*bis*(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 (*j*A) 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—

(*a*) 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; or

(*b*) to expenditure in respect of equity shares in a REIT or a controlled company, as defined in section 25BB(1), that is a resident except to the extent that such amount was taken into account in determining the cost price or value of trading stock under section 11(*a*), 22(1) or (2).

Section 9D(9)(*f*A)(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—

(*f*A) 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. Concession or compromise in respect of a 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;

"concession or compromise" means any arrangement in terms of which—

(*a*) a debt is—

(i) cancelled or waived; or

(ii) extinguished by—

(*aa*) redemption of the claim in respect of that debt by the person owing that debt or by any person that is a connected person in relation to that person; or

(*bb*) merger by reason of the acquisition by the person owing that debt of the claim in respect of that debt,

otherwise than as the result or by reason of the implementation of an arrangement described in paragraph (*b*);

(*b*) a debt owed by a company is settled, directly or indirectly—

(i) by being converted to or exchanged for shares in that company; or

(ii) by applying the proceeds from shares issued by that company;

"debt" means any amount that is owed by a person in respect of—

(*a*) expenditure incurred by that person; or

(*b*) a loan, advance or credit that was used, directly or indirectly, to fund any expenditure incurred by that person,

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

"debt benefit", in respect of a debt owed by a person to another person, means—

(*a*) in the case of an arrangement described in paragraph (*a*)(i) of the definition of "concession or compromise", the amount cancelled or waived;

(*b*) in the case of the extinction of that debt by means of an arrangement described in paragraph (*a*)(ii) of the definition of "concession or compromise", the amount by which the face value of the claim in respect of that debt held by the person to whom the debt is owed prior to the entering into of that arrangement exceeds the expenditure incurred in respect of—

(i) the redemption of that debt; or

(ii) the acquisition of the claim in respect of that debt;

(*c*) in the case of the settling of that debt by means of an arrangement described in paragraph (*b*) of the definition of "concession or compromise", where the person who acquired shares in a company in terms of that arrangement did not hold an effective interest in the shares of that company prior to the entering into of that arrangement, the amount by which the face value of the claim held in respect of that debt prior to the entering into of that arrangement exceeds the market value of the shares acquired by reason or as a result of the implementation of that arrangement; or (*d*) in the case of the settling of that debt by means of an arrangement described in paragraph (*b*) of the definition of "concession or compromise", where the person who acquired shares in a company in terms of that arrangement held an effective interest in the shares of that company prior to the entering into of that arrangement, the amount by which the face value of the claim held in respect of that debt prior to the entering into of that arrangement exceeds the amount by which the market value of any effective interest held by that person in the shares of that company immediately after the implementation of that arrangement exceeds, solely as a result of the implementation of that arrangement, the market value of the effective interest held by that person in the shares of that company immediately prior to the entering into of that arrangement;

"group of companies" means a group of companies as defined in section 41.

"market value" in relation to shares acquired or held by reason or as a result of implementing a concession or compromise in respect of a debt means the market value of those shares immediately after the implementation of that concession or compromise.

(2) Subject to subsection (8), this section applies where—

(*a*) a debt benefit in respect of a debt owed by a person arises in respect of a year of assessment by reason or as a result of a concession or compromise in respect of that debt during that year of assessment; and

(*b*) the amount of that debt is owed by that person in respect of or was used by that person to fund, directly or indirectly, any expenditure in respect of which a deduction or allowance was granted in terms of this Act.

(3) Where—

(*a*) a debt benefit arises in respect of a debt owed by a person as contemplated in subsection (2); and

(*b*) the amount of that debt is owed in respect of or was used as contemplated in paragraph (*b*) 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 the debt benefit arises,

the debt benefit 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 benefit arises, be applied to reduce the amount so taken into account in respect of that trading stock.

(4) Where—

(*a*) a debt benefit arises in respect of a debt owed by a person as contemplated in subsection (2);

(*b*) the amount of that debt is owed in respect of or was used as contemplated in paragraph (*b*) 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 the debt benefit arises,

(*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 debt benefit in respect of that debt, less any amount of that debt benefit that has been applied to reduce an amount as contemplated in subsection (3) 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 benefit arises.

(5) Where—

(*a*) a debt benefit arises in respect of a debt owed by a person as contemplated in subsection (2); and (*b*) the amount of that debt is owed in respect of or was used as contemplated in paragraph (*b*) of that subsection to fund expenditure other than expenditure incurred—

(i) in respect of trading stock that is held and not disposed of by that person at the time the debt benefit arises; or

(ii) in respect of an allowance asset,

the debt benefit 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 benefit arises.

(6) Where—

(*a*) a debt benefit arises in respect of a debt owed by a person as contemplated in subsection (2); and

(*b*) the amount of that debt is owed in respect of or was used as contemplated in paragraph (*b*) of that subsection to fund expenditure incurred in respect of an allowance asset that was not disposed of in a year of assessment prior to that in which that debt benefit arises,

the debt benefit 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) the debt benefit has not been applied as contemplated in paragraph 12A of the Eighth Schedule to reduce the amount of expenditure as contemplated in paragraph 20 of that Schedule in respect of that allowance asset,

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 benefit arises.

(6A) Where—

(*a*) a debt benefit arises during any year of assessment in respect of a debt owed by a person as contemplated in subsection (2); and

(*b*) the amount of that debt is owed in respect of or was used as contemplated in paragraph (*b*) of that subsection to fund expenditure incurred in respect of an allowance asset that was disposed of in a year of assessment prior to that in which that debt benefit arises,

that person must, if the amount determined in respect of that disposal as a recovery or recoupment of a deduction or allowance is less than the amount that would have been so determined had that debt benefit been taken into account in the year of assessment in which the disposal occurred, treat the amount of that difference as an amount recovered or recouped for purposes of section 8(4)(*a*) in the year of assessment in which that debt benefit arises.

(7) Where a debt benefit arises in respect of a debt owed by a person that was used to fund expenditure incurred in respect of an allowance asset, 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 debt benefit 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 a debt benefit in respect of 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,

in respect of which donations tax is payable; 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;

(*d*) to another person where the person that owes that debt is a company if—

(i) that company owes that debt to a company that forms part of the same group of companies as that company; and

(ii) that company has not carried on any trade,

during the year of assessment in which that debt benefit arises as well as during the immediately preceding year of assessment: Provided that this paragraph must not apply in respect of any debt—

(*aa*) incurred, directly or indirectly by that company to fund expenditure incurred in respect of any asset that was subsequently disposed of by that company by way of an asset-for-share, intra-group or amalgamation transaction or a liquidation distribution in respect of which the provisions of section 42, 44, 45 or 47, as the case may be, applied; or

(*bb*) incurred or assumed by that company in order to settle, take over, refinance or renew, directly or indirectly, any debt incurred by—

(A) any other company that forms part of the same group of companies; or

(B) any company that is a controlled foreign company in relation to any company that forms part of the same group of companies;

(*e*) to another person where the person that owes that debt is a company that—

(i) owes that debt to a company that forms part of the same group of companies as that company; and

(ii) reduces or settles that debt, directly or indirectly, by means of shares issued by that company:

Provided that this paragraph must not apply in respect of any debt that was incurred or assumed by that company in order to settle, take over, refinance or renew, directly or indirectly, any debt incurred by another company which—

(*aa*) did not form part of that same group of companies at the time that that other company incurred that debt; or

(*bb*) does not form part of that same group of companies at the time that that company reduces or settles that debt, directly or indirectly, by means of shares issued by that company; or

(*f*) to the extent that the debt so owed—

(i) is settled by means of an arrangement described in paragraph (*b*) of the definition of “concession or compromise”, and

(ii) does not consist of or represent an amount owed by that person in respect of any interest incurred by that person during any year of assessment.

Section 23C(1)

23C. Reduction of cost or market value of certain assets.—(1) Notwithstanding the Seventh Schedule, where regard is to be had to the cost to the taxpayer or the market value of any asset acquired by him or her or to the amount of any expenditure incurred by him or her, 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 24I(3)(*a*) and (4)

(3) In determining the taxable income of any person contemplated in subsection (2), there shall be included in or deducted from the income, as the case may be, of that person—

(*a*) any exchange difference in respect of an exchange item of or in relation to that person, subject to subsection (10A); and

(4) Subject to section 11, in determining the taxable income of any person contemplated in subsection (2) in respect of a debt owing to that person as referred to in paragraph (*b*) of the definition of "exchange item"—

(*a*) to the extent that on realisation the debt was irrecoverable by reason of becoming bad; or

(*b*) the realisation of the debt resulted in a loss determined in the foreign currency due to a decline in the market value of that debt,

the amount of—

(i) any foreign exchange gain, relating to the debt as described in paragraph (*a*) or (*b*), that is or was included in the income of that person in the current or any previous year of assessment must be deducted from the income of that person; and

(ii) the amount of any foreign exchange loss, relating to the debt as described in paragraph (*a*) or (*b*), that is or was deducted from the income of that person in the current or any previous year of assessment must be included in the income of that person.

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.

Section 36(7EA)

(7EA) Subject to paragraph 12A(6)(*a*) to (*d*) and (*f*) of the Eighth Schedule, where a debt benefit, as defined in section 19, arises in respect of a debt that is owed by a person and that debt was used directly or indirectly to fund any amount of capital expenditure incurred, the debt benefit in respect of that debt must be applied to reduce any amount of capital expenditure incurred in the year of assessment that the debt benefit arises: Provided that any amount of the debt benefit that exceeds the capital expenditure incurred in the year of assessment that the debt benefit arises, must be treated as an amount received by or accrued to that person carrying on mining operations during that year of assessment in respect of a disposal of assets the cost of which has been included in capital expenditure incurred in respect of the mine to which that capital expenditure relates.

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. Concession or compromise in respect of a debt.—(1) For the purposes of this paragraph—

"allowance asset" . . . . . .

"capital asset" . . . . . .

"concession or compromise" means any arrangement in terms of which—

(*a*) a debt is—

(i) cancelled or waived; or

(ii) extinguished by—

(*aa*) redemption of the claim in respect of that debt by the person owing that debt or by any person that is a connected person in relation to that person; or

(*bb*) merger by reason of the acquisition, by the person owing that debt, of the claim in respect of that debt, otherwise than as the result or by reason of the implementation of an arrangement described in paragraph (*b*);

(*b*) a debt owed by a company to a person is settled, directly or indirectly—

(i) by being converted to or exchanged for shares in that company; or

(ii) by applying the proceeds from shares issued by that company;

“debt” means any amount that is owed by a person in respect of—

(*a*) expenditure incurred by that person; or

(*b*) a loan, advance or credit that was used, directly or indirectly, to fund any expenditure incurred by that person,

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

“debt benefit”, in respect of a debt owed by a person to another person, means—

(*a*) in the case of an arrangement described in paragraph (*a*)(i) of the definition of “concession or compromise”, the amount cancelled or waived;

(*b*) in the case of the extinction of that debt by means of an arrangement described in paragraph (*a*)(ii) of the definition of “concession or compromise”, the amount by which the face value of the claim in respect of that debt held by the person to whom the debt is owed prior to the entering into of that arrangement exceeds the expenditure incurred in respect of—

(i) the redemption of that debt; or

(ii) the acquisition of the claim in respect of that debt;

(*c*) in the case of the settling of that debt by means of an arrangement described in paragraph (*b*) of the definition of “concession or compromise”, where the person who acquired shares in a company in terms of that arrangement held no effective interest in the shares of that company prior to the entering into of that arrangement, the amount by which the face value of the claim held in respect of that debt prior to the entering into of that arrangement exceeds the market value of the shares acquired by reason or as a result of the implementation of that arrangement; or

(*d*) in the case of the settling of that debt by means of an arrangement described in paragraph (*b*) of the definition of “concession or compromise”, where the person who acquired shares in a company in terms of that arrangement held an effective interest in the shares of that company prior to the entering into of that arrangement, the amount by which the face value of the claim held in respect of that debt prior to the entering into of that arrangement exceeds the amount by which the market value of the effective interest held by that person in the shares of that company immediately after the implementation of that arrangement exceeds, solely as a result of the implementation of that arrangement, the market value of the effective interest held by that person in the shares of that company immediately prior to the entering into of that arrangement;

“group of companies” means a group of companies as defined in section 41.

“market value” in relation to shares acquired or held by reason or as a result of implementing a concession or compromise in respect of a debt means the market value of those shares immediately after the implementation of that concession or compromise.

(2) Subject to subparagraph (6), this paragraph applies where—

(*a*) a debt benefit in respect of a debt owed by a person arises in respect of a year of assessment by reason or as a result of a concession or compromise in respect of that debt during that year of assessment; and (*b*) the amount of that debt is owed by that person in respect of or was used by that person to fund, directly or indirectly, any expenditure, other than expenditure in respect of trading stock in respect of which a deduction or allowance was granted in terms of this Act.

(3) Where—

(*a*) a debt benefit arises in respect of a debt owed by a person as contemplated in subparagraph (2); and

(*b*) the amount of that debt is owed in respect of or was used as contemplated in item (*b*) of that subparagraph to fund expenditure incurred in respect of an asset that was not disposed of by that person in a year of assessment prior to that in which that debt benefit arises,

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

(4) Where—

(*a*) a debt benefit arises in respect of a debt owed by a person as contemplated in subparagraph (2); and

(*b*) the amount of that debt is owed in respect of or was used as contemplated in item (*b*) of that subparagraph to fund expenditure incurred in respect of an asset that was disposed of in a year of assessment prior to that in which that debt benefit arises, that person must if the amount determined in respect of that disposal as—

(i) a capital gain; or

(ii) a capital loss,

differs from the amount that would have been determined, whether as a capital gain or as a capital loss, in respect of that disposal had that debt benefit been taken into account in the year of the disposal of that asset, treat that absolute difference as a capital gain to be taken into account in respect of the year of assessment in which the debt benefit arises: Provided that in taking that debt benefit into account in respect of the year of disposal of that asset that person must take into account the extent to which the expenditure in respect of that asset has been reduced by any other debt benefit taken into account, in terms of this subparagraph, in respect of that disposal.

(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 benefit arose 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 a debt benefit in respect of 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,

in respect of which donations tax is payable;

(*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 the person that owes that debt is a company, if—

(i) that company owes that debt to a company that forms part of the same group of companies as that company; and

(ii) that company has not carried on any trade,

during the year of assessment during which that debt benefit arises and the immediately preceding year of assessment: Provided that this subitem must not apply in respect of any debt—

(*aa*) incurred, directly or indirectly, by that company to fund expenditure incurred in respect of any asset that was subsequently disposed of by that company by way of an asset-for-share, intra-group or amalgamation transaction or a liquidation distribution in respect of which the provisions of section 42, 44, 45 or 47, as the case may be, applied; or

(*bb*) incurred or assumed by that company in order to settle, take over, refinance or renew, directly or indirectly, any debt incurred by—

(A) any other company that forms part of the same group of companies; or

(B) any company that is a controlled foreign company in relation to any company that forms part of the same group of companies;

(*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 debt benefit in respect of that debt does not, at the time that the debt benefit arises, 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—

(*a*) if—

(i) the debt was reduced as part of any transaction, operation or scheme entered into to avoid any tax imposed by this Act; and

(ii) 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

(*b*) if that company—

(i) 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;

(ii) has at any stage withdrawn any step taken to liquidate, wind up, deregister or finally terminate its corporate existence; or

(iii) does anything to invalidate any 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;

(*f*) to another person where the person that owes that debt is a company that—

(i) owes that debt to a company that forms part of the same group of companies as that company; and

(ii) reduces or settles that debt, directly or indirectly, by means of shares issued by that company:

Provided that this subitem must not apply in respect of any debt that was incurred or assumed by that company in order to settle, take over, refinance or renew, directly or indirectly, any debt incurred by another company which—

(*aa*) did not form part of that same group of companies at the time that that other company incurred that debt; or

(*bb*) does not form part of that same group of companies at the time that company reduces or settles that debt, directly or indirectly, by means of shares issued by that company; or

(*g*) to the extent that the debt so owed—

(i) is settled by means of an arrangement described in paragraph (*b*) of the definition of "concession or compromise"; and

(ii) does not consist of or represent an amount owed by that person in respect of any interest incurred by that person during any year of assessment.

(7) Any tax which becomes payable as a result of the application of paragraph (*b*) 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) …..; or

(iii) applied to reduce an amount of expenditure incurred in respect of—

(*aa*) trading stock as contemplated in section 19(3); or

(*bb*) any other asset as contemplated in paragraph 12A(3); 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—

(i) which is applied to reduce the expenditure in respect of an asset of the debtor in terms of section 19(3) or paragraph 12A(3); or

(ii) which must be taken into account by the debtor as a capital gain in terms of paragraph 12A(4);

(*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