A CRITICAL ANALYSIS OF THE INCOME TAX IMPLICATIONS OF LOAN ACCOUNT FUNDING IN THE SMALL AND MEDIUM-SIZED ENTERPRISES (SMEs) ENVIRONMENT.

by

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DECLARATION

I, Gideon Pieter van Zyl, declare that the work presented in this treatise is an original piece of work which is made available for photocopying, and for inter-library loan. It has never been presented to any other University or Institution. Where other people's works have been used, references have been provided. It is in this regard that I declare this work as originally mine. It is hereby presented in partial fulfilment of the requirements for the award of the Master of Commerce (Taxation).

Signed ………………………………………….

Date ………………………………………….

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SUMMARY

The global economy is still recovering from the effects of the sub-prime crisis. The economic downturn has created international tax policies that seem to encourage debt funding. Some commentators are of the view that debt and equity should have a uniform tax treatment. South Africa has not escaped the aftermath of the economic meltdown and had three credit downgrades since the second half of 2009.

The first objective of this treatise was to determine whether loan funding still has a role to play in a SME environment. This was considered in the context of interest-free or low-interest rate loans advanced by companies to shareholders or other connected persons and interest-bearing loans due by companies that in substance clearly have equity features.

The primary enquiry pertaining to debit loans is whether the debt arose by virtue of any share held in the company. It is submitted that a causal connection is required between any share in that company and the advance made. Where a company parts with funds for no *quid pro quo* a deemed dividend *in specie* is triggered. Conversely, where a loan was made on commercial grounds the company will not be in breach, even if the loan is interest-free.

A loan that lacks a reasonable redemption period is more akin to equity and to this extent a deemed dividend will be triggered where a loan owing by a company to a shareholder or other connected person is not redeemable within 30 years. There is ambiguity with regards to the inception of the 30-year period for pre-existing loan agreements. Taking the *contra fiscum* rule into account, it is submitted that the 30-year period should only

commence from the effective date due to the impracticalities involved and because the concept of an 'instrument' did not previously exist.

It is submitted that shareholder and other connected person loans are not by default equity, to the extent that the transaction is on commercial grounds and in substance a loan. It is further submitted that loan funding still has a role to play in a SME environment and that South Africa has no need for uniform tax rules pertaining to debt and equity, due to the anti-avoidance provisions highlighted above.

The poor state of the local economy prompted Treasury to introduce new debt relief rules to assist distressed debtors. The second objective of this treatise was to analyse whether the new rules will provide tangible relief to distressed debtors as this was one of the short comings of the previous system.

It is submitted that the new ordering rules delay the incurrence of an immediate tax as trading stock held and not disposed of, the base cost of an asset or the balance of an assessed capital loss is first reduced compared to the old rules where it instantly triggered a recoupment or a deemed disposal for CGT purposes.

Tangible relief is provided to distressed debtors as a tax debt reduced has no normal tax consequences. This provides an opportunity for companies under business rescue because SARS rank on par with concurrent creditors. As a result, the tax debt reduced is likely to be higher under business rescue than liquidation.

Key words: SME, loan, deemed dividend, shareholder, connected person, debt reduction, business rescue.

CHAPTER 1 Introduction and background

1.1 Debt versus equity

The global economy and world markets are still recovering from effects of the sub-prime crisis and the subsequent economic downturn which has resulted in international tax policies that seem to encourage debt funding.

An article in *The Economist* is of the view that debt and equity should have the same tax treatment:[1]

> 'Debt has many wonderful qualities—allowing firms to invest and individuals to benefit today from tomorrow's income. But the tax subsidies have tilted the economy in a woeful direction. They have created a financial system that is prone to crises and biased against productive investment; they have reduced economic growth and worsened inequality. They are a man-made distortion and they need to be fixed.'

Most international tax systems treat debt and equity differently from a domestic law perspective. Interest on loans generally qualify as a deduction for the borrower and is taxed in the hands of the lender. Dividends in turn are not deductible, but generally subject to tax relief in the form of an exemption, in the hands of the payee.[2]

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[1] Jon Berkley 'The great distortion: Subsidies that make borrowing irresistible need to be phased out' (2015) *The Economist*. [Online] Available from: http://www.economist.com/news/leaders/21651213-subsidies-make-borrowing-irresistible-need-be-phased-out-great-distortion [Accessed: 1 August 2015].
[2] OECD 'BEPS Action 4: Interest deductions and other financial payments' (2015) at 2. [Online] Available from: http://www.oecd.org/ctp/aggressive/discussion-draft-action-4-interest-deductions.pdf [Accessed: 19 July 2015].

The position in South Africa is no different as interest on loans payable are deductible in terms of s 24J(2) of the Income Tax Act[3] (the Act) provided that the amount incurred was for purposes of trade and in the production of income. Similarly such an amount will be included in gross income of the lender in terms of s 24J(3). Conversely dividends paid by resident companies are not tax deductible, but such distributions received are included in the gross income of shareholders in terms of special inclusion para (*k*) to the 'gross income' definition in s 1 of the Act. The Act also provides relief as local dividends are exempt in terms of s 10(1)(*k*). Dividends may however be subject to dividends tax.

The effective tax rate to withdraw profit by means of a dividend, assuming the shareholder is not a company, is 38.8%.[4] This cost could potentially act as deterrent for normal investing activities and lead to more debt funding where tax benefits are available.

The tax benefits associated to debt funding have also led to the creation of more complex financial instruments, so-called hybrid instruments, that have characteristics of both debt and equity, for example convertible preference shares. This would further support the plea from *The Economist* to have a neutral tax treatment for debt and equity.

SARS has introduced new anti-hybrid debt instrument recharacterisation rules[5] aimed to curb the mischief where instruments are labelled as debt in order to obtain a tax

[3] 58 of 1962.
[4] Remaining reserves after tax = 100% - 28% (normal tax) = 72% x 15% dividends tax = 10.8% + 28% = 38.8%.
[5] Two anti-avoidance provisions namely s 8F (amended) and s 8FA.

deduction, but where such instruments clearly have equity features. A pragmatic approach is followed whereby SARS looks at the substance and ignores the legal form.[6]

The first objective of this treatise is to evaluate, in light of the call for uniform tax treatment for debt and equity and recent amendments to tax legislation, whether loan funding still has a role to play in the context Small and Medium-sized Enterprises (SMEs).[7]

In doing so, the following issues are addressed:

- Are shareholder and other connected person loans by default equity or does commercial substance still have a role to play? [Refer to 3.2 and 4.3.3].
- Consider whether there is any benefit in paying dividends tax on interest foregone rather than to charge interest on the loan? [Refer to 3.4].
- What is the position of existing loans granted prior to the amendments to s 8F and the introduction of s 8FA? [Refer to 4.3].
- Terms of the loan agreement:
    - Payable on demand or regular refinance? [Refer to 4.2.2.1, 4.3.2 and 4.4.3]
    - Interest bearing or interest-free? [Refer to 3.4 and 4.4.1]
- Do subordination agreements have any impact on the tax treatment? [Refer to 4.2.2.2, 4.3.1 and 4.4.2]

[6] Annexure C - Draft Explanatory Memorandum on the Tax Laws Amendment Bill, 2013: Anti-Hybrid Debt Instrument Recharacterisation Rules at 1. [Online] Available from: http://www.treasury.gov.za/public%20comments/TLAB%202013/2013042901%20-%20Annexure%20C%20EM.pdf [Accessed: 14 September 2015].

[7] It is assumed that SMEs are unlisted, not necessarily 'small business corporation' as defined in s 12E(4) nor a micro business as defined in Part II of the Sixth Schedule to the Act.

1.2 Debt relief

South Africa has not escaped the aftermath of the economic meltdown. This is supported by three credit downgrades by Moody's since the second half of 2009 from A2 to Baa2.[8]

Treasury has recognised the increasing number of debtors in financial distress due to the economic downturn and other factors unique to the South African economic landscape, for example load-shedding and labour disputes.[9] For years of assessment commencing on or after 1 January 2013, Government introduced new uniform rules relating to debt reduction for less than full consideration as the tax burden on taxpayers receiving the debt reduction has largely nullified any financial advantage obtained under the previous system.[10] The introduction of s 19 and para 12A to the Eighth Schedule of the Act aims to provide relief to taxpayers under financial distress, including companies under business rescue.[11]

The second objective of this treatise is to analyse whether the new regime will provide tangible relief to distressed debtors as this was one of the short comings of the previous system.

In doing so, the following issues are considered:

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[8] Long term rating for the Government of South Africa, Moody's Org ID: 686830. Last downgrade date - 6 November 2014 as at 17 June 2016. [Online] Available from: https://www.moodys.com/credit-ratings/South-Africa-Government-of-credit-rating-686830 [Accessed: 17 June 2016].
[9] Explanatory Memorandum on the Taxation Laws Amendment Bill, 2012 at 44. [Online] Available from: http://www.SARS.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-2012-01%20-%20Explanatory%20Memorandum%20Taxation%20Laws%20Amendment%20Bill%202012.pdf [Accessed: 13 August 2015].
[10] SARS Draft Interpretation Note: 'Reduction of Debt' (2015) in § 2. [Online] Available from: http://www.SARS.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2015-38%20-%20Draft%20IN%20on%20reduction%20of%20debt.pdf [Accessed: 9 September 2015].
[11] Chapter 6 of the Companies Act, 71 of 2008.

- A comparison of the tax consequences between the old and new debt relief provisions. [Refer to 5.3]
- Are there any additional tax considerations as a result of business rescue? [Refer to 5.4]
- What other taxes should be considered when debts are waived? [Refer to 5.5]

1.3 Structure

The approach to the treatise is as follows:

- This chapter: Introduction and background – The purpose of this study, the research objectives, methodology, assumptions and scope limitations are explained.
- Chapter 2: Tax treatment of debt and equity – A brief overview of the legislative provisions applicable debt and equity is discussed.
- Chapter 3: Loans to shareholders and connected persons - An evaluation is performed on the tax consequences of loans advanced to shareholders and other connected persons in relation to a company. The common law principles relating to causation and a synopsis of the General Anti-Avoidance Rule (GAAR) are incorporated.
- Chapter 4: Interest recharacterisation rules – The amendments to s 8F, the introduction of s 8FA and the impact thereof on pre-existing loan agreements are evaluated. A discussion of potential tax planning opportunities and tax risks when formalising loan agreements is incorporated.

- Chapter 5: Debt relief – A comparison is performed between the previous system and the new regime of debt relief. A brief discussion on the impact of business rescue is incorporated together with an overview of other taxes that need to be considered when debt reduction takes place.
- Chapter 6: Conclusion – An overall conclusion summarising the findings of the treatise.

1.4 Research methodology

A qualitative approach was followed to meet the research objectives. Books, online resources such as LexisNexis, tax journals and tax cases were scrutinized.

A number of the provisions considered in this treatise relate to fairly recent amendments to the Act. As a result limited guidance was available and these provisions have not been challenged in our courts to date. The Legislature's intention and reasons for introducing these provisions as detailed in the explanatory memorandums were often referred to as a result.

1.5 Assumptions and limitation of scope

1.5.1 Assumptions on the definition of SME

The Davis Tax Committee (DTC) said that:[12]

[12] Davis Tax Committee Interim Report on Small and Medium Enterprises: Taxation Considerations (2014) at 5. [Online] Available from: http://www.taxcom.org.za/docs/DTC%20SME%20Report%20for%20Public%20Comment%20by%2011%20July%202014.pdf [Accessed: 13 March 2016].

> 'There is currently no universal accepted definition of small and medium size businesses in South Africa.'

The DTC highlighted inconsistencies between the interpretation thereof between of the South African National Development Plan, the National Small Enterprise Act[13] and the Income Tax Act.

It should be noted that for purposes of their recommendations under that report the DTC applied the Income Tax Act definition of SMEs which they deemed to be limited to 'small business corporations' as defined in s 12E(4) and 'micro business' in terms of Part II of the Sixth Schedule to the Act.

For the purposes of this treatise it was assumed that SMEs are unlisted, owner managed businesses where the turnover could be more than R20 million or where a shareholder or member possibly has an interest in more than one company or close corporation. It was therefore assumed in the context of this treatise that a SME is not necessarily a 'small business corporation' as defined in s 12E(4) nor a 'micro business' as defined in Part II of the Sixth Schedule to the Act, although they may have qualified as such.

1.5.2 Other assumptions and scope limitations

The following fall outside the scope of this treatise:

- the mechanics of hybrid instruments;
- listed debt;
- listed equity;

[13] 102 of 1996.

- pre-trade interest;
- Sharia compliant financing arrangements;
- contributed tax capital;
- residency status;
- foreign loans, foreign dividends and withholding tax on interest;
- the mechanics of the yield to maturity method under s 24J; and
- fringe benefit provisions pertaining to loans.

CHAPTER 2 Tax treatment of debt and equity

2.1 Introduction

In order to evaluate the merits of a uniform tax treatment of debt and equity as discussed in the previous chapter one needs to understand the current fiscal provisions applicable to each form of funding. The aim of this chapter is to discuss the tax treatment of debt and equity for both the payer and the payee.

Generally speaking there are three sources of funding, namely debt, equity and retained income. Retained income is internal in nature as past profits fund future operations and infrastructure investment, whereas debt and equity are usually funding of an external nature.

Miller and Modigliani[14] were of the view that the capital structure applied by a company to finance its operations is irrelevant in a perfect market. The advantage of debt due to the tax deductibility of interest would be closely offset by an increase in the cost of equity due to the additional risk associated with debt funding.[15] They assumed in a perfect market there is no tax, transaction and liquidation costs. However in South Africa interest is tax deductible[16] and ignoring other characteristics of a perfect market, the value of a company increases due to the debt funding. This additional value is created by the tax

[14]Merton Miller and Franco Modigliani performed extensive research on company capital structures. This research is known as the Modigliani and Miller Theorem, also referred to as the capital structure irrelevance principle (1958). [Online] Available from: http://www.investopedia.com/walkthrough/corporate-finance/5/capital-structure/modigliani-miller.aspx [Accessed: 12 November 2015].
[15] F Vigario *Managerial Finance* 2 ed (2001) at 51.
[16] Refer to 2.3 below.

saving as a result of gearing.[17] Too much gearing could adversely affect a company and lead to business rescue or even liquidation and it is this behaviour that the article in *The Economist* is concerned about.

Debt funding yields interest, is redeemable and the obligation to pay exists without regard of the financial performance of borrower. In other words payment is required without consideration of profitability or availability of cash reserves.[18]

Equity funding in turn yield dividends, is non-redeemable[19] and the obligation to pay depends on the financial performance on the debtor company. Put differently it is discretionary and can be postponed without any legal right to claim payment by the shareholder.[20]

2.2 Definitions

2.2.1 Loan or debt

Neither the term 'loan' nor 'debt' is defined in s 1 of the Act. The term 'debt' is defined in s 19(1) and para 12A(1) of the Eighth Schedule of the Act, but that definition has limited scope and is mainly of assistance with regards to the reduction of debt. This will be discussed in detail in chapter 5. Paragraph 1 of the Seventh Schedule of the Act defines 'loan' as follows:

[17] Gearing refers to the use of debt funding instead of equity funding.
[18] Explanatory Memorandum on the Taxation Laws Amendment Bill, 2013 at para 2.1. [Online] Available from: http://www.SARS.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-2013-02%20-%20Explanatory%20Memorandum%20Taxation%20Laws%20Amendment%20Bill%202013.pdf [Accessed: 15 August 2015].
[19] Equity in its most basic form normally issued share capital.
[20] Explanatory Memorandum on the Taxation Laws Amendment Bill 2013 at para 2.1.

> 'includes any form of credit and any loan applied directly towards the replacement of any other loan'.

This definition does provide some insight, but its application is largely limited to the taxing of fringe benefits.

The dictionary meaning of 'loan' is:

> 'A thing that is borrowed, especially a sum of money that is expected to be paid back with interest.'[21]

> 'an amount of money that is given to someone for a period of time with a promise that it will be paid back'.[22]

'Loan' is defined as follows by Investopedia:[23]

> 'The act of giving money, property or other material goods to another party in exchange for future repayment of the principal amount along with interest or other finance charges. A loan may be for a specific, one-time amount or can be available as open-ended credit up to a specified ceiling amount.'

The above definitions highlight that a loan should have the following key characteristics:

- there needs to be an initial advance of property, usually money;

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[21] [Online] Available from: http://www.oxforddictionaries.com/definition/english/loan [Accessed: 22 October 2015].

[22] [Online] Available from: http://www.merriam-webster.com/dictionary/loan [Accessed: 25 October 2015].

[23][Online] Available from: http://www.investopedia.com/terms/l/loan.asp#ixzz3pJDkCzUT [Accessed: 22 October 2015].

- the advance is provided with the condition or expectation that funds will be repaid.[24]

The expectation of repayment suggests that the right to use the borrowed funds is for a specific or temporary period only. As compensation for the advance of funds the lender will usually charge interest.

2.2.2 Interest

The term interest is defined as follows in s 24J(1) of the Act:

> '"interest" includes the—
>
> '(*a*) gross amount of any interest or related finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement;
>
> '(*b*) amount (or portion thereof) payable by a borrower to the lender in terms of any lending arrangement as represents *compensation for any amount to which the lender would, but for such lending arrangement, have been entitled*; and
>
> '(*c*) . . .
>
> *irrespective* of whether such amount is—
>
> '(i) calculated with reference to a fixed rate of interest or a variable rate of interest; or

[24] This conclusion is supported by National Treasury in its Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004 at 19. [Online] Available from: http://www.SARS.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-2004-02%20-%20%20Explanatory%20Memorandum%20Revenue%20Laws%20Amendment%20Bill%202004.pdf [Accessed: 1 November 2015].

> '(ii) *payable* or *receivable* as a *lump sum or in unequal instalments* during the term of the financial arrangement'.

(Emphasis added.)

Regardless of what the compensation due to the lender is called in the loan agreement it is specifically included in the definition of 'interest' via para (*b*).

Subparagraph (ii) places emphasis that interest remains the same regardless of how the repayment intervals are arranged in the loan agreement. This further supports one of the key characteristics of a loan, namely the obligation of repayment.

2.2.3 Equity

The standard financial definition of equity is the value by which an entity's assets exceeds its liabilities. The difference is normally share capital and retained earnings on a company's[25] balance sheet.

From a tax point of view equity represents the participating interest that a shareholder has in a company's after tax profits.

Section 1 of the Act defines 'equity share' as follows:

> 'means any share in a company, excluding any share that, neither as respects dividends nor as respects returns of capital, carries any right to participate beyond a specified amount in a distribution'.

[25] Para (*f*) to definition of 'company' in s 1 of the Act specifically includes a close corporation.

In a typical SME there is one class of ordinary shares and all the shareholders have the same right to share in dividends according to their proportional shareholding.

2.2.4 Dividend

Section 1 of the Companies Act[26] defines 'distribution' as follows:

> '"distribution" means a direct or indirect—
>
> '(*a*) *transfer* by a company of *money or other property of the company, other than its own shares*, to or for the benefit of one or more *holders of any of the shares*, or to the *holder* of a *beneficial interest* in any *such shares*, of that company . . ., whether—
>
> '(i) in the form of a *dividend*;
>
> '(ii) . . .
>
> '(iii) . . .
>
> '(iv) . . .
>
> '(*b*) *incurrence of a debt* or other obligation by a company for the benefit of one or more holders of any of the shares of that company . . .; or
>
> '(*c*) *forgiveness or waiver* by a company of a debt or other obligation owed to the company by one or more holders of any of the shares of that company . . .;
>
> but does not include any such action taken upon the final liquidation of the company'.

(Emphasis added.)

A direct transfer of money is a standard dividend, for example a dividend of 20 cents per share. However a dividend may also be in the form other than cash, for example trading

[26] 71 of 2008.

stock distributed to shareholders. The Income Tax Act refers to a distribution other than cash as a dividend *in specie*.

The use of the word transfer would suggest that a dividend needs to be declared and paid or in the case of other property the shareholder needs to take possession thereof in order to qualify for a distribution under para (*a*). A dividend that was declared, but not yet paid to the shareholder will qualify as the incurrence of a debt by the company for the benefit of the shareholder and qualify as a distribution under para (*b*).[27]

Where a company incurs a debt or obligation to the benefit of a shareholder with the intention of repaying a pre-existing debt no distribution takes place as this is merely a repayment of the shareholder's loan. Similarly an advance made to a shareholder on loan account will not trigger a distribution from a Companies Act perspective.[28] This is however a deemed dividend in terms of s 64E(4) of the Income Tax Act, this will be discussed in detail in chapter 3.

Where a shareholder loan is forgiven as envisaged by para (*c*) a distribution is triggered. This will be discussed in more detail under debt relief in chapter 5 of this treatise.

Section 4 of the Companies Act requires that the solvency and liquidity test be satisfied where a company declares a dividend. It entails the following:

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[27] P Delport and Q Vorster *Henochsberg on the Companies Act 71 of 2008* at 23.
[28] *Ibid* at 26.

- the company's assets fairly valued should be equal to or exceed the fair value of liabilities including contingent assets and liabilities subsequent to the distribution; and
- that the company will be able to pay its debts as they become due in the ordinary course of business for a year after the declaration of the dividend.

Section 1 of the Act defines the term 'dividend' as follows:

> 'means any amount *transferred or applied* by a *company* that is a *resident* for the benefit or on behalf of *any person in respect of any share* in that company, whether that amount is transferred or applied—
>
> '(*a*) by way of a distribution made by; or
>
> '(*b*) as consideration for the acquisition of any share in,
>
> that company, but *does not include* any amount so transferred or applied to the extent that the amount so transferred or applied—
>
> '(i) results in a reduction of contributed tax capital of the company;
>
> '(ii) constitutes *shares* in the company; or
>
> '(iii) . . .'.

(Emphasis added.)

It is important to point out that the concept of dividend is only applicable to resident companies and close corporations.

The focus from a Companies Act point of view is on the shareholder whereas the Income Tax Act places emphasis on the share.[29] The definition of 'distribution' in s 1 of the Companies Act refers to 'the benefit of one or more holders of any of the shares, or to the holder of a beneficial interest in any such shares, of that company' suggests that a shareholder and company relationship is required for a dividend. From an Income Tax perspective the distribution needs to be made 'in respect of any share held in that company'. The cause of such transfer has to be because of a share, but the use of the phrase 'any person' would suggest that it is not limited to a shareholder and company relationship. For example, a payment to a connected person in relation to a shareholder could constitute a dividend. A more detailed discussion pertaining to connected persons and causation will follow in chapter 3.

The definition specifically excludes a return of shares and contributed tax capital. The reason for this is that there are capital gains tax implications that need to be considered by the shareholder. These capital gains tax considerations, however, are outside the scope of this treatise.

2.3 Tax treatment of interest

Section 24J is the charging provision that includes accrued interest in the taxable income of the lender (s 24J(3)) and it provides for the deduction of interest incurred in the hands of the borrower (s 24J(2)). Prior to 2005, s 24J did not contain these provisions. Its primary objective then was to provide rules to establish the value and timing of interest accruals and deductions. Prior to the 2005 amendments amounts were taxed when they fell within

[29] *Ibid* at 27.

the ambit of the 'gross income' definition, or qualified for deduction under the general deduction formula.[30]

The primary enquiry in the application of s 24J is whether there is a borrower and lender relationship and critically if the agreement provides for interest, as defined in s 24J(1), on the capital.

If the agreement provides for interest, such interest is spread over the term of the instrument by applying a yield to maturity calculation, except where an alternative method is used.

Where a company is the lender s 24J will apply, except if the loan is payable on demand (s 24J(12)).

Relief is provided for trusts and individuals as this section will only apply where the loan term exceeds one year and is issued at a discount or a premium or bears deferred interest.[31]

Where loans to do not fall within the ambit of s 24J the interest on these loan will be included in taxable income via the 'gross income' definition, s 1 of the Act, and could qualify for a deduction under s 11(*a*) of the Act.

It is worth pointing out that s 24J(3) unlike the 'gross income' definition will tax the accrued interest even if it is of a capital nature. Similarly s 24J(2) will allow a deduction

[30] Section 11(*a*).
[31] Deferred interest may apply in two scenarios: 1. Interest is calculated using a constant interest rate over the term of the loan, but the payment thereof is postponed by at least one year from the inception of the loan. 2. Interest that is not calculated using a constant interest rate.

even if the interest incurred is of a capital nature, in contrast with s 11(*a*) where no deduction is permitted if the amount is of a capital nature. The reason for this is to ensure the tax treatment of interest is consistent with the tax treatment of exchange differences, which is not subject to the capital nature test.[32] *Broomberg* on the other hand suggests the reason for this is that interest is essentially not capital in nature.[33]

The trade and in the production of income requirements from the general deduction formula still applies – the same words are used in s 24J(2).

Where s 24J applies, in order to prevent double taxation and double deductions s 24J(5) states that actual receipts and payments of interest are excluded from gross income and deductions under s 11 respectively.

The mechanics of the 'yield to maturity' calculation is fairly complex and is beyond the scope of this treatise. It is worth highlighting the following statement made in *Silke*:[34]

> 'In truth though, s 24J is anything but simple and essentially amounts to an extremely detailed and complex piece of legislation. The ability of taxpayers to apply its provisions correctly, if at all, runs just a little ahead of the capacity of SARS to enforce it. It is probably only the more sophisticated taxpayers who are capable of complying with the arduous task of correctly applying the provisions thereof.'

The above raises the question of whether SMEs really have the capacity to apply s 24J or do they simply apply the requirements of the 'gross income' definition on the earlier of

[32] Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004 at 22.
[33] Des Kruger *Broomberg on Tax Strategy* 5 ed (2012) at 221.
[34] A P de Koker and R C Williams *Silke on South African Income Tax* in § 17.61.

receipt of accrual[35] without spreading the interest over the term of the loan agreement and similarly claiming a deduction for interest actually incurred.[36] It seems that the prevailing SARS practice is to allow taxpayers to claim interest actually incurred, without obliging them to perform a yield to maturity calculation.

2.4 Tax treatment of dividends

Prior to 1 April 2012 resident companies who distributed dividends to their shareholders were liable for Secondary Tax on Companies (STC) at 10%. In terms of present law the shareholder is liable for dividends tax at 15% even though the company usually withholds this amount on behalf of the shareholder and makes the payment to SARS, other than a dividend *in specie*.

Dividends tax was introduced to harmonise our domestic law with international standards. To encourage foreign investment South Africa had to introduce legislation that had the same principles as other jurisdictions.[37] Tax treaties did not provide relief to shareholders as STC was a tax charge on the company and not the shareholder.[38]

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[35] It was held in *Lategan v CIR* 1926 CPD 203, 2 SATC 16 at 20 that an amount accrues to a taxpayer in the year of assessment in which he becomes entitled to the amount, irrespective of the fact that the amount may only be due and payable in a later year of assessment.

[36] The phrase 'actually incurred' was said to mean unconditional legal obligation by Corbett JA in *Edgars Stores Ltd v CIR* 1988 (3) SA 876 (A), 50 SATC 81 at 90.

[37] SARS 'Comprehensive Guide to Dividends Tax' (2015) in § 1.3. [Online] Available from: http://www.SARS.gov.za/AllDocs/OpsDocs/Guides/LAPD-IT-G19%20-%20Comprehensive%20Guide%20to%20Dividends%20Tax%20-%20External%20Guide.pdf [Accessed: 10 October 2015].

[38] Article 10 of the OECD Model Tax Convention on Income and Capital, provide guidelines on best practices for allocating taxing rights to dividends. Some tax treaties provide for a reduced dividend tax rate below the rate of 15%. [Online] Available from: http://www.oecd.org/tax/treaties/47213736.pdf [Accessed: 27 June 2016].

Where a resident company declares a dividend *in specie* the company and not the shareholder is liable for the dividends tax.

Dividends paid by resident companies are not deductible from income, but such distributions received are included in the gross income of shareholders in terms of special inclusion para (*k*) to the 'gross income' definition in s 1 of Act. The Act, however, provides relief as local dividends are exempt in terms of s 10(1)(*k*). Hence SMEs will usually be exempt from income tax on the receipt of a dividend, but will be liable for dividends tax unless the shareholder is a company.[39]

2.5 Conclusion

This chapter highlights that a loan is initiated by an extension of credit on the condition that the funds will be repaid on a future date and regardless what the loan agreement calls the compensation paid for the use of funds borrowed it is classified as interest from a tax perspective.

Interest incurred is allowed as a deduction under s 24J(2) in terms of the yield to maturity method. Interest may alternatively be deductible under the s 11(*a*) where the requirements of s 24J were not met. The complexity of the yield to maturity calculation might lead to additional cost of tax compliance for SMEs and in practice it would seem that they are likely to favour the general deduction formula given that the prevailing SARS practice is to allow this approach.

[39] Sections 64F(1)(*a*) and 64FA(1)(*a*).

The Companies Act interpretation of a dividend is narrow compared to that of the Income Tax Act. The emphasis is placed on the shareholder and company relationship in that Act whereas the Income Tax Act is concerned with the causal link between the share and the distribution received. Hence a distribution does not necessarily need to be for the direct benefit of the shareholder, but rather any person in respect of such a share.

In the following chapter the tax consequences of advances made by a company to connected persons, in particular if there is a relation to a shareholder, is considered.

CHAPTER 3 Loans to shareholders and connected persons

3.1 Introduction

The previous chapter sets out the legislative provisions pertaining to debt and equity. The aim of this chapter is to evaluate whether loans advanced to shareholders and other connected persons in relation to a company still has a role to play in the context of SMEs. A discussion of the common law principles relating to causation together with a synopsis of the business rationale for connected person loans in a SME environment other than to obtain a tax benefit is also incorporated.

3.2 Debit loan accounts

In addition to a dividend as defined, the Act also provides that under certain circumstances an amount is deemed to be a dividend for dividends tax purposes.

One such instance is where the company has a debit loan during the year of assessment then the requirements of s 64E(4)(*a*) become important. It states:

> 'Where, during any year of assessment, any amount is *owing to a company* by—
>
> '(i) a person that is—
>
> '(*aa*) not a company;
>
> '(*bb*) a resident; and
>
> '(*cc*) a *connected person* in relation to that company; or
>
> '(ii) a person that is—

'(*aa*) not a company;

'(*bb*) a resident; and

'(*cc*) a *connected person* in relation to a person contemplated in subparagraph (i),

in respect of a *debt*, *that company* must, for the purposes of this Part, be *deemed* to have paid a dividend *if that debt arises by virtue of any share held* in that company by a person contemplated in subparagraph (i).'

(Emphasis added.)

To summarise the following is required to fall within the ambit of s 64E(4)(*a*):[40]

- The amounts must be due to a company (debit loan in the books of a company);
- The borrower must be a resident natural person or a trust that is a resident;[41]
- The borrower must be a connected person in relation to the company, or a connected person in relation to a person who is a connected person to the company;
- Critically the loan must arise by virtue of any share held in the company (causation).

The causation and connected person requirements will be discussed in more detail below. The residency test falls outside the scope of this treatise.

The dividend is deemed to be a distribution of an asset *in specie* and accordingly the company is liable for the dividends tax.

[40] *Silke* in § 9.40.
[41] As there is no dividends tax if the shareholder is a company in terms of s 64FA(1)(*a*).

The amount of the deemed dividend is the greater of the market-related interest[42] less the interest charged on the loan for that year of assessment or nil. The amount of the deemed dividend is nil if the interest charged on the loan exceeds the official interest rate.

3.2.1 By virtue of any share

The critical enquiry under s 64E(4) is whether the debt arose by virtue of any share held in that company. If this question is answered in the affirmative, then only can one proceed with the secondary enquiry of connected person in relation to that company or connected person in relation to a person who is a connected person in relation to that company.[43]

It should be noted that this section does not apply where the interest charged on the debt is equal to or exceeds the market-related interest rate or to the extent that the amount was a deemed dividend under the STC regime.

There is no specific case law relating to s 64E as dividends tax is a fairly new piece of legislation.[44] The meaning of the phrase 'by virtue of' is not defined in the Act. However this phrase came under the spotlight on a number of occasions in our courts.

In *Stander v CIR*[45] the phrase 'by virtue of' was decided in the context of employment[46] namely 'in respect of or by virtue of any employment or the holding of any office'. Judge

[42] Official rate of interest in terms of para 1 of the Seventh Schedule to the Act. This is the South African repurchase rate (Repo) of 7% plus 100 basis points. The official interest rate is 8% since 18 March 2016. [As at 24 June 2016].
[43] On the assumption the person is a resident and not a company.
[44] It came into operation on 1 April 2012.
[45] 1997 (3) SA 617 (C), 59 SATC 212.
[46] Paragraph (*c*) to the 'gross income' definition.

President Friedman was of the view that the phrase 'by virtue of' and 'in respect of' has a similar meaning.[47] In support of this inference he quoted the following dictum by Whitaker P in *ST v COT*:[48]

> 'Ordinarily the phrase . . . means "by force of", "by authority of", "by reason of", "because of", "through" or "in pursuance of". (See Black's Law Dictionary 4 ed 252.) Each of these definitions suggests there must be a *direct link* between the *cause* and the *result*.'

(Emphasis added.)

The Supreme Court of Appeal concurred with the judgment in the *Stander* case that: [49]

> 'there is no material difference between the expressions "in respect of" and "by virtue of" in para (*c*). They connote a causal relationship between the amount received or accrued [result] and the taxpayer's services or employment [cause]'.

The above is significant in the context of this treatise as the 'dividend' definition uses the phrase 'in respect of any share in that company' whereas the deeming provisions s 64E(4)(*a*) refers to 'by virtue of any share held in that company' hence the discussion around causation applies equally to both. That being said s 64E(4)(*a*) is an anti-avoidance provision and is likely to be the more contentious provision where more disputes will arise.

Our courts also considered causation with regards to income received or accrued to minor children 'by reason of any donation, settlement or other disposition' made by the

[47] *Stander v CIR* 59 SATC 212 at 221.
[48] (1972) 35 SATC 99 at 100.
[49] *Stevens v C: SARS* 2007 (2) SA 554 (SCA), 69 SATC 1 at 7.

parent.[50] It is inferred from *Kohler v CIR* that 'by reason of' bears a similar meaning to 'in consequence of'.[51]

Chief Justice Centlivres who delivered the judgment in *CIR v Widan* interpreted the phrase 'by reason of' in terms of s 9(3)[52] as follows: [53]

> 'When income has been received by a minor child the inquiry is whether such income has been so received "by reason of any donation, settlement or other disposition" made by the parent of that child. There must be some causal relation between the donation [cause] and the income [result] in question.'

It is submitted, as a result of the above judgments with regards to para (*c*) of the 'gross income' definition and s 7(3), that a deemed dividend will only be triggered in terms of s 64E(4) if there is a causal connection between any share in that company [cause] and the advance of a loan [result].

3.2.1.1 Causation

With regards to causation it is important to understand the distinction between *causa sine quo non* and *causa causans*. This can be best explained with reference to case law. In the *Stander* case the taxpayer was employed as a bookkeeper by a motor dealership. He received an overseas holiday for him and his wife, not from his employer, but from the vehicle manufacturer. The manufacturer appreciated the quality of the reports pertaining to this dealership and that assisted the manufacturer in its business. In terms of para (*c*)

[50] Section 7(3) of the Act.
[51] 16 SATC 312 at 317.
[52] Section 9(3) was the equivalent to s 7(3) of the current Act.
[53] *CIR v Widan* 1955 (1) SA 226 (A) at 234.

of the 'gross income' definition any amount including any voluntary award received or accrued in respect of services will be included in gross income. The fact that the taxpayer was an employee of the dealership is a *cause sine quo non* for receiving the prize, had he not worked there he would clearly not have been able to receive this holiday.[54] Importantly the services were not rendered to the manufacturer and even though it was beneficial to them it does not mean it was 'in respect' of services rendered. The necessary causal connection between the services to his employer and the prize received from the manufacturer was missing. Put differently the services rendered to the dealership did not constitute the *causa causans*[55] of this award as he did not enter a competition nor did he have an expectation to receive any accolade from the manufacturer for the tasks he ordinarily performed for his employer. The fact that the manufacturer thought that the reports were excellent is the reason he received the prize, not his employment at the dealership.

In a seemingly similar case[56] pertaining to the same provision, the taxpayer was a business man who received an award from the police for providing information which lead to the arrest and conviction of persons involved in an illegal diamond transaction. His motive for sharing the information with the police was to safeguard his reputation and standing in the community. The tax court[57] unanimously held that informing the police was in fact the rendering of a service, but in a 2-1 split decision held the required causal link between

[54] A *causa sine quo non* is sometimes referred to as the "but for" test. But for his employment at the dealership he would not have received the prize.
[55] Direct or proximate cause.
[56] *C: SARS v Kotze* 64 SATC 447.
[57] ITC 1683 (1999) 62 SATC 406.

the service and reward was lacking. Foxcroft J explained the term *causa sine quo non* as follows in the Cape Provincial Division:[58]

> 'But for the information there would have been no reward.'

He went on to explain *causa causans* as follows:

> 'The important question is the proximate or direct cause of the payment.'

It was held that the tax court erred and that the act of informing the police was in fact the *causa causans* that lead to the police rewarding the taxpayer. This is contrasted with the *Stander* case as the nature of the award in that case was an accolade, from a third party, rather than the quality of remuneration for services rendered.

Another important point that was highlighted by the *Kotze* judgment was how to deal with matters where there are more than one cause that is attributable to the result and to this end Foxcroft J quoted what was said by Galgut AJA:[59]

> 'No difficulty arises when one cause only has to be considered. The difficulty arises when there are two or more possible causes. In such a case the proximate or actual or effective cause (it matters not which term is used) must be ascertained, and that is a factual issue. I cannot put it better than is done by Ivamy at 255, where it is said that an earlier event may be a dominant cause in producing the damage or loss; it may be the *causa sine qua non* but the issue is, is it the *causa causans*?'

[58] *C: SARS v Kotze supra* at 452.
[59] *Incorporated General Insurance Limited v Shooter* 1987 (1) SA 842 (AD) at 862D.

The above dictum suggests that determining the cause is a question of fact. The starting point is to determine all the aspects that contributed to the loan being advanced by the company. In order to establish if a factor is a *causa sine quo non* one can apply the 'but for' test, as highlighted in the *Kotze* case.[60] It is possible that there may be more than one *causa sine quo non* that resulted in the company making the advance to the borrower, but ultimately it has to be determined if that *causa sine quo non* is also the *causa causans* that lead to the advance being made.

It is true that the case law discussed above relate to other provisions in the Act and one has to be mindful not to make inferences that are unfounded or where the facts are clearly different. However the common law principles illustrated above are still of value in determining the proximate, actual or effective cause, in the context of s 64E(4).

3.2.1.2 Business or commercial reasons

An advance made to a shareholder or connected person as envisaged in terms of s 64E(4)(*a*) will not by default give rise to a deemed dividend. The connected person relationship with the company will at least be a *causa sine quo non* for the payment, but all the relevant factors and circumstances will need to be taken into account to determine if it is also the *causa causans*.

In a SME environment a shareholder is often also a director of the company and an advance might relate to services rendered, in which case an interest-free or low-interest rate loan will constitute a fringe benefit in terms of paras 2(*f*) and 11 of the Seventh

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[60] Amanda Singleton 'Causation and Taxation II' (2004) 18 *Tax Planning* 81.

Schedule and will be included in the gross income of the director rather than a dividends tax charge for the company. In order to determine if the services or the shareholding is the *causa causans* the minutes of meetings, resolutions and loan agreements will need to be inspected to determine the intention of all involved.

In the *Airworld*[61] case, the taxpayers were two close corporations who had surplus funds which they advanced to a trust where the sole member, his wife and the descendants of the sole member were the beneficiaries. Hurt AJA, who delivered the majority judgement, highlighted the following practical consideration that will also be of value in interpreting s 64E(4) today:[62]

> 'Where it [distribution] is made to the shareholder, there can be little doubt that it is made for his benefit, and there will be no difficulty in concluding that it is to be treated as the surrogate of a "dividend". Where the distribution is made to a person or entity other than the shareholder, the question which immediately arises is: Why would the company decide to confer a benefit on that particular person or entity? It must be borne in mind that the type of distributions . . . offer little or no *quid pro quo* to the company. If there *is* a *quid pro quo*, *eg* the settlement of a debt owed by the company or a loan at a market-related rate of interest, the provisions . . . render the deeming provisions . . . inapplicable.'

(Emphasis added.)

The majority therefore held that a payment to the trust under the circumstances was a payment to the sole member as he could control the ultimate destination of the payment.

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[61] *C: SARS v Airworld CC* & another [2008] 2 All SA 593 (SCA), 2008 (3) SA 335 (SCA), 70 SATC 48.
[62] *Ibid* at para 26.

This case raises an important question 'why would the company decide to confer a benefit on that particular person or entity?'. If there is commercial substance to an advance made to a connected individual or trust, then in order to discharge the onus[63] the taxpayer should be able to prove that there was some form of *quid pro quo*.

The SARS Comprehensive Guide to Dividends Tax states:[64]

> 'an amount owing to a company will not be subject to dividends tax if the debt arose for a *business* or a *commercial reason* and not "by virtue of a share held" in the company by a person referred to in s 64E(4)(a)(i)'.

(Emphasis added.)

It is submitted that there will be no deemed dividend, as long as SMEs apply the same criteria to connected persons as those offered to third parties.

It will be fairly difficult for SARS to verify the above other than by inspecting the credit applications or invoices issued for the same product or services to both third parties and connected persons. It is very possible that formal documentation such as credit applications are not required for connected persons due to the fact that they have similar owners, for example a trading trust or partnership that is a trade debtor of a company.

There is a risk that SMEs might manipulate their financial statement classicisation where they have both an interest-free loan and say 60 days interest-free credit terms with the same connected person. The expectation is that debtor's balance will relate to sales

[63] Section 102(1) of the Tax Administration Act, 28 of 2011, places the burden of proof on the taxpayer.
[64] SARS 'Comprehensive Guide to Dividends Tax' (2015) in § 3.4.1.

transactions at arm-length on the same terms as transactions with unconnected persons. The interest-free loan on the other hand is more likely to be associated with the 'by virtue of any share' requirement which could trigger a deemed dividend.

It is important to note that there may be more than one possible cause that leads to a company making an advance to a shareholder or other connected person. All the factors need to be considered to determine the dominant cause in line with the causation guidelines explained above.

3.2.1.3 General Anti-Avoidance Rule (GAAR)

Section 64E(4) is a specific anti-avoidance provision. The General Anti-Avoidance Rule (GAAR)[65] is an alternative method used to combat tax avoidance in addition to the specific anti-avoidance provisions contained in the Act.[66]

In the context of a business an avoidance arrangement will fall foul of the GAAR if its primary objective is to obtain a tax benefit and one or more of the following tainted elements are present:[67]

- it was done in a fashion that would not normally be employed for *bona fide* business purposes other than to obtain a tax benefit; or
- it lacks commercial substance as detailed in s 80C; or
- where the terms are different to those normally applicable to parties dealing at arm's length; or

[65] Sections 80A-80L of the Act, also referred to as impermissible tax avoidance arrangements.
[66] SARS 'Draft Comprehensive Guide to the General Anti-Avoidance Rule' (2011) in § 1.4.1.
[67] Section 80A as explained in the SARS 'Draft Comprehensive Guide to the General Anti-Avoidance Rule' (2011) in § 2.1.

- where it directly or indirectly leads to the misuse or abuse of any provision in the Act.

This treatise is only concerned with the *bona fide* business purposes and the commercial substance requirements applied under the GAAR. A discussion thereof is likely to provide some insights when dealing with the same requirements under s 64E(4), and other specific anti-avoidance provisions. It is clearly stated in the SARS Comprehensive Guide to Dividends Tax that where a debt stems from business and commercial reasons there will be no deemed dividend even if there is a shareholder or connected person relationship as envisaged by s 64E(4)(*a*).

The business purposes test is mainly concerned with the method or manner the transaction is carried out. The use of the phrase 'not normally' would suggest that it has to be considered from customary business practices, thus more generally than from only the taxpayer's perspective.[68]

In the context of s 64E(4) it needs to be established whether the funds were advanced 'by virtue of any share' or whether it was made for business or commercial reasons. The business purpose test will consider customary business practices and industry norms for similar transactions in order to determine if the business reasons are the *causa causans* which lead to the payment.

[68] *Ibid* in § 6.2.

In the construction industry, for example, advances are regularly made to allow the contractor to purchase materials and pay wages. It is submitted that under these circumstances the business purposes test will be satisfied.

Where a taxpayer endeavours to act outside of the normal *bona fide* industry practices it could very well fall foul of the business purpose test and be subjected to dividends tax as the 'by virtue of any share' factor is likely to be the proximate cause.

The lack of commercial substance provision contained in s 80C is very specific to the GAAR and provides less assistance than initially anticipated. It does however highlight criteria that are indicative of a lack of commercial substance that are relevant to loans advanced by a company, namely:[69]

- Doctrine of substance over form – it is implied from the term 'commercial substance', where for example a loan agreement is structured vastly different from the substance of its operation.
- Round trip financing – offsetting or cancelling of loans could be used to understate debit loan balances. For example where a loan due by connected party A is offset without due grounds against a credit loan with connected party B to reduce the potential deemed dividend.
- Accommodating tax indifferent parties – for example to deliberately channel interest income from a juristic person to natural person in order benefit from the s 10(1)(*i*) annual interest exemption of R23 800.

[69] *Ibid* in § 6.4.

- Inconsistent characterisation by parties – this could be in terms of the classification between loan and trade receivable or between debt and equity to obtain the desired tax result.

If any of the above indicators are present it is submitted that it is more likely than not that the loan was advanced 'by virtue of any share' rather than for commercial reasons and a deemed dividend will follow.

3.2.2 Connected person

Once it is established that the debt arose by virtue of any share held in that company the second enquiry, whether the recipient of the advance is a connected person in relation to that company or connected person in relation to a person who is a connected person in relation to that company, becomes applicable.

SMEs are often businesses that are managed and run by the owners and their families and related party transactions often take place as a result. The 'connected person' definition is vital to specific anti-avoidance provisions, such as s 64E(4), which regulate the tax consequences of transactions entered into between related parties. Related-party transactions are more likely to be misused or abused in order to obtain a tax advantage than transactions entered into between unrelated parties, hence the need for special rules that govern connected person transactions.[70]

The 'connected person' definition, s 1 of the Act, is split into the following relations:

[70] SARS Interpretation Note: No. 67 (Issue 2): 'Connected Persons' (2014) in § 2. [Online] Available from: http://www.SARS.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2012-67%20-%20Connected%20Persons.pdf [Accessed 8 August 2015].

- Natural persons [para (*a*)];
- Trusts [para (b)] and connected person in relation to a trust [para (bA)];
- Partnership, including foreign partnerships [para (c)];
- Company [para (d)];

3.2.2.1 Natural persons

A connected person in relation to a natural person is any relative and any trust of which the natural person or relative of the natural person is a beneficiary.

The term 'relative' is defined in s 1 of the Act. It means a person's spouse or any person related to him or his spouse within the third degree of consanguinity.[71]

3.2.2.2 Trusts

A connected person in relation to a trust is any beneficiary of a trust and any connected person in relation to such beneficiary.

The meaning of beneficiary came under scrutiny in a split decision of the Supreme Court of Appeal.[72] The argument put forward by counsel for the taxpayer was that in a discretionary trust a person is a potential beneficiary until the trustees exercise their discretion to make a distribution of income or capital. It is only at that point that vesting takes place and he migrates from a potential beneficiary to a beneficiary with a vested right. The dissenting judgment agreed with counsel for the taxpayer and followed a

[71] Consanguinity is said to mean: 'State of being related by blood or descended from a common ancestor'. Per Encyclopia.com [Online] Available from: http://www.encyclopedia.com/topic/consanguinity.aspx [Accessed: 12 November 2015].
[72] *C: SARS v Airworld supra*.

restrictive interpretation of the term beneficiary and was of the view that it is limited to a beneficiary with a vested right only. Conversely Hurt AJA, who delivered the majority judgment, was of the view that the term should be given its ordinary meaning:[73]

> 'it did not intend that word to be given a restricted meaning. I consider that to give it its "ordinary meaning" of "a beneficiary named as such in the trust deed"'.

Today there is no ambiguity as the term 'beneficiary', as defined in s 1 of the Act: it categorically includes a person with a vested or contingent interest in a trust.

3.2.2.3 Partnerships

The individual partners of a partnership are liable for income tax and not the partnership itself. In terms of s 24H(2) each member of a partnership is deemed to be carrying on the trade of the partnership.[74]

A connected person in relation to a member of any partnership or foreign partnership includes any other member and any connected person in relation to any member.

3.2.2.4 Connected person in relation to a company

The 'connected person' definition in s 1 of the Act is comprehensive and has a very wide reach. However a connected person in relation to a company for purposes of the deemed dividend provision in s 64E(4)(*a*) is narrower due to the fact that it relates only to a person other than a company. Paragraph (*d*) of the 'connected person' definition deals with a connected person in relation to a company and as a result of the above limitation only

[73] *Ibid* at 62.
[74] This view was confirmed in the Free State High Court: *Grundlingh v C: SARS* (2010) 72 SATC 1.

subparagraphs (iv) and (vi) are relevant. What this effectively means is that it is limited to a company relationship with a natural person or a trust in terms of s 64E(4)(*a*)(i)(*aa*). However one also has to consider any resident connected persons, other than a company, in relation to a person who is a connected person in relation to that company (s 64E(4)(*a*)(ii)(*cc*)) and this extends the net significantly.

Para (*d*)(iv) provides for a situation where a person other than a company individually or jointly with any connected person in relation to that person holds directly or indirectly at least 20% of the equity shares or voting rights in the company.

The following is an example of a deemed dividend on a debit loan:[75]

<u>EXAMPLE</u> – Deemed dividend on debit loan

<u>Background:</u>

On 1 March 2014, C (Pty) Ltd advanced an interest-free loan of R1 000 000 to Mr A who owns 80% the shareholding in B (Pty) Ltd, who in turn owns 12.5% of the ordinary shares in C (Pty) Ltd. The A Family Trust, of which Mr A is the donor, owns 5% of the ordinary shares in C (Pty) Ltd, Miss D, who is a beneficiary of the A Family Trust and Mr A's granddaughter, has a 5% stake in C (Pty) Ltd.

Assume a market-related interest rate of 6.75% and that the loan was advanced by virtue of a share held in C (Pty) Ltd. Assume all persons are residents. C (Pty) Ltd has a 28 February 2015 year end.

<u>Commentary:</u>

A Family Trust is a connected person in relation to Mr A not because he is the donor, but due to the fact that his granddaughter Miss D is a beneficiary of the trust and he is a connected person in relation to her within the second degree of consanguinity. The connected person rule in relation to a trust beneficiary para (*b*)(ii) of 'connected person' definition applies.

[75] This example was adapted and is based on a combination of examples in the SARS Interpretation Note: No. 67 (Issue 2): 'Connected Persons' (2014), the SARS 'Comprehensive Guide to Dividends Tax' (2015) in § 3.4.1. and *Silke* in § 9.41.

<u>EXAMPLE</u> – Deemed dividend on debit loan (continued)

<u>Commentary:</u>

Mr A, is a connected person in relation to C (Pty) Ltd as he indirectly owns 10% (80% x 12.5%) plus 5% owned by A Family Trust plus 5% owned by Miss D = 20%. Para *d*(iv) of 'connected person' definition and s 64E(4)(*a*)(i) applies.

C (Pty) Ltd will be deemed to have paid a dividend *in specie* of R67 500 (R1 000 000 x 6.75% (the official rate of interest)) on 28 February 2015 and will need to pay the dividends tax of R10 125 (R67 500 x 15%) in terms of s 64E(4)(*b*).

If the loan was granted to Miss D instead of Mr A the position would be similar as she also jointly with connected persons hold 20% of the share capital in terms of s 64E(4)(*a*)(ii).

The example above illustrates that even if the shares in a company are widely held an indirect shareholding coupled with some seemingly insignificant shareholdings of related individuals or linked trusts could lead to a combined shareholding of 20%. In the owner managed environment the risk of a potential deemed dividend on debit loans will always need to be considered.

3.2.2.5 Connected person in relation to a close corporation

In the SME landscape the use of close corporations is fairly common. The Close Corporations Act[76] was introduced on 1 January 1985 with the aim to provide an easier, more flexible, relatively inexpensive juristic person compared to a private company under the old Companies Act.[77] This corporation is a legal person separate from its members and provides limited liability and was, and still is, a popular vehicle for a single entrepreneur or closely held owner managed enterprises. There is a social component to

[76] 69 of 1984.
[77] 61 of 1973.

this as it provided an opportunity to combat unemployment and to grow the small business sector. The new Companies Act was introduced with the same objectives of encouraging entrepreneurship, simplification and flexibility as was the case when close corporations were introduced. The new Act came into effect on 1 May 2011 and effectively prohibits the formation of new close corporations and the conversion of companies to close corporation. This will over time lead to the phasing out of these corporations.[78] Despite the corporate reform, close corporations may continue to operate under the Close Corporations Act.[79] It is important to note that the business rescue provisions in chapter 6 of the new Companies Act also covers close corporations,[80] refer to 5.4 for the detailed discussion on business rescue.

Section 29 of the Close Corporations Act provides that only natural persons may be members of a close corporation. However a trustee of an *inter vivos* trust may be a member where no juristic person is directly or indirectly a beneficiary of the trust. This exception will cease to apply if the number of natural persons entitled to receive a benefit from the trust when added to the number of members of the corporation exceed ten.

From a tax point of view generally there is no distinction between a company and close corporation as the latter is specifically included in the definition of a 'company', but with regards to the connected person definition a clear distinction exists.

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[78] J J Henning and J T Pretorius *Close Corporations and Company Service* Volume 1: Close Corporations in § 2.01 and § 2.10.
[79] This act was significantly amended as a result of the new Companies Act.
[80] Section 66(1A) of the Close Corporations Act.

Paragraph (*d*)(vi) of the 'connected person' definition states that a connected person in relation to a close corporation is any member and any relative of such member or any trust which is a connected person in relation to such member.[81]

Contrary to para (*d*)(iv) there is no 20% connected person rule for close corporations. Perhaps the reason for that is perhaps because the ownership is already limited to a maximum of ten members.[82] In a situation where a close corporation has two members, one with 99% of the members' interest and the other with 1%, even the 1% member will be a connected person in relation to the corporation. Whereas if the corporation was converted into a company a debit loan to the 1% member will not by itself lead to a deemed dividend. This anomaly seems odd in light of the fact that one of the aims of corporate reform was to harmonise the treatment of companies and close corporations and as mentioned generally a close corporation and company is taxed in the same manner. The deeming provision with regards to dividend tax on debit loan accounts could place the close corporation at a disadvantage in the circumstances explained above.

The connected person definition has an extremely wide reach in terms s 64E(4)(*a*) because it also includes a person who is a connected person in relation to a person who is a connected person to that company. It is therefore submitted that owner managed companies and corporations need to mindful of all resident connected person relationships, other than where the connected person is a 'company 'as defined in s 1 of the Act.

[81] Para (*d*)(vi)(*cc*) is not relevant as it relates to a close corporation or a company.
[82] Section 28 of the Close Corporations Act.

An overview of the purposive approach and considerations whether or not to charge interest on loans granted to connected persons follow below.

3.3 Purposive approach

The basic principles of fiscal interpretation always need to be borne in mind. In the majority judgment of the *Airworld* case it was said that:[83]

> 'In recent years courts have placed emphasis on the purpose with which the Legislature has enacted the relevant provision. The interpreter must endeavour to arrive at an interpretation which gives effect to such purpose. The purpose (which is usually clear or easily discernible) is used, in conjunction with the appropriate meaning of the language of the provision, as a guide in order to ascertain the legislator's intention.'

Interestingly enough the *Airworld* case is one of the leading cases with regards to the purposive approach and it also deals with deemed dividends albeit in the context of STC.

To understand the purpose of s 64E(4) it is useful to consult the explanatory memorandum where the provision was first introduced. The explanation provided is that the same motivation exists to avoid dividends tax as was the case under the STC regime and as a result dividends tax also requires an anti-voidance provision to combat the mischief of extracting value without incurring a liability for dividends tax.[84]

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[83] *C: SARS v Airworld supra* at para 25.

[84] Explanatory Memorandum on the Taxation Laws Amendment Bill, 2009 at 50. [Online] Available from: http://www.SARS.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-2009-01%20-%20Explanatory%20Memorandum%20Taxation%20Laws%20Amendment%20Bill%202009.pdf [Accessed: 13 March 2016].

The memorandum lists the following value extraction triggers that will yield a deemed dividend:

- Interest-free or low-interest rate loans advanced to connected persons;[85]
- Waiver of pre-existing loans made by the company to such connected persons;
- Settlement of a third party debt on behalf of such a connected person;
- Change in residency status of company to non-resident.[86]

A significant distinction between the deemed dividend provision under dividends tax and STC is that the taxable amount for dividends tax is not calculated on the capital amount, but only on the interest differential. It can almost be considered as a penalty to the company for not charging interest at the market-related interest rate.

It is important to note that where a shareholder loan or other connected person loan is written off, the principal amount is used to calculate the dividend and not only the 15% on the interest differential. This is because the word 'distribution' as used in para (*a*) to the 'dividend' definition in s 1 of the Act includes the waiver of debt owed by any person in respect of any share.[87]

Where the company makes a settlement to a third party, on behalf of a shareholder or other connected person, a deemed dividend is likely to be calculated on the interest differential in terms of s 64E(4)(*b*)(ii) unless there is from the outset no intention that the shareholder or other connected person will repay the company. In this scenario the

[85] It is assumed that it is limited to resident natural persons and resident trusts who are connected persons in relation to a company or a connected person in relation to a person who is a connected person in relation to a company.
[86] As indicated earlier the residency status falls outside the scope of this treatise.
[87] SARS 'Comprehensive Guide to Dividends Tax' (2015) at 26 and 48.

dividend in terms of s 1 will be calculated on the principal amount similar to the outright waiver of a debt.

3.4 Interest-bearing vs interest-free

Depending on the circumstances of the two connected parties there may be arguments for and against charging interest on the loan advanced by the company to the connected counter party. Where the borrower is a connected company there is no risk of incurring dividends tax for the lender company, but there may well be benefits in charging interest. For example if the lender has an assessed loss it will be able utilise that loss and the connected company, on the assumption the requirements of s 24J(2) are complied with, will obtain a deduction for the interest incurred.

Where the borrower is a connected trust or natural person and the lender company has an assessed loss it will be beneficial to charge interest, at the market-related interest rate, because again the company can utilise its assessed loss and the trust or natural person can claim an interest deduction assuming all requirements pertaining to s 24J(2) (or where s 24J might not apply, to s 11(a)) are satisfied. To the extent that the loan is not repaid the receivable for the company continues to accumulate and should the loan be written off in the future the principal amount on which the dividends tax will be calculated will be higher as a result of the capitalised interest.

Where no connected party to the loan agreement has an assessed loss (especially if both parties are companies) there certainly is an argument not to charge interest because there will be no tax outflow provided the requirements of s 64FA(1)(*a*) are complied with.

Where the borrower is a connected trust or natural person and no interest is charged the amount of the dividend tax payable by the lender company will only be calculated at 15% of the market-related interest on the loan as against normal tax at 28% if interest was charged. Where connected trusts or natural persons are not trading they are unlikely to receive an interest deduction and then the deemed dividend position could be advantageous.

3.5 Conclusion

This chapter evaluated whether loans advanced to shareholders and other connect persons in relation to a company still has a role to play in the context of SMEs. The special anti-avoidance provision contained in s 64E(4) and the business rational and commercial substance indicators according to the GAAR were considered to identify under which circumstance these loans are in substance equity regardless of its legal form.

The tax consequence of falling foul of the specific anti-avoidance provision is a deemed dividend *in specie*. The reason for this is that the lack of interest or the low rate of the interest charged to a person with such a special relationship with that company in the absence of commercial substance the loan is more akin to equity hence the tax consequence is a dividend charge to the company.

The primary enquiry under this anti-avoidance provision is whether the debt arose by virtue of any share held in the company. The meaning of the phrase ‘by virtue of’ is not defined in the Act. However this phrase came under the spotlight on a number of occasions in our courts. Although these judgments were in the context of other provisions in the Act, it is submitted that the same principles apply to s 64E(4) namely, that a causal connection is required between any share in that company [cause] and the advance of a loan [result].

The *Airworld* case provides practical guidance when dealing with loans advanced by a 'company' as defined to a connected person in relation to that company. The enquiry is why would a company be prepared to part with funds for little or no *quid pro quo?* A lack of *quid pro quo* would suggest that no business or commercial reasons are applicable to the advance of funds and as such the payment is likely to be subject to dividends tax.

The onus is on the taxpayer to prove that an advance made to a connected person has same terms and conditions that are customary to the industry within which it operates. A pragmatic approach will be to identify all the factors that could contribute to the loan being made by the company. The 'but for' test will assist in identifying if a factor or factors qualify as a *causa sine quo non*. Where there is more than one possible cause that could lead to the origination of the loan an enquiry into the dominant or proximate cause is likely to yield the correct result. Where the terms are consistent with those of third parties or a reasonable *quid pro quo* is provided in exchange for the loan, it is submitted that the causal connection required to trigger the anti-avoidance provision is missing as the commercial reasons are the *causa causans* that lead to the advance to the connected person.

If the primary enquiry is answered in the affirmative the secondary enquiry pertaining to a connected person in relation to that company or a connected person in relation to the first mentioned, can be considered. Due to the wide reach of the 'connected person' definition even where shares are widely held the possibility of reaching the combined

20% shareholding between connected persons under para (*d*)(iv) should always be considered. This poses a potential tax risk when read with specific anti-avoidance provisions such as s 64E(4). The 'connected person' definition under certain circumstances could have adverse tax consequences for a close corporation when compared to a private company, as there is no 20% threshold and any member regardless of the membership interest is a connected person in relation to a close corporation. This also widens the net for connected persons in relation a member and it seems to go against the grain of company reform.

The second part of this treatise will deal with debt relief and it is worth emphasising that where loans are waived or granted with no intention of enforcing repayment the dividend is calculated on the principal balance and not the interest differential.

The next chapter evaluates the new anti-hybrid debt recharacterisation rules and the impact thereof on historical loans made prior to the inception thereof. Potential tax planning opportunities and tax risks when formalising loan agreements are discussed.

CHAPTER 4 Interest recharacterisation rules

4.1 Introduction

In the first chapter the question was raised whether loan funding still has a role to play in the context of SMEs, in light of a call for the uniform tax treatment of debt and equity. The preceding chapter would suggest that loans advanced by a company on commercial grounds and on terms that are customary to the industry would certainly have a role to play in the ordinary business operations of a SME without triggering a charge for dividends tax.

This chapter evaluates the amendments to s 8F, the introduction of s 8FA and the impact thereof on pre-existing loan agreements. These two anti-avoidance provisions were introduced to curb the mischief where instruments are labelled as debt in order to obtain a tax deduction, but where such instruments clearly have equity features.

A discussion of potential tax planning opportunities and tax risks when formalising loan agreements is incorporated. Consideration is given to the tenure of a loan including the option to refinance, payable on demand or determined future date, subordination agreements and critically whether or not to charge interest.

4.2 Anti-hybrid debt instrument recharacterisation rules

4.2.1 The old rules

When s 8F was originally enacted in 2004 it provided anti-avoidance rules for both hybrid debt instruments and hybrid equity instruments. For hybrid debt instruments, with equity features, no deduction was permitted for interest paid or payable. However the interest would retain its nature in the hands of the payee and would likely be taxable.[88] Under the old regime the focus was mainly on convertible instruments, for example a debenture that was convertible into shares. It further provided that in order to qualify as a hybrid instrument the conversion features had to be exercisable within three years from the date that the debt instrument was issued.

4.2.2 The new rules

The explanatory memorandum on the Taxation Laws Amendment Bill, 2013 highlights the short comings of s 8F which lead to the amendments:[89]

> 'artificial classifications *go beyond the use of mere conversion features*. For instance, *an instrument lacking a maturity for repayment is a strongly questionable form of debt*'.

(Emphasis added.)

The emphasis placed on the lack of maturity highlights the most significant change for SMEs in terms of what constitutes a hybrid debt instrument. This is detailed in s 8F(1)(*c*) quoted below:

> 'that *company owes* the amount to a *connected person* in relation to that company *and* is *not obliged* to *redeem* the *instrument*, *excluding* any instrument *payable on demand*, *within 30 years* from the date of issue of that instrument: Provided that, for the purposes of this paragraph, where the company has the right to—

[88] Explanatory Memorandum on the Taxation Laws Amendment Bill 2013 at para 2.1.
[89] *Ibid*

‘(*aa*) convert that instrument to; or

‘(*bb*) exchange that instrument for,

a financial instrument *other than a share*—

‘(A) that conversion or exchange must be *deemed to be an arrangement* in respect of that instrument; and

‘(B) that instrument and that financial instrument must be de*emed to be one and the same instrument* for the purposes of *determining the period* within which the company is obliged to redeem that instrument’.

(Emphasis added.)

Section 8F(1)(*c*) highlights that a loan will be a hybrid debt instrument when:

- a company owes an amount (credit loan);[90]
- to a connected person in relation to that company;[91]and
- that company is not obliged to settle the loan within 30 years from the date of issue, save if the loan is payable on demand.

The last point warrants further analysis.

How does the 30-year rule work and under what circumstances can it be said that a loan is payable on demand?

[90] In contrast with s 64E(4) where debit loans were evaluated.
[91] Refer to 3.2.2 for the detailed discussion on this matter. Where the amount is owing to a company, that is a connected person in relation to that company there will be no deemed dividend if the requirements of s 64FA(1)(*a*) are met. Hence the application will also be limited to natural persons and trusts as discussed for s 64E(4).

4.2.2.1 The 30-year requirement

Earlier in this treatise it was determined that one of the key characteristics of a loan is that it is granted on the condition or with the expectation that funds will be repaid and further that the right to use borrowed funds is for a specific period only.[92] This view was confirmed by the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2013:[93]

> 'A key feature of debt is the holder's ability to redeem the capital amount loaned within a reasonable period. Instruments without this key feature operate more like equity (i.e. shares), and the yield on these instruments will accordingly be treated as equity yields (i.e. dividends *in specie*).'

Thirty years is a significant amount of time and the basis for this rule is that if there is no requirement that compels the company to discharge the liability within this substantial timeframe the loan is akin to equity. It is important to note that this rule only applies to loans due to connected persons, very often the shareholders who already have an equity interest in the company.[94] In an owner managed environment loans are often made to connected parties without proper documentation or clarity on the terms such as the interest rate, tenure and instalment intervals. Ultimately the onus falls on the company taxpayer to prove that it was compelled to settle the loan within 30 years and the absence of proper documentation will make this task much more onerous.

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[92] Refer to 2.2.1.
[93] At paragraph 2.1 *B. Instrument focused recharacterisation* 1. Features – second paragraph (page 29).
[94] Pieter van der Zwan 'Time to Consider the Terms of Company Loans Carefully' (2014) *TaxTalk* [Online] Available from: http://www.thesait.org.za/news/154619/Time-to-consider-the-terms-of-company-loans-carefully.htm [Accessed: 17 March 2016].

Relief is provided if the loan is payable on demand. There is no further guidance under what circumstances this will apply and guidance will need to be obtained from our case law.[95]

The meaning of the phrase 'payable on demand' was explained as follows by Selikowitz J in *Standard Bank of SA Ltd v Oneanate Investments (Pty) Ltd*:[96]

> 'A loan without agreement as to a time for repayment is at common law repayable on demand. Although by no means linguistically clear, the phrase "payable on demand" is used in this context in our law to mean that no specific demand for repayment is necessary and the debt is repayable as soon as it is incurred.'

The above dictum suggests that in the absence of any categorical repayment terms the loan is repayable as soon as it is incurred. This common law principle will assist SMEs not to fall foul of the 30-year rule as often they have no loan agreements governing the repayment terms.

In their financial statements SMEs often use the phrase 'there are no fixed terms of repayment' with regards to related party loan disclosures. This would suggest that the amount is payable on demand and this is usually supported by classifying the loan as a current liability on the balance sheet.

Where the borrower company has the right to refinance or exchange the initial loan for a new loan, essentially replacing the initial loan with a new one under some form of

[95] *Ibid*.
[96] [1995] 4 All SA 128 (C) at 160.

refinancing arrangement, the replacement loan will be deemed to be one and the same as the initial loan for purposes of determining the cumulative 30 year redemption period.

Where a loan from shareholder for example has a term of 16 years on the face of it there seems to be no problem, but where redemption takes place after the 16 year period and shortly thereafter is refinanced with a similar amount for another 16 years then it would possibly qualify for as a hybrid debt instrument as it collectively exceeds the 30 year threshold.

The relevant facts and circumstances need to evaluated on a case by case basis, but it would seem that SMEs might find a safe harbour by not having categorical repayment terms.

4.2.2.2 Subordination

Under s 8F(1)(*b*) a hybrid instrument will be present where the obligation to pay an amount in respect of that instrument is conditional upon the assets exceeding its liabilities when measured at their respective market values. The question arises whether a subordination agreement could lead to recharacterisation.

In a SME environment where connected person transactions are common one would expect that these agreements would be entered into where the borrower company is in financial distress. The standard wording normally stipulates that repayment will only be made to the lender when the borrower's assets fairly valued exceeds it liabilities. It will thus in all likelihood be a hybrid debt instrument.

The other point to consider is that when the repayments are suspended it cannot be said that it is payable on demand and, should there be no obligation to settle within 30 years and the counter party to the loan agreement is a connected person in relation to that company, this could potentially also cause a problem under s 8F(1)(*c*).

It seems that it was an unintended consequence for subordination agreements to fall within the ambit of the new hybrid debt instrument rules as Treasury proposed, on 24 February 2016, that a concession should be made to exclude loans subject to subordination agreements from the recharacterisation net.[97]

4.2.2.3 Hybrid interest

Section 8F is focussed on corpus of the instrument itself whereas s 8FA in turn is focussed on the yield of the instrument.[98]

Section 8FA(1) requires the following features in order for a yield to be classified as hybrid interest:

- the yield must not be determined with reference to a specified interest rate or the time-value of money; or
- the interest rate increases as the profits of the debtor company increases.

Where the interest rate was increased as a results of an increase in profits the hybrid interest is calculated as the difference between the interest at the increased rate and the

[97] National Treasury Budget Review 2016 at 161. [Online] Available from: http://www.treasury.gov.za/documents/national%20budget/2016/review/FullReview.pdf [Accessed: 17 March 2016].
[98] Explanatory Memorandum on the Taxation Laws Amendment Bill 2013 para 2.1.

lowest interest rate for that loan during the current and the previous five years of assessment.

4.2.2.4 Tax treatment under the new rules

The tax treatment is line with the objective of these anti-avoidance rules where the instrument or the yield is in substance more like equity than debt it will be treated as equity from a tax point of view. Consequently the interest pertaining to these instruments is deemed to be a dividend in the hands of both the borrower and the lender. Similar to the old rules the borrower will be denied a deduction for interest, but now the lender will receive a dividend, and not interest as per the old regime, which is generally exempt from normal tax. It should be borne in mind that where the lender is a person other than a company, the borrower company is liable for the dividends tax on the dividend *in specie*.

An instrument in the context of ss 8F and 8FA refers to interest-bearing debt. Where an interest-free loan exists no recharacterisation will take place regardless of whether it falls foul of the 30-year, subordination or hybrid interest rules.

The new recharacterisation rules do not apply to 'small business corporations' as defined in s 12E(4), regulated debt issued by banks and insurance companies. It is assumed for purposes of this treatise that the owner managed business are not necessarily small business corporations, banks or insurers. Therefore this does not necessarily provide any relief in the context of this discussion.

4.3 Impact on historical loans

The new anti-hybrid debt instrument rules came into effect on 1 April 2014 and apply to any amount of interest incurred by a company on or after this date. It does not state that it only applies to loan agreements entered into from 1 April 2014 onwards. This is important as interest may be recharacterised as a deemed dividend *in specie* on pre-existing loans owing by the company prior the effective date of this new regime.

4.3.1 Subordination: current law *vs* 2016 budget proposal

Where a company at 31 March 2014 had an interest-bearing loan owing that was subject to a subordination agreement that company would lose its interest deduction from 1 April 2014 onwards as it would qualify as a hybrid debt instrument under s 8F(1)(*b*). This puts a company that is already under financial distress at a further disadvantage. Possibly this company has an assessed loss, but regardless thereof the company is not in a position to increase the assessed loss as a result of the deduction being denied. The concession proposed by Treasury does not indicate that it will work retrospectively and in the interim companies also need to mindful of the interest deduction that may be sacrificed as result of entering into new subordination agreements.

The aim of the new rules, although having a wider reach than the old rules, is to prevent companies from obtaining an unfair tax advantage by artificially claiming interest on a debt instrument that essentially have equity features.

A mismatch might occur when a profitable company, that does not have an assessed loss, is able to claim a deduction for interest, but the lender who receives the interest income has an assessed loss and therefore there is a leakage to the fiscus.[99] The typical position where a borrower company is required to enter into a subordination agreement the position will be opposite to the above and would also be to the detriment of SARS, as explained in the example below.

EXAMPLE – Subordination agreement: borrower company has an assessed loss

Background:

Company A and Trust B (trading trust), who are connected persons in relation to each other, entered into a loan agreement on 1 March 2007 whereby Trust B advanced an amount of R1 000 000 to company A that is repayable in 10 annual instalments of R100 000 on the last day of the year of assessment. Assume a 28 February year end. The loan bears interest at the prime lending rate, assume 10% throughout.

Company A experienced financial difficulties and on 1 March 2012 the loan owing to Trust B (the remaining R500 000) was subordinated until such time as its assets fairly valued exceeds its liabilities. At 28 February 2016 the loan balance amounted to R600 000 (assumed – no actual yield to maturity calculation was performed). Company A had an assessed loss of R250 000 carried forward from 28 February 2015. Trust B has taxable income of R100 000 at 28 February 2016 before taking the loan income into account.

Below find a comparison between the tax consequences for the year ended 28 February 2016 if (1) it is assumed that the subordination agreement is not subject to s 8F(1)(*b*) and (2) current provision of s 8F(1)(*b*) which will trigger recharacterisation.

Commentary:

Section 8F(1)(*b*) does not require a connected person relationship, but it is more likely for subordination agreements to take place between connected persons in a SME environment. The example does not address the potential risk of excessive interest deductions, but it is assumed that the prime lending rate is appropriate for purposes of this example.

Up to 31 March 2014 the interest incurred on the loan due to Trust B, even after it was subordinated, will qualify for a deduction in hands of Company A in terms of s 24J(2). Consequently the interest accrued to Trust B in terms of s 24J(3).

[99] This scenario will not trigger s 8F unless the instrument is in substance equity. *Bona fide* loans will not be affected.

<u>EXAMPLE</u> – Subordination agreement: borrower company has an assessed loss (continued)

<u>Commentary:</u>

From 1 April 2014 onwards no deduction of interest will be allowed as the existing subordination agreement triggers s 8F(1)(*b*) and therefore the interest incurred will be deemed to be a dividend *in specie*. Trust B will be deemed have received this dividend, which is exempt from normal tax under s 10(1)(*k*), but no exemption is granted for dividends tax in terms of s 64FA. The dividends tax will be for the account of Company A in terms of s 64G(1)(*a*) which adds a further cash outflow for a company that is already experiencing financial difficulties.

Income tax consequences at 28 February 2016	(1) Assume no s 8F(1)(*b*)		(2) Apply s 8F(1)(*b*)	
	Company A	Trust B	Company A	Trust B
(Assessed loss brought forward) / Taxable income before loan income	(250 000)	100 000	(250 000)	100 000
Interest deduction s 24J(2)	(60 000)			
Interest included in gross income s 24J(3)		60 000		
Dividend included in gross income para (*k*)				60 000
Section 10(1)(*k*) exemption for local dividend				(60 000)
(Assessed loss to be carried forward) / Taxable income	(310 000)	160 000	(250 000)	100 000

R60 000 used for simplicity – no yield to maturity calculation was performed.

The example above looks at both scenarios for two reasons, firstly to prove that the current legislation leads to less revenue for SARS and secondly the difference between the current legislation and if the budget proposal were to be implemented.

If it is assumed that subordination agreements do not trigger recharacterisation or Treasury makes the proposed concession, SARS could collect an additional R24 600 (R60 000 x 41%) in terms of income tax on the assumption that Trust B does not distribute any income to the beneficiaries.[100] The same result would be achieved if the loan was advanced by a natural person who is already at the maximum marginal tax rate and who has exhausted the R23 800 interest exemption under s 10(1)(*i*).

If it is assumed that subordination agreements do trigger a recharacterisation as envisaged under the current legislation, there is no income tax differential as shown in the table above. However SARS will only collect R9 000 (R60 000 x 15%) in the form of dividends tax. It could be argued that SARS also does not increase the assessed loss of Company A by R60 000 which is worth R16 800 (60 000 x 28%) and equates to R25 800 (R9 000 + R16 800) in total, but there is no guarantee that Company A will return to profitability and the time value of money was also not considered.

Where the tax position under both scenarios are considered jointly for the borrower and the lender then the actual outflow is less under the current regime. This could be fairly valuable in a connected person or small group scenario, bearing in mind there is no connected person requirement for s 8F(1)(*b*). If the parties to the subordination agreement were both companies SARS will collect no dividends tax[101] and in that scenario there can be little doubt, from a monetary perspective, that the combined tax consequence for the borrower and the lender under the current subordination recharacterisation rules favour a typical company in financial distress that also has an assessed loss even if the connected counter party has no assessed loss. The only

[100] This might be forced onto taxpayers as the 2016 budget does mention a proposal to limited the use of discretional trust for income-splitting. National Treasury Budget Review 2016 at 49.
[101] Provided the requirements of s 64FA(1)(*a*) were complied with.

disadvantage is that the connected person lender will in all likelihood need make a further advance in order to cover the dividends tax.

It will be interesting to learn how the Treasury proposal will be implemented and if they will add a special rule if the parties to the subordination agreement are connected persons.

4.3.2 Determination of 30-year period

The 30-year rule requires the determination of the date of issue of the loan. In addition, where the borrower company has a right to refinance or exchange that loan for another loan, the replacement loan will be considered as the same loan for purposes of the determining of the 30-year redemption period.

For SMEs that have been in business for a considerable amount of time it might be fairly cumbersome to determine the date of issue of the first advance of the loan. The loan might have been replaced or re-advanced on a number of occasions since that initial advance.

The other problem would be to determine where the amount was repaid and subsequently re-advanced and at who’s instance the refinance was done, namely the borrower company or the lender connected person?

Where regular refinancing was done between the borrower company and connected person lender, would a break where no funding was provided reset the determination of the 30-year period?

Unfortunately neither the Act nor the explanatory memorandum provides enough clarity in order to address the practical issues raised above. It should be borne in mind that in general there is a presumption against retrospective application and even though the interest will only be recharacterised from 1 April 2014 onwards a pragmatic approach should be followed for establishing the issue date of the loans that have been in existence for a number of years.

Where a loan was first advanced fifty years ago, there was no way that a taxpayer would have known that in the future there will be a requirement to retain records off all amounts due on interest-bearing loans to connected persons. The concept of connected person did not, if it existed back then, have the same wide reach as it has today. In addition, the requirement to keep record of the cumulative tenure of replacement loans that have fixed repayment terms and further at who's instance it was issued would seem impractical, if not impossible.

In the alternative it can be argued that since s 8F only came into effect on 1 April 2014 and therefore the concept of 'instrument' as defined, in this section, also only also came into effect at this date. As a result, any interest-bearing loan to a connected person prior the effective date does not comply with s 8F and consequently the 30-year rule only applies to instruments issued subsequent to the effective date. This seems to be a more equitable solution for the taxpayer, taking the *contra fiscum* rule into account.

4.3.3 Intention

Where an interest-bearing loan was advanced by a shareholder and said loan has fixed repayment terms under the loan agreement, but the company did not make any repayments and the shareholder never attempted to collect these amounts, can it be said that the intention from inception was not to provide a loan but rather an equity investment? Would SARS under these circumstances only be able to apply s 8F(1)(*c*) once the 30 year period has lapsed? Could the debtor company perhaps argue that the loan has prescribed as the lender never enforced or claimed payment in the terms of the agreement?

One of the key characteristics of a loan is the repayment requirement and therefore the substance of the above agreement seems more akin to equity. The words 'not obliged to redeem the instrument . . . within 30 years from the date of issue of that instrument' in s 8F(1)(*c*) would suggest that SARS will be able to apply this rule from the date of issue[102] if they are convinced that the shareholder had no intention to enforce the repayment terms under the loan agreement, and not only when the 30 year period has lapsed. This is further supported by the reasons for change paragraph in the explanatory memorandum as quoted earlier in this chapter, that artificial classifications go beyond the mere use of conversion features and that where an instrument lacks a redemption date it is questionable whether it is in substance debt. SARS normally look at the substance of the agreement rather than only the legal form.

In *CIR v Visser* the following was said about the taxpayer's intention:[103]

> 'His intention is not necessarily determined by what he says was his intention, but by the inference as to the intention to be drawn from the facts of the case.'

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[102] If issue date is before 1 April 2014 recharacterisation can only commence on 1 April 2014.
[103] 1937 TPD 77, 8 SATC 271 at 276.

An enquiry into a natural person's state of mind is required in order to determine his intention.[104] In simple terms the *ipse dixit* is what the taxpayer says his intention is but it does not mean that the court necessarily needs to accept this. It needs to be considered in the context of the relevant facts and other evidence.[105]

In the situation above it will be difficult for the shareholder[106] to convince a court that the intention was to advance a loan as the repayment terms of the agreement was never enforced and any reference to the legal agreement would show the form is different to the substance and actions of the company and the shareholder.

It may be possible to argue prescription, but where the loan is disclosed in the financial statements it would act as the acknowledgement of the liability and therefore interrupt the three year prescription period[107] in terms of s 11 of the Prescription Act.[108] Generally the aim of this type of arrangement would be to obtain a tax deduction for the borrower and perhaps an attempt to claim the deduction in the tax return can also be argued to be an interruption of prescription. From a tax deductibility point of view if there is no intention to repay the loan, it is difficult to argue that the interest was incurred because in substance there is no unconditional legal obligation.[109]

[104] P Haupt *Notes on South African Income Tax* (2014) in § 2.7.5.
[105] *Malan v KBI* [1983] 4 All SA 235 (A), 1983 (3) SA 1 (A) at 18.
[106] Assume also a director of the company.
[107] *Henochsberg* at 24.
[108] 68 of 1969.
[109] *Edgars Stores Ltd v CIR supra* at 90.

4.4 Tax risks and planning opportunities

The new rules were introduced as taxpayers and their advisors found creative ways in which to obtain tax deductions on a sham basis and very often there was a tax leakage to the fiscus. These provisions are fairly technical and specialised and an entrepreneur who is concerned with managing his business and its cash flow requirements may fall foul thereof if the company's loan obligations are not properly managed.

4.4.1 Interest-free loans

Where the transaction is not a sham and the company is charged a market related interest rate based on its credit risk, the company should be able to obtain an interest deduction, provided the requirements of s 24J(2) are complied with.

A deemed dividend under the new rules can be avoided if no interest is charged on the loan as ss 8F and 8FA only apply to interest-bearing loans. Where both parties to the loan agreement are companies there is no risk of a deemed dividend for the lender company under s 64E(4)(*a*).[110]

It is unlikely to lead to donations tax where the lender is a trust or natural person because an interest-free loan is not a 'donation' as defined in s 55 of the Act[111] nor a donation under common law.[112]

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[110] Refer to 3.2.

[111] A 'donation' is defined as 'any gratuitous disposal of property including any gratuitous waiver or renunciation of a right'.

[112] This was confirmed in *CIR v Berold* 1962 (3) SA 748 (A), [1962] 3 ALL SA 454 (A).

There is a rider to the above statement as the 2016 budget contains a proposal that where the founder sells an asset to a trust and grants the trust an interest-free loan in lieu of payment, such interest-free loan will be regarded as a donation.[113]

There is however a risk for natural persons in terms of the s 7 attribution rules to the Act which deals with the phrase 'by reason of any donation, settlement of other disposition', where under certain circumstances, income is deemed to be that of a person other than the person who received it or it accrued to. There needs to be a causal connection between the 'donation, settlement of other disposition' and the income earned.[114]

In the *Berold* case through a number of arranged transactions a company had an amount owing to a trust on which no interest was charged. By not charging interest the company could afford to declare a dividend, which at the time was subject to a super tax in the hands of the recipient. The dividend vested in minor children, via a trust, of which they were the beneficiaries. SARS deemed the amounts that accrued to the minor children to be that of their father as he donated the shares and the loan owing by the company through this arrangement. It was held that by refraining from charging interest on the loan it was a continuous 'donation, settlement of other disposition' of interest in terms of the equivalent to s 7(3) of the Act and that the SARS appeal succeeded.[115] The above case highlights that natural persons should be mindful of the s 7 attribution rules if they elect not to charge interest on loans.

[113] National Treasury Budget Review 2016 at 49.
[114] Refer to 3.2.1.1 for the causation discussion.
[115] *CIR v Berold supra* at 457.

4.4.2 Subordination considerations

In light of the proposed amendments to exclude subordination agreements from the recharacterisation rules companies should guard against making any hasty decisions in this regard, until guidance is provided whether or not this unintended consequence will be rectified retrospectively.

The tax position of both parties to a loan agreement need to be considered before deciding on a course of action. If the lender has an assessed loss it will be beneficial to not enter into the subordination agreement in order for the borrower to claim an interest deduction and for the lender to utilise its assessed loss.

As explained earlier in this chapter a typical borrower company that needs to enter into a subordination agreement is already in financial difficulty and would generally have an assessed loss. Under these circumstances rather than to increase the assessed loss with an interest deduction it might be better to incur the deemed dividend charge, especially where the parties to the agreement are connected persons, than for the lender to pay income tax at a potential maximum rate of 41%.

Under the STC regime a deemed dividend could escape the deeming provision if the company had an accounting loss in terms of s 64C(2)((*e*).[116] The difference for dividends tax is that the interest amount is deemed to a dividend *in specie* that is declared and paid.[117] The opening words to s 64C(2) uses the phrase 'deemed to be a dividend

[116] This is in the context of a provision similar s 64E(4).
[117] The phrase 'declared and paid' is used in s 8F(2)(*a*)(i) and s 8FA(2)(*a*)(i) in the context of hybrid debt instruments. Section 64E(4)(*a*) in the context of debit loans by virtue of a shares states 'deemed to have been paid'.

declared' hence it is not deemed to be paid as for the dividends tax provision. No amount is transferred or applied by way of a distribution.[118] The deemed dividend provision under s 8F(1)(*b*) will apply to a borrower company that has a loan payable subject to a subordination agreement even if the that company has an accounting loss.

4.4.3 30-year rule considerations

4.4.3.1 Connected trusts and natural persons

There is no tax risk when the amount is owed to a third party even if the repayment obligation extends beyond 30 years. That being said it seems unlikely that a third party will extend funding for this amount of time for no *quid pro quo*. The 'connected person' definition has a wide reach, as was detailed in the previous chapter. If the lender is not a company, even with a small shareholding, it could potentially trigger s 8F(1)(*c*) where that person jointly with any other connected person holds more than 20% of the shares or voting rights in the company. Owner managed companies need to consider all loans payable to trusts and natural persons (including partnerships) and evaluate if there is a connected person relationship.[119]

4.4.3.2 Payable on demand

One way in which SMEs will be able to avoid the deeming provisions of s 8F(1)(*c*) is to either categorically state in the loan agreement that the loan is payable on demand or to rely on the common law principle that in the absence of any explicit repayment terms the

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[118] This interpretation is consistent with a SAIT Technical enquiry 10 November 2014. [Online] Available from: http://www.thesait.org.za/news/201906/Interest-free-loan-to-a-shareholder-possible-deemed-dividend.htm# [Accessed: 20 March 2016].
[119] No deemed dividend between companies provided the requirements of 64FA(1)(*a*) are complied with.

loan is payable as soon as it is incurred. This is likely to be the default method to retain an interest deduction and stay clear of the deemed dividend obligation.

SMEs need to always take the relevant facts and circumstance into account before relying on the 'payable on demand' escape route. In *Stockdale and another v Stockdale*[120] a loan was advanced by the respondent's in-laws to settle her bond and for as long as she remained married to their son it was understood that no repayment notice will be issued. An acknowledgement of debt was signed, which provided that the capital and interest outstanding should be repaid within 30 days from receiving notice from her husband's parents and that she was entitled to repay this amount at any time without prior notice. Her husband's parents were aware of the fact that she did not have the means to settle the loan immediately nor within 30 days, if such notice was issued. The circumstances changed due to their divorce and the consequent sale of the property. This lead to the issue of the payment notice. It was held that although there were no fixed repayment terms it cannot on the facts be said that the loan was payable on demand, it is only when her circumstances changed, the divorce, that the amount became payable.

Although this case deals with prescription it does raise two risks: firstly, where a loan is advanced to a company and the lender is aware that the borrower company cannot perform under this loan it could potentially fall foul of s 8F(1)(*b*)[121] and secondly, the reliance on the 'payable on demand' escape route needs to be carefully considered in light of the relevant facts and circumstances.

[120] 2004 (1) SA 68 (C), [2003] 3 All SA 358 (C).
[121] Pieter van der Zwan 'Time to Consider the Terms of Company Loans Carefully' (2014) *TaxTalk*.

To avoid any ambiguity, it is recommended that the financial statement disclosure should state that the loan is 'payable on demand', rather than to simply state that it has no fixed terms of repayment, but on its own this will not be decisive.

4.4.3.3 Refinancing considerations

Where SMEs regularly refinance or replace existing connected person loans they might fall into the hybrid debt definition as the replacement loan is deemed to one and the same instrument for calculating the 30 year redemption period. If there is a break, for example where the company has additional cash reserves to settle the connected person loan and it is not immediately replaced, then the 30 year period should reset.

On the other hand, if funding is obtained from a third party, say a financial institution, to settle the connected person loan the 30 year period will restart and, more importantly, s 8F(1)(*c*) does not apply as it is limited to connected person payables. SARS will also look at the substance where a deliberate scheme is put into place to create an artificial loan payable to a third party in order to escape the deemed dividend.[122]

With refinancing and replacement of loans owner managed companies might be able to escape the deemed dividend consequences, for example with a legitimate finance arrangement with a third party. However it does not necessarily mean because an interest deduction was allowed for the replaced loan that a deduction will be allowed for the new loan. SMEs might find some solace from ITC 1553[123] where an investment holding company refinanced loans due its directors with loans from its subsidiaries. SARS

[122] The GAAR in s 80A to s 80L could also be used by SARS to attack this behaviour.
[123] 55 SATC 105.

disallowed the interest deduction on loans from subsidiaries. The court applied the test laid down in *Port Elizabeth Electric Tramway Co Ltd v CIR*[124] namely that it is necessary to determine the purpose of expenditure and how closely connected the expenditure is to the income earning activities. The statement by Judge President Melamet may well assist with claiming an interest deduction for refinanced loans:[125]

> 'In the instant case where the loans were allegedly raised for the purpose of repaying existing loans to directors, the deductibility of expenditure incurred in respect of new loans, will be determined by reference to the purpose for which the original loans were raised. More particularly the interest payable in respect of a loan which was raised for the purpose of repaying an old loan will be deductible if any interest paid on the old loan would have been deductible.'

Loan agreements between a borrower company and its connected person should where possible assign the right to refinance to the lender rather than the borrower. This will ensure the 30 period resets every time the loan is replaced.

4.5 Cost of compliance

SMEs usually don't have the same number of professionals in their employ as big corporations and often the owners are preoccupied with operational matters and as a result legal and compliance issues are often neglected. SMEs are then faced with the cost of obtaining advice from tax practitioners and hiring attorneys to draft legal agreements. Very often because of the nature of family run business formal minutes and resolutions

[124] 1936 CPD 241, 8 SATC 13 at 17 and 18.
[125] 55 SATC 105 at 112 and 113.

are not in place. The problem is in the absence of documentation to prove that a loan is not a hybrid debt instrument it will be more onerous to discharge the burden of proof. If the matter goes to court witness testimonies and the owner's *ipse dixit* will need to be consistent with the circumstances. SMEs will need to weigh up their tax risk with the associated cost of compliance. Relief is only provided to SMEs at the smaller end of the scale, the so-called 'small business corporations' as defined in s 12E(4). The problem is that in certain industries it will be difficult to comply with the R20m turnover threshold[126] or have three or more unconnected full-time employees for core operations throughout the year.[127]

4.6 Conclusion

In the first chapter two questions were raised firstly, whether loan funding still has a role to play in the context of SMEs; secondly, whether shareholder and other connected person loans are by default equity or does commercial substance still have role to play?

The previous chapter submitted that loans advanced by a company to its shareholders and other connected persons, 'by virtue of any share' on commercial grounds and on terms that are customary to the industry, will still have a role to play in the ordinary business operations of a SME without triggering a charge for dividends tax on these debit loans.

In this chapter loans owing by a company were considered, in the context of anti-hybrid debt recharacterisation rules. These rules are not always limited to loans due to

[126] Section 12E(4)(*a*)(i).
[127] Section 12E(4)(*a*)(iv) read with s 12E(4)(*d*).

connected persons. Interestingly enough the consequence for falling foul of the recharacterisation rules on these credit loans is also a deemed dividend *in specie*. The difference here is that the deemed dividend is calculated on the interest incurred whereas for the debit loans it is calculated on the interest that should have been charged.[128]

An important shift in focus is that the new recharacterisation rules also seeks to catch instruments that are classified as loans but, because they lack a reasonable redemption period they are more akin to equity and to this extent the 30-year rule was introduced for connected person payables. The 30-year rule will require SMEs to rethink the manner in which they draft refinancing agreements to firstly ensure they avoid the deemed dividend provisions as the replacement loan is deemed to one and the same instrument for determining the 30 year period if the borrower company has the right to call for the refinance and secondly if they escape the deemed dividend that they retain their existing interest deduction.

There is an escape route where the loan is payable on demand which is supported by the common law principle that in the absence of any categorical repayment terms the loan is payable as soon as it is incurred. In a situation where the lender at the time of issuance is aware that the borrower cannot perform under the loan agreement it is possible that reliance cannot be placed on the payable on demand escape route as explained in the *Stockdale* case.

[128] The market-related interest rate less the interest the interest actually charged, save where the interest charged exceeds the market-related interest in which case there will be no deemed dividend in terms of s 64E(4)(*b*).

There is no connected person requirement for subordination agreements and the tax consequences between third parties will be to the detriment of the borrower company, that is in all likelihood already in financial distress, because the interest deduction is sacrificed and it will be liable for the dividends tax. For connected persons in a typical scenario where the borrower company has an assessed loss it will be more advantageous as the joint tax consequences of the connected persons will be less if they enter into a subordination agreement.

It is submitted that shareholder and other connected person loans are not by default equity. It is only when interest-bearing instruments are disguised as loans in order to obtain an artificial interest deduction, where the loan clearly has equity features, that a loan will be deemed to be equity from a taxing rights perspective. Bear in mind it is the interest that is recharacterised and not the loan instrument itself. SMEs with b*ona fide* loans on commercial terms which operate in substance and in form as a loan will not be subject to recharacterisation and provided the requirements of s 24J(2) are complied with the interest incurred will qualify as a deduction.

In the next chapter the tax consequences pertaining to the new debt relief rules are considered in light of the deficiencies of the old rules and the current economic climate. That chapter briefly considers the impact of business rescue.

CHAPTER 5 Debt relief

5.1 Introduction

In the preceding chapters the first objective namely, to determine whether loan funding still has a role to play in a SME environment, was considered in the context of loans advanced by companies to connected persons and interest-bearing loans due by companies that in substance clearly have equity features. It was concluded that loan funding still has a role to play where the loan operates on a commercial basis without an intention to obtain an artificial tax benefit.

In this chapter the second objective is evaluated namely, whether the new debt relief system provides tangible relief to distressed SMEs when compared to the deficiencies of the previous debt relief regime. A brief discussion on the impact of business rescue is incorporated together with an overview of other taxes that need to be considered when debt reduction takes place.

5.2 Current outlook

On 8 March 2016 Moody's announced that South Africa is on review for downgrade. The following explanation was provided:[129]

> 'The decision to place the ratings on review was prompted by the continuing rise in risks to the country's medium-term economic prospects and to its fiscal strength, notwithstanding the tighter fiscal stance undertaken in the 2016/17 budget. The review will allow Moody's

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[129] [Online] Available from: https://www.moodys.com/research/Moodys-places-South-Africas-Baa2-ratings-on-review-for-downgrade--PR_344855 [Accessed 24 March 2016].

> to assess to what extent government policy can stabilize the economy and restore fiscal strength in the face of heightened domestic and international market volatility.'

Moody's list amongst others the following risks:

- The severity of the draught which leads to increased food prices and puts more pressure on inflation targets that are already at the higher end of the range.
- The above inflationary pressures have resulted in interest rate hikes of which more are expected;
- Low commodity prices;
- The depreciation of the rand;
- The public sector wage bill and strikes.

South Africa's growth dropped to 1.3% in 2015 which is the lowest since 2009, mainly due to the aftermath of the sub-prime crisis.[130] Since July 2009 South Africa received three downgrades from A2 to Baa2, the last downgrade was on 6 November 2014.[131] Although Moody's, Standard & Poor's and Fitch confirmed South Africa's rating the outlook remains negative. The Finance Minister's task to convince rating agencies that the South African economy is stable is far from over. The recent downgrade scares highlight the poor state of the economy and that the country needs fiscal policies that will assist SMEs to navigate through this testing economic climate.

[130] *Ibid.*

[131] As at 17 June 2016.

5.3 Tax consequences of debt relief

In order to evaluate if the new system of debt relief will assist SMEs to navigate through the challenging economic climate a brief overview is provided on the new ordering rules, followed by a comparison between the old and new rules.

For the remainder of this chapter any reference to a paragraph relates to the Eighth Schedule of the Act, unless stated otherwise. The terms 'debtor' or 'borrower' and 'creditor' or 'lender' were used interchangeably, but to avoid any confusion in particular if a trade debtor and trade creditor relationship exists for a transaction on revenue account the term 'debtor' and 'creditor' was preferred.

5.3.1 Overview of new rules

Treasury introduced new ordering rules relating to debt reduction for less than full consideration because the tax burden on taxpayers receiving the debt reduction has largely nullified any financial advantage obtained under the old rules.[132] The new ordering rules of debt relief apply to all years of assessment commencing on or after 1 January 2013. Section 8(4)(*m*), proviso (ii) to s 20(1)(*a*) and para 12(5) were deleted and replaced by s 19 and para 12A.[133]

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[132] Explanatory Memorandum on the Taxation Laws Amendment Bill, 2012 at 44.

[133] SARS 'Comprehensive Guide to Capital Gains Tax' (Issue 5) 2015 in § 6.2.6.1 [Online] Available from: http://www.SARS.gov.za/AllDocs/OpsDocs/Guides/LAPD-CGT-G01%20-%20Comprehensive%20Guide%20to%20Capital%20Gains%20Tax%20-%20External%20Guide.pdf [Accessed 25 March 2016] and SARS Draft Interpretation Note: 'Reduction of Debt' (2015) in § 2.

5.3.1.1 Reduction amount

The term 'reduction amount' is central to the debt relief discussion. It is defined as follows in s 19(1) and para 12A(1):

> 'in relation to a debt owed by a person, means any amount by which that debt is reduced less any amount applied by that person as considered for that reduction'.

In a SME environment it often happens that a connected person in relation to the borrower makes a payment to the lender on behalf of the borrower. The amount paid by the connected person will qualify as 'consideration' given by the borrower for purposes of the definition of 'reduction amount' if the borrower becomes obligated to repay the connected person.[134] In these circumstances no debt reduction takes place.

Conversely, where the borrower does not become obligated to the connected person for the amount settled on its behalf, no consideration is applied for purposes of determining the 'reduction amount' on the original debt. Therefore the full amount paid by the connected person to the lender will constitute the 'reduction amount' for the borrower.[135]

5.3.1.2 Interaction between s 19 and para 12A

The nature of the underlying expenditure funded by the reduced debt will determine the tax treatment to be applied in terms s 19 (revenue account) and para 12A (capital gains tax). Section 19 applies where the reduced debt funded expenditure for which a

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[134] SARS Draft Interpretation Note: 'Reduction of Debt' (2015) in § 4.1.4.
[135] *Ibid.*

deduction or an allowance was granted under the Act, including an allowance asset. Paragraph 12A applies where the reduced debt funded expenditure for which no deduction or allowance was granted under the Act or in respect of an allowance asset. Section 19 and para 12A are mutually exclusive, except where the reduced debt funded an allowance asset. It should be borne in mind that both s 19 and para 12A deal with the tax consequences of the debtor.

The new ordering rules can be summarised as follows:[136]

- Trading stock held and not disposed of at the time of the reduction of the debt – The reduction amount must be applied to any s 11(*a*) deduction or the value of opening stock (s 22(2)) as well as any closing stock (s 22(1)). [s 19(3)] Any excess of the reduction amount is treated as a recoupment under s 8(4)(*a*). [s 19(4)]
- Trading stock disposed of and tax deductible expenditure, excluding capital allowances – The reduction amount is treated as a recoupment under s 8(4)(*a*) to the extent that the expenditure was allowed as a deduction. [s 19(5)]
- Allowance assets – The reduction amount first reduces any base cost of the allowance asset [para 12A(3)]. Any excess of the reduction amount is treated as a recoupment under s 8(4)(*a*). [s 19(6)] Future capital allowances will be limited to the cost of the asset less the reduction amount and any previous allowances claimed on the asset. [s 19(7)]
- Capital assets that are not allowance assets – The reduction amount first reduces the base cost of the asset. [para 12A(3)] Any excess reduction amount is applied

[136] The reduction amount must be applied in the sequence of the subsections of s 19 or the subparagraphs of para 12A.

to reduce any assessed capital loss. [para 12A(4)(*b*)(i)] Any further excess of reduction amount remaining will have no tax effect.

5.3.1.3 Exclusions

One of the objectives of the new debt relief rules is to ensure that there is no double taxation[137] and therefore the new rules do not apply where any of the following exclusions are present:

- the debt reduction comprises property of an estate and reduction is in favour of an heir or legatee by virtue of a bequest; [s 19(8)(*a*) and para 12A(6)(*a*)]
- the debt reduction is donation as defined in s 55(1); [s 19(8)(*b*)(i) and para 12A(6)(*b*)(i)];
- any deemed donation in terms of s 58 where the property was disposed of for inadequate consideration; [s 19(8)(*b*)(ii) and para 12A(6)(*b*)(ii)] or
- the debt reduction is in relation to employment.[138] [s 19(8)(*c*) and para 12A(6)(*c*)]

The above apply to s 19 and para 12A and will be elaborated on in 5.5 below, save for debt reduction in relation to employment which falls outside the scope of this treatise.

Paragraph 12A also contains the following additional exclusions, similar to those of para 12(5), where the new rules do not apply:

- the debt reduction is between a borrower and lender that form part of the same group;[139] [para 12A(6)(*d*)] or

[137] SARS Draft Interpretation Note: 'Reduction of Debt' (2015) in § 2.
[138] Fringe benefit in terms of para 2(*h*) of the Seventh Schedule.
[139] The s 41 definition of 'group of companies'.

- the debt reduction is between a borrower company who is a connected person in relation to the lender in anticipation of liquidation or deregistration of the borrower company. [para 12A(6)(*e*)]

The above two exclusions are listed for sake of completeness, but because they are essentially the same as the old rules it won't receive any further attention.

5.3.2 Revenue account

5.3.2.1 Assessed loss

In 1997, s 8(4)(*m*) was introduced due to uncertainty whether amounts not actually recovered or recouped may be recouped in terms of s 8(4)(*a*).[140] It provided that any expenditure actually incurred or allowed as a deduction, in the current or any previous year of assessment, but has not yet been paid and the obligation to pay such amount is subsequently reduced or extinguished by reason of either the termination or variation of an agreement or prescription or waiver of a claim, the amount so reduced or extinguished will be deemed to be recovered or recouped for the purposes of section 8(4)(*a*).[141]

It should be noted that s 8(4)(*m*) was subject to s 20. Proviso (ii) to s 20(1)(*a*) stated that where the debtor had an assessed loss the balance of the assessed loss carried forward was reduced by the benefit received on the waiver of debt from the creditor, to the extent

[140] Explanatory Memorandum on the Income Tax Bill, 1997 at 12. [Online] Available from: http://www.SARS.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-1997-02%20-%20%20Explanatory%20Memorandum%20Income%20Tax%20Bill%201997.pdf [Accessed: 24 March 2016].
[141] *Ibid*.

that amount was used to fund expenditure or an asset and a deduction was allowed in terms of s 11.

SMEs in financial distress that are likely to benefit from debt relief will often have an assessed loss. With the inception of the new rules both s 8(4)(*m*) and proviso (ii) to s 20(1)(*a*) were deleted. The new rules do not contain any specific provision that address the position of a SME with an assessed loss.

A possible reason for eliminating the reduction of balance of assessed loss is because s 8(4)(*m*) and s 20 are mutually exclusive. Where an unpaid debt was reduced, assuming the expenditure was previously allowed as a deduction, by an amount greater than the balance of the assessed loss SARS will be out of pocket because there is a balance with no tax consequences as s 8(4)(*m*) could not provide for recoupment under s 8(4)(a) where s 20 was applicable.[142]

Our common law does not provide any assistance, Schreiner ACJ in overturning the decision of the tax court in favour of SARS found it unnecessary to decide on the co-relation of s 8(4)(*m*) and proviso (ii) to s 20(1)(*a*) in the *Louis Zinn*[143] case.

Gerrie Swart is of view that because s 8(4)(*m*) was subject to s 20 it clarifies the order of precedence to ensure a compromise benefit does not lead to double taxation.[144] The reason therefor is that proviso (ii) to s 20(1)(*a*) applied only in limited circumstances and

[142] P Haupt *Notes on South African Income Tax* (2012) in § 11.1.6 suggests that s 8(4)(*m*) did not apply if s 20 was applicable, even where the assessed loss balance was less than the waiver benefit received, *Silke* in § 8.129 concurs with this view.
[143] *CIR v Louis Zinn Organisation (Pty) Ltd* 1958 (4) SA 478(A), 22 SATC 85 at 96.
[144] Gerrie Swart 'Recoupments, Accounting Practice, and Income-Tax Principles' (2003) 15 *SA Merc LJ* 459.

that was to avoid the possibility of double taxation when s 8(4)(*m*) was applicable and the taxpayer had an assessed loss.

Under the new rules the provisions of s 20(1)(*a*) is sufficient to assist SMEs with an assessed loss to utilise that assessed loss against any s 8(4)(*a*) recoupment triggered in terms of ss 19(4) to 19(6).

This is further supported by the wording of para 56(2)(*c*) which reads:

> '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—
>
> '(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)*'.

(Emphasis added.)

It is therefore submitted that the new debt relief rules even in the absence of specific provision pertaining to assessed losses still provides relief to a SMEs with an assessed loss.

5.3.2.2 Trading stock held and not disposed of

The goal of the new rules is to delay the incurrence of an immediate tax for as long as possible.[145] Given the current economic climate and the recent downgrade scares it is essential that this goal is achieved, particularly for SMEs.

[145] Explanatory Memorandum on the Taxation Laws Amendment Bill, 2012 at 50.

Under the old rules there was no provision to first reduce the value of stock on hand. It would have triggered an immediate recoupment in terms of s 8(4)(*a*) of trading stock previously purchased regardless if it was sold or not, provided it fell within the ambit of s 8(4)(*m*).

Effectively stock held and not disposed of at any given time represents a future tax deduction, that is because purchases are allowed as a deduction in terms of s 11(*a*) when incurred, but an adjustment is made for closing stock on hand in terms of s 22(1) which effectively limits the deduction to stock actually disposed of during the year. The future deduction will be carried forward to the subsequent tax year as the prior year's closing stock is provided as a deduction in the subsequent year in terms of s 22(2).

It should be borne in mind that the reduction of the cost price, in terms of s 19(3), will only apply to the extent that the borrowed funds were used to purchase trading stock that is still on hand and has a remaining cost price at the time of the reduction of the debt.[146]

EXAMPLE – Trading stock held and not disposed of

Facts:

The taxpayer has no opening stock and had purchases R10 000 from one supplier. The value of closing stock and at year is R6 000. At year end the creditor, who has not received any payment for goods purchased decided to waive R2 000 of the balance owing. Other than the above the company had a taxable income of R15 000.

[146] *Ibid* at 49.

EXAMPLE – Trading stock held and not disposed of (continued)

Result:

	Old rules	New rules	Notes
Taxable income before stock considerations	15 000	15 000	
Purchases - s 11(*a*)	(10 000)	(8 000)	1
Recoupment – s 8(4)(*a*)	2 000	-	2
Closing stock s 22(1)	6 000	4 000	1
Taxable income	**13 000**	**11 000**	

Notes:

1. In terms of s 19(3) the value of purchases [s 11(*a*)] and closing stock s 22(1) both need to be reduced by the reduction amount of R2 000 in terms of the SARS Draft Interpretation Note: 'Reduction of Debt' (2015) in § 4.3. This ensures that no tax deduction is obtained where the reduction amount is no longer included in closing stock, and therefore included in income.
2. In terms of s 8(4)(*m*) there was be a recoupment under s 8(4)(*a*) where a deduction was claimed and the debt was reduced prior to the payment of the debt.

The above example illustrates that the new rules are more favourable to taxpayers as the incurrence of tax is delayed until the trading stock is disposed of. However, s 19(3) does reduce the amount of the deduction upon the ultimate disposal of the trading stock.

To the extent that stock on hand was impaired as permitted in s 22(1)(*a*), 'due to damage, deterioration, change of fashion or decrease in the market value', and the reduction amount reduced the value of the impaired stock on hand to nil then any excess of the reduction amount will be recouped for the purposes of s 8(4)(*a*) in terms of s 19(4). It effectively provides for a recoupment of the value of the stock impairment to the extent the stock is held and not disposed of.

The new rules do provide relief for SMEs because immediate taxation is delayed due to the order of the rules. The reduction amount is first applied against future deductions, in other words the value of stock on hand and not disposed is reduced to nil in terms of s 19(3) and any excess of the reduction amount will be applied as income in terms of s 19(4).

5.3.2.3 Trading stock disposed of and tax deductible expenditure

In *Omnia Fertilizer Ltd v C: SARS*[147] a number of suppliers did not provide invoices nor claim payment. The taxpayer determined material and transport costs based on prevailing rates and SARS allowed deductions in terms of s 11(*a*). In their financial statements they recorded 50% of the unclaimed amounts as revenue after one year and the balance after two years. SARS taxed these amounts as recoupments, in terms of s 8(4)(*a*), when it was recognised as revenue in the financial statements. The taxpayer argued that there cannot be any recoupment where the obligation which lead to the deduction could still be demanded, as prescription has not taken place.

Howie JP said that:[148]

> 'If the taxpayer later, in effect erases the debt from its books and treats the amount concerned as available for another purpose, the questions which arise are:
>
> '(*a*) whether the debt has for some reason ceased to exist and, if not,
>
> '(*b*) whether the amount unpaid, but expended in the eyes of the tax law, has nevertheless, for all practical purposes, *reverted to the taxpayer's* "*pocket*".

[147] 65 SATC 159.
[148] *Ibid* at 163.

> As indicated, the taxpayer's argument is that an affirmative answer to (*a*) is essential before recoupment can occur. I disagree. A debt also ceases to exist on payment, not only when it prescribes. And *if it does cease to exist before payment occurs even then there may not be recoupment until the taxpayer takes some or other step to recoup*. The crucial enquiry, therefore, is (*b*).'

(Emphasis added.)

Based on historic practices the taxpayer regarded itself at liberty to deal with unclaimed funds as unexpended and therefore credited the amounts to revenue. This conduct was considered by the court to be the 'other step to recoup' that reverted the amount to the taxpayer's pocket.

The judgment received criticism mainly because the taxpayer's accounting treatment was the determining factor that lead to the recoupment. It is submitted by Gerrie Swart that:[149]

> 'The taxpayer's accounting entry does not as such qualify as recoupment. A recoupment can arise only if a legally enforceable benefit accrues to that taxpayer as a result of a change in the legal relationship between that taxpayer and the creditor involved.'

He further concluded that:

> 'A recoupment will arise only to the extent to which the underlying liability is reduced or extinguished, or its enforceability is affected, whether in terms of a waiver, or the variation of the contract giving rise to it, or by means of prescription.'

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[149] Gerrie Swart 'Recoupments, Accounting Practice, and Income-Tax Principles' (2003) 15 *SA Merc LJ* 459.

David Clegg conversely had the following comments on the *Omnia* case:[150]

> 'At first sight, this is something at odds with the more usual position that accounting treatment has nothing to do with income tax. But, on reflection, this is possibly not substantially different from the equivalent position in s 11(*i*), dealing with bad debts . . . dependent upon the creditor's own (reasonable) evaluation.'

The tax years in question were before s 8(4)(*m*) was introduced, but it was enacted at the time the case appeared before Supreme Court of Appeal. The taxpayer believed that the wording of s 8(4)(*m*) assisted their argument in that the intention of the legislature was that recoupment essentially had to comprise the extinction of the obligation underlying the allowed expenditure. The court rejected this argument and said it 'merely enables recoupment'.[151]

The key principal from this case is that recoupment is a mechanism to ensure that once a deduction for the expense was allowed a taxpayer cannot benefit from this deduction if it is shown not be an expense at all. What drives recoupment is not whether the liability was legally terminated, but whether a deduction was previously allowed.

Clegg, suggests that the *Omnia* judgment provides an opportunity where an expense was incurred and allowed as a deduction and the creditor does not enforce repayment, there can be no recoupment in terms of s 8(4)(*a*) unless the taxpayer takes an active step to appropriate the unclaimed amounts to revenue. He indicates that the debtor can disclose

[150] David Clegg 'Opportunity Lost, Opportunity Found' (2004) 18 *Tax Planning* at 7.
[151] *Omnia Fertilizer Ltd v C: SARS supra* at 164.

the payable on its balance sheet until it prescribes or is written off, without being open to attack from SARS.[152]

With the deletion of s 8(4)(*m*), is this opportunity still be available to taxpayers in terms of s 19?

The *Omnia* case deal with purchases of material and transport costs, but it will apply equally to any other operating expenditure. The facts of the *Omnia* case do not provide any information whether the material was on hand or not. Therefore, it is assumed that s 19(5), which does not apply to stock held and not disposed of, will be the appropriate ordering rule to compare against s 8(4)(*m*). Although s 8(4)(*a*) was amended a number of times subsequent to the *Omnia* judgment those mainly relate to new sections that either had to be included or excluded for the application of the recoupment provision. Notably as a result of the new rules to avoid double taxation subparagraphs (ii) and (iii) were inserted, but none of the amendments have any impact in determining if s 19(5) provides the same opportunity as s 8(4)(*m*) did.

Where a SME purchased trading stock on credit and a deduction was claimed for the expenditure incurred and the creditor subsequently decides to waive the debt or it prescribes, s 8(4)(*m*) deemed there to be a recoupment under s 8(4)(*a*). On the other hand, if a loan was raised and the loan proceeds were used to pay for the trading stock and subsequently the loan was waived or it prescribed there is no recoupment as the

[152] In 2004 when the article was published s 8(4)(*m*) was still effective.

expenditure in relation the trading stock was already paid for.[153] This would suggest that a direct connection was required between the debt and expenditure under s 8(4)(*m*).

Section 19(5) similar to s 8(4)(*m*) requires the reduction amount to be recouped in terms of s 8(4)(a), provided a deduction or an allowance was previously granted. However, s 19(2) referred to in s 19(5)(*a*) provides the most significant distinction, it provides that:

> 'Subject to subsection (8), this section applies where a debt that is owed by a person is reduced by any amount and—
>
> '(a) the amount of *that debt was used, directly or indirectly, to fund any expenditure* in respect of which a deduction or allowance was granted in terms of this Act; and
>
> '(b) the amount of that reduction exceeds any amount applied by that person as consideration for the reduction.'

(Emphasis added.)

The emphasis above makes it clear that there is no direct connection required between the debt and the expenditure as was the case under s 8(4)(*m*).

Consequently, under the new rules where a loan is raised and the loan proceeds are used to pay for trading stock and the loan is subsequently written off there can now be a recoupment, provided a sufficiently close connection exists between the loan and the expenditure incurred. Under these circumstance the taxpayer is worse off than under the old rules, provided the stock is no longer on hand, but to obtain a benefit for the same

[153] P Haupt *Notes on South African Income Tax* (2012) in § 3.19.3.

trading stock just because it was funded indirectly was probably not what the legislature intended with s 8(4)(*m*).

The fact that indirect funding may now also lead to recoupment will make the opportunity referred to much more valuable.

Section 19(2)(*b*) provides that the reduction granted by the lender needs to exceed any *quid pro quo* provided by the borrower. Section 8(4)(*m*) makes no mention of consideration, although in determining the amount 'relieved or partially relieved' common sense should have prevailed to deduct any consideration, but now there is no ambiguity as the Act is clear. In the context of unclaimed payments similar to the *Omnia* case this does not have an impact as no consideration was applied.

Section 8(4)(*m*) said 'for the purposes of paragraph (*a*) be deemed to have recovered or recouped' compared to 'be deemed, for the purposes of section 8(4)(*a*)' used in s 19(5)(*b*) would suggest that it also 'merely enables recoupment' as was the case under s 8(4)(*m*).

Therefore, it is submitted that the opportunity with regards to unclaimed amounts from creditors can be disclosed as payables on the balance sheet, rather than to be appropriated to income, until the date of write-off or prescription applies equally to s 19 as it did for s 8(4)(*m*). When the amounts are formally written of or prescribe s 19(5) will allow for the inclusion of the amount in terms of s 8(4)(*a*) on the same basis as s 8(4)(*m*) did. If the debtor has an assessed loss the recoupment amount for purposes of s 19(5) will be available for offset in terms of s 20(1)(*a*).

5.3.3 Capital gains tax (CGT)

Prior to the introduction of capital gains tax on 1 October 2001 there were no tax consequences where loans were written off, other than recoupments in terms of s 8(4)(*m*) or the reduction to an assessed loss in terms of proviso (ii) to s 20(1)(*a*), as discussed above.[154]

The capital gains tax rules contained in para 12(5) were residual rules and in terms of their order they were only applied once it was determined that there were no revenue account tax implications.[155] This was to ensure that there is no double taxation. Another argument is that the full allowance or deduction was claimed on revenue account and if the recoupment or the reduction of the assessed loss does not occur at 100%, in terms of s 8(4)(*m*) or proviso (ii) to s 20(1)(*a*), but only at a 50% inclusion for CGT purposes the fiscus would be out of pocket.[156]

The time of disposal depends on the circumstances for example, if a loan was written off normally when the lender informed the borrower of this decision. Where a loan has prescribed it is in accordance with s 11 of the Prescriptions Act. The SARS Comprehensive Guide to CGT states:[157]

> 'A debt is allowed to prescribe through the effluxion of time falls within para 12(5).'

[154] In terms of employment: para 2(*h*) of the Seventh Schedule might apply, but this falls outside the scope of this treatise.
[155] Explanatory Memorandum on the Taxation Laws Amendment Bill, 2012 at 44.
[156] Assuming the borrower was a company, at the time CGT was introduced the inclusion rate was 50%.
[157] SARS 'Comprehensive Guide to Capital Gains Tax' (Issue 5) 2015 in § 6.2.5.9.

The permanent write-off of a tax debt[158] was a discharge of debt for no consideration and could potentially trigger para 12(5).[159] The Explanatory Memorandum on the Taxation Laws Amendment Bill, 2012[160] lists this as the most significant deficiency of the old rules because a portion of the tax debt forgiven was essentially clawed back by SARS due to the deemed disposal triggered under para 12(5).

In chapter 2 the definition of the term 'debt' or 'loan' were considered and it was concluded that the ordinary dictionary meaning should be considered.[161] The comment was made that the term 'debt' is defined in s 19(1) and para 12A(1) of the Eighth Schedule of the Act, but that it was mainly of assistance with regards to the reduction of debt. In the context of debt reduction, the term 'debt' is defined as follows:

> 'does not include a tax debt as defined in section 1 of the Tax Administration Act'.

The definition of 'debt' in the context of s 19(1) and para 12A(1) clearly excludes a tax debt and therefore a reduction of a tax debt will not have any revenue or capital account consequences.[162] It is therefore submitted that the most problematic issue of the previous regime of debt relief is adequately addressed under the new rules.

[158] Section 197 of the Tax Administration Act.
[159] SARS 'Comprehensive Guide to Capital Gains Tax' (Issue 5) 2015 in § 6.2.5.4.
[160] At 44.
[161] The key characteristics of the terms 'debt' or 'loan' were the requirement of an initial advance of property, usually money and that the advance is made on condition or expectation of repayment. Refer to 2.2.1.
[162] SARS Draft Interpretation Note: 'Reduction of Debt' (2015) in § 4.1.3.

5.3.3.1 Allowance assets

For allowances assets the interaction between para 12A and s 19 is significant. The order of the allowance asset rules is firstly, if the asset is still on hand, to apply the reduction amount in terms of para 12A(3) to reduce the base cost for purposes of para 20 and secondly, any excess reduction amount will be deemed to be a recoupment for purposes of s 8(4)(*a*) in terms of s 19(6) to the extent an allowance or deduction was granted in terms of the Act.

Where for example a shareholder loan funded an allowance asset which is subsequently reduced there is no capital gain at time of debt reduction. A capital gain or loss can only arise upon the disposal of the allowance asset.[163]

It is important to also bear in mind where the reduction amount in terms of para 12A(3) was less than the base cost of the allowance asset any future allowance, for example a wear-and-tear allowance in terms of s 11(*e*), will be limited to the initial base cost less previously claimed allowances and the reduction amount applied in terms of para 12A(3).

It is therefore submitted that the objective to delay immediate tax is achieved by the order of the allowance asset debt relief rules.

5.3.3.2 Capital assets that are not allowance assets

For capital assets that are not allowance assets similar principles apply as for allowance asset in that the base cost of the asset is reduced in terms of para 12A(3), provided the asset is on hand at the time of the debt reduction. However to the extent the asset is no

[163] *Ibid* in § 4.5.

longer held or the base cost was reduced to nil under para 12A(3) any assessed capital loss will be reduced in terms of para 12A(4)(*b*)(i). If there is no assessed capital loss then there is no further tax consequence.

Similar to an allowance asset if the loan is subsequently reduced there is no capital gain at the time of debt reduction, a capital gain or loss can only arise upon the disposal of the asset. Conversely under the old rules a capital gain was immediately triggered in terms of para 12(5).

An important exception where the old rules did not apply was in terms of para 20(3), where a capital asset was acquired on credit and the debt was subsequently reduced. It should be noted that there are two sides to the transaction: the asset and the liability. To the extent that the asset was still on hand the base cost was reduced and as a result matching was achieved because the benefit of the debt reduction was eliminated. When the asset is sold in the future the capital gain will be higher due to the reduced base cost of the asset. If the reduction of the debt was treated as a capital gain it would have resulted in double taxation. Where the borrower no longer holds the asset it triggered a capital gain in terms of para 12(5).[164]

As noted in para 4.10.5 of the draft interpretation note, [165] a capital gain or capital loss is calculated for the year of assessment and not at the time the asset is disposed of. Therefore, during the year of assessment in which the asset is disposed of adjustments can be made to the base cost of an asset in terms of para 20(3)(*b*) before or after the

[164] SARS 'Comprehensive Guide to Capital Gains Tax' (Issue 5) 2015 in § 6.2.5.10.
[165] SARS Draft Interpretation Note: 'Reduction of Debt' (2015) in § 4.10.5.

disposal. It should be noted that if the disposal of the asset occurred in a previous year of assessment and the debt reduction takes place in a subsequent year para 20(3)(*b*) will not apply.

Paragraph 3(*b*)(ii), before its amendment as a result of the new rules, dealt with a scenario where the asset was disposed of in a previous year of assessment and in the current tax year the base cost was reduced, for example due to a waiver of debt, which would normally result in capital gain in terms of para 3(*b*)(ii). Therefore under the old rules it did not trigger another capital gain under para 12(5).

The old rules did not have an assessed capital loss provision similar to para 12A(4)(*b*)(i), but for years of assessment commencing prior to 1 January 2013, where para 12(5) triggered a capital gain and the asset was no longer on hand such capital gain could be applied against the balance of an aggregated capital loss brought forward from the prior year to calculate a taxpayers aggregate capital gain (para 6) or aggregate capital loss (para 7) for the year of assessment.

At first glance it appears that the new rules would not lead to a different result from the old debt relief rules, as the base cost was then reduced under s 20(3)(*b*) on a similar basis as para 12A(3) and although a capital gain was triggered under para 12(5) it could be offset against the aggregate capital loss, but the there are two problems with this reasoning.

Firstly, assume that a capital asset other than an allowance asset is no longer on hand when the debt is reduced, it was disposed of in a previous tax year, and there is no balance of an assessed capital loss brought forward. The order of the new rules state: reduce the base cost, if any, in terms of para 12A(3), then reduce the balance of any assessed capital loss in terms of para 12A(4)(*b*)(i) and then nothing. Therefore there is no capital gain when the debt is reduced for a capital asset, other than an allowance asset that is no longer on hand and if there is no balance of an assessed capital loss brought forward. Under the old rules if the asset was disposed in a previous tax year then there could be no para 20(3)(*b*) reduction of base cost and it follows that a capital gain in terms of para 12(5) would be triggered.

Secondly, SARS is of the view that para 20(3)(*b*) only applies to direct funding.[166] Therefore, where an owner managed company obtains loan funding from its shareholder and use the loan proceeds to acquire an asset from a third party the base cost cannot be reduced in terms of s 20(3)(*b*). Although the view is expressed in the context of the new rules there is no reason to believe it would not have applied to the old rules as the key phrases 'the expenditure' and 'by any other person' was not amended when the new rules were introduced. Therefore the reliance on the para 20(3)(*b*) exception to avoid a capital gain under para 12(5) where the asset is on hand will be limited to direct funding.

From the discussion above it is submitted that the new debt relief provisions do succeed in its objective to delay immediate tax, which was one of the short comings of the old regime, as there is no capital gain when either a capital asset or an allowance asset was funded by the reduced debt.

[166] *Ibid*.

5.3.3.3 CGT consequence of the lender

Paragraph 56(1) provides that the lender must disregard any capital loss on a claim owed by a connected person borrower.

The old rules worked on the basis that symmetry was required in order for the lender to claim a capital loss.[167] The position under the new regime is similar. The changes made to para 56(2) flow from the introduction of s 19 and para 12A. For example, under the old rules if a capital gain was recognised in para 12(5) the lender was permitted to claim a capital loss, the new rules provide that the lender can claim a capital loss[168] where the base cost of the asset was reduced in terms of para 12A(3) or where the balance of the assessed capital loss was reduced in terms of para 12A(4)(*b*)(i).

The tax consequence for the lender has not changed due to the new rules as the changes are largely cosmetic.

5.3.4 Allocation of debt reductions

SMEs face a practical problem when a partial debt reduction takes place on an interest-bearing loan. Should the reduction amount be appropriated against interest or capital?

[167] SARS 'Comprehensive Guide to Capital Gains Tax' (Issue 5) 2015 in § 6.2.5.1.

[168] A loss under these circumstances are not clogged. In terms of para 39 a capital loss between connected persons are normally clogged and is only available for offset against future capital gains with the same connected person, however paragraph 56(2) exists 'despite' para 39 and therefor para 56(2) overrides para 39 per SARS 'Comprehensive Guide to Capital Gains Tax' (Issue 5) 2015 in § 6.2.5.3.

In *Standard Bank Ltd v Oneanate Investments (Pty) Ltd (In Liquidation)*[169] a dispute arose amongst others whether the repayments made on a bank overdraft should be appropriated to interest or capital. Zulman JA stated the following in this regard:[170]

> 'it would be better to state the rule of appropriation to interest first and then to capital'.

This principle can equally be applied to debt reduction by establishing what portion of the outstanding balance comprise of interest and capital respectively.[171]

SMEs often borrow to fund a combination of assets and operating expenditure, in particular where the funding was obtained from a shareholder or other connected person. SMEs will need to keep accurate record of what represent interest, operating expenditure and capital assets. The SARS Draft Interpretation Note: 'Reduction of Debt' (2015)[172] suggests that in the above situation the reduction amount should first be applied to unpaid interest and then proportionately against operating expenditure. It states further that a taxpayer cannot choose to apply the reduction amount against capital assets and then trading stock held and not disposed of to reduce the incurrence of immediate tax. It does however state that where an alternative basis is more appropriate the onus will be on the taxpayer to justify.

Such an alternative basis could perhaps occur where there is a practice that the SME repays the oldest balance first.[173] In this scenario if oldest balance was used to purchase

[169] [1998] 1 All SA 413 (A).
[170] *Ibid* at 430.
[171] SARS Draft Interpretation Note: 'Reduction of Debt' (2015) in § 4.11.
[172] *Ibid*.
[173] Common law principle confirmed by *Zietsman V Allied Building Society* [1989] 4 All SA 111 (O) at 122 and *Fluxman v Brittain* 1941 AD 273 at 300.

a plot of land followed by operating expenditure the repayment should first be allocated against unpaid interest which will result in a s 8(4)(*a*) recoupment in terms of s 19(5). There will be a valid argument that the base cost of the land should then be reduced in terms of para 12A(3). Failing that, any capital assessed loss can be reduced in terms of para 12A(4)(*b*)(i) and any remaining reduction amount can be applied against other operating expenditure in terms of s 19(5). The SME will need to be able to prove this past practice of paying the oldest balance first and retain detail records of the aging of the debt.

5.4 Business rescue

The new Companies Act introduced the concept of business rescue to the South African business community. The low economic growth and overall negative outlook for the South African economy is likely to cause financial distress to more companies and as a result business rescue will be encountered on a more frequent basis. A brief discussion on the background of business rescue and the tax considerations that flow from business rescue is therefore necessary.

The objective of business rescue is to provide an opportunity for a financially distressed company to be rehabilitated in order to continue to exist on a solvent basis or to provide an increased return for the creditors or shareholders compared to the liquidation of the company.[174]

[174] Section 128(1)(*b*)(iii) of the Companies Act, 71 of 2008.

The board of a company can voluntarily enter into business rescue proceedings if the company is in financial distress and reasonable prospects of rehabilitating the company exist.[175]

In terms of s 131 of the Companies Act, any shareholder, creditor, employee or trade union may apply to court for an order to place the company under business rescue, provided the company has not yet filed for voluntary business rescue proceedings. The person applying to the court needs to show that the company is in financial distress, failed to honour payment terms of a contract or in respect of employment or otherwise just and equitable financial reasons. Similar to voluntary business rescue there needs to be reasonable prospects of rescuing the company.

Creditors are usually prepared to accept an amount less than the face value of the debt during business rescue, in particular if the company can continue to exist on a solvent basis post business rescue. Although the creditors agree in principle how much they are prepared to sacrifice when they vote on the adoption of the business rescue plan the final determination can normally only be made once the assets are disposed of, the business rescue practitioner and related costs are paid.[176]

The question from a tax point of view is: when does the debt reduction take place for purposes of s 19 or para 12A – at the time the business rescue plan is adopted or when the final distribution is received?

[175] Section 129(1) of the Companies Act, 71 of 2008.
[176] SARS Draft Interpretation Note: 'Reduction of Debt' (2015) in § 4.5.

The time of debt reduction will depend on the facts and circumstances, but it normally takes place when the final determination of the distribution is made and the business rescue practitioner informs the creditor.[177]

Where the reduction amount is certain at the time the business rescue plan is adopted the s 19 and para 12A provisions will be triggered at that point and won't be suspended until the final distribution notice is received from the business rescue practitioner.[178] Section 152(4) of the Companies Act states that once the business rescue plan is adopted it is binding on the company and the creditors.

In *C: SARS v Beginsel NO & Others*[179] the court had to decide if SARS was a preferential creditor in business rescue proceedings. SARS argued that all preferent creditors as contemplated in s 99 of the Insolvency Act[180] should be classified as unsecured creditors in terms of s 145(5)(*a*) of the Companies Act. This would effectively provide that SARS would be able vote at the value of its claim against the company. SARS was of the view that ordinary concurrent creditors as envisaged under s 103 of the Insolvency Act should be classified as concurrent creditors in terms of s 145(*b*) of the Companies Act, who would normally be subordinated in a liquidation and only be entitled to vote at their liquidation value, which usually is negligible. If the court accepted these arguments SARS would have carried the vote at the meeting to decide on the business rescue plan.

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177 *Ibid*.
178 *Ibid*.
179 [2015] JOL 34497 (WCC).
180 24 of 1936.

With regards to the above arguments Fourie J said that:[181]

> ' … is not only contrary to the ordinary grammatical meaning of the words used in the said section, but also leads to an illogical result that fails to balance the rights and interests of all relevant stakeholders'.

It was further held that:[182]

> '[I]f it were the intention of the Legislature to confer a preference on SARS in business rescue proceedings, it would have made such intention clear. This could easily have been done, but no trace of such an intention on the part of the Legislature is found in the Act. In my view . . . having regard to the purpose of business rescue proceedings, justifies only one conclusion, namely, that SARS is not, by virtue of its preferent status conferred by section 99 of the Insolvency Act, a preferent creditor for purposes of business rescue proceedings under the Act.'

This judgment is important because it clarifies that SARS is will be treated like any concurrent creditor for business rescue proceedings.

Based on the above SARS is likely to prefer liquidation over business rescue unless the reasonable prospects to rescue the company are compelling. For the debtor company under business rescue there is a potential tax planning opportunity because if SARS rank on par with other concurrent creditors the tax debt that will be reduced is likely to be higher under business rescue than for liquidation. The definition of the term 'debt' for

[181] *C: SARS v Beginsel supra* at 13.
[182] *Ibid* at 14.

purposes of s 19 and para 12A exclude a tax debt and therefore a larger portion of the overall debt reduction will be exempt from normal tax.

5.5 Other taxes

5.5.1 Donations tax

One of the objectives of the new debt relief rules is to ensure amounts are not subject to the provisions of s 19 or para 12A and donations tax.

A donation triggers a disposal for CGT purposes,[183] however s 19(8)(*b*) and para 12A(6)(*b*) provides that the new rules do not apply to the extend the debt is reduced by way of donation as defined in s 55 or any deemed donation in terms of s 58 where the property was disposed of for inadequate consideration.

The donations tax exclusion does not require the reduction amount to be subject to donations tax, hence the exclusion to the new debt relief rules will still apply even if one of the exemptions to s 56 apply.[184] A natural person will for example will not be subject to donations tax if the value of all property donated for the year of assessment is less than R100 000 in terms of s 56(2)(*b*).

[183] Paragraph 11(1)(*a*).
[184] SARS Draft Interpretation Note: 'Reduction of Debt' (2015) in § 4.9.2.

5.5.1.1 Donations as defined

In chapter 4 it was submitted that an interest-free loan is currently not a 'donation' as defined, but where the loan principal is reduced by means of donation it could result in donations tax.

The term 'donation' is defined is s 55(1) as:

> 'means any *gratuitous* disposal of property including and *gratuitous* waiver or renunciation of a right'.

(Emphasis added.)

It was held by Marais JA in *Welch's Estate v C: SARS* that the legal and common law definition of the term 'donation' is consistent:[185]

> '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*"'.

(Emphasis added.)

[185] [2004] 2 All SA 586 (SCA), 66 SATC 33 at 314.

Thus in order to determine if the new debt relief rules apply or whether donations tax apply there needs to be an enquiry into the motive of the disposition. Was the debt reduced because of gratuitousness, pure liberality or disinterested benevolence? To the extent this question is answered in the affirmative there will be no normal tax consequences under the new debt relief provisions.

5.5.1.2 Deemed donation in terms of s 58

Section 58(1) provides for a deemed donation where property is disposed of for consideration which in the opinion of SARS is inadequate. The value of the deemed donation will be reduced by an amount equal to the consideration rendered.

Section 58 was also considered in *Welch's Estate v C: SARS* and Marais JA held that:[186]

> 'the definition of "donation" in s 55(1) plays no role in interpreting or giving effect to the provision in s 58. It is thus clear, in applying this provision, 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'.

Thus for s 58 to apply there is no gratuitous intent requirement as for s 55. The determining factor for s 58 is whether in the opinion of SARS the consideration is adequate.

This exclusion does create a problem where for example a loan of R500 000 is reduced and the consideration paid is R300 000. Should the R200 000 difference be treated as a

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[186] *Ibid* at 315.

donation in terms of s 58 or does this represent the 'reduction amount' as defined in s 19 and para 12A?

In a scenario where there is some commercial benefit to the lender for example under business rescue where there is the expectation that the borrower company will be able continue in existence on a solvent basis post business rescue it would seem that s 19 or para 12A is more likely to apply than s 58.

5.5.2 Estate duty

One of the objectives of the new debt relief rules is to ensure that amounts are not subject to the provisions of s 19 or para 12A together with estate duty.

An estate planning tool often employed by tax practitioners is for a natural person to sell growth assets such as shares and property to a trust on loan account, usually interest-free, in order to avoid donations tax and estate duty. The benefit from an estate duty point of view is that the loan receivable is pegged and the growth in the value of the assets occur in the trust.[187]

Generally, in the last will and testament this loan is bequeathed to the trust. Under the old rules this would likely have resulted in a capital gain under para 12(5) in the hands of the trust and this loan also formed part of the property of the estate.

Due to the specific exclusions in s 19(8)(*a*) and para 12A(6)(*a*) under the new rules if the loan is bequeathed by the estate there will be no revenue or capital account tax

[187] It should be noted that in the 2016 budget it was proposed that the asset transferred through the loan will be included in the estate of the founder at death in order to curb the above practice. National Treasury Budget Review 2016 at 49.

implications even if the value of estate is less than the abatement amount R3 500 000[188] and no estate duty is payable.

Similar to the donations tax provision the reduction amount does not have to be subject to estate duty, it only requires the property to form part of property of the deceased estate for purposes of the Estate Duty Act.

The above exclusion is beneficial because under the old regime a debt reduction could have resulted in both CGT and Estate Duty.

5.5.3 Dividends tax

Neither s 19 nor para 12A contains any exclusion pertaining to dividends tax.

It was noted earlier in this treatise that the forgiveness or waiver by a company of a debt owed by a shareholder qualifies as a 'distribution' in terms para (*c*) of the definition of 'distribution' in s 1 of the Companies Act.[189]

It was also noted that where a company waives a loan owing by a shareholder it will trigger dividends tax at 15% of the principal amount reduced in terms of para (*a*) of the 'dividend' definition in s 1 of the Act.[190] However it is not only limited to a shareholder and company relationship as the 'dividend' definition provides that 'any amount transferred or applied by a company . . . for the benefit or on behalf of any person in respect of any share in that company' constitutes a dividend. It is therefore submitted that an amount transferred or applied for the benefit or on behalf of a person other than

[188] Section 4A(1) of the Estate Duty Act, 45 of 1955.
[189] Refer to 2.2.4.
[190] Refer to 3.3.

a shareholder will constitute a dividend to the extent it is causally connected to the shareholding and hence in respect of a share.[191] The reference to 'any person' will more often than not be a 'connected person' as defined in s 1 of the Act.

The same will be achieved if the lender company settles an amount on behalf of such a person and that person does not become indebted to the lender company for the amount so reduced.

This means that the impact of the new debt relief rules need to be considered in conjunction with dividends tax where parties to the debt reduction are connected to each other. The above does not apply if the lender and the borrower are connected companies[192] and importantly if a commercial reason or employment is *causa causans* for the debt reduction.

Prior to 1 April 2012 debt relief to a connected person would only have resulted in a STC charge of 10%. Because the dividends tax rate is 5% higher, even with the benefits obtained under the new debt relief rules, companies need to carefully consider the cost of dividends tax when they reduce a loan granted to a shareholder or connected person other than a company if such loan was granted 'in respect of any share'.

5.5.4 Value-Added Tax (VAT)

The new debt relief rules do not contain any exclusions pertaining to Value-Added Tax.

[191] SARS '*Comprehensive Guide to Dividends Tax*' (2015) at 26 and 27.
[192] Resident companies are exempt in terms of s 64F(1)(*a*).

Section 22(1) of the Value-Added Tax Act[193] (the VAT Act) provides the VAT treatment for the creditor. It provides that a creditor who accounts for VAT on the invoice basis may claim the tax fraction[194] of the debt reduced as input tax. This section requires a taxable supply for a consideration in money and that the creditor has declared the output tax relating to this debt, in order to claim the input tax credit.[195]

Section 22(3)(*a*) of the VAT Act provides the VAT treatment for the debtor. It states that where a debtor who accounts for VAT on the invoice basis and claimed an input tax deduction in respect of a taxable supply of goods or services and has not paid the full consideration in respect of that supply within twelve months from the date it becomes payable the debtor must account for output tax equal to the tax fraction of the unpaid debt in the next VAT return after the expiry of the twelfth month period.[196]

Taxable supplies between companies within the same wholly owned group[197] will have no clawback after 12 months for the debtor and the creditor may not claim an input tax credit on the amount written off.[198]

A company under business rescue currently receives no VAT relief from the clawback of input credits previously claimed. This will add an additional strain on a company that is

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[193] 89 of 1991.
[194] Currently 14/114.
[195] SARS 'VAT 404 Guide for Vendors' (2015) in § 15.1. [Online] Available from: http://www.SARS.gov.za/AllDocs/OpsDocs/Guides/LAPD-VAT-G02%20-%20VAT%20404%20Guide%20for%20Vendors%20-%20External%20Guide.pdf [Accessed: 11 April 2016].
[196] This also referred as the clawback of input tax previously claimed.
[197] Section 22(6)(*b*) of VAT Act provides 100% and not 70% as per the 'group of companies' definition in s 1 of the Income Tax Act.
[198] Section 22(3A) and s 22(6) of the VAT Act.

already in financial distress and that clawback could perhaps lead to the liquidation of that company.

The timing of the VAT clawback is problematic. For purposes of s 19 and para 12A the time of the debt reduction is normally when the business rescue practitioner informs the creditor of the final settlement. It was noted earlier in this treatise that SARS is not a preferent creditor under business rescue. It might therefore be beneficial for a company that is considering voluntary business rescue[199] to account for the clawback prior to the 12 month period to ensure the VAT liability includes the clawback at the time the business rescue plan is presented. If the business rescue plan is adopted the VAT liability reduced by SARS will not lead to any tax consequences under s 19 or para 12A as a tax debt is excluded from the definition of 'debt'. If the clawback liability is declared after the business rescue plan was adopted the taxpayer may apply for a compromise under s 200 of the Tax Administration Act, but this is likely to be more cumbersome and the decision to reduce the debt is entirely at the discretion of SARS.

5.6 Conclusion

With South Africa narrowly escaping from a further credit downgrade and economic growth at its lowest rate since 2008 there is a need for fiscal policies that will assist not only SMEs, but taxpayers in general.

The main criticism against the old system of debt relief was that the tax debt written off triggered a deemed disposal, for capital gains tax purposes, which largely nullified the

[199] A company has less control if an affected person makes an application to the court.

benefit received by the taxpayer. The new rules do succeed to provide tangible relief to distressed SMEs because a tax debt is now clearly excluded from the ambit of s 19 and para 12A.

The interaction between s 8(4)(*m*) and proviso (ii) to s 20(1)(*a*) caused some uncertainty and even the Supreme Court of Appeal reserved judgement on its co-existence.[200] Under the new rules there is no specific rule dealing with the position of a SME with an assessed loss, but it is submitted that the ordinary provisions of s 20(1)(*a*) will allow a taxpayer to utilise its assessed loss where a recoupment is triggered in terms of ss 19(4) to 19(6).

The other objective of the new rules is to delay the incurrence of an immediate tax for as long as possible. This objective was achieved as the reduction amount is first applied against future deductions, the value of stock on hand and not disposed of, and any excess of the reduction will be applied as income.

The opportunity David Clegg identified as a result of the *Omnia* judgment still applies under s 19 as it did under s 8(4)(*m*), provided that SMEs do not appropriate unclaimed amounts to income prior to prescription or actual write off.

The capital gains tax relief under the new rules provides a significant benefit to SMEs and again it achieves the objective to delay the incurrence of an immediate tax. For a capital asset or an allowance asset no CGT is triggered when the debt is reduced. It is only when the asset is disposed of that CGT is triggered. It must be borne in mind that the base cost reduction under para 12A(3) will lead to a higher capital gain at time of disposal and

[200] The *Louis Zinn* case, refer 5.3.2.1.

future capital allowance will be reduced. Under the old rules a deemed disposal was triggered under para 12(5) when a debt was reduced save for the exceptions in terms of paras 20(3)(*b*) and 3(*b*)(ii).

Where the reduced debt funded a capital asset other than an allowance asset tangible relief is further provided as the old rules did not have a provision similar to para 12A(4)(*b*)(i) where the balance of an assessed capital loss is reduced and moreover where the base cost was reduced to nil or the asset is no longer on hand and there is no balance of an assessed capital loss there is no further tax consequence.

For partial debt reductions on an interest-bearing loan the reduction amount is first applied against interest and then against operating expenditure. However SMEs who keep detailed records and have the practice to settle the oldest balance first may be able to apply the reduction amount against interest and then in terms of the aging of the expenditure. Often the first items purchased for start-up enterprises are plant and equipment or trading stock and provided it was incurred prior to operating expenditure the reduction amount once applied against interest can be utilised to reduce the base cost of the asset, the balance of an assessed capital loss and then the value of trading stock on hand and not disposed of.

The new Companies Act introduced the concept of business rescue to the South African business community. In light of the current economic climate the expectation is that business rescue will become more prevalent going forward. In the *Beginsel* case it was held that SARS is not a preferential creditor in business rescue as is the case under liquidation proceedings. This provides a tax saving opportunity for companies under business rescue because SARS rank on par with other concurrent creditors and the tax debt reduced is likely to be higher under business rescue than for liquidation, if the SARS liability is significant in proportion to the overall debt. A similar benefit can be achieved where the clawback of the input tax credit is declared prior to the adoption of the business rescue plan.

The new debt relief rules also aim to avoid double taxation and to this extent donations tax, estate duty and fringe benefits will not result in additional tax consequences under s 19 and para 12A. SMEs need to be mindful of potential dividends tax consequences when a loan owing by a shareholder or connected person in relation to that shareholder is reduced. The other tax risk is the clawback of input tax credit previously claimed which could have an adverse effect on cash flows and perhaps in future SARS might provide relief in this regard in particular for companies under business rescue.

CHAPTER 6 Conclusion

6.1 Role of loan funding in SME's

The first objective was to determine whether loan funding still has a role in a SME environment and was considered in the context of interest-free or low interest rate loans advanced by companies to shareholders and other connected persons and interest-bearing loans due by companies that in substance clearly have equity features.

In particular, where a company parted with funds to a shareholder or connected person for no *quid pro quo*, a deemed dividend *in specie* was triggered by the lender company. Essentially the loan advance is viewed as surrogate of dividend declaration hence the tax treatment is deemed to be a dividend.

Where a loan is advanced to a connected person, as envisaged in s 64E(4), on commercial grounds and on terms that are customary to the industry the required causal connection is missing. Therefore the 'by virtue of any share held in that company' requirement although it might be the *causa sine quo non*, it is not the *causa causans* that ultimately lead to company parting with the funds. As a result it is submitted that loans to shareholders and other connected persons in a SME environment are not by default equity, provided there is commercial substance or a reciprocal *quid pro quo*.

Depending on the circumstances it might in some instances be beneficial to pay the dividend tax rather than to charge a market-related interest on the loan. For example, where the lender company does not have an assessed loss and an advance is made to a non-trading trust that does not qualify for a deduction in terms of s 24J(2). From a cash flow point of view, it will be advantageous to pay dividends tax at 15% rather than to pay normal tax at 28%.

The new recharacterisation rules now also seeks instruments that are classified as loans, but because they lack a reasonable redemption period they are more akin to equity and to this extent the 30-year rule was introduced for connected person payables. The 30-year rule will require SMEs to rethink the manner in which they draft refinancing agreements to firstly ensure they avoid the deemed dividend provisions as the replacement loan is deemed to one and the same instrument for determining the 30 year period if the borrower company has the right to call for the refinance and secondly if they escape the deemed dividend that they retain their existing interest deduction.

The new anti-hybrid debt instrument rules came into effect on 1 April 2014 and apply to any amount of interest incurred by a company on or after this date. It does not state that it only applies to loan agreements entered into subsequent to the effective date. This is important as interest may be recharacterised on pre-existing loans prior the effective date of this new regime.

This requirement is impractical, if not impossible, for SMEs that have been in existence for a long time in particular if the loan was regularly refinanced at the instance of the borrower company. In applying the *contra fiscum* rule it could be argued that s 8F only came into effect in 2014 and therefore the term 'instrument' as defined also only also came into effect at this time. As a result, any interest-bearing loan owing to a connected person prior the effective date does not comply with s 8F and consequently the 30-year rule only applies to instruments issued subsequent to the effective date.

There is an escape route where the loan is payable on demand which is supported by the common law principle that in the absence of any categorical repayment terms the loan is payable as soon as it is incurred. In a situation where the lender at the time of issuance is aware that the borrower cannot perform under the loan agreement it is possible that reliance cannot be placed on the payable on demand escape route as explained in the *Stockdale* case.

There is no connected person requirement for subordination agreements and the tax consequences between third parties will be to the detriment of the borrower company that is in all likelihood already in financial distress, because the interest deduction is sacrificed and it will be liable for the dividends tax. For connected persons in a typical scenario where the borrower company has an assessed loss it will be more advantageous as the joint tax consequences of the connected persons will be less if they enter into a subordination agreement and it triggers s 8F(1)(*b*).

The recharacterisation rules only applies to interest-bearing loans. Where a loan is interest-free there can be no deemed dividend for the borrower company nor donations tax, but SMEs need to consider the s 7 attribution rules as highlighted in the *Berold* case.

In both instances where the substance of the arrangement is more akin to equity the taxing rights will be that of a dividend. The inference drawn from the above is that loan funding still has a role to play in an owner managed environment provided the basis for the transaction is on commercial grounds and in substance a loan.

The call for a uniform tax treatment in *The Economist* is likely be of less value in South Africa as our fiscal policies do not allow individuals to deduct the interest on their bonds for tax purposes and there are specific anti-avoidance rules together with the GAAR to tax artificial loans in terms of the substance rather than the form of the transaction.

6.2 New debt relief rules for distressed debtors

The second objective of this treatise was to analyse whether the new regime of debt relief provides tangible relief to distressed debtors as this was one of the short comings of the previous system.

The new debt relief rules do provide tangible relief to SMEs as the incurrence of an immediate tax is delayed through the order of the new rules. The value of trading stock held and not disposed of or the base cost of an asset or the balance of an assessed capital loss is first reduced compared to the old rules where it resulted in an immediate recoupment or a deemed disposal for CGT purposes.

The main criticism against the old system of debt relief was that a tax debt written off triggered a deemed disposal which largely nullified the benefit received by the taxpayer. The new rules do succeed to provide tangible relief to distressed SMEs because a tax debt is now clearly excluded from the ambit of s 19 and para 12A.

The above provides an opportunity for companies under business rescue because SARS rank on par with other concurrent creditors and the amount of the tax debt reduced is likely to be higher under business rescue than for liquidation, if the SARS liability is significant in proportion to the overall debt.

With regards to VAT owner managed business do not obtain tangible relief as there is no provision to assist distressed SMEs and Treasury needs to consider potential relief in this regard, especially in the challenging economic climate where SMEs are expected to provide the largest growth in employment opportunities. It is recommended that SMEs that are considering voluntary business rescue should declare the VAT clawback of input tax credits prior to the adoption of the business rescue plan in order to benefit from the tax debt exclusion under s 19 and para 12A.

Although there are some short comings in particular with regards to VAT and a potential dividends tax risk, on an overall basis the new rules do provide tangible relief to financially distressed SMEs.

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