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Revised debt reduction rules

by Annalie Pinch

The debt reduction provisions contained in section 19 of the Income Tax Act, 1962 (the "**Act**") and paragraph 12A of the Eighth Schedule to the Act have been amended with effect from 1 January 2018 and are applicable to years of assessment commencing on or after that date. As a result of the changes, the ambit of these provisions has widened significantly, as discussed below, and the additional circumstances to the rules find application are worth noting.

Subject to the exclusions provided for in section 19(8) and paragraph 12A(6), the debt reduction provisions apply where:

1. a "debt benefit" in respect of a debt owed by a person arises;
2. by reason or as a result of a "concession or compromise" in respect of that debt; and
3. the amount of the debt was used by that person as envisaged in section 19 or paragraph 12A.

The focus of this discussion is on the phrases "debt benefit" and "concession or compromise" introduced in terms of the latest changes to section 19 and paragraph 12A.

Concession or compromise

A "concession or compromise" is defined in section 19(1)(*a*) and paragraph 12A(1)(*a*) as any arrangement in terms of which:

- any term or condition in respect of a debt is changed or waived;
- any obligation is substituted, whether by means or novation or otherwise, for the obligation in terms of which that debt is owed (paragraph (*a*) of the definition); or
- a debt owed by a company is settled, directly or indirectly by (1) being converted to or exchanged for shares in that company or (2) applying the proceeds from shares issued by that company (paragraph (*b*) of the definition).

Accordingly, where the terms of a debt are changed, or where an obligation is substituted or novated, it should be considered whether the remaining requirements of the debt reduction provisions are met.

Another scenario that is often encountered and may now result in the application of the debt reduction provisions is where a creditor subscribes for shares in a debtor company and the creditor's obligation to make payment of the subscription price is set off against the debtor company's obligation to repay the debt, thereby resulting in the settlement of a debt by a company by way of set off. This is on the basis that the debt would be settled by applying the proceeds from shares issued by the company as envisaged paragraph (*b*) of the "concession or compromise" definition. It should then be considered whether a "debt benefit" arises as a result of such concession or compromise in respect of the debt.

Debt benefit

"Debt benefit", in respect of a debt owed by a person to another person, means for purposes of section 19 and paragraph 12A, any amount by which the face value of the claim held by that other person in respect of that debt, prior to the entering into of any arrangement in respect of that debt, exceeds:

- in the case of an arrangement described in paragraph (*a*) of the definition of "concession or compromise", **the market value of the claim in respect of the debt**;
- in the case of an arrangement described in paragraph (*b*) of the definition of "concession or compromise":
  - where the person who subscribed for or acquired shares did not hold shares in that company prior to the entering into of that arrangement, the **market value of the shares**; or
  - where the person who subscribed for or acquired shares in a company, held shares in that company prior to the entering into of that arrangement, the amount by which **the market value of the shares held by that person in that company after the implementation of that arrangement exceeds the market value of the shares held by that person in the company prior to entering into that arrangement**. (our emphasis)

Therefore, simply put, a debt benefit will arise if the face value of the debt prior to the "concession or compromise" exceeds the market value of the claim in respect of the debt or the shares acquired in terms of the "concession or comprise".

In the context of a concession or compromise within a group, the debt reduction provisions may be excluded by virtue of section 19(8)(*e*) and paragraph 12(6).

Same group of companies exclusion

In terms of this exclusion, the debt reduction provisions do not apply to a debt benefit in respect of any debt owed by a person to another person where the person that owes the debt is a company that:

- owes the amount to a company (ie, creditor company) that forms part of the same group of companies (defined to only include South African resident companies) as that company (ie, debtor company); and
- reduces or settles the debt, directly or indirectly, by means of shares issued by that debtor company.

However, this exclusion does not apply in respect of any debt that was incurred or assumed by that company (the debtor company) in order to settle, take over, refinance or renew, directly or indirectly, any debt incurred by another company which 1) did not form part of that same group of companies at the time that that other company incurred that debt or 2) does not form part of the same group of companies at the time that that company (the debtor company) reduces or settles that debt by means of shares issued by it.

Conclusion

The revised debt reduction provisions now apply under significantly wider circumstances than before. Unless any specific exclusions apply, where changes to the terms of a debt or the settlement of a debt by way of set off involving the issue of shares are envisaged, the application of the funds and whether a debt benefit would arise should be carefully considered. Essentially, whether a "debt benefit" arises is determined with reference to the difference between the face value of the debt prior to the concession or compromise and the **market value** of the claim or shares acquired, and any difference may give rise to adverse tax consequences for the debtor, unless the exclusions apply.

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