

When debt relief causes debt distress

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The proposed debt relief measures in the 2017 amendments to section 19 and paragraph 12A of the Eighth Schedule of the Income Tax Act 58 of 1962 (ITA) did not provide much relief to assist companies in financial distress, as was the intention in the Explanatory Memorandum to the draft Taxation Laws Amendment Bills, 2017.



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In fact, the measures appear to have caused more distress due to the financial implications and the legislative uncertainty during the interim period between the effective date of 1 January 2018 and the date when any amendments proposed by the Budget Review 2018 would take effect. The old debt reduction rules in section 19 and paragraph 12A were expanded significantly to apply to any concession or compromise of debt which gave rise to a debt benefit to a debtor. The old debt reduction rules only applied when there was an actual waiver or reduction of debt owed.

Concession or compromise

The new definition of concession or compromise is wide covering all forms of debt restructuring including any changes and waivers of terms and conditions of debt, an exchange of any obligation for the debt obligation, and direct or indirect settlements of debt with shares in the debtor. The purpose of the expanded definition was to provide for a tax trigger event for any possible debt restructuring or refinancing strategy and to ensure that any benefit to the debtor, when triggered, results in an immediate tax impact to the debtor.

The old position provided for a tax impact on the debtor when there was an actual amount of debt waived or reduced. The new position provided for a tax impact on a notional valued debt benefit to the debtor when there was a concession or compromise. A debt benefit arises for the debtor if the face value of the claim before the concession or compromise exceeds the market value of the claim after. Where debt is settled with shares, a debt benefit arises for the debtor if the face value of the claim before the settlement is greater than the market value of the shares. There is, however, no provision to deal with a negative value "debt benefit" on the same claim in the future.

Group relief is only available between resident debtors and creditors in the same group where:

- the debt benefit arises as a result of direct and indirect settlements of debt with shares; or
- the debtor did not trade in the year of assessment in which the debt benefit arises and during the previous year.

Notably, there is no group relief where a South African debtor receives a write-off of its foreign shareholder loan.

Webber Wentzel made submissions to National Treasury on the above issues. Fortunately, the Budget has noted concerns about unintended consequences of the 2017 amendments and proposes further amendments to these provisions to address these concerns.

Debt benefit

We hope that the 2018 draft bill will provide for the definition of concession or compromise to be narrowed to exclude any change in the terms and conditions of debt, or exchange or novation of obligations.

A debt refinancing for a longer period to enable a debtor to repay would trigger a debt benefit under the current wording. The increased debt term would already give rise to increased interest payments over the extended period and finance costs. There is no further need to levy a notional charge on the debtor for the perceived debt benefit.

We hope that the concept of requiring valuation of a debt benefit will be revisited entirely. A major issue faced by debtors is the difficulty of obtaining the value of a debt benefit. A debtor would need to value the market value of claims or market value of shares arising as a result of implementing the concession or compromise. These market values would then need to be compared with the face value of the debt where debt is defined to exclude interest. There is also the expense of having to obtain complex valuations each time the debtor enters into a "concession or compromise" which results in a debt benefit. As a concession or compromise is widely defined, the expense may be frequent for a distressed debtor, which is no relief at all. Notably, this expense is aside from the tax impact which would also be significant.

Retrospective effect

We hope that any proposed amendments will be made with retrospective effect from the effective date of 1 January 2018 as the new provisions (which are in force) have a number of practical difficulties, as discussed above. Submissions by the tax community to postpone the effective date to at least 1 January 2019 to avoid the prevailing levels of uncertainty during this interim period were, unfortunately, not accepted.

The budget notes that it has taken many years to build the foundation of trust that underpins South Africa's tax morality. Corruption and wasteful expenditure in the public sector have eroded taxpayer morality and steps would be taken to address this. We hope that there will also be clearer tax amendments in the future and more regard for concerns raised by the tax community as this would also contribute towards rebuilding the culture of trust.

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