Legislative developments: Revisions to the debt relief rules

9 November 2018

In brief

Section 19 of the Income Tax Act, 1962 ("the Act") and paragraph 12A of the Eighth Schedule to the Act, which contain the "debt relief" rules, underwent substantial amendment in the 2017 legislative cycle. These amendments gave rise to significant practical problems.

This year, the Taxation Laws Amendment Bill, 2018 ("the TLAB"), again proposes substantial amendments to the debt relief rules. The amendments, which are largely retrospective to the date on which the amendments of the 2017 legislative cycle became effective (i.e. years of assessment commencing on or after 1 January 2018), seek to address the problems of the amendments made in the 2017 legislative cycle.

In detail

The purpose of the debt relief rules is to bring within the tax net any benefit that accrues to a debtor as a result of a waiver, cancellation, reduction or discharge of the debt owed by the debtor, particularly where the amount of the debt was used to fund tax deductible expenditure or to fund capital or allowance assets in respect of which an allowance was previously claimed in terms of the Act.

These rules (which are an accepted part of most tax systems globally) have always existed in the Act in one form or another, the most recent iteration being the rules contained in section 19 and paragraph 12A of the Eighth Schedule to the Act, which were introduced in 2013.

Due to concerns of government relating to avoidance, the 2017 legislative cycle saw substantial changes to section 19 and paragraph 12A. It is widely accepted that there were a number of problems with the 2017 amendments, particularly with regard to their practical implications.

For example, one effect of the 2017 amendments is that a simple change in any of the terms or conditions attaching to a debt can result in a taxable event. This can result in tax being triggered on an "unrealised" basis, which is contrary to accepted principles and gives rise to a plethora of practical problems (think, for example, of the simple subordination of a debt, which will generally result in a taxable event despite there not being any significant change in the respective financial positions of the parties, nor any actual flow of any funds).

Another example of the problems with the 2017 amendments is that they require a determination of the amount of the "debt benefit" (i.e. generally, the amount that must be brought to account for tax purposes) each and every time the rules are triggered (by a "concession or compromise", a term which is itself extremely broadly defined and includes, for example, a simple change in any term or condition attaching to a debt). The practical difficulties of imposing this requirement are further compounded by the requirement that the amount of the debt benefit must be determined by comparing the "face value" of the debt before the concession or compromise with the "market value" of the debt after that concession or compromise.

Yet another issue with the 2017 amendments relates to the fact that the rules are often triggered where there is no or potentially no loss to the fiscus. This issue is best illustrated by, for example, the waiver of non-interest bearing debt by way of a debt to equity conversion (i.e. the capitalisation of an equity loan).

Proposed changes

In order to address the practical problems with the 2017 amendments, a number of changes are proposed in this year's TLAB. Aside from what appears to be a set of more practicable and implementable rules, the most significant changes in this regard are the following:

- Only events that result in an actual "realisation" of the debt will trigger tax. Thus, for example, a simple subordination of a debt will no longer trigger tax (unless, of course, the subordination results in actual realisation of the debt).
- In the case of loan capitalisations, it is proposed that the application of the rules will generally be limited to circumstances in which the interest-bearing debt is converted into equity for less than face value and where the relevant debt was interest-bearing.

As is already the case with the 2017 amendments, interest-bearing group debt that is converted to equity will still be excluded from the application of the rules.

Because of the significant practical issues associated with the 2017 amendments, it is proposed that the above amendments apply retrospectively with effect from the date that the 2017 amendments took effect (i.e. tax years commencing on or after 1 January 2018).

In addition, amendments are proposed to close certain capital gains tax and donations tax "loopholes" that have been identified by Treasury. Consequently, the existing donations tax exclusion from the debt relief rules will only apply to a debt relief arrangement to the extent that donations tax is payable in respect of a donation arising from that arrangement. As regards capital gains tax, the debt relief rules are currently not triggered where the relevant debt was used to fund a capital or allowance asset that is no longer held by the debtor when the debt is waived. It is now proposed that the debt relief rules be triggered where this is the case.

The takeaway

The debt relief rules are of critical importance in almost all commercial arrangements. Taxpayers should be aware of the proposed changes to the rules, particularly in view of the fact that it is proposed that the changes will apply retrospectively to 1 January 2018.

Let's talk

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