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Debt relief: Tax inconvenience for companies already in financial distress

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Orientation: The *Income Tax Act* has tax consequences for both the debtor and the creditor when a debt is waived as a result of a concession or compromise. This article focuses on the income tax implications for the debtor.

Research purpose: Even though symmetry is achieved when calculating the tax implications for the debtor, it causes inconvenience and economic hardship. The research identified examples of where deferral relief has been granted in the *Income Tax Act*, and this is used as a motivation to extend similar relief for the distressed debtor.

Motivation for the study: Companies were already trading under tough economic conditions before the advent of coronavirus disease 2019 (COVID-19) The pandemic has compounded the situation and introduced new challenges; hence, debt waivers have become increasingly prevalent.

Research approach/design and method: A qualitative research methodology was applied using the doctrinal approach in conducting the research.

Main findings: Where a debt is waived in a company that is already in financial distress, this may lead to a recoupment and or capital gains that trigger immediate tax consequences for the company.

Practical/managerial implications: The recoupment and/or capital gain, which is subject to tax, creates undue hardship, inconvenience on the already distressed debtor and further impacts the ability of South African Revenue Service (SARS) to collect the tax debt.

Contribution/value-add: The authors seek to rectify the identified problem by suggesting that a legislative amendment be introduced to allow the distressed taxpayer relief through a deferral of inclusion in taxable income.

Keywords: concession or compromise; debt benefit; recoupment; capital gain; section 19, paragraph 12A; relief.

Introduction

The South African economy is facing severe challenges. Smith (2019) highlights this dilemma by pointing to two pertinent aspects: 'Facing slowing growth and credit downgrades, South Africa's economy is stuck in the mire'. The South African Revenue Service (SARS) corporate income tax collections have already seen a decrease of 2.5% (excluding interest on overdue accounts) from the 2017 and 2018 to the 2018 and 2019 year (SARS 2019:22). Further, the estimated number of insolvencies increased by 21.7% in 2019 compared with 2018 (StatsSA 2020:3). These trends confirmed that companies were struggling financially in the current economic conditions. The outbreak of coronavirus disease 2019 (COVID-19) pandemic will have a further significant negative impact on companies. South African Revenue Service revealed that the April 2021 preliminary revenue outcome for corporate collections exceeded the revised budget by 6.5%; however, collections were down by 4.8% in the prior year (SARS 2021). South African Revenue Service further anticipated that the number of companies that will apply for business rescue will grow over the next year. A total of 216 liquidations were recorded in March 2021 – this is an increase of 49% compared with the same month of the previous year (StatsSA 2021:2). In light of this, the authors submit that it is anticipated that debt relief amongst taxpayers will become increasingly prevalent and relevant.

Literature review

The debt relief rules currently contained in section 19 of the South African *Income Tax Act*, Act No. 58 of 1962 (Republic of South Africa 1962) (the *Income Tax Act*) and paragraph 12A of the Eighth

Schedule of the *Income Tax Act* (the Eighth Schedule) were first introduced in 2013 (PricewaterhouseCoopers 2017). Section 19 and paragraph 12A applies to the debtor. Both section 19 and paragraph 12A has undergone a series of legislative amendments over the years. The most recent amendments were introduced to section 19 and paragraph 12A by the *Taxation Laws Amendment Act*, Act No. 23 of 2018 (Republic of South Africa 2018). The amendments introduced came into effect on 01 January 2019 and apply in respect of years of assessment commencing on or after that date, that is, the first year of application is for a company with a tax year ending December 2019 (Republic of South Africa 2018).

The current rules apply where a 'concession or compromise' results in a 'debt benefit' in respect of a 'debt', all defined terms in section 19 and paragraph 12A.

Whereas section 19 applies where a debt previously funded tax-deductible expenditure, for example, operating expenses, as well as allowance assets, paragraph 12A applies where a debt previously funded capital assets (both allowance and non-allowance assets) (National Treasury 2018).

When the scope requirements of section 19 and/or paragraph 12A are met, the consequences are that future deductions and capital allowances are reduced and future capital gains are increased, at best, but at worst, immediate recoupments and capital gains are created. The research problem at hand is that income tax can be imposed on an entity that already is unable to pay its debts. To address the research problem, international theoretical frameworks were considered.

According to Adam Smith, an economist and pioneer in the early 1700s, 'a good tax system should encompass four pillars: equity, certainty, convenience and economy' (Smith 1994:887–890). As a result, a tax amount, due date and method of payment should not only be certain but also should be convenient for the taxpayer. This means that the taxes should be due at a time or in a manner that is most likely to be convenient to the taxpayer (American Institute of Certified Public Accountants [AICPA] 2001:10).

The Organisation for Economic Co-operation and Development (OECD) has issued guidance on supporting businesses in financial distress to avoid insolvency during the COVID-19 crisis. It suggests insolvency relief techniques such as prohibiting creditor actions against businesses, amongst other factors. This could help to postpone insolvency procedures and gain valuable time for restructuring (OECD 2020). The OECD also supports indirect governmental support for struggling businesses, citing tax deferral as one example of such support (OECD 2020).

This article seeks to remedy the research problem by incorporating the convenience pillar and postponement, by recommending an amendment to the *Income Tax Act*, by providing relief through a deferral of inclusion in taxable income.

The study was limited to evaluating the income tax implications of debt relief in the hands of the debtor. Value-added tax implications were therefore not considered. The research did not consider international comparisons.

Research methodology

The interpretive paradigm, together with the qualitative research methodology, was appropriate as this research involved the interpretation of legislation and other writings (Plano Clark & Creswell 2008). This approach is resourceful in understanding and describing data (Babbie & Mouton 2009) such as documentary data involved in research in the field of taxation.

The method that was applied can be described as a doctrinal research approach (McKerchar 2009). It provides a systematic exposition of the rules governing a particular legal category – in the present case, the legal rules relating to section 19 and paragraph 12A, together with SARS Interpretation Notes, journals, articles and writings of experts in the field.

The policy reasoning behind section 19 and paragraph 12A

Prior to 01 January 2013, the reduction of debt was subject to income tax, capital gains tax and donations tax under various provisions of the *Income Tax Act*, that is, section 8(4)(m), section 54, paragraph 2(h) of the Seventh Schedule, paragraph (ii) of the proviso to section 20(1)(a), paragraph 3(b)(ii), paragraph 12(5) and paragraph 20(3)(b) of the Eighth Schedule. Debt reductions because of an inability to pay, which funded revenue deductions or allowances, triggered firstly a reduction of excess losses and secondly to the extent that the excess losses are fully absorbed, the excess was taxed as a recoupment. Because of an inability to pay, debt reductions that funded assets triggered one of two effects, either a reduction of expenditure in respect of capital assets (i.e. base cost) or a capital gain. The problem was the debt benefit relief was offset by potential taxes imposed on the party receiving the benefit, which was corrected through legislative amendment (National Treasury 2012).

National Treasury (2012:44) cites the reason for the change in legislation as follows:

Debtors in distress-seeking relief are a recurring economic concern. With the recent global financial crisis, an unusually large number of companies are experiencing financial distress. Relief for these companies is essential if local economic recovery is to occur. The tax system unfortunately acts as an added impediment to the recovery of companies and other parties in financial distress. In particular, the potential tax imposed upon parties receiving the benefit of debt relief effectively undermines the economic benefit of the relief (with Government partially reversing the relief by claiming a proportionate share of tax). Most problematic issue is that tax debt forgiven by SARS because of a taxpayer's inability to pay also gives rise to capital gain (i.e. retriggering a portion of the tax just relieved).

With effect from years of assessment beginning on or after 01 January 2013, a new uniform system that provides relief to those in financial distress was adopted in the form of section 19 and paragraph 12A. The new legislation introduced ordering rules (National Treasury 2012).

The policy principles in designing section 19 and paragraph 12A ensured that the debt benefit first reduces the base cost of a debt-funded asset that is still on hand and then triggers a recoupment of previous deductions or allowances, thus ensuring that possible income tax is imposed on the debtor only as a last resort (National Treasury 2012). Therefore, the possibility continues to exist that debt relief can trigger income tax implications for the debtor. This possibility has become increasingly prevalent and relevant since the outbreak of COVID-19.

Section 19 and paragraph 12A has gone through a number of legislative amendments over the years to address various concerns. The policy principles have, however, been consistently carried through in legislative amendments. The most recent amendment was enacted in 2018 by the *Taxation Laws Amendment Act*, Act No. 23 of 2018. For the purpose of this study, the problem at hand arises only where the already distressed debtor is placed in an immediate tax payment position. This is as a result of the recoupment and/or capital gain that is taxed under section 19 read with paragraph 12A because of a 'concession or compromise'.

Analysis

Scope

Section 19 and paragraph 12A considers the income tax implications in the hands of the debtor when a debt that was previously owed by the debtor is written off by a creditor. Section 19 considers the income tax implications where the debt previously funded tax-deductible expenditure, trading stock as well as allowance assets. Paragraph 12A considers the income tax implications where the debt previously funded an asset (i.e. allowance and non-allowance assets). The following policy principles are written into section 19 and paragraph 12A:

- Firstly, the benefit is applied to reduce the base cost (cost less allowances) of the asset that is still on hand in terms of section 19(3) (trading stock) and paragraph 12A(3) (allowance and non-allowance assets). The policy reasoning for firstly reducing the base cost is to ensure that there are no immediate tax implications in the hands of the debtor (National Treasury 2012).
- Secondly, any previous tax benefit, that is, deduction or allowance, is recouped and taxed in terms of section 19(4)–(6) and paragraph 12A(6A), but only to the extent that the base cost is not able to absorb the debt benefit. The policy reasoning to trigger a recoupment of previous deductions or allowances is to ensure that immediate tax only arises as a last resort (National Treasury 2012).
- Finally, the exclusions from the application of section 19 and paragraph 12A are aimed at ensuring that a reduction of debt is subject to only one of the following taxes that is, estate duty, donations tax, income tax on a fringe benefit received by an employee, income tax on income or capital gains tax (SARS 2016).

Both section 19 and paragraph 12A does not apply between inter-group debt. South Africa does not have group taxation, and therefore, inter-group tax relief is written into various sections of the *Income Tax Act* (South African Institute of Chartered Accountants [SAICA] 2010). Further, section 19 is also not applicable to non-interest-bearing loan conversions as well as interest-bearing loan conversions to the extent that the amount converted does not represent interest (National Treasury 2018). In addition, paragraph 12A is also not applicable under a liquidation, winding up or deregistration unless further requirements are met in which case the exclusion no longer applies.

If a debt funded a revenue expense, trading stock or a capital asset (allowance or non-allowance asset), the scope requirements of section 19 and paragraph 12A apply, as discussed below.

The current rules apply where a 'concession or compromise' results in a 'debt benefit' in respect of a 'debt', defined terms in section 19 and paragraph 12A. A 'concession or compromise' includes:

- A debt that is cancelled or waived or
- A debt that is extinguished (by redemption or merger) or
- Loans converted into shares.
- The 'debt benefit' is calculated following the terms of section 19(1):
- The amount cancelled or waived;
- The amount by which the face value of the debt exceeds the expenditure to redeem that debt or to acquire the claim in respect of that debt;
- Where the creditor does not hold shares in the company before the conversion, as the amount by which the face value of the claim held by the creditor in respect of that debt prior to the conversion exceeds the market value of the claim in respect of the shares held or acquired by reason of or as a result of the conversion;
- Where the creditor holds shares in the company before the conversion, as the amount by which the face value of the claim held by the creditor in respect of that debt prior to the conversion exceeds the market value of any effective interest held immediately after the conversion, exceeds the market value of the effective interest prior to the conversion.

The term 'debt' is broadly defined to take its ordinary meaning but does not include a tax debt as defined in section 1 of the *Tax Administration Act* No. 28 of 2011 (hereafter the TAA) (Republic of South Africa 2011).

Section 19 and paragraph 12A applies to both directly and indirectly funded arrangements. The term 'debt' is broadly

defined to take its ordinary meaning but does not include a tax debt as defined in section 1 of the *TAA*. A directly funded debt occurs, for example, where a creditor sells goods or services on credit, and because of the debtor's inability to repay the debt, the creditor writes off the debt (SARS 2016).

New ordering rules have been introduced where an asset is not on hand when the debt is written off. The tax implications will depend on whether the debt funded a non-allowance or an allowance asset.

Debt funded a non-allowance asset: In terms of paragraph 12A(4), the debtor must recalculate the capital gain or loss had the debt been written off before the asset was sold and compare this to the capital gain or loss recognised when the asset was in fact sold. The absolute difference will have to be accounted for in the current year (i.e. in the year when the debt is waived) by the debtor as an additional capital gain.

Debt funded an allowance asset: In terms of section 19(6A) read with paragraph 12A(4)(b), the debtor must recalculate the additional recoupment and capital gain or loss as if the debt had been written off before the asset was sold, and this must be compared to the recoupment and capital gain or loss recognised at the time of the actual disposal. The difference in the recoupment must be recognised as an additional recoupment and the absolute difference in the capital gain or loss must be recognised as a capital gain and taxed.

Implications – Revenue expenditure and trading stock

If debt that funded a revenue expense or trading stock is written off, and the requirements of section 19 are met, the tax implications will be as shown in Figure 1 and are set out below. The proposed steps are listed and the contexts described.

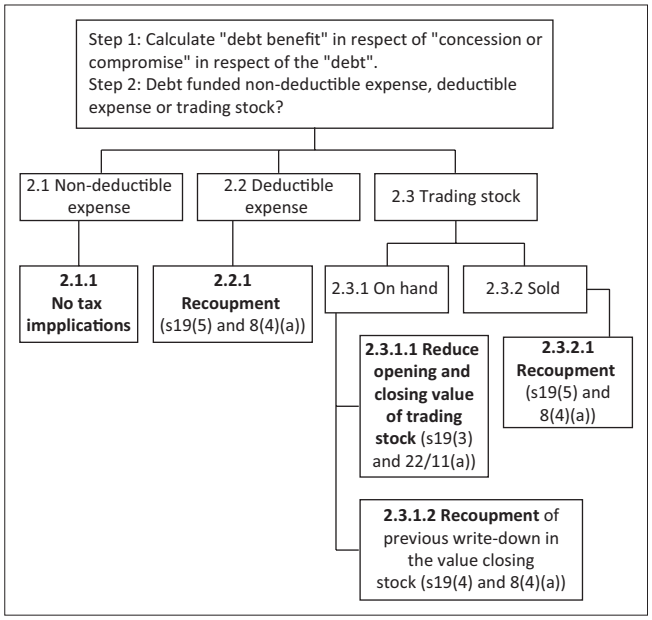


FIGURE 1: Debt funded a revenue expense or trading stock.

Application of the ordering rules contained in section 19:

Step 1: Calculate the 'debt benefit' arising from a 'concession compromise' in respect of a 'debt' as defined in the *Income Tax Act*.

Step 2: Determine whether the 'debt' funded a non-deductible expense, deductible expense or trading stock.

Step 2.1: Debt funded non-deductible expense

Step 2.1.1: No further tax implications

As the debt funded a previous non-deductible expense, for example, the payment of a fine that is prohibited in terms of section 11(a) read with section 23(o), the debt benefit will hold no further tax implications for the debtor.

Step 2.2: Debt-funded deductible expense

Step 2.2.1: Recoupment

Where the debt funded previous tax deductions, that is, operating expenses deductible under section 11(a), the debt benefit will trigger a recoupment of the previous deductions in terms of section 19(5) and section 8(4)(a).

Step 2.3: Debt-funded trading stock

Step 2.3.1: On hand

Step 2.3.1.1: Reduce the opening and closing value of trading stock

Where the debt-funded trading stock that is still on hand, first reduce the opening and closing value of trading stock on hand; that is, first reduce the tax value, thereby ensuring that there are no immediate tax implications for the debtor.

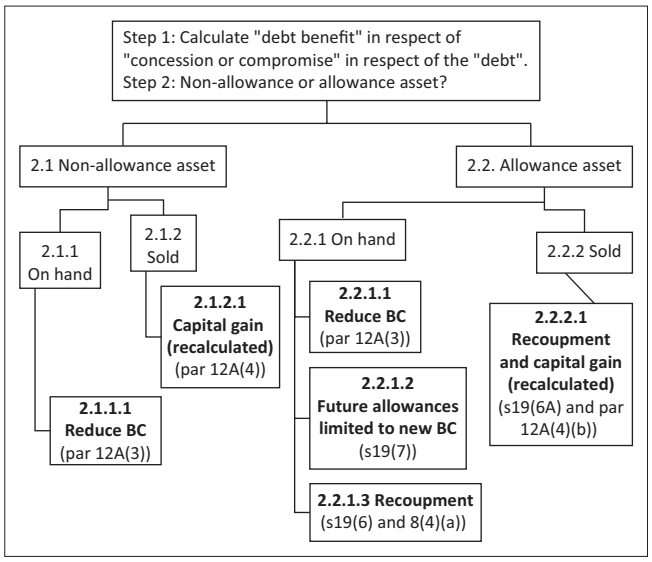
Step 2.3.1.2: Recoupment of the previous write down in the value of closing stock

Where the debt-funded trading stock that was previously written down in value in terms of section 22(1) (i.e. closing stock written down), the debtor received a deduction for the write down in the value of closing stock. The debt benefit will thus trigger a recoupment of the deduction previously claimed by the debtor, only if and to the extent that the debt benefit is greater than the carrying value of the trading stock on hand.

Step 2.3.2: Sold

Step 2.3.2.1: Recoupment

Where the debt-funded trading stock that is no longer on hand, this has the effect that the debtor received a deduction that is a product of section 11(a) read together with section 22; hence the debt benefit will trigger a recoupment of the previous deduction claimed.



BC, base cost.

FIGURE 2: Debt funded a capital asset.

Implications – capital assets

If debt funded a capital asset (allowance or non-allowance asset) and the requirements of section 19 read with paragraph 12A are met, the tax implications will be as shown in Figure 2 and set out below. The proposed steps are listed and the contexts described.

Application of the ordering rules contained in section 19 and paragraph 12A:

Step 1: Calculate the 'debt benefit' arising from a 'concession compromise' in respect of a 'debt' as defined in the *Income Tax Act*.

Step 2: Determine whether the 'debt' funded a non-allowance asset or an allowance asset.

Step 2.1: Debt funded a non-allowance asset

Determine whether the asset is still on hand or sold.

Step 2.1.1: On hand

Step 2.1.1.1: Reduce base cost

Reduce the base cost by the 'debt benefit' in terms of paragraph 12A(3). If there is still a 'debt benefit' remaining after having applied the base cost reduction, there are no further tax implications arising for the debtor.

Step 2.1.2: Sold

Step 2.1.2.1: Capital gain recalculated

In terms of paragraph 12A(4), the debtor must recalculate the capital gain or loss as if the debt had been written off before the asset was sold and compare this to the capital gain or loss recognised when the asset was in fact sold. The debtor will have to account for the absolute difference in the capital gain or loss that must be recognised as a capital gain and taxed in the current year.

Step 2.2: Debt funded an allowance asset

Step 2.2.1: On hand

Step 2.2.1.1: Reduce base cost

First, reduce the base cost of the asset on hand by the 'debt benefit', in terms of paragraph 12A(3). If there is still a 'debt benefit' remaining after having applied the base cost reduction, then consider step 2.2.1.2; otherwise there are no further tax implications arising for the debtor.

Step 2.2.1.1: Future allowances limited to new base cost

As the asset is still on hand, the debtor can still claim capital allowances on the asset, provided that all the scope requirements for the application of the capital allowance section are complied with. In terms of section 19(7), the future capital allowances calculated can, however, not exceed the new calculated base cost as determined under step 2.2.1.1 above.

Step 2.2.1.3: Recoupment

Then, recoup the past allowances claimed to the extent of the remaining balance of the 'debt benefit', in terms of section 19(6) read with section 8(4)(a).

Step 2.2.2: Sold

Step 2.2.2.1: Recoupment and capital gain recalculated

In terms of section 19(6A) read with paragraph 12A(4)(b), the debtor must recalculate the additional recoupment and capital gain or loss as if the debt had been written off before the asset was sold, and this must be compared to the recoupment and capital gain or loss recognised at the time of the actual disposal. The difference in the recoupment must be recognised as an additional recoupment and the absolute difference in the capital gain or loss must be recognised as a capital gain and taxed.

Summary of policy principles in the new ordering rules

The policy principles of section 19 and paragraph 12A have been carried over consistently in the legislative changes. Therefore, the possibility continues to exist that debt relief can trigger income tax implications for the debtor who is already in financial distress.

It is submitted that the new rules attempt to achieve the following broad policy objectives in respect of the debtor:

- Reduce the base cost and limit future deductions.
- Recoup past deductions and/or allowances.
- Tax the future cash flow benefits.

BOX 1: South African Institute of Chartered Accountants example.

Facts:

Jodee (Pty) Ltd ('Jodee') is a company that produces ice cream that is sold in bulk to wholesalers, and all its income is derived from such sales. Jodee is a South African resident for tax purposes with a 31 December financial year end. Jodee was considered to be a small business corporation as defined in section 12E of the *Income Tax Act* for the 2019 year of assessment. Joe is the sole shareholder of Jodee and contributed R8 million as consideration for acquiring all 800 issued ordinary shares of the company.

Jodee purchased an industrial freezer for R1 000 000 (excluding VAT) that was brought into use on 15 October 2019. The purchase was financed by means of a credit facility obtained from Commercial Asset Financiers (Pty) Ltd ('CAF') on the following terms and conditions:

The credit facility bears interest at an effective fixed rate of 12% per annum;

Interest is calculated and paid at the end of each month; and

The principal amount is repayable on 14 October 2024.

Commercial Asset Financiers is a financial institution that provides finance to small- and medium-sized enterprises and its operating model is to support risky ventures. Commercial Asset Financiers previously converted debt to equity for its clients when necessary. Commercial Asset Financiers and Jodee are not connected persons as defined in section 1(1) of the *Income Tax Act*.

Jodee claimed the full cost of the freezer as an allowance in terms of section 12E(1) during the 2019 year of assessment.

Required:

Explain the normal tax consequence for Jodee, if the existing loan from CAF was written off in the 2021 year of assessment.

Solution:

The debt written off meets the definition of a 'concession or compromise', that is, as the debt that is cancelled or waived.

The debt benefit is the amount cancelled or waived.

The debt benefit is therefore R1 000 000, being the difference between the amount loaned and the amount waived.

The paragraph 20 expenditure (base cost) in respect of the asset (industrial freezer) must be reduced by the debt benefit amount of R1 000 000 (paragraph 12A[3]).

However, the industrial freezer was already fully written off for tax purposes in 2019.

Therefore, the debt benefit of R1 000 000 must be treated as a recoupment for purposes of section 8(4)(a) (section 19[6]).

A recoupment of R1 000 000 must be included in the gross income of Jodee should the loan be written off (paragraph [*n*] of the gross income definition).

Source: Adapted from SAICA (South African Institute of Chartered Accountants), 2021a, *Initial test of competence (Part I – Qualifying examination) April 2021*, viewed 16 June 2021, from https://www.saica.co.za/Default.aspx?TabId=1168&language=en-ZA

VAT, Value-Added Tax.

BOX 2: Authors' simulated example.

Facts:

Tax year 1

A restaurant used a bank overdraft credit facility of R1 000 000 to fund operating expenses (salaries, rental, etc.). COVID-19 restrictions meant that the company could not trade under level 5 lockdown, and this severely impacted sales. The restaurant generated R100 000 from sales and used this amount to revamp the restaurant in an attempt to attract new customers and retain their customer base. The restaurant claimed the section 11(e) wear and tear allowances on the refurbishment during the year of assessment. Assume the refurbishments qualify for a 20% allowance per annum.

Tax year 2

Customers do not return after level 3 is announced, and the restaurant struggles to produce sales. The company sinks into financial distress because of an inability to repay the bank overdraft. The bank writes off the overdraft as there is nil value on the equipment, given the limited market for restaurant equipment, post-COVID-19.

Result:

Tax year 1

The restaurant will be taxed on the sales generated (section 1 definition of 'gross income').

The operating expenses of R1 000 000 will be claimed as deductions (section 11[a]).

The restaurant will receive a R20 000 deduction, that is, R100 000 × 20% (section 11[e]).

Tax year 2

The debt written off meets the definition of a 'concession or compromise', that is, as a debt that is cancelled or waived.

The debt benefit is the amount cancelled or waived.

The debt benefit is therefore R1 000 000 being the difference between the amount loaned from the bank and the amount waived.

The loan from the bank was used to fund tax-deductible operating expenses.

Therefore, the debt benefit of R1 000 000 must be treated as a recoupment for purposes of section 8(4)(a) (section 19[5]).

A recoupment of R1 000 000 must be included in the gross income of the restaurant should the loan be written off (paragraph [*n*]) of the 'gross income' definition).

The calculations are presented below:

Tax: Year 1	***R***
Sales	100 000
Operating cost (s11[a])	(1 000 000)
Equipment (s11[e])	(20 000)
Assessed loss	**(920 000)**

Tax: Year 2	***R***
Sales	0
Equipment (s11[e])	(20 000)
Debt benefit recoupment	1 000 000
Assessed loss carried forward from year 1	(920 000)
Taxable income	**60 000**

Simulated examples will now be considered where debt relief will trigger immediate income tax implications for the distressed debtor.

Simulated examples

The previous section dealt with the income tax implications of section 19 and paragraph 12A. In this section, simulated examples will be used to display instances where a debt is written off in a company that is already in financial distress, which triggers immediate tax implications in the hand of the debtor:

- Box 1 is an example assessed in the SAICA April 2021 Initial Test of Competence (ITC)[1] and
- Box 2 is a simulated example that the authors present that is most prevalent post-COVID-19.

The problem is, therefore, that the current tax treatment where a debt is waived results in tax payable on the recoupment for a company that is already in financial distress.

Further, according to SARS (2020):

> A debtor company in liquidation that is indebted to a connected person is excluded from paragraph 12A because symmetry is achieved in the tax system. On the one hand the debtor company enjoys the benefit of not having to reduce the base cost of its assets as a result of the debt benefit whilst on the other hand the creditor is required to disregard the resulting capital loss under paragraph 56(1). There is a risk that symmetry will not be achieved if a similar rule was included in section 19. For example, a debtor company whose debt to a connected person is waived may suffer an effective income inclusion with a tax effect of 28%, whilst the creditor group company may have a capital loss on waiver of the debt with a lower tax effect as a result of the lower inclusion rate applicable to a net capital gain. Also, capital losses may be set-off only against capital gains and are unavailable for set-off against taxable income (own emphasis). (p. 30)

South African Revenue Service acknowledges that where a debt is waived between connected persons, the debtor company may suffer an effective income inclusion with a tax effect of 28%. South African Revenue Service therefore confirms that the problem at hand may exist in practice.

The problem that a debt benefit creates

As stated earlier, the policy thinking behind the introduction of section 19 and paragraph 12A was to reduce the burden

1.SAICA sets and administers the ITC. 'The ITC is the standard setting examination which is written after the completion of an accredited Certificate in Training of Accounting (CTA) programme and is an assessment of core technical competence. To be eligible to write this examination a candidate must hold a CTA that has been accredited by SAICA'. (SAICA 2021b)

on a company in financial distress. The policy thinking was therefore to tax the debtor immediately as a last resort. However, as the debtor is already in financial distress, where the taxpayer will be taxed immediately on the recoupment as a last resort this will place a further economic burden on the taxpayer. If the debtor is left in a tax-paying position, whilst not being able to pay its obligations, this will force the company into liquidation.

'A good tax system should encompass four pillars, namely equity, certainty, convenience and economy' (Smith 1994:887–890). According to the AICPA (2001):

> [*T*]he sum, time and manner of payment of a tax should not only be certain, but the time and manner of its payment should also be convenient to the contributor. (p. 10)

A further comment on convenience is the following (AICPA 2001):

> Facilitating a required tax payment at a time or in a manner that is most likely convenient for the taxpayer is important. For example, assessment of tax upon the purchase of goods should occur at the time of purchase when the person still has the choice as to whether to buy the goods and pay the tax. Convenience of payment is important in helping to ensure compliance with the tax system. The more difficult a tax is to pay, the more likely that payment will not happen. (p. 12)

'Taxation should produce the right amount of tax at the right time, whilst avoiding both double taxation and unintentional non-taxation' (OECD 2014:31). If the debtor is immediately taxed as a result of the debt benefit, this will lead to an increased income tax liability that it will not be able to pay, thus not producing the right amount of tax at the right time.

South Africa is an associate and participant in the OECD, and as a result South African policymakers gain access to the OECD expertise and good policy practices (OECD 2021). The international broad tax policy considerations that have traditionally guided the development of taxation systems include 'neutrality, efficiency, certainty and simplicity, effectiveness and fairness, as well as flexibility' (OECD 2014:30). Taxation should be fair on the debtor and fiscus alike. If the debtor is immediately taxed on the recoupment as a result of the debt benefit, this will lead to economic hardship in the hands of the debtor even whilst achieving tax symmetry. This achieves neutrality at the costs of convenience and economic hardship. In light of the current economic situation, the authors argue that the latter should be prioritised. Further, for SARS this might lead to a total loss of revenue, should the taxpayer be liquidated.

The prevalence of the problem

The problem arises when a company already in financial distress is placed in a tax-paying position because of the recoupment/capital gain triggered by a 'concession or compromise'.

Companies utilise debt as one of the common funding sources for the acquisition of assets and the payment of operating expenses. Debt payments take place in accordance with the contractual repayment terms. Various factors such as difficult economic trading conditions may lead to an inability by the company to repay the outstanding debt that funded assets and/or operating expenses. Companies in financial distress that cannot repay their debts will have no option but to consider business rescue or file for liquidation.

The struggling economy was compounded by further financial stresses because of the outbreak of COVID-19 (Power Digital 2020). Advocate Rory Voller, the Commissioner for the Companies and Intellectual Property Commission, commented as follows (Power Digital 2020):

The state of the economy has been slowly digressing for many years now. Since the lockdown has started, there has certainly been an uptick in business going into business rescue. We are gearing ourselves for a few applications that are going to come through.

Companies that have already filed for business rescue are scaling down their operations or considering liquidation, include but are not limited to the following (Business Insider SA 2020):

- Edcon.
- Comair.
- Media24 publications.
- Associated Media.
- Caxton Magazines.
- Phumelela Gaming & Leisure.
- Pretoria Society of Advocates.
- Prada in South Africa.
- Time Freight.
- Flight Centre's Cruiseabout.
- Hout Bay's Mariner's Wharf.
- Bishop Bavin School.
- Rebel Tech.
- A number of restaurants and bars.

The Franchise Association of South Africa has issued a warning (Businesstech 2021):

> Untold damage to the restaurant industry as a result of the current lockdown restrictions in place, which includes a ban on the sale of alcohol. At the time of the strict lockdown, around 80% of members canvassed in the first half of 2020 believed that they would not be able to continue to maintain their businesses beyond the end of the year.

Authors' simulated example (Box 2) demonstrated the income tax problem at hand currently faced by this industry.

The authors therefore submit that the problem of immediate taxation as a result of a recoupment/capital gain from a debt benefit is currently both relevant and prevalent in the market. The problem has been compounded by the outbreak of COVID-19. The income tax treatment of a recoupment/capital gain taxed in the already distressed company as a

result of a debt benefit should therefore be addressed as a matter of urgency by National Treasury.

Proposed remedy to the problem

It is submitted that recognising immediate taxation on the recoupment/capital gain as a result of a debt benefit is not convenient. Even though it results in an equitable tax treatment for a company that is already in financial distress, it may be considered counterproductive, because future tax revenue is jeopardised if companies are forced into liquidation by taxes due.

Should immediate tax on the debt benefit be levied, the tax treatment will lead to economic hardship for the taxpayer even whilst achieving tax symmetry. This achieves neutrality at the costs of convenience and economic hardship; the authors submit that the later should be prioritised. It also goes against the National Treasury policy objectives that were taken into account when designing section 19 and paragraph 12A, that is, to provide relief for companies already in financial distress to enable the recovery of the local economy. The authors recognise that the taxpayer received past tax benefits through income tax deductions that were externally funded. Therefore, a recoupment of said deductions is necessary to achieve tax symmetry. The authors do not disagree with the principle. However, it is submitted that the inconvenience caused by the timing of an immediate tax payable should be reconsidered.

The *Income Tax Act* already offers various forms of relief in terms of provisions, rollover relief and deferrals.

Most deductions are claimed under section 11(a), the general deduction formula, which is the positive test. Section 23 prohibits certain deductions, which is the negative test. Section 11(a) must be read together with section 23. Section 23(e) specifically prohibits a deduction of a provision. As a result, unless the *Income Tax Act* expressly allows it, a provision cannot be claimed as a deduction. The following are examples of where the *Income Tax Act* grants a specific deduction in respect of a provision:

- Section 11(j) that grants a deduction for an allowance for doubtful debts;
- Section 24 that grants an allowance for trading stock sold by a taxpayer under an instalment credit agreement; and
- Section 24C that grants an allowance in respect of future expenditure.

The relief granted is added back in the following year of assessment; therefore the relief is granted for 1 year.

The *Income Tax Act* also provides for specific rollover relief in section 13(3). The recoupment on the sale of a building that was subject to the section 13 allowance can be deferred at the taxpayer's election and is set off against the cost of the replacement building if the scope requirements are met. The replacement asset must be brought into use within 12 months from the event giving rise to the recoupment. The SARS Commissioner may extend this period.

Further, the Eighth Schedule to the *Income Tax Act* also provides capital gains tax rollover relief under:

- Paragraph 65, involuntary disposals (at the taxpayer's election), and
- Paragraph 66, reinvestment in replacement assets.

Where paragraph 65 is elected or paragraph 66 applies, then section 8(4)(e) also extends the rollover relief to the recoupment on the asset disposed off. The replacement assets must be brought into use within 3 years from the disposal of that asset. The capital gain and recoupment are spread over the useful life of the replacements asset(s).

Further, the *Income Tax Act* also provides for inter-spousal roll-over relief in terms of section 9HB. There is no time limitation on the roll-over relief provided.
With the advent of COVID-19, the following tax payment deferrals were announced and included in the *Income Tax Act*:

1. Employees' Tax Deferral of 35% of an employer's total employees tax liability and
2. Provisional Tax Deferral of 35% of a taxpayer's provisional tax liability.

The authors submit that, similar to the relief discussed above, an amendment to section 19 and paragraph 12A should be effected that allows a taxpayer in severe financial distress to defer the inclusion of the recoupment/capital gain in taxable income that is triggered by a 'concession or compromise'.

The authors suggest the deferral of inclusion in taxable income be introduced. The distressed debtor has 2 years from the end of the year of assessment in which the immediate tax consequences are triggered, within which to spread the inclusion in taxable income. South African Revenue Service will therefore not impose penalties and interest during the deferral period. Should the taxpayer fail to pay the tax liability within 2 years, the debt becomes payable immediately, with interest. By providing struggling companies relief through this suggested inclusion deferral, the companies will be allowed time to recover financially, and this will assist with the recovery of the local economy.

The authors submit that although SARS may be out of pocket with a time value of money element because of the deferral of inclusion in taxable income over a 2-year period, in comparison to the time it takes to complete a liquidation, the 2-year timeframe appears to be a sensible trade-off (Liquidation Attorneys n.d.). South African Revenue Service may land up financially worse off if the distressed taxpayer enters liquidation as the liquidation distribution tends to be minimal (Fin24 2020).

Conclusion

The problem discussed in this article arises when already distressed debtors are placed in a tax-paying position because

of the recoupment/capital gain triggered as a result of the debt waiver. This recoupment/capital gain is triggered in terms of section 19 and paragraph 12A. The recoupment/capital gain is necessary as it achieves tax symmetry. However, the crux of the issue is the tax inconvenience and hardship that is placed on distressed debtors. This might make tax debts difficult to collect and jeopardise future tax revenue, which is counterproductive. South African Revenue Service confirms that the problem at hand can exist.

Companies have been struggling to trade in tough economic conditions, and the outbreak of COVID-19 has further compounded the effect on companies. As a result, a number of companies have filed for business rescue or liquidation. The tax liability imposed on companies that are already in financial distress is a further impediment.

The proposed solution is that National Treasury considers relief through deferral of inclusion in taxable income for the distressed debtor. More specifically, the problem will be addressed if the distressed debtor has 2 years from the end of the tax year in which the recoupment/capital gain is taxed to spread the inclusion in taxable income. A 2-year period is reasonable and would not leave SARS out of pocket in comparison to liquidation.

The suggestion for the deferral of the inclusion in taxable income is in line with the OECD's recommendations as previously discussed in the literature review section. The capacity to spread the tax liability over more than 1 year may allow the taxpayer to avoid liquidation and continue operating.

National Treasury is implored to address the problem by urgently introducing legislative amendments to remedy the problem.

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Competing interests

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Authors' contributions

M.E.H. was responsible for the write-up of the following sections, the introduction, literature review, research methodology, the policy reasoning behind section 19 and paragraph 12A sections. R.W. was responsible for the write-up of the following sections, the simulated examples and reference list. M.E.H. and R.W. Jointly wrote the following sections abstract, proposed remedy to the problem and conclusion.

Ethical considerations

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Data availability

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Disclaimer

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