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Amendments to the debt relief tax rules

The Income Tax Act contains a set of rules that affect the borrower when it is relieved of a debt obligation. These rules were significantly amended in 2017, with a number of adverse implications. During the 2018 legislative cycle the debt relief rules were further amended to refine the problematic aspects introduced in 2017. This article provides a brief overview of the amendments made to these rules as part of the 2018 legislative cycle.

The Income Tax Act contains specific rules that determine the tax implications if a taxpayer is relieved of its debts obligations. These rules were significantly amended during the 2017 legislative cycle. The National Treasury acknowledged various concerns with the 2017 amendments. As a result, a number of further amendments, some retrospective with the same effective date as the 2017 amendments, were made in the 2018 legislative cycle. This article provides a brief overview of certain amendments to these debt reduction rules as part of the 2018 legislative cycle.

Trigger event for the rules to apply

The definition of a *concession or compromise*, as a trigger for the debt relief rules to apply, was introduced in 2017. It included waivers or cancellation of debts, as one would expect, but also changes to the terms or conditions of a debt while the outstanding debt amount remained payable. The effect of the latter was problematic as changes in collateral or sub-ordinations now had tax implications for borrowers whose credit risk position had deteriorated, despite the fact that the full debt was still payable.The definition was also broadened to specifically refer to debt capitalisation as a form of debt concession or compromise.

The 2018 amendments return to a more conventional approach where a concession or compromise only arises if the face value of the debt amount owing is reduced. In terms of this definition a concession or compromise will arise when a debt is:

- Cancelled or waived,
- Extinguished by redemption or through merger when the borrower acquires the debt claim, or
- Settled, directly or indirectly, by conversion or exchange for shares of the borrower, or using proceeds from a share issue.

The last category is aimed at debt capitalisation arrangements.

Tax effect of the debt relief rules

If a compromise or concession occurs, the debt benefit from this event must be calculated. The 2018 amendments align the calculation of this debt benefit amount with the revised trigger events to ensure that only realised benefits have a tax impact.

The rules then require that the borrower trace how it used the debt in respect of which the relief was enjoyed. This is required to adjust the borrower's position to reflect the fact that it did not actually incur the expenditure funded by the debt of which it was relieved. If the debt funded deductible expenditure, the debt benefit is treated as a recoupment to reverse that deduction. Where the debt funded the acquisition of an asset, the base cost of the asset is adjusted with the amount of the debt benefit. The 2018 amendments introduced an additional tracing rule that requires an adjustment to previously calculated recoupments and capital gains on assets funded with the debt where these assets were disposed of before the compromise or concession occurred.

In the case of a debt capitalisation the effect of the debt relief rules is further limited to only apply to the interest component of the capitalised debt by excluding debt benefits in respect of capitalised debts from the rules to the extent that the debt does not consist of interest. This is arguably a fair outcome as expenditure funded from the proceeds of issuing equity instruments would generally qualify for deductions. Where similar expenditure is initially funded with debt, the deductions allowed should not be recouped or adjusted when that debt is subsequently converted into equity.

In conclusion

The provisions applicable to debt compromises and concessions have evolved into a complex web of rules. The complexity of these rules should not be underestimated despite the fact that some underlying principles may appear simple at first glance.