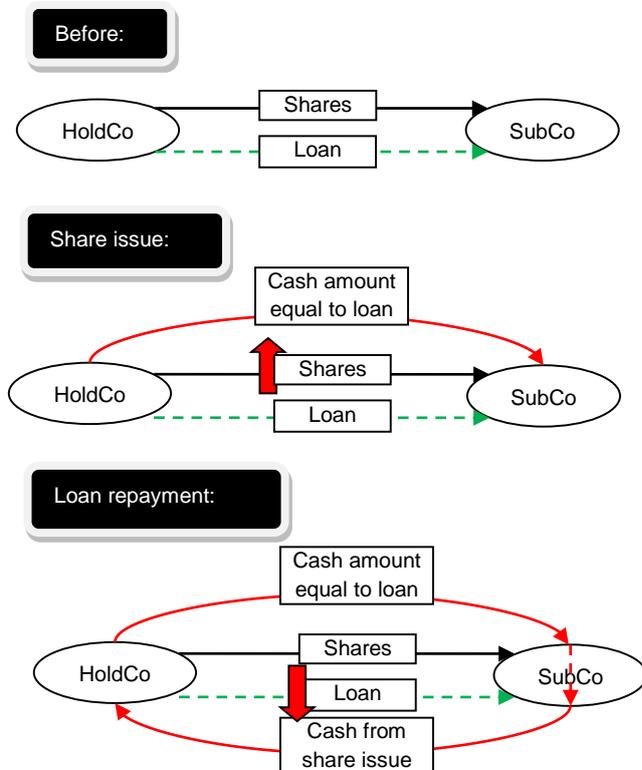


If you wish to receive these updates regularly, you can request this by sending an email with the word "Subscribe" in the subject to [newsletter@pvdz.co.za](mailto:newsletter@pvdz.co.za) or by subscribing at [www.pvdz.co.za](http://www.pvdz.co.za).

Loans can be converted into equity for a number of reasons. A lender may wish to become an investor/shareholder in the borrower. In other cases, it may be that a loan that was advanced to the borrower by a shareholder remains outstanding and circumstances (ability to repay or further borrowing requirements) require that such a loan should rather be converted into part of the equity of the company.

Capitalisation of a loan effectively results in the borrower settling the loan by issuing its own shares. In light of the Supreme Court of Appeal judgment in the case of *C:SARS v Labat Africa Ltd* 74 SATC 1 ('Labat case'), where it was held that the issuing of its own shares by a company does not constitute expenditure actually incurred, some debate exists as to whether a capitalisation of a loan may result in a debt reduction for tax purposes. Binding Private Ruling 173 (BPR173) was issued on 2 July 2014 and deals with the following scenario:



The holding company (HoldCo) in this case was a foreign company, therefore the group company exclusions did not apply. The effect of the two transactions is that the holding company will end up with the same cash in its hands (as it flows back to it in the form of the repayment of the loan), while the borrower's loan owing to the holding company is extinguished and the HoldCo holding more shares in the SubCo.

The ruling deals with the question whether section 19 or paragraph 12A would apply in this instance. In order to understand the ruling, a brief overview of the current debt reduction regime is required.

### Current debt reduction regime

The tax regime relating to the reduction of debt for consideration less than the amount of the debt changed with effect from years of assessment starting on or after 1 January 2013. In an extremely simplified form, the new regime,<sup>1</sup> which is contained in section 19 of the Income Tax Act ('Act') and paragraph 12A to the Eighth Schedule to the Act, comes down to the following:

- If the debt was used to fund deductible expenditure, a recoupment of some kind would arise;
- If the debt was used to fund the acquisition of an asset still on hand at the time of the reduction, the base cost of the asset is reduced;
- If the debt does not fall into the above categories, but the taxpayer has an assessed capital loss, this capital loss is reduced;
- Reduction of debts that do not fall into the above categories do not have tax implications.

The trigger to the above tax implications is a reduction of a debt. The term 'reduction' is not defined, but both section 19 and para 12A define the term 'reduction amount' as "in relation to a debt owed by a person, means any amount by which that debt is reduced less any amount applied by that person as consideration for that reduction". From this it can be derived that a reduction would exist where the consideration given by the borrower to settle a debt is less than the amount by which the outstanding debt is reduced.

<sup>1</sup> There are a number of detailed exceptions and exclusions to this regime.

If you require technical tax or IFRS assistance or an inhouse seminar please feel free to contact Pieter van der Zwan at 083 417 5904 or [pieter@pvdz.co.za](mailto:pieter@pvdz.co.za) or to visit [www.pvdz.co.za](http://www.pvdz.co.za) and submit a request on the relevant page.

Please note that the information in this newsletter is only for awareness purposes. It is recommended that you consult the original source of information if you wish to rely on this in making tax-related decisions or that you obtain advice based on the specific facts and circumstances of the transaction or decision in question.



Pieter van der Zwan  
& Associates

Technical Advisory Services  
Tax · IFRS

## Tax implications of capitalization of loans

### Important aspects of the ruling

Despite the fact that the loan in the case of the ruling was used to fund deductible (according to the taxpayer) operating expenditure, the ruling is that section 19 does not result in a recoupment. This would presumably be due to the fact that a debt is not reduced. At first glance, this could indicate that SARS' view is that the shares issued constitute consideration.

It is however interesting to note that the ruling is subject to amongst others the following conditions:

- "The subscription price for the new issue of shares is to be settled in cash by Holdco"; and
- "The loan amount owed to Holdco will be settled in cash, by the Applicant as contemplated in the proposed transaction".

These conditions would suggest that had the transaction taken place by SubCo issuing the shares for Holdco giving up the right to repayment of the loan as consideration (combination of the two transactions), the outcome may not have been similar. This warrants further analysis of the scenario had the two steps been combined into one:

It should firstly be noted that it is not completely unheard of for a single transaction with the same effect as a number of steps to have a different tax implications from the multiple steps. This is accepted in the following extract from the judgment in the Labat case where Harms AP stated:

"...[T]he Full Court said that if the agreement had been that Labat-Anderson would have purchased the shares at an agreed price and that the proceeds of the sale would be applied to the purchase price, there could be no doubt that the transaction would constitute an expenditure by the company of its share capital, and that it is difficult to see the difference between this construction and the present agreement. ... The fact that the parties may have constructed their agreement differently and tax-efficiently is entirely beside the point."

In the SARS Comprehensive Guide on CGT, it is pointed out (in the context of donations by the lender to the borrower (trust) that are used to settle the loan) that:

"Whether the reduction in the loan account constitutes a cancellation of debt will depend on how the transaction is structured. Some commentators have suggested that no gain will arise if cash were donated to the trust as this would not amount to the cancellation of debt. It is submitted that

this strategy is not without its risks. South African courts have not always taken kindly to cheque-swapping antics as the taxpayer in ITC 1583 discovered to his cost".

Introducing cash flow into a transaction would not necessarily disguise its true effect for tax purposes.

As the presence of cash would therefore not necessarily be decisive for the application of section 19, it is important to understand the context of the Labat judgment. In arriving at his view, Harms AP stated the following with regard to foreign case law that the taxpayer referred to:

"The first judgment relied on was *Osborne v Steel Barrel Co Ltd* [1942] 1 All ER 634 (CA). ... There is at least no indication that the statute used the term 'expenditure'. The court decided that the issue of shares for the acquisition of assets amounted to 'consideration' given by the company. That is hardly contentious. ... This, too, does not appear to be contentious but how it bears on the question whether the issue of shares amounts to 'expenditure' I do not understand".

This extract makes it clear that the Labat judgment was made in relation to the term 'expenditure', not 'consideration'. The term 'reduction amount' in section 19 and para 12A refers to 'consideration' as opposed to 'expenditure'. It is therefore submitted that capitalization of loan, with or without cash flow, should not result in a reduction for purposes of section 19 and para 12A if the value of the shares issued (consideration) is equal to the amount of the debt reduced.

### Concluding thoughts

The ruling clarifies the position that where a loan is repaid from the proceeds of a share issue to the borrower, the debt reduction provisions of the Act are not triggered. Arguments exist for the view that the capitalisation of a loan in exchange for shares without any cash flow should similarly not constitute a debt reduction as the lender is effectively in a position where it receives something of value to settle the loan. The conditions to the ruling would however suggest that transactions where the lender effectively gives up value and a loan is extinguished (such as a donation to a trust which is used to repay the loan) are still at risk of being viewed as a debt reduction from the borrower's perspective.

---

If you require technical tax or IFRS assistance or an inhouse seminar please feel free to contact Pieter van der Zwan at 083 417 5904 or [pieter@pvdz.co.za](mailto:pieter@pvdz.co.za) or to visit [www.pvdz.co.za](http://www.pvdz.co.za) and submit a request on the relevant page.

Please note that the information in this newsletter is only for awareness purposes. It is recommended that you consult the original source of information if you wish to rely on this in making tax-related decisions or that you obtain advice based on the specific facts and circumstances of the transaction or decision in question.