A CRITICAL ANALYSIS OF THE TAX CONSEQUENCES OF DEBT REDUCTONS, IN THE CONTEXT OF INSOLVENCY, DEATH AND THE LIQUIDATON OF A DECEASED ESTATE

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Abstract

The present research was conducted in an effort to address certain problems and a legal anomaly that is specifically related to the tax treatment of reduced debts stemming from the death or insolvency of natural persons in South Africa.

At the beginning of 2013 the National Treasury enacted certain amendments to the debt reduction provisions of the Income Tax Act 58 of 1962 with the intention of streamlining the tax treatment of reduced debts and granting debt relief to financially distressed debtors. In spite of these recent amendments to the provisions of the Income Tax Act, there are certain problems and a legal anomaly which still currently relate to the tax consequences of reduced debts in South Africa. These problems and the legal anomaly are based on the failure of the recent amendments to successfully address debt reduction which arises in the context of the death and/or insolvency of natural persons. The objective of this research was therefore to analyse the tax consequences of reduced debts arising in the context of the death and the insolvency of natural persons and to explain how the problems and legal anomaly associated with these tax consequences can be rectified.

The research design was qualitative within the framework of an interpretive paradigm. A mixed methodology approach was followed as identified in the Arthurs Report (1983), namely the interdisciplinary and the doctrinal methodologies. This approach encompassed two legal research methods namely the expository and legal reform research methods.

The research explained the underlying nature of the tax consequences of reduced debts arising in the context of the death and the insolvency of natural persons and formulated specific reform measures aimed at remedying the problems and the legal anomaly that currently exist. Two amendments were proposed. It was proposed that the tax liability which arises when debts are reduced through the wills of deceased persons and the reduction of debts stemming from the insolvency of natural persons should be expressly excluded from falling within the ambit of the provisions which give rise to tax consequences whenever debt reduction takes place.

Key words:

South African tax; reduced debts; deceased estates; insolvency; Income tax; Value-Added Tax

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CHAPTER 1: INTRODUCTION

1.1 CONTEXT OF THE RESEARCH

This research is based upon a comprehensive enquiry into the income tax and value-added tax consequences of debt reduction arising within the context of death or the insolvency of natural persons in South Africa. Debt reduction itself is a method through which debt relief is granted to debtors. In the past tax consequences placed a tax burden as opposed to tax relief on debtors whose debts had been reduced – some of whom had already been financially distressed. The National Treasury decided to enact amendments to the Income Tax Act 58 of 1962 (referred to as "the Income Tax Act") to alleviate this tax burden and grant further debt relief to financially distressed debtors. In spite of these recent amendments there are certain problems and a legal anomaly which still currently plague the tax consequences of reduced debts in South Africa – particularly the tax consequences of reduced debts arising within the context of death or the insolvency of natural persons. It is the purpose of this research to critically analyse the tax consequences of such debt reductions.

At the beginning of 2013 the National Treasury enacted certain amendments to the debt reduction provisions of the Income Tax Act. The respective amendments were enacted in terms of the Taxation Laws Amendment Act 22 of 2012 (referred to as the "Taxation Laws Amendment Act, 2012") which was promulgated on the 1st February 2013. The National Treasury's rationale for enacting the recent amendments is explained by the background to the amendments provided in the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2012 (hereafter referred to as the "Explanatory Memorandum"). The Explanatory Memorandum (National Treasury: 2012: 48) explains the reasons for the proposed changes to the debt reduction regime as follows:

> Debtors in distress seeking relief are a recurring economic pattern. 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 tax potentially 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 is that tax

> debt forgiven by SARS due to a company's inability to pay tax [this would also apply to an individual] also gives rise to a capital gain (i.e. retriggering tax).

Prior to the enactment of the recent amendments to the Income Tax Act reduced debts gave rise to ordinary income tax, capital gains tax as well as donations tax consequences. The manner in which these tax consequences arose can be summarised in the following manner:

- ordinary income used to arise in terms of sections 8(4)(m) and 20(1)(a)(ii);
- capital gains tax arose in terms of paragraph 12(5) which was to be read in conjunction with paragraph 13(1)(g)(ii) of the Eighth Schedule; and
- donations tax arose in terms of the provisions of sections 54, 55(1), 55(3), 59 and 60 of the Income Tax Act.

In terms of the previous practice the reduction of debts gave rise to yet another debt – one that was owed to the SARS by virtue of the reduction of a debt. The National Treasury expressed concern over the previous practice which failed to grant relief to debtors in financial distress. In order to remedy this situation the tax laws relating to reduced debts were restructured through the following measures:

- the removal of certain provisions, such as sections 8(4)(m) and 20(1)(a)(ii) as well as paragraph 12(5) of the Eighth Schedule, from the Income Tax Act;
- the amendment of provisions, such as section 8(4)(a) and paragraph 13(1)(g)(ii) of the Eighth Schedule, which would be affected by the removal of provisions from the Income Tax Act; and
- the addition of new provisions to the Income Tax Act: section 19 and paragraph 12A of the Eighth Schedule.

The reason for the amendments is a desire to streamline the tax treatment of reduced debts and to grant debt relief to financially distressed debtors. Although the Explanatory Memorandum itself only makes explicit mention of debt relief as the reason behind the recent amendments it is still possible to divide the recent amendments into two broad categories:

- amendments which standardised the terminology used in reference to reduced debts; and
- amendments which granted tax relief to financially distressed debtors who experience debt reduction.

To a certain extent the two categories are interlinked. The first category arose from a need to ensure that all of the different possible methods of debt reduction are actually addressed by the debt reduction provisions of the Income Tax Act. Prior to the recent amendments only some of the different methods of debt reduction were expressly addressed by the debt reduction provisions in the Income Tax Act. By standardising the terminology used in order to refer to reduced debts, the range of debt reduction methods explicitly addressed by the debt reduction provisions in the Income Tax Act could be expanded.

The second category extends debt relief to taxpayers whenever debt reduction arises in terms of the different methods of debt reduction that are identified by the first category. According to the Explanatory Memorandum (National Treasury: 2012) the main types of tax relief that were adopted are capital debt relief and ordinary debt relief. On the one hand the capital debt relief took the form of the reduction of the base cost of the asset acquired with the debt and the reduction of an assessed capital losses associated with capital assets. The ordinary debt relief, on the other hand, was achieved though the reduction of the cost price and the provision for the recoupment of deductions and allowances granted in respect of the expense or cost of the asset associated with revenue assets. There is a difference in the extent to which these two forms of relief can be applied to taxpayers. Whilst the capital debt relief provides complete tax relief for taxpayers, the ordinary debt relief only offers a partial form of tax relief for taxpayers. In terms of the capital debt relief any capital amounts that still remained after the reduction of the base cost and assessed losses are to be disregarded for capital gains tax purposes. In contrast the ordinary debt relief does not extend this far. After the cost price of revenue assets have been reduced any amounts that remain give rise to ordinary revenue in the form of recoupments.

In spite of these recent amendments to the provisions of the Income Tax Act, there are certain problems and a legal anomaly which still currently plague the tax consequences of reduced debts in South Africa. These problems and the legal anomaly are based on the failure on the part of the recent amendments to successfully address debt reduction which arises in the context of two particular methods of debt reduction namely: death and the insolvency of natural persons.

Insofar as the context of death is concerned debt reduction takes place in either one of three ways. Firstly, debt reduction may take place, in terms of contractual common law principles, as a result of the actual death of a debtor. Under such circumstances debt reduction takes place at the moment of death if such debt reduction had been provided for in the provisions of the contracts that had been entered into by a deceased person. Secondly, if the assets of a deceased estate prove to be insufficient for the purposes of meeting the estate's liabilities, the creditors of the estate can reduce their claims against the estate sufficiently in order to keep the deceased estate solvent.Thirdly, debt reduction may take place in terms of section 56(2) of the Administration of Estates Act 66 of 1965 when the executor of a deceased person's estate ultimately receives his or her discharge from the Master of the Supreme Court – where a deceased estate's liabilities exceed its assets.

Debt reduction takes place through insolvency in terms of the provisions of the Insolvency Act 24 of 1936 in one of two ways. Firstly, debt reduction occurs once the creditors of an insolvent estate have accepted an offer of composition in terms of the section 119 of the Insolvency Act, which entails the settlement of an insolvent estate's liabilities through debt reduction. Secondly, once an insolvent debtor has been rehabilitated in terms of either section 124 or section 127A of the Insolvency Act any debts still owed by an insolvent debtor are extinguished in terms of section 129(1)(b) of the Insolvency Act.

Prior to the enactment of the recent amendments to the Income Tax Act there were five key problems that arose in connection to debt reduction within the context of the administration of deceased estates and the insolvency of natural persons:

- The absence of standardised terminology used in reference to reduced debts;
- The lack of tax relief for deceased estates and insolvent estates;
- The reduction of funds available to pay the creditors of both deceased estates and insolvent estates due to the tax debt owing to the Revenue Services in respect of the debt reduction;
- The reduction of debts through the wills of deceased persons. Such debt reductions placed a tax burden upon the heirs and/or legatees of deceased taxpayers; and
- The disjuncture that existed between the provisions of the Income Tax Act, on the one hand, and the Insolvency Act, on the other hand, in relation to the tax treatment of reduced debts. The disjuncture between the Income Tax Act and the Insolvency Act is

comprised of two components. Firstly, there is a distinction between the legal personality of insolvent debtors prior to sequestration and insolvent estates following the commencement of sequestration. Even though the Income Tax Act treats an insolvent debtor as a separate taxpayer from the one that is recognised prior to the commencement of sequestration, the Insolvency Act does not recognise insolvent debtors as new legal persons once sequestration has commenced. Secondly, a discrepancy exists between the life-span of the insolvent estate as recognised by the Insolvency Act on the one hand and the Income Tax Act on the other hand. Although the Insolvency Act recognises the existence of insolvent estates from the commencement of sequestration until the moment at which either a composition is implemented or rehabilitation takes place, the position under the Income Tax Act differs. The Income Tax Act only recognises the existence of insolvent estates from the commencement of sequestration till the date on which an insolvent estate is finally wound up.

As a result of the failure on the part of the recent amendments to successfully address debt reduction which arises in the context of death and the insolvency of natural persons, the abovementioned problems which existed prior to the enactment of the recent amendments to the Income Tax Act still continue to exist. The only exception to this is the standardised terminology used in reference to reduced debts – a problem which has been successfully addressed by the recent amendments. Despite the continued existence of the other problems and legal anomaly that have been identified, a comprehensive investigation into the current tax consequences of reduced debts in the context of death and the insolvency of natural persons in South Africa has not yet been undertaken by researchers.

The current state of events gives rise to the questions with which the present research is concerned. What is the nature of the tax consequences of reduced debts arising in the context of death and the insolvency of natural persons and how can the problems and legal anomaly associated with these tax consequences be rectified? Whilst some commentary on the recent amendments to the Income Tax Act does exist, such commentary is not comprehensive enough and does not address the problems and legal anomaly which currently exists. The present research has been conducted with the objective of filling this gap in the existing research.

1.2 GOALS OF THE RESEARCH

The goal of this research was to investigate the problems that continue to exist in relation to the taxation of debts reduced as a result of death or the insolvency of natural persons in South Africa. This involved the following sub-goals:

- the analysis of the various laws that govern the reduction of debts within the context of death or the insolvency of natural persons;
- an examination of the specific tax laws that apply to the administration of deceased estates as well as the insolvency of natural persons – within the context of debt reduction;
- the systematic exposition of the laws governing the tax consequences of debt reduction within the context of death or the insolvency of natural persons;
- evaluating the adequacy of the laws governing the tax consequences of debt reduction within the context of the death or insolvency of natural persons; and
- conducting a comparative analysis of the Australian legal system with specific focus on the tax consequences of debt reduction in the context of death or the insolvency of natural persons, to be used as the basis for the recommendation of changes to the relevant South African laws governing the tax consequences of debt reduction in the context of death or the insolvency of natural persons.

1.3 METHODS, PROCEDURES AND TECHNIQUES

The research methodology to be applied can be described as legal research methodology. The exact nature of the legal research is classifiable as a form of mixed method research. In adopting a mixed method of legal research this research combines two types of legal research methods identified in the Arthurs Report (1983, in Chynoweth, 2008) in its landmark study on the state of legal research and scholarship in Canada in 1982. The two types of legal research methods that will be applied in this research are expository research and legal reform research. The mixed methods of legal research will be combined in a sequential manner. The research will commence with the application of the expository research method and then proceed with the application of the legal reform research method.

The expository research will be used in order to analyse the various laws which relate to the subject-matter that forms the topic of this research. This research method has been adopted in order to meet the objectives of the first four sub-goals by the explication of the laws relating to the following aspects:

- the various laws that govern the reduction of debts within the context of death or the insolvency of natural persons;
- the specific tax laws that apply to the administration of deceased estates as well as the insolvency of natural persons; and
- the laws governing the tax consequences of debt reduction within the context of death or the insolvency of natural persons.

Thereafter the findings of the expository research will be examined critically in order to formulate appropriate recommendations, where necessary, in terms of the legal reform research method. This research method has been adopted in order to meet the objectives of the last two sub-goals. This means that the legal reform research method will facilitate the evaluation of the adequacy of the laws governing the tax consequences of debt reduction within the context of the death or insolvency of natural persons. Furthermore, it will recommend suitable legal reforms for amendments to be made to the laws governing the tax consequences of debt reduction within the context of death or the insolvency of natural persons.

The research methodology adopted in this research is based purely on documentary data. Subsequently the research methodology will adopt a qualitative orientation that will be based on documentary data accessed through the application of an extended literature survey. Since the data exists in a textual form any analysis of the data will have to be an analysis of texts. Accordingly the nature of the analysis can be classified as a form of legal hermeneutics (Botha: 2005). Insofar as the analysis of the data is concerned, an explanatory approach will be undertaken.

The specific documents which will be subjected to analysis can be listed as follows:

1. the Income Tax Act;

2. Interpretation Note 8 (SARS: 2013) which was issued in relation to the Income Tax Act;
3. the Value-Added Tax Act 89 of 1991;
4. the Prescription Act 68 of 1969 (referred to as “the Prescription Act”);
5. the Administration of Estates Act 66 of 1965 (referred to as “the Administration of Estates Act ”);
6. the Estate Duty Act 45 of 1955 (referred to as “the Estate Duty Act”);
7. the Insolvency Act 24 of 1936 (referred to as “the Insolvency Act”);
8. the Income Tax Assessment Act 1997 (referred to as “the Australian Income Tax Assessment Act”);
9. the Goods and Services Tax Act 1999 (referred to as “the Australian Goods and Services Tax Act”);
10. the Administration and Probate Act 1958 (referred to as “the Australian Administration and Probate Act”); and
11. the Bankruptcy Act 1966 (referred to as “the Australian Bankruptcy Act”).

In keeping with the requirements of good scholarship this research takes into account essential issues such as ethical considerations as well as the reliability and validity of the research. The ethical consideration which is relevant for the purposes of this research pertains to the aspect of honesty with professional colleagues. This ethical consideration will be upheld in this research through the reporting of research findings in a complete and honest manner. Within this context credit will be given through the full acknowledgement of other people’s ideas or words.

The validity and reliability of this research will be ensured through two separate methods. Insofar as the validity of legal research is concerned it would appear that the validity of such research is an inherent aspect of the research methodology itself. The reliability and validity of the research will be ensured through the use of authoritative data and the analysis of such data in accordance with appropriate methods and techniques that have been accepted by the legal scholastic community.

1.4 RESEARCH STRUCTURE

The structure of the succeeding chapters of the research is set out as follows:

Chapter 2 describes the underlying research methodology that was adopted for the purposes of carrying out this research. In particular the chapter explains the research design, individual research methodologies as well as the separate research methods that have been used throughout the research.

Chapter 3 provides an understanding of the various laws pertaining to the reduction of debts by means of an analysis of the discrepancy between the various methods of debt reduction and the previous debt reduction provisions of the Income Tax Act which did not adequately encompass the various methods of debt reduction. The goals of this chapter have been accomplished through the application of a three-prong process. Firstly, an extensive overview of the different methods of debt reduction has been provided. Although all of the different methods of debt reduction are discussed in the process, the various laws that govern the reduction of debts within the context of death as well as the insolvency of natural persons are addressed in greater detail. Whilst debt reduction within the context of death is regulated by the common law of contract and the provisions of the Administration of Estates Act, debt reduction through the insolvency of natural persons is regulated by the provisions of the Insolvency Act. Secondly, a description has been provided of the manner in which the key provisions of the Income Tax Act, which used to apply to reduced debts prior to the recent amendments, failed to fully encompass the various forms of debt reduction. Thirdly, this discussion is followed by a description of the manner in which the recent amendments include the various forms of debt reduction within the ambit of the Income Tax Act.

Chapter 4 develops the discussion of debt reduction through the death or insolvency of natural persons. Insofar as the law of taxation is concerned these methods of debt reduction are regulated by the common law of contract, the Administration of Estates Act and the Insolvency Act. The two methods of debt reduction are also regulated by certain provisions found in the Income Tax Act and the Value-Added Tax Act. A more holistic picture of the nature of these two methods of debt reduction is developed through the explanation of the specific provisions of the Income Tax Act which apply to the administration of deceased estates and the insolvency of natural persons.

Chapter 5 constitutes a systematic exposition of the income tax laws governing the tax consequences of debt reduction within the context of death or the insolvency of natural persons. The income tax consequences arising from the reduction of debts is addressed by the provisions of sections 8(4)(a), 11(i), 19, 54, 55(1), 55(3), 59 and 60 as well as paragraphs 12A, 35A, 35(1)(a) and 56 of the Eighth Schedule to the Income Tax Act. The analysis takes cognisance of the debt reduction provisions deleted as a result of the recent amendments to the Income Tax Act such as sections 8(4)(m) and 20(1)(a)(ii) as well as paragraphs 12(5) of the Eighth Schedule. Furthermore, due to the difference in the fundamental natures of the old and new provisions the specific effects of these two sets of provisions will also be discussed.

Chapter 6 evaluates the adequacy of the laws governing the tax consequences of debt reduction within the context of the death or insolvency of natural persons. More specifically two sets of issues are identified and described. Firstly, the specific problems and legal anomaly which currently plague the taxation of insolvent estates subjected to debt reduction and secondly the issues relating to the taxation of deceased estates subjected to debt reduction. These two sets of issues are explained within the specific problem areas that continue to exist in spite of the recent amendments to the Income Tax Act.

Chapter 7 discusses the value-added tax aspects which complement the income tax issues addressed in chapters four and five through a two-fold process. Firstly, a systematic exposition is undertaken of the value-added tax laws governing the tax consequences of debt reduction within the context of death or the insolvency of natural persons – namely sections 22(1) and 22(3) of the Value-Added Tax Act. Secondly, an explanation is provided of the specific provisions of the Value-Added Tax Act which apply to the administration of deceased estates and the insolvency of natural persons. In this regard, the relevant provisions are to be found in section 22(3)(b)(ii) of the Value-Added Tax Act which is to be read in conjunction with ancillary provisions found in sections 8(2), 46(g), 46(h), 53(1)(a) and 53(1)(b) of the Act.

Chapter 8 formulates suitable recommendations for amendments aimed at remedying the existing problems and the legal anomaly pertaining to the tax consequences of debt reduction within the context of death or the insolvency of natural persons. The precedent for these proposed reforms has been derived from the Australian legal system. The relevant aspects of

the Australian legal system that were analysed for such purposes are the Australian Income Tax Assessment Act, the Australian Goods and Services Tax Act; the Australian Administration and Probate Act; the Australian Bankruptcy Act as well as certain aspects of the Australian common law of contract. After conducting an examination of the relevant aspects of the Australian legal system and comparing these with similar aspects in the South African legal system, a key set of principles are extracted from the Australian legal system and applied to the South African legal system in order to formulate suitable recommendations for amendments.

Chapter 9 provides the conclusion to the thesis. It summarises the findings of the preceding chapters and demonstrates how the goals of the research have been achieved.

CHAPTER 2: RESEARCH METHODOLOGY

2.1 INTRODUCTION

In the preceding chapter it was pointed out that a gap exists in the available literature in South Africa pertaining to the tax consequences of reduced debts arising on the insolvency or death of a natural person. The existence and exact nature of the tax consequences resulting from the reduction of debts has not received much attention in the available body of literature. It was noted that what is currently missing from the available body of literature is a comprehensive account of the tax consequences of reduced debts in South Africa, and particularly in the case of the death or insolvency of a natural person.

This chapter will describe the research methodology that was adopted in the quest to address the goals of the research. Although a brief outline of the research methodology has already been given in chapter 1, it is necessary that a fuller description be given. A detailed framework of the methodologies that may be appropriate for research in the field of law is set out below in **Figure 1**.

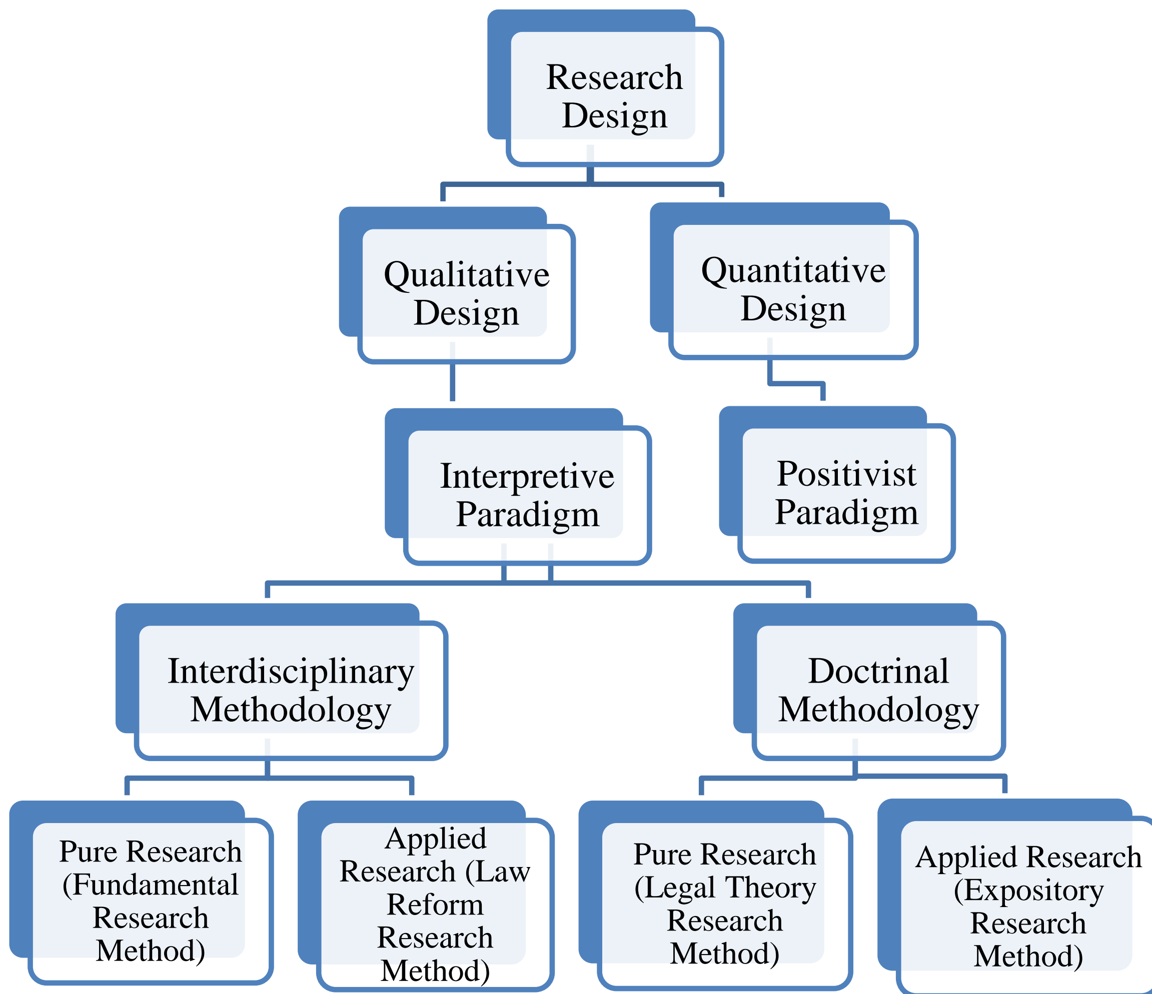

Figure 1

The present research clearly does not employ a quantitative design. As the research method involves an analysis and interpretation of legislation and common law, the design is clearly qualitative. The outline of the qualitative design presented in the illustration represents a combination of the qualitative research structure used in social science research to describe the research methodology and the legal research structure identified in the Arthurs Report (1983). Qualitative research paradigms embody different research methodologies. Although the qualitative research structure encompasses disciplines such as the law it appears that the nature of legal research requires a research structure that is more specific to the discipline of law. In order to address this issue the Arthurs Report (1983) identified a research structure

that legal researchers could use to describe the process of conducting legal research.[1] The format adopted in the Arthurs Report (1983, in Chynoweth, 2008) took the form of a matrix as set out below in **Figure 2**.

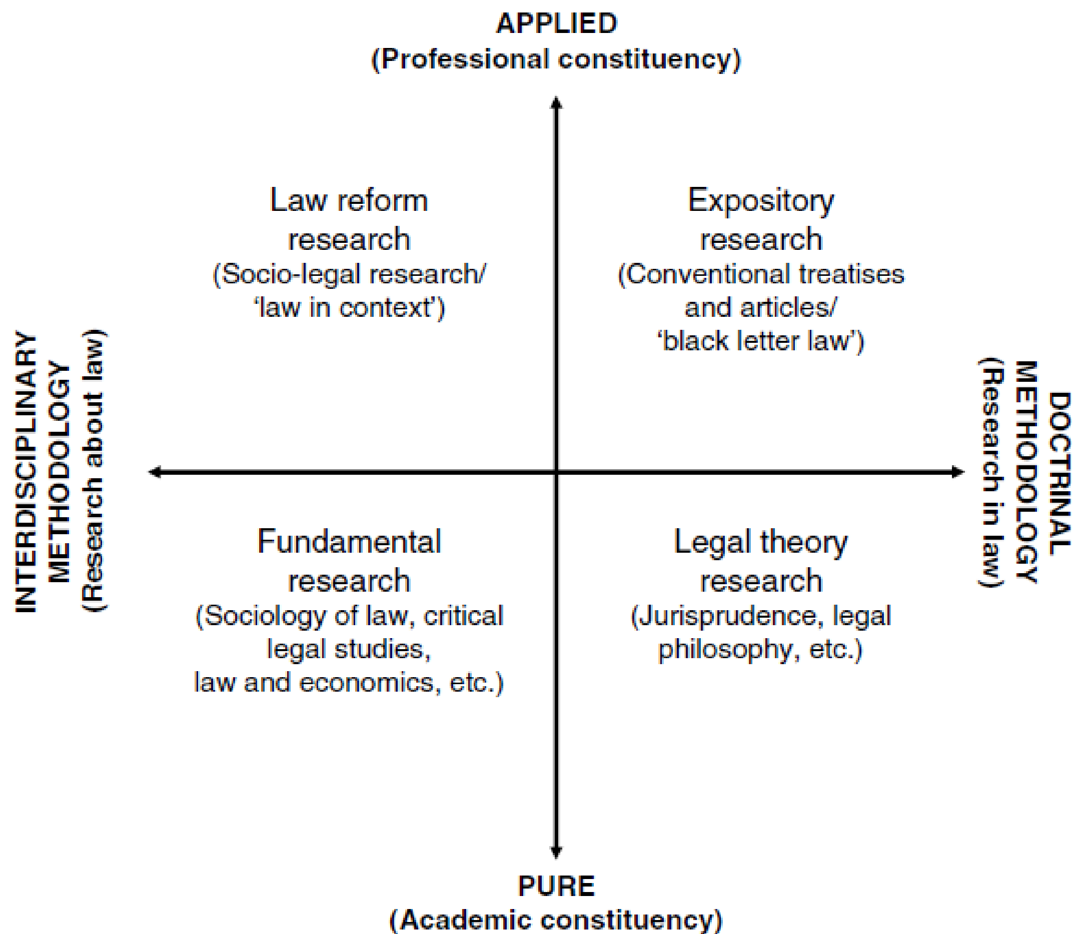

Figure 3.1 Legal research styles (Arthurs, 1983).

The matrix illustrated in **Figure 2** identifies two legal research methodologies. Each methodology could be applied in a pure (theoretical) or applied (practical) orientation. Accordingly four different research methods could be applied within the structure identified by the Arthurs Report. As useful as it may be, the matrix formulated in the Arthurs Report does not link the legal research methodologies to the general qualitative research structure. Since law is a social science any research structure formulated by legal researchers should be able to be classified within the ambit of the social science qualitative research structure. The outline illustrated in **Figure 1** classifies legal research within the ambit of the social science qualitative research structure. This classification presents the components of the legal

[1] The Arthurs Report was a landmark study on the state of legal research and scholarship in Canada in 1982.

research structure described in the Arthurs Report in the form of a matrix. The components of this matrix were presented in the form of a hierarchy, thereby enabling these components to be linked to the social science qualitative research structure in a coherent manner.

2.2 RESEARCH DESIGN

The research was conducted within the framework of a qualitative research design. The qualitative research design is an umbrella concept that encompasses research which is subjective and uses language as well as descriptions instead of numbers and symbols (Williams: 1998). The qualitative research design was selected due to its ability to enable researchers to study social and cultural phenomena (Myers: 1997) and thereby provide answers in various social settings.

A qualitative research design was adopted in order to explain the manner in which certain concepts are used to construct reality within the context of a legal system. The aim was to construct a legal model that represented the current manner in which reality has been constructed, which was then tested against an ideal reality which served as a benchmark. Where the actual reality fell short of this benchmark, reforms were proposed to bring the actual reality closer to the ideal reality, based upon the underlying principles of the law which had been identified.

In the process of applying the qualitative research design a four-stage approach as outlined by Kirk and Miller (1986) was utilised. These four stages may be listed as follows:

- Invention (research design)
- Discovery (data collection)
- Interpretation (analysis)
- Explanation (documentation)

2.3 RESEARCH PARADIGM

The term "research paradigm" was defined by Kuhn (1970: viii) as "universally recognised scientific achievements that, for a time, provide model problems and solutions for a community of practitioners". From the range of possible research paradigms the interpretive paradigm, which was pioneered by Max Weber and Wilhem Dilthey (Neuman: 2006),

appeared to be the most appropriate paradigm, due to its compatibility with the qualitative research method (Plano Clark & Creswell: 2008) as well as its resourcefulness in understanding and describing data (Babbie & Mouton: 2009).

The interpretive research paradigm is founded upon certain ontological and epistemological assumptions pertaining to the nature of reality. Ontologically the paradigm conceives reality as a socially constructed phenomenon. According to Williams (1998) this means that reality is viewed as a social phenomenon that is constructed from multiple subjective realities that merge to form an inter-subjective consensus view of reality that is perceived by entire societies. Myers (1997) describes the construction of reality as a process which emanates from the conception of abstract ideas which are ultimately crystallised in a concrete manner in the form of spoken language, written texts as well as observable behaviour. Both statute law and the common law are clearly social artefacts developed through social processes, based on economic and political interaction and ultimately the consensus of members of society.

Epistemologically interpretive research takes on a subjectivist orientation (Creswell: 2007; Denzin & Lincoln: 2003). Accordingly, researchers interpreting the nature of reality are themselves considered to be participants in the construction of a new interpretation of reality emanating from the research (Denzin & Lincoln: 2003). Such newly constructed realities are based upon multiple subjective realities that had been constructed previously by other individuals.[2] In the present research, although the data (legislative provisions and common law principles) "speak" through the medium of the researcher's interpretation, the subjective influence of the research is deliberately avoided.

Reality was described in the present research through the development of a simple legal model. The model was constructed in manner that enabled it to account for the problems and legal anomaly which currently plague the taxation of reduced debts in South Africa, in relation to the insolvency or death of a natural person. The model also provided the basis upon which reform-oriented recommendations, aimed at rectifying the problems and legal anomaly, could be conceptualised. Accordingly the structure of the model was formulated on

[2] Geertz (1973) describes the interpretation of data by researchers as the subjective interpretation of other people's subjective constructions of reality.

the premise that legal systems are compositions of various concepts that are reflected in spoken language, written text as well as observable behaviour. In order to unravel the essence embodied by legal systems only the concepts crystallised in the form of written text were subjected to analysis.[3] This approach required the use of non-empirical research methods founded upon *a priori* assumptions.

2.4 RESEARCH METHODOLOGIES

Research paradigms apply one or more research methodologies. The present research relied on a mixture of the research methodologies that were identified in the Arthurs Report (1983). According to Chynoweth's description of the Arthurs Report (Chynoweth: 2008) there are two research methodologies that were identified in the Arthurs Report. These two methodologies are the interdisciplinary and doctrinal methodologies. The interdisciplinary methodology encompasses research methods that take the form of external enquiries pertaining to the law as a social entity. This methodology relates to research about law rather than research in law. In contrast the doctrinal methodology encompasses research conducted within the field of law. This methodology is concerned with the identification of legal doctrines through the analysis of legal rules.

Each of the two methodologies that have been identified can take on a pure or applied orientation (Chynoweth: 2008). Whereas pure research is tantamount to theoretical research, applied research is the equivalent of practical research. In the application of the two research methodologies in the present research only the applied orientation was used.

2.5 RESEARCH METHODS

The data collection and analysis were conducted by applying two of the different research methods identified by the Arthurs Report (1983)[4], expository and reform-oriented research, as explained below. The research methods were applied within the ambit of the interdisciplinary and doctrinal research methodologies in accordance with their applied orientations.

[3] The decision was made on the basis that in a world in which reality is constructed socially the law is encapsulated in fully fledged legal systems (such as the South African legal system) in the form of written text.

[4] The different research methods can be seen as the different manners in which the interdisciplinary and doctrinal research methodologies can be applied – that is, in either their pure or applied form.

Expository research

Expository research was defined in the Pearce Report (1987) as research which provides a systematic exposition of the rules governing a particular legal category, analyses the relationship between rules, explains areas of difficulty and, perhaps, predicts future developments. To a large degree the definition postulated in the Pearce Report encapsulates the manner in which the expository research method was applied in the present research.

The application of the expository research method entailed an interpretation of the law as embodied in two sources of the South African law – the common law and Acts of Parliament. The relevant common law was subjected to case law analysis. This involved the extraction of the core legal principles, known as the *ratio decidendi*,[5] emanating from court judgments. The Acts of Parliament that were analysed were subjected to a form of analysis known as statutory interpretation. In addition to case law as well as Acts of Parliament, the expository research method also relied on other texts such as authoritative text-books and journal articles.

The interpretation of the law as embodied in the common law took place within two contexts. Firstly, it formed an integral component of the overview of the different methods of debt reduction. Secondly, it was incorporated into the systematic exposition of the income tax laws governing the tax consequences of debt reduction within the context of death or the insolvency of natural persons.

The specific method of statutory interpretation that was employed throughout the research in the analysis of Acts of Parliament was the contextual approach to statutory interpretation.[6] The contextual approach was selected on the basis of court rulings that have recognised it as the most appropriate statutory interpretation method in accordance with the provisions of the Constitution of the Republic of South Africa, 1996 (hereinafter referred to as "the

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[5] The concept *ratio decidendi* is defined by Williams (2006: 92) as the rule of law upon which a (judicial) decision is founded.

[6] This form of statutory interpretation goes beyond an analysis of the literal text that has been used in order to construct legislative provisions. It considers the wider context within which statutory provisions exist. The contextual approach's capability to venture beyond the plain meaning of legislative provisions enables it to be used as a tool for deducing the real intention of the legislature in enacting legislative provisions (Botha: 2005; Du Plessis: 1999; Hosten *et al*: 1995 and Kellaway: 1995).

Constitution").[7] The specific Acts of Parliament that were analysed in detail are the Prescription Act, Administration of Estates Act, Estate Duty Act, Insolvency Act, Income Tax Act and the Value-Added Tax Act.

Law reform research

Law reform research was defined in the Pearce Report (1987) as research which intensively evaluates the adequacy of existing rules and which recommends changes to any rules found wanting. Through the use of this research method the deficient rules found in the legal model that had been constructed through the application of the expository research method were evaluated and reform-oriented recommendations were proposed in order to address the deficient rules.

2.6 CONCLUSION

This chapter set out to describe the research structure that was adopted in the quest to furnish an explanation of the manner in which debts reduced through the insolvency or death of a natural person could be treated for tax purposes. The research structure adopted can be summarised as follows. The research design, which was derived directly from the objectives of the research, took on a qualitative orientation. This design was applied within the framework of an interpretive paradigm. In order to produce optimum results the present research employed the use of a mixed methodology approach. This entailed the use of two methodologies namely the interdisciplinary and the doctrinal methodologies. Both the doctrinal methodology and the interdisciplinary methodology were applied in an applied form. As a result two separate research methods were utilised in the process. These research methods are the expository and legal reform research methods.

[7] According to Botha (2005) the contextual approach to statutory interpretation has been endorsed by the Constitutional Court as the preferred method of statutory interpretation.

CHAPTER 3: THE LEGAL NATURE OF REDUCED DEBTS

3.1 INTRODUCTION

The preceding chapter described the research methodology that was adopted in the present research. The chapter described the research design, paradigm, methodologies and methods that were adopted in the course of the research.

The purpose of the present chapter is to provide a detailed explanation of the interaction between the different methods of debt reduction and the recent amendments enacted in terms of the Taxation Laws Amendment Act, 2012. The analysis in this chapter is based upon the premise that the law is a normative system which regulates a certain set of underlying subject-matter.[8] Accordingly it follows that a comprehensive understanding of the operation of the law of taxation must take into consideration the nature of the underlying subject-matter that it regulates – in this case reduced debts. In order to shed light on the nature of the interaction between the different methods of debt reduction and the recent amendments the analysis in this chapter addresses three matters.

Firstly, the chapter provides an extensive overview of the different methods of debt reduction. As was mentioned in the introductory chapter the previous debt reduction provisions of the Income Tax Act did not adequately address the various forms of debt reduction. In order to identify the methods of debt reduction which had been excluded prior to the recent amendments to the Income Tax Act it is necessary to consider each existing method of debt reduction. This should serve to shed light on the methods of debt reduction that had previously been excluded by the provisions of the Income Tax Act as well as the manner in which the recent amendments have brought all methods of debt reduction within the ambit of the Income Tax Act. Furthermore, although this chapter will not focus exclusively on debt reduction through death and the insolvency of natural persons, the nature of the discussion itself will place these two methods of debt reduction within a contextual perspective.

[8] According to Prebbles (1994) the law is coupled to its underlying subject-matter in the form of a symbiotic relationship.

The first matter to be addressed in this chapter is divided into two broad categories. The first category is an explanation of the legal nature of reduced debts. The second category is a detailed account of the various methods through which debt reduction can arise. There are at least fourteen different methods that have been identified. These fourteen different methods of debt reduction have been divided into two broad categories, namely debts reduced through agreements concluded between contracting parties and debts reduced through the operation of the law.

After providing an extensive overview of the different methods of debt reduction the analysis will proceed to address the two other matters. The first of these two matters will involve a description of the manner in which the key provisions of the Income Tax Act, which used to apply to reduced debts prior to the recent amendments, failed to adequately address the various forms of debt reduction. The third and final matter to be discussed in this chapter will consist of a description of the exact manner in which the recent amendments managed to encompass the various forms of debt reduction within the ambit of the Income Tax Act.

3.2 DIFFERENT METHODS OF DEBT REDUCTION

It would appear that there are two ways or modes through which debts can be reduced.[9] Firstly debts may be reduced through agreements concluded between contracting parties, and secondly they may be reduced through the operation of the law.

3.2.1 Reduction of debts through agreements concluded between contracting parties

Debt reduction through agreement arises when the parties to an existing contract agree to vary or discharge their contract either formally or informally (Christie: 2011). According to Christie (2011) the legal authority which supports this assertion can be found in the following cases: Meyer and Meyer v Tainton (1890) 4 SAR 14; Duncker v Paddon and Brock Ltd 1903 TH 166 at 174; Albu v Eloff and Witwatersrand Land and Exploration Co Ltd 1903 TS 163 at 174; Potgieter v Jaffe 1911 EDL 397; Van Gelderen v Schaff 1912 CPD 76; and Van Streepen & Germs (Pty) Ltd v Transvaal Provincial Administration 1987 4 SA 569 (A) 588 F-J. According to Hutchison and Pretorius (2012) the exact manner in which debt reduction through agreement takes place can take several different forms.

[9] The general consensus is that debts can be reduced through two modes. This is apparent in general contract law textbooks written by Christie (2011), Van der Merwe (2007) and Hutchinson (2012). Kerr (2002) makes use of a different approach by opting to make use of five categories. It should be noted that the categories utilised by Kerr simply constitute sub-categories in the works of the other textbook authors.

There are eight methods in terms of which debts can be reduced through agreements concluded between contracting parties:

- Effluxion of time
- Notice
- Release
- Waiver
- Novation
- Delegation
- Compromise
- Assignment of debts

3.2.1.1 <u>Effluxion of time</u>

The general position of the South African law is that contracts that run for specified periods of time terminate automatically at the end of such specified time periods (Hutchison & Pretorius: 2012). Insofar as consumer agreements are concerned the Consumer Protection Act 68 of 2008 (hereafter referred to as the "Consumer Protection Act") regulates the termination of contracts as a result of the effluxion of time. According to section 14(2) read with section 14(4) of the Consumer Protection Act a consumer agreement that is subject to a fixed time period must not exceed its maximum time period – if such a period has been prescribed for that particular type of agreement. This effectively restricts contracts such as debt contracts to the time period that is specified in a contract. Once this time period lapses the contractual obligations are terminated.[10]

3.2.1.2 <u>Notice</u>

A debt may be reduced if notice of such reduction is given in advance. Cancellation of contracts by notice is a feature of contracts that run for specified periods of time. The notice is given before this specified time-period lapses in order to cancel the contract in question, in terms of section 14 of the Consumer Protection Act which permits fixed-term consumer contracts to be reduced by consumers by means of notice.[11]

[10] It should be pointed out that if contractual obligations have not been fulfilled at this point in time the aggrieved party still has the recourse to legal remedies for breach or specific performance.

[11] Hutchison and Pretorius (2012) point out that the cancellation notice given in terms of section 14 of the Consumer Protection Act must be given by a consumer at least twenty days before the actual cancellation of a contract.

3.2.1.3 Release

Release from a contract is a bilateral debt-extinguishing agreement between a creditor and a debtor in terms of which a debtor is freed from his or her contractual duties (Van der Merwe: 2007). The courts have placed emphasis on the bilateral nature of contractual releases as a distinguishing feature of this type of agreement. This may be observed in the judgments passed in the following cases: Union Free State Mining & Finance Corporation Ltd v Union Free State Gold & Diamond Corporation Ltd 1960 (4) SA 547 (W); Ledingham v Commercial Union Insurance Co of SA Ltd 1993 (2) SA 760 (C) and Ex Parte Liquidator, Vautid Wear Parts (Pty) Ltd (in Liquidation) 2000 (3) SA 96 (3). Hutchison and Pretorius (2012) point out that contractual release can be either partial or complete in nature.

3.2.1.4 Waiver

A waiver takes place when one of the parties to a contract undertakes, either through his or her words, actions or inaction, to refrain from enforcing one or more or all of his or her contractual rights (Christie: 2011). It should be noted that a waiver is a unilateral act performed by a creditor (Hutchison & Pretorius: 2012). This can be gathered from cases such as Total SA (Pty) Ltd v Bekker 1992 (1) 617 (A) at 627. In order for an act to amount to a waiver it needs to entail a creditor's relinquishing of the right to claim performance from a debtor, which has the direct effect of extinguishing a debtor's duty to render performance to a creditor. This flows from the fact that the existence of a contractual duty is dependent upon the existence of a contractual right in terms of which the duty may be enforced.

3.2.1.5 Novation

The term 'novation' was defined in Rose v Cloete (1847) 3 M 377. In this case the court defined the term 'novation' as the replacement of an existing obligation by a new one with the subsequent effect of discharging the existing obligation. A novation can sometimes take the form of a delegation or a compromise.

3.2.1.6 Delegation

Delegation is a form of novation in terms of which a third party is introduced as a debtor in substitution for the original debtor (Christie: 2011). The nature of delegation was addressed by the court in the case of Van Achterberg v Walters 1950 3 SA 734 (T) 745. In the Van Achterberg case delegation was described as a form of novation which necessitates a new

contract to which the creditor, the original debtor and the debtor proposed in his/her/its place all have to be parties. The presiding officer, Millin J, took note of the fact that when novation takes place by way of delegation the creditor in question has to agree to accept the new debtor in the place of the old debtor. The ultimate result is that the original debtor is discharged of his/her/its debts which are subsequently transferred to the new debtor (Christie: 2011).

3.2.1.7 Compromises

The term 'compromise' has been defined in two cases namely, Cachalia v Harberer & Co 1905 TS 457 and Vena v Port Elizabeth Divisional Council 1933 EDL 75. In the *Cachalia* case the court defined the term 'compromise' as an agreement whereby each party abates some of his/her/its previous demands and subsequently recedes to some extent from the position formerly taken up. The *Vena* case provided a slightly different definition. In terms of this definition the term 'compromise' was defined as an adjustment of claims and disputes by mutual concession, either without resort to legal proceedings or on condition of abandoning such proceedings if already commenced.

3.2.1.8 Assignment of debts

Assignment of a debt entails a transfer by a debtor of his or her contractual duties to a third party (Van der Merwe: 2007). Although assignment resembles delegation – in the sense that it transfers contractual duties from an original debtor to a new debtor – it does not lead to the novation of any existent contractual obligations.

3.2.2 Reduction through the operation of the law

The operation of the law involves the suspension of the legal principles that normally apply in terms of contract law. As such, contractual obligations are suspended. There are six methods in terms of which debts can be reduced through the operation of the law:

- Set-off (*compensatio*)
- Merger (*confusio*)
- Supervening impossibility of performance
- Prescription
- Administration of deceased estates
- Insolvency

3.2.2.1 Set-off

Set-off is a debt-extinction process that takes place when two parties have claims against each other (Hutchison & Pretorius: 2012). According to Christie (2011) as well as Van der Merwe (2007) the extent to which amounts are set-off against each other depends on the difference between the amounts of the underlying debts in question. If the debts are equal in amount they are both discharged. If however the debts happen to be unequal the smaller amount is discharged whilst the larger amount is reduced by the amount of the smaller debt (Christie: 2011). The practical application of set-off as a debt extinction method is set out in the following cases: Schierhout v Union Government (Minister of Justice) 1926 AD 286; Standard Bank of South Africa Ltd v SA Fire Equipment (Pty) Ltd 1984 (2) SA 693 (C); and In re Trans-African Insurance Co Ltd (In Liquidation) 1958 (4) SA 324 (W).

3.2.2.2 Merger

The nature and effect of merger was articulated in the case of Grootchwaing Salt Works Ltd v Van Tonder 1920 AD 492 at 497. In this case the presiding officer, Innes CJ, defined merger as, "the concurrence of two qualities or capacities in the same person and in respect of the same obligation". The learned judge went on to point out that merger has the effect of destroying the obligations in respect of which it operates. This outcome is based upon the reasoning that a person can neither be his own creditor nor his own debtor. It follows that in the absence of a debtor upon whom a debt can be imposed a debt is effectively extinguished.

3.2.2.3 Supervening impossibility of performance

This method of contractual cancellation arises if the conditions that are necessary for contractual performance to take place cease to exist (Kerr: 2002). The general rule in this regard was confirmed by the Appellate Division in the case of Peters, Flamman & Co v Kokstad Municipality 1919 AD 427 at 434 - 435. In this judgment the presiding officer, Solomon ACJ, stated the general rule as follows: "By the Civil law a contract is void if at the time of its inception its performance is impossible … So also where a contract has become impossible of performance after it had been entered into the general rule was that the position is then the same as if it had been impossible from the beginning". The courts apply an objective test in the process of determining the impossibility of performance. This principle was confirmed by the Appellate Division in the case of Bob's Shoe Centre v Heneways Freight Services (Pty) Ltd 1995 (2) SA 421 (A) 425 at 432.

3.2.2.4 **Prescription**

Prescription takes place when a debtor's duty to pay or repay a debt lapses as a result of the passage of a certain period of time specified in the provisions of the Prescription Act. The prescription of debts is addressed by the provisions of chapter three of the Prescription Act. According to section 10 of the Prescription Act, prescription has the effect of extinguishing the existence of debts, after the lapse of certain time periods. Section 11 of the Prescription Act lays down the specific prescription periods for different types of debts. Thus the time period after which a particular debt will prescribe depends upon the nature of the underlying debt in question. Once all of the periods stipulated in section 11 have lapsed debt reduction takes place as a result of prescription.

In spite of the provisions of section 11 of the Prescription Act, certain circumstances may sometimes prevent the completion of prescription within the specified time periods. A clear distinction is drawn between the postponement and the interruption of prescription. Each of these two different categories of extenuating circumstances is governed by separate provisions of the Prescription Act. Prescription can be postponed or delayed by a variety of impediments. These impediments are all listed in section 13 of the Prescription Act.[12] The provisions of section 13 have the effect of postponing the period of prescription as a result of the existence of these different impediments.

In addition to postponement the process of prescription may also be subjected to interruption. Such interruption is governed by the provisions of sections 14 and 15 of the Prescription Act.

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[12]The relevant provisions of section 13 are as follows –

(1) If -

(f) the debt is the object of a dispute subjected to arbitration; or

(g) the debt is the object of a claim filed against the estate of a debtor who is deceased or against the insolvent estate of the debtor or against a company in liquidation or against an applicant under the Agricultural Credit Act, 1966 (Act No. 28 of 1966); or

(h) the creditor or the debtor is deceased and an executor of the estate in question has not yet been appointed; and

(i) the relevant period of prescription would, but for the provisions of this subsection, be completed before or on, or within one year after, the day on which the relevant impediment referred to in paragraph (a), (b), (c), (d), (e), (f), (g) or (h) has ceased to exist;

the period of prescription shall not be completed before a year has elapsed after the day referred to in paragraph (i).

(2) A debt which arises from a contract and which would, but for the provisions of this subsection, become prescribed before a reciprocal debt which arises from the same contract becomes prescribed, shall not become prescribed before the reciprocal debt becomes prescribed.

In terms of section 14 the process of prescription may be interrupted through a debtor's express or tacit acknowledgment of a liability. Another method through which the process of prescription can be interrupted is by judicial proceedings. The interruption of prescription by judicial proceedings is governed by the provisions of section 15 of the Prescription Act which specifies the different types of judicial proceedings that have the effect of interrupting prescription. Once the impediments which serve to delay or interrupt the process of prescription have ceased to exist, the process continues to run until it has finally lapsed.

3.2.2.5 <u>Administration of deceased estates</u>

Debt reduction can arise on the death of a (natural) person. Following the death of a person, debt reduction can take place, under normal circumstances, at either one of two different points – firstly, at the moment that the person dies and secondly, at the moment at which the executor of the deceased person's estate ultimately receives his/her discharge from the Master of the Supreme Court. A complete description of the manner in which such debt reduction takes place can only be provided within the context of the legal processes which come into operation after the death of a person. This process is known as the administration of deceased estates, which is regulated by the Administration of Estates Act and any case law decided in relation to the provisions of this Act. The objective of the Administration of Estates Act is to achieve due distribution of a deceased person's assets among creditors and to ensure that any remaining residue is allocated to the deceased person's heirs and/or legatees accordingly.

After a person has died, the deceased person's estate vests with an executor who is tasked with the responsibility of liquidating a deceased estate.[13] Once an executor has finalized the liquidation and distributions of a deceased estate, the estate account must be confirmed by the Master. Thereafter the executor shall be entitled to obtain his/her discharge from the Master of the Supreme Court in terms of section 56(1) of the Administration of Estates Act.

3.2.2.5.1 <u>The reduction of a debt as a result of the death of a debtor</u>

The reduction of a debt as a result of the death of a debtor is based upon the contractual provisions of the respective contracts which are entered into by deceased persons. In other

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[13] Such vesting does not take place in a personal capacity but rather in a fiduciary capacity. This point was confirmed in <u>Lindenberg v Giess</u> 1957 (3) SA (SWA). Executors are appointed by the Master of the High Court in terms of the provisions of section 13 read with the provisions of sections 14, 15, 16 and 18 of the Administration of Estates Act.

words the extent to which an executor is bound to render any contractual performance emanating from a contract concluded by a deceased person is based upon the provisions of the contract in question. The authority for this legal principle can be found in the following cases: Ex parte Weinrich's Executors 1939 CPD 37; Ex parte Becker's Executors1939 CPD 496; Ex parte Wolman 1946 CPD 672; and Hitzeroth v Brooks 1965 3 SA 444 (A) 452 B-D.

Accordingly, if a contract provides for contractual discharge on the death of the debtor it follows that the executor will not be bound by the contract in question. Under such circumstances a deceased estate can be subjected to debt reduction if a debtor happens to die before he/she has fully paid or repaid an outstanding debt. The debt reduction in question will take place at the point in time at which the debtor dies.

As the debt reduction leads to the extinction of a debt or liability, thus in effect benefitting the estate, such conversion should have an impact on a deceased person's liquidation and distribution account. This is as a result of the fact that the reduced amount would not be reflected in the deceased person's liquidation account as a liability. The assets and liabilities of a deceased person are taken into account in the process of calculating the estate duty that is owed by a deceased estate. This means that in the process of calculating the estate duty a debt that has been reduced upon the death of a debtor will not be reflected as a liability that would constitute a deduction from the value of the estate. Such debts cancelled as a result of the death of the person would also have income tax consequences, which will be discussed below.

3.2.2.5.2 The reduction of a debt as a result of the executor's discharge

In the event that a contract does not provide for contractual discharge on the death of the debtor it follows that the executor will be bound by the contract in question beyond the death of a debtor. Under such circumstances debt reduction takes place in the period that follows the death of the debtor. The authority which supports this can be found in the following cases: Friedlander v De Aar Municipality 1944 AD 79 at 93; Lentz v Schroder's Estate 1955 1 SA 366 (E); and Lorentz v Melle 1978 3 SA 1044 (T) 1057.

The debt is included as a liability owed by a deceased person in the deceased's liquidation account, and therefore taken into consideration in the calculation of the estate duty owed by a

deceased estate. These liabilities are deducted from a deceased estates' gross value in terms of section 4 of the Estate Duty Act. Under such circumstances the final point at which debts can be reduced is the point at which an executor obtains his/her discharge from the Master of the High Court. Any debts which remain unsettled at this point cannot be claimed beyond this point. This stems from the provisions of section 56(2) of the Administration of Estates Act. Although the provisions of the relevant section do not expressly stipulate that debts are reduced at this point this inference has been based upon the premise that a debt that can no longer be enforced under such circumstances would be discharged by means of the operation of the law. The implication flowing from section 56(2) of the Administration of Estates Act is that debts which still exist at this point are incapable of being enforced and therefore effectively discharged.

The exact nature of the discharge can be summarized in the following manner. Any debts that are still owed at the point of an executor's discharge would be owed by the deceased estate that the executor represents. Although the executor would be responsible for settling these debts this duty is a fiduciary duty and does entitle the executor to settle such debts in his/her personal capacity. Once an executor has been discharged of his/her official duties any unsettled debts no longer have a legal person against whom they can be enforced or claimed. This effectively deprives creditors with unsettled debts of their personal rights to claim performance through the payment or repayment of such unsettled debts. Ultimately this means that the termination of the legal duty to render performance through the payment or repayment of a debt subsequently terminates the existence of any personal rights in terms of which such performance was due to be rendered.

3.2.2.6 Insolvency

Insolvency is defined by Bertelsmann *et al* (2008) as a collective debt collection mechanism that ensues when debtors fail to pay their debts as they become due. The insolvency of natural persons is regulated by the law of insolvency – that is the Insolvency Act 24 of 1936 and cases decided in relation to the provisions of this Act. The objective of the Insolvency Act, which is based upon a concept known as the *concursus creditorum*, is to achieve due distribution of a debtor's assets among creditors in the order of their preference (Sharrock *et al*: 2012). The insolvency of natural persons accomplishes its end through a process known as sequestration which commences when a court grants a sequestration order in terms of section

12(1) of the Insolvency Act against a debtor, declaring the debtor to be insolvent. Sequestration comes to an end in terms of section 129(1)(a) of the Insolvency Act when yet another process known as rehabilitation takes place.

Technically speaking sequestration commences when a provisional order of sequestration is granted by a court in terms of section 10 of the Insolvency Act. Since this type of sequestration order is only provisional it can be confirmed or set aside. In terms of section 12(1) of the Insolvency Act a court may confirm a provisional sequestration order. If a court is dissatisfied with the basis upon which a petition has been made for the sequestration of the estate of a debtor it may set aside the provisional sequestration order in terms of section 12(2) of the Insolvency Act. Since the provisions of section 10 of the Insolvency Act lack an element of finality it may therefore be more accurate to state that sequestration commences when a court grants a sequestration order against a debtor in terms of section 12(1) of the Insolvency Act.

Provisional orders of sequestration may have certain implications for debt reductions. This is evidenced by the judgment in Mahomed v Lockhat Brothers & Co Ltd 1944 AD 230 at 142. In this Appellate Division case it was pointed out that debtors who have been provisionally sequestrated can avoid insolvency by entering into compromise agreements with their respective creditors. Such compromises are not regulated by the provisions of the Insolvency Act as they are governed by the common law relating to contractual agreements (Sharrock *et al*: 2012). These common-law compromises have the effect of reducing the debts that debtors owe to their creditors. In order for agreements of this nature to be binding they must first be approved by all of the concurrent creditors to whom debtors are indebted. The ruling in Prinsloo en 'n ander v Van Zyl NO 1967 (1) SA 581 (T) 583 stresses the importance of this point. According to this judgment, if the unanimous consent of a debtor's concurrent creditors cannot be obtained a dissenting creditor may nullify the effect of a compromise agreement by applying for the confirmation of the provisional order of sequestration in terms of section 12(1) of the Insolvency Act, which effectively converts the order into a final order of sequestration.

Once a final order of sequestration has been granted by a court in terms of section 12(1) of the Insolvency Act the process of sequestration commences. This process entails divesting a

debtor of the ownership of his or her assets and liabilities (for insolvency law purposes legal objects are known as assets whilst duties to render contractual performance through the repayment of money to creditors are known as liabilities). In De Villiers NO v Delta Cables (Pty) Ltd 1992 (1) SA 9 (A) the Appellate Division held that following the commencement of sequestration ownership of any property belonging to an insolvent debtor vests with the trustee of that insolvent debtor's estate. In the judgment Van Heerden JA pointed out that this finding may be inferred from the interpretation of the provisions of section 20(1)(a) of the Insolvency Act. The divested assets and liabilities, which are known as the insolvent debtor's 'estate', are vested with a trustee specifically appointed to administer the insolvent estate.[14] Such divestment is mandated by the provisions of section 20(1)(a) of the Insolvency Act. This divestment is not absolute and indeed in terms of section 23 of the Insolvency Act there are certain rights and duties which insolvent debtors retain in spite of the sequestration of their estates.

Partnerships, which are normally not regarded as legal persons are granted legal personality in terms of the Insolvency Act.[15] This practice has certain consequences. In terms of section 13 of the Insolvency Act a partnership's estate is capable of being sequestrated. The sequestration of a partnership has the effect of terminating the existence of the partnership (Sharrock *et al*: 2012). When a court sequestrates a partnership estate, section 13(1) of the Insolvency Act provides that the partnership's estate is to be simultaneously sequestrated along with the separate estates of the partners that make up such a partnership. The practice of simultaneously sequestrating partnerships along with their constituent partners excludes *en commandite* and special partners. Sharrock *et al* (2012) explain that when the estate of a person who is a partner (as opposed to the partnership itself) is sequestrated it is not necessary for the partnership estates or the private estates of the other partners to be sequestrated as well. Nevertheless, in such a case, the existence of the partnership would be terminated by the sequestration of the estate of one of its partners.

[14] The term 'estate' was defined in the case of Ex parte Foxcroft 1923 OPD 234. In this case the term 'estate' was defined as a collection of assets and liabilities. Despite this judgment Sharrock, Smith and Van der Linde (2012) contend that a debtor who has only liabilities may still be regarded as having an estate for sequestration purposes. As authority for this argument Sharrock *et al* (2012) cite the case of Miller v Janks 1944 TPD 127 in which the court sanctioned the sequestration of an insolvent person who only had liabilities. In the Miller case the presiding officer Murray J pointed out that an estate is no less an estate because at one time it has only assets, at another time only liabilities and at yet another time both assets and liabilities (Sharrock *et al*: 2012).

[15] Such legal *persona* is granted in terms of the definition of the term 'debtor' as found in section 1 of the Insolvency Act. This definition includes within its ambit partnerships or the estates of partnerships.

After a trustee has been appointed to administer an insolvent estate the assets belonging to the insolvent estate are realised with the purpose of settling the claims that creditors have against the insolvent debtor in question. The realisation of assets belonging to an insolvent estate leads to one of two results, namely a surplus or a deficit. Surpluses occur when the assets of an insolvent estate exceed the liabilities of the estate, whereas deficits arise when the liabilities of an insolvent estate exceed the assets of the estate. If a surplus arises it is possible to use the income realised from the disposal of the assets of an insolvent estate to settle all the liabilities against the insolvent estate in full. Conversely if a deficit arises the amount of income realised from the sale or disposal of assets is insufficient to meet the liabilities of an insolvent estate.

Following the realisation of the assets belonging to an insolvent estate, the proceeds from such realisation are used to settle claims that creditors have against the insolvent debtor. This settlement takes place, in terms of section 113 of the Insolvency Act, through the distribution of realised proceeds amongst the creditors. Furthermore, according to Walker v Syfret 1911 AD 141 these claims are settled in accordance with an order of preference that is determined in terms of the provisions of the Insolvency Act. This order of preference is based upon the classification of the creditors into three categories namely secured, concurrent and preferent creditors. This classification system determines the position or rank that each creditor occupies in relation to the order of preference for receiving outstanding payments from an insolvent debtor's estate.

A 'secured creditor' is defined by Sharrock *et al* (2012: 183) as a creditor who/that holds security for his/her/its claim. The term 'security' is defined in section 2 of the Insolvency Act as property of an insolvent estate over which a creditor has a preferent right by virtue of any special mortgage, landlord's legal hypothec, pledge or right of retention (lien).

The definition of the term 'preferent creditor' can be derived from the definition of the term 'preference' in section 2 of the Insolvency Actin terms of which the term 'preference' is defined as the right to payment of a claim against an insolvent estate out of the assets of the estate in preference to other claims. The definition goes on to note that the term 'preferent' has a corresponding meaning. The problem with this definition is that it is too wide and fails to draw a distinction between secured and unsecured creditors. A strict interpretation of this

definition can lead to the conclusion that secured creditors are preferent creditors on the basis that they receive payment of their claims before other creditors. A narrower definition is adopted by Sharrock *et al* (2012: 184) who define a 'preferent creditor' as a creditor whose claim is not secured but who nevertheless ranks above the claims of concurrent creditors. The specific provisions in terms of which an order of preference is created for preferent creditors can be found in sections 96, 97, 98, 98A, 99, 101, 102 and 103 of the Insolvency Act.

Sharrock *et al* (2012: 182) defines 'concurrent creditors' as the creditors that are paid out of an insolvent estate's free residue after any preferent creditors have been paid.[16] This definition is derived from the provisions of section 103(1)(a) which stipulate that any balance of the free residue that remains after payments have been made to preferent creditors, in terms of sections 96 to 102, should be made to proven unsecured or otherwise non-preferent creditors in proportion to the amount of their respective individual claims.

The relevant provisions of the Insolvency Act that relate specifically to the taxes payable by an insolvent estate are to be found in sections 99(1) and 101(a) of the Act. These provisions list the taxes that must be paid by an insolvent estate, including taxes that were owed by an insolvent person prior to the commencement of sequestration as well as taxes that accrue to an insolvent estate following the commencement of sequestration. Sections 99(1) and 101(a) of the Insolvency Act create a preference for the collection of unpaid income taxes that had been owed by solvent persons prior to the commencement of sequestration. The tax liabilities pertaining to these unpaid taxes arise prior to the commencement of sequestration.

The provisions of section 99(1) of the Insolvency Act stipulate the manner in which the free residue is distributed amongst an insolvent's concurrent creditors. These provisions apply to a broad range of concurrent claims that are settled by any amounts which make up the free residue. Amounts owed to the SARS are simply a component of the various claims set out in section 99(1). Whilst income taxes are specifically accounted for by the provisions of section 99(1)(b) of the Insolvency Act, value-added taxes are specifically accounted for in terms of the provisions of section 99(1)(cD) of the Insolvency Act.

[16] The term 'free residue' is defined in section 2 of the Insolvency Act as the portion of an insolvent estate which is not subject to any right of preference by reason of any special mortgage, legal hypothec, pledge or right of retention (lien).

Any balance of the free residue that still remains after the application of section 99(1) is settled in terms of the provisions of section 101. Section 101(a) of the Insolvency Act creates a general preference for the collection of taxes based upon tax liabilities created in terms of Acts of Parliament; any interest arising from such tax liabilities; and tax liabilities owed by the partners of insolvent partnerships. The fact that these tax liabilities may only become payable after the date of sequestration is immaterial as it does not prevent the application of section 101 of the Insolvency Act. Although the SARS is classified as a preferent creditor, in terms of section 101 of the Insolvency Act, it is important to note that such preference only relates to income that is derived before the date of sequestration. For the purposes of income that is derived after the date of sequestration the SARS is actually classified as a concurrent creditor.

The distribution of the proceeds derived from the realisation of the assets of an insolvent estate paves the way for the rehabilitation of an insolvent debtor. Rehabilitation takes place either through the expiration of a specific time period in terms of section 127A of the Insolvency Act or through a court order of rehabilitation being granted to an insolvent debtor in terms of section 124 of the Insolvency Act. It should be noted that rehabilitation does not apply to partnerships as the provisions of section 128 of the Insolvency Act expressly prevent the rehabilitation of a partnership estate which has been sequestrated.[17] In the case of rehabilitation through the effluxion of time, section 127A of the Insolvency Act provides for the automatic rehabilitation of any insolvent debtor following the expiration of a period of ten years from the date of sequestration of an insolvent debtor's estate.

Rehabilitation takes place in terms of section 124 of the Insolvency Act once a court has granted an insolvent debtor an order of rehabilitation. In contrast to section 127A of the Insolvency Act, section 124 of the Insolvency Act enables insolvent debtors to become rehabilitated before a time period of ten years has elapsed. The provisions of section 124 of the Insolvency Act require an insolvent debtor to make an application for an order of rehabilitation. The application process does not guarantee an insolvent debtor that he or she will be granted an order of rehabilitation. This point is reflected in case law. In Ex parte Woolf 1958 (4) SA 190 (N) the court noted that courts are not obliged to grant rehabilitation orders even where an insolvent debtor has duly complied with the provisions of the

[17] The rationale behind this provision is based on the fact that a partnership estate ceases to exist once it has been sequestrated (Sharrock *et al*: 2012).

Insolvency Act. This would seem to indicate that the court has the discretion of either granting or rejecting an insolvent debtor's application for an order of rehabilitation. This point is reinforced by the judgment in Ex parte Hittersay 1974 (4) SA 326 (SWA) where the court found that an insolvent person does not have a right to rehabilitation.

According to section 124 of the Insolvency Act there are four circumstances under which a rehabilitation order may be sought:

1. If an insolvent debtor's creditors accept an offer of composition (in terms of section 124(1) of the Insolvency Act).[18]
2. If certain periods of time have passed since the confirmation of a trustee's first (liquidation) account (in terms of section 124(2) of the Insolvency Act).
3. If no claim has been proved against an insolvent estate after a period of six months, an insolvent debtor may apply for rehabilitation in terms of section 124(3) of the Insolvency Act.
4. If all the proved claims against an insolvent estate have been settled in full an insolvent debtor may apply for rehabilitation in terms of section 124(5) of the Insolvency Act.

The presence of a deficit in an insolvent estate's liquidation account does not prevent an insolvent estate from being wound up, even though a portion of the claims against such insolvent estates remains unsettled. Under such circumstances the creditors of the insolvent estate accept an offer of composition in terms of the section 119 of the Insolvency Act. A composition as defined in Ochse v Van Aardt 1924 OPD 256 at 271 – 272 and Vlachos v Supermeats Mtuba (Pty) Ltd 1968 (4) SA 35 (D) at 41 – 42 is an agreement between an insolvent and his or her creditors in terms of which the parties agree that the creditor's claims will be settled by payment of an amount that is less than 100 cents in the rand for every claim proved or to be proved against the estate of the insolvent.

According to Bertelsmann *et al* (2008) composition agreements are classified as statutory novations by nature.[19] As legal authority for this position Bertelsmann *et al* cite the case of

[18] The type of composition that is catered for by section 124(1) is statutory by nature as it is regulated by the provisions of section 119 of the Insolvency Act.

Ilic v Parginos 1985 (1) SA 795 (A). Since the novation of a contract leads to a discharge of contractual obligations that existed under the contract, composition agreements, as statutory novations, actually result in the discharge of the contractual obligations that exist between insolvent debtors and their creditors. It is common cause that an insolvent debtor who has concluded a composition agreement with his or her creditors must still apply for rehabilitation. It is submitted that this should not imply that the granting of a rehabilitation order under such circumstances would lead to the discharge of the debtor's contractual duty towards his or her creditors, as it would have already been discharged by the conclusion of the composition agreement.

Rehabilitation has a marked effect on the contractual duties that exist in relation to debts owed to the creditors of an insolvent estate. In the case of a surplus this contractual duty is performed through the full settlement of the claims against an insolvent estate. By contrast in the case of a deficit the contractual duty to render performance through the repayment of debts owed to creditors is not fulfilled due to the impossibility of such performance. In either case the contractual duties vested in an insolvent estate are not discharged simply because the duties have or have not been performed. Christie (2011) provides an explanation as to why the winding up of the insolvent estate does not lead to contractual discharge of the duties vested in an insolvent estate. According to Christie (2011) the process of insolvency suspends the normal methods of contractual discharge and replaces them with a method determined in terms of Insolvency Act instead of contract law. Therefore even if the two ordinary methods of contractual discharge occur after sequestration has already commenced such contractual discharge is not recognised according to the Insolvency Act.

In terms of the Insolvency Act discharge only occurs once the creditors of an insolvent estate have accepted an offer of composition in terms of the section 119 of the Insolvency Act and/or once an insolvent debtor has been rehabilitated in terms of either section 124 or section 127A of the Insolvency Act. According to section 129(1)(b) of the Insolvency Act rehabilitation has the effect of discharging all the debts owed by an insolvent debtor provided

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[19] By itself the statement that composition agreements amount to statutory novations does not state much. The information that it conveys is that composition agreements are novations that are brought into effect by statutory provisions as opposed to the parties to a contract. It does not explain the meaning of the term 'novation' itself. In order to grasp the fuller meaning of the term 'novation' case law defining this term must be consulted. The term 'novation' was defined in Rose v Cloete (1847) 3 M 377. In this case the court defined the term 'novation' as the replacement of an existing obligation by a new one with the subsequent effect of discharging the existing obligation.

that such debts were due before sequestration or that they have a cause that arose before sequestration.[20] In the case of the rehabilitation of a partner's estate rehabilitation has the effect of releasing the partner from all private debts as well as the partner's liabilities for a partnership's debts (Sharrock *et al*: 2012). According to Christie (2011) the discharge effected in terms of section 129(1)(b) of the Insolvency Act, is classified as discharge through the operation of the law.

The discharges have certain implications. In the case of a surplus the discharges enable performance of a contractual duty to be officially recognised. In the case of a deficit the discharge leads to the termination of the insolvent estate's duty to pay any unpaid debts. This absolution from the payment of unpaid debts constitutes debt relief. The discharge of debts through composition agreements and rehabilitation extinguishes the performance that debtors undertake to render to credit providers in terms of credit transactions. Since performance is a legal object to which personal rights are attached (Heaton: 2008),[21] the extinction of such a legal object would leave a credit provider with a personal right that lacks a legal object. This position is untenable in terms of the law.[22] Consequently a credit provider's personal right to claim performance would be extinguished by the extinction of a debtor's duty to render performance. The overall result of the extinction of a credit provider's personal right and a debtor's duty is the termination of any contractual obligations that had been created between the credit provider and the debtor in terms of a credit transaction.

3.2.2.7 <u>Overlap between different methods of debt reduction through the operation of the law</u>

There is an overlap that exists between some of the different methods of debt reduction through the operation of the law. Such overlap occurs in relation to prescription, insolvency and the administration of estates.

[20] It is apparent that debts need not arise prior to sequestration in order to qualify for discharge by rehabilitation. A debt can still be discharged by rehabilitation even if it becomes due after sequestration. The only condition that must be met by a debt which arises after sequestration is that the debt's initial cause must have arisen before sequestration took place. From this it is possible to discern the type of debts which are not discharged by rehabilitation. The only debts that cannot be discharged by rehabilitation are those which arise after sequestration and have a cause which arose after sequestration.

[21] Kruger and Skelton (2010) identify the specific legal rights that are attached to performance. According toKruger and Skelton these rights are known as personal rights.

[22] The position itself is untenable due to the requirement that a legal right should always be attached to some legal object (Hosten: 1995). In the absence of a legal object a legal right simply cannot exist.

3.2.2.7.1 <u>Prescription and insolvency</u>

The process of prescription may sometimes run concurrently with the process of insolvency. When this type of interaction takes place it is regulated simultaneously by the provisions of the Prescription Act as well as those of the Insolvency Act. According to section 13(1)(g) of the Prescription Act read with section 13(1)(i) of the same Act the prescription period is extended as a result of sequestration. These provisions only apply to debts which cannot be collected as a result of sequestration. The provisions only apply to particular debts if the creditors with claims to such debts are able to successfully prove the existence of such claims against an insolvent estate.

The effect of the provisions of sections 13(1)(g) and 13(1)(i) of the Prescription Act is to extend the prescription period so that it can run its course after rehabilitation has taken place. In such cases debts that would have prescribed during the period in which sequestration took place will prescribe one year after rehabilitation has taken place. This may, however, be at odds with the provisions of the Insolvency Act since debts are supposed to be discharged as a result of rehabilitation in terms of the provisions of section 129(1)(b) of the Insolvency Act. This is supported by Bertelsmann *et al* (2008) who contend that the provisions in sections 13(1)(g) and 13(1)(i) of the Prescription Act are unnecessary since claims due before sequestration are discharged at the point of rehabilitation.

3.2.2.7.2 <u>Prescription and the administration of deceased estates</u>

In addition to overlapping with the process of insolvency, the process of prescription may sometimes overlap with the administration of deceased estates, in terms of the provisions of section 13(1)(g) read with the provisions of sections 13(1)(h) and 13(1)(i) of the Prescription Act. These provisions only apply to debts that have not been collected by the time that the administration of a deceased estate has been concluded. It follows that these debts must be owed to creditors who are able to successfully prove the existence of such claims against a deceased estate. In the case of <u>Kilroe-Daley v Barclays National Bank Ltd</u> 1984 (4) SA 609 (A) the Appellate Divisions made it clear that if a claim is rejected then the impediment brought about by the administration of a deceased estate will cease at that point.

The cumulative effect of the provisions of sections 13(1)(g), 13(1)(h) and13(1)(i) of the Prescription Act is to extend the prescription period so that it can run its course after the

Master has confirmed a deceased estate's accounts. The impediment to the completion of prescription that is brought about by administration of a deceased estate ceases to exist once an estate's accounts have been confirmed. Under such circumstances the process of prescription itself comes to a completion upon the effluxion of a period of one year from the date of the confirmation of the deceased estate's final account. The legal principles pertaining to overlap between prescription and the administration of deceased estates have been extracted from case law. The relevant law can be found in the following Appellate Division judgments: Leipsig v Bankorp Ltd 1994 (2) SA 128 (A) 135A-136B; and Kilroe-Daley v Barclays National Bank Ltd 1984 (4) SA 609 (A) 622 C-D.

3.2.2.7.3 Insolvency and the administration of estates

The issue of insolvency is not restricted to living persons, but can arise in the process of administering deceased estates where such estates are insolvent. This gives rise to a situation under which both the Insolvency Act and Administration of Estates Act can be relevant. The relevant Act under which an insolvent deceased estate is wound up ultimately dictates the manner in which debt reduction may occur in relation to insolvent deceased estates.

In order to accommodate the insolvency of deceased estates the Administration of Estates Act contains provisions that specifically address the regulation of insolvent deceased estates in section 34 of the Act. In terms of section 34(1) the executor of a deceased estate is tasked with the duty of establishing the solvency of a deceased estate. If a deceased estate happens to be solvent the executor may proceed to liquidate and distribute the assets of the estate in accordance with the provisions of the Administration of Estates Act. This procedure differs from the one that is to be followed if a deceased estate happens to be insolvent. Should an executor come to the conclusion that a deceased estate is insolvent he/she must notify the creditors of the estate of his/her conclusion. Furthermore the creditors are given a period of notice during which a majority of the creditors must inform the executor (in writing) to surrender the estate under the Insolvency Act. Should a majority of the creditors request that the estate be surrendered under the Insolvency Act, the executor must comply with this request. Thereafter the deceased estate is administered in accordance with the provisions of the Insolvency Act.

If a majority of the creditors do not request that the estate should be surrendered under the Insolvency Act within the specified period of notice, the executor may proceed to administer the estate in term of section 34(2) of the Administration of Estates Act. This method is not the only means through which the executor may proceed to administer an insolvent deceased estate in terms of the Administration of Estates. If the creditors of a deceased estate are prepared to reduce their claims against the estate sufficiently or interested parties pay in an amount that is sufficient to keep the deceased estate solvent the estate may be administered as a solvent deceased estate in terms of the Administration of Estates Act (Meyerowitz: 2010).[23] Where creditors opt to reduce their claims against a deceased estate debt reduction takes place. Under such circumstances the executor proceeds to liquidate and distribute the assets of the estate in accordance with the provisions of the Administration of Estates Act.

In spite of the provisions of section 34(1) of the Administration of Estates Act creditors are not compelled to wait for the executor of a deceased estate to determine the solvency of the estate before they can lodge an application for the compulsory sequestration of the estate. This is apparent from the provisions of section 34(13) as well as relevant case law. The provisions of section 34(13) stipulate that the provisions of section 34 do not prevent the sequestration of any estate in terms of the Insolvency Act. The effects of this provision can be observed in Paarl Board of Executors v Estate Ansell 1916 CPD 8 where the court held that the creditors of a deceased estate could apply for the compulsory sequestration of the respective estate before the executor of the deceased estate had determined the solvency of the estate.

Once a sequestration order declaring a deceased estate to be insolvent has been granted the deceased estate is administered in accordance with the provisions of the Insolvency Act. Consequently the executor of an insolvent deceased estate is divested of his/her estate which then vests in a trustee appointed by the Master of the Supreme Court.

An important question that arises in relation to the overlap between the laws of insolvency and the administration of deceased estates pertains to the point at which debt reduction takes. The answer to this question depends upon the relevant Act under which an insolvent deceased

[23] It must be pointed out that Meyerowitz (2010: 17-1) does not cite any relevant provisions of the Administration of Estates Act or case law as authority for this assertion.

estate is eventually administered. When an insolvent deceased estate is administered in terms of the Insolvency Act debt reduction takes place if the creditors of the insolvent deceased estate accept an offer of composition in terms of section 119 of the Insolvency Act. In contrast when an insolvent deceased estate is administered in terms of the Administration of Estates Act debt reduction can take place if the creditors of an insolvent deceased estate reduce their claims against the estate in order to permit the estate to be administered by the executor as a solvent estate in terms of the Administration of Estates Act. Furthermore any debts which remain unsettled at the point that an executor obtains his/her discharge from the Master of the Supreme Court cannot be claimed beyond this point. [24]

[24] This stems from the provisions of section 56(2) of the Administration of Estates Act. The implication flowing from section 56(2) is that debts which still exist at this point are incapable of being enforced and therefore effectively discharged.

3.3 DEBT REDUCTION METHODS PRIOR TO THE AMENDMENTS TO THE INCOME TAX ACT

Prior to the amendments to the Income Tax Act, the terminology relating to debt reduction in the Income Tax Act did not adequately encompass each and every single method of debt reduction. The manifestation of this problem has been summarised in **Table 1**:

Methods of debt reduction	Terms used in Income Tax Act	Methods of debt reduction covered by Income Tax Act
Effluxion of time; notice; release; waiver; novation; delegation; compromise; assignment of debts; set-off; merger; supervening impossibility of performance; prescription; administration of deceased estates; and insolvency.	Section 8(4)(m) Cancellation, termination or variation of an agreement, prescription, waiver of or release of a claim for payment. Section 20(1)(a)(ii) Concessions and compromises. Paragraph 12(5) of the Eighth Schedule Reduction and discharge.	Section 8(4)(m) Could be applied to all of the different methods of debt reduction, as described in the sub-section. Section 20(1)(a)(ii) Could only be applied to compromises and waivers. Paragraph 12(5) of the Eighth Schedule Could be applied to all of the different methods of debt reduction, as described in the sub-paragraph.

Own formulation

3.4 THE STANDARDISATION OF THE RELEVANT TERMINOLOGY

Prior to the recent amendments there was a problem of terminology which suggested that the tax consequences of debt reductions only applied to voluntary debt reductions. Various terms were used in tax legislation in order to refer to reduced debts, including concessions by creditors, compromise benefits, waived debts, discharged debts and reduced debts. Various terms relating to the "cancellation" of a debt were previously included in the Income Tax Act: "concessions or compromises" (section 20(1)(a)(ii)), "cancellation, termination or

variation of an agreement, prescription, waiver of or release of a claim for payment" (section 8(4)(m)) and "reduced or discharged debts" (paragraph 12(5) of the Eighth Schedule).

The terminology problem was addressed by the amendments to the Income tax Act through the use of standard terminology relating to debt reductions. The specific changes to the legislation can be traced to the definition of the term "reduction amount" in section 19 and paragraph 12A of the Eighth Schedule of the Income Tax Act. These two provisions share a similar definition for the term "reduction amount". In both of these provisions the term "reduction amount" is defined in the following manner:

> " **'reduction amount'**, 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."

The definition of a "reduction amount" clearly incorporates all forms of debt reduction within the ambit of the new debt reduction provisions of the Income Tax Act. This has helped to eliminate the problem that had existed as a result of the manner in which the provisions of section 20(1)(a)(ii) had been framed.

3.5 CONCLUSION

The analysis in this chapter addressed three matters. Firstly, it provided an extensive overview of the different methods of debt reduction. Secondly, it described the terminology used in the key provisions of the Income Tax Act, which used to apply to reduced debts prior to the recent amendments, and how such terminology failed to adequately include the various forms of debt reduction. Thirdly, it described the manner in which the recent amendments to the Income Tax Act standardised the terminology, so that the various forms of debt reduction are now included within the ambit of the Income Tax Act.

The various methods through which debt reductions arise were analysed. All in all there are at least fourteen different methods which were identified. These different methods of debt reduction were divided into two broad categories. Debts may be reduced through agreements reached between contracting parties or through the operation of law.

Debt reductions through contractual agreements arise when the parties to existing contracts agree to vary or discharge their contracts either formally or informally. This category encompasses the following debt reduction methods:

- Effluxion of time;
- Notice;
- Release;
- Waiver;
- Novation;
- Delegation;
- Compromise; and
- Assignment of debts.

Debt reductions through the operation of the law involve the suspension of the legal principles that normally apply in terms of contract law. As such, contractual obligations are suspended. This category encompasses the following debt reduction methods:

- Set-off (*compensatio*);
- Merger (*confusio*);
- Supervening impossibility of performance;
- Prescription;
- Administration of deceased estates; and
- Insolvency.

The analysis of the different methods of debt reduction which arise through the operation of the law revealed that there is an overlap that exists between some of the different methods, namely prescription, insolvency and the administration of estates. The manner in which these different methods of debt reduction overlap with one another can be summed up in the following manner:

- prescription and insolvency;
- prescription and the administration of deceased estates; and
- insolvency and the administration of estates.

The chapter then proceeded to explore the key provisions of the Income Tax Act, which used to apply to reduced debts prior to the recent amendments: sections 8(4)(m), 20(1)(a)(ii) and paragraph 12(5) of the Eighth Schedule. Prior to the recent amendments various terms relating to the "reduction" of a debt were included in the Income Tax Act: "concessions or compromises" (section 20(1)(a)(ii)), "cancellation, termination or variation of an agreement, prescription, waiver of or release of a claim for payment" (section 8(4)(m)) and "reduced or discharged debts" (paragraph 12(5) of the Eighth Schedule). This led to a discrepancy

between the some of the provisions of the Income Tax Act and the various debt reduction methods.

The terminology problem which arose in terms of the provisions of the Income Tax Act was addressed by the recent amendments to the Act through the use of standard terminology – the use of the term "debt reduction" – relating to the different methods of debt reduction in section 19 and paragraph 12A of the Eighth Schedule of the Income Tax Act.

During the analysis in the chapter it became apparent that the treatment of two methods of debt reduction – reduction through death and reduction through the insolvency of natural persons – is complex and requires that special attention be directed to the provisions of certain statutes. Although the relevant statutes – in this case the Administration of Estates Act and the Insolvency Act – were discussed, there are other aspects relating to these two debt reduction methods that were not addressed. These other aspects are linked to the presence, in both the Income Tax Act and the Value-added Tax Act, of provisions that apply specifically to the administration of estates and the insolvency of natural persons. Consequently the tax consequences of any debt reduction that arises within the context of these two debt reduction methods must take these provisions into consideration.

In the chapter that follows an analysis will be conducted into the nature of the provisions of the Income Tax Act which apply specifically to the administration of estates and the insolvency of natural persons. A discussion of the provisions of the Value-added Tax Act will be deferred to the seventh chapter of this thesis.

CHAPTER 4: INCOME TAX PROVISIONS RELATING TO THE ADMINISTRATION OF ESTATES AND INSOLVENCY

4.1 INTRODUCTION

The analysis in the preceding chapter addressed three matters. Firstly, it provided an overview of the different methods of debt reduction. This involved categorising fourteen different methods of debt reduction into two broad categories – debt reduction through contractual obligations and debt reduction through the operation of the law. Secondly, it described the terminology used in the Income Tax Act that applied to reduced debts prior to the recent amendments, demonstrating that the terminology did not include the various forms of debt reduction. Thirdly, it described the recent amendments to the Income Tax Act, which now deals with the various forms of debt reduction.

Debt reductions which arise within the context of death and insolvency were discussed and it was found that debt reduction may arise within the context of death under three circumstances:

- as a direct result of the death of a debtor;
- if the creditors of a deceased estate reduce their claims against the estate to the extent necessary to keep the deceased estate solvent, the reduced claims constitute reduced debts; or
- as a result of the discharge of an executor of a deceased estate from his/her official duties in terms of section 56(2) of the Administration of Estates Act.

Debt reductions may arise within the context of the insolvency of natural persons under two circumstances:

- once the creditors of an insolvent estate have accepted an offer of composition in terms of section 119 of the Insolvency Act; or
- once an insolvent debtor has been rehabilitated in terms of either section 124 or section 127A of the Insolvency Act any debts still owed by an insolvent debtor are reduced in terms of section 129(1)(b) of the Insolvency Act.

In addition to the debt reduction provisions in the Income Tax Act, there are other provisions that apply specifically to the administration of deceased estates and the insolvency of natural

persons. Consequently debt reduction arising within the context of death and the insolvency of natural persons is regulated by the provisions of the Income Tax Act on the one hand and either the Administration of Estates Act (in the case of death) or the Insolvency Act (in the case of the insolvency of natural persons).

The provisions of the Administration of Estates Act as well as the Insolvency Act which are concerned with the reduction of debts have already been discussed in the preceding chapter. This chapter seeks to provide a holistic picture by explaining the nature of the provisions of the Income Tax Act which apply to the administration of deceased estates and the insolvency of natural persons, to the extent that these provisions relate to the reduction of debts.

4.2 INCOME TAXATION AND THE ADMINISTRATION OF DECEASED ESTATES

The link between income tax and the administration of deceased estates is based on an interaction between the two respective legal fields. As has been explained in chapter three, the death of a person leads to the administration of the deceased person's estate and the subsequent liquidation and distribution of the estate. The transfer of property that takes place in the process gives rise to certain income tax consequences. Furthermore there are certain deemed transfers of property that also give rise to income tax consequences.

After the death of a person there are two entities with which the SARS becomes concerned for tax purposes:

- a deceased person in the year of his/her death; and
- a deceased person's estate.

4.2.1 Taxation of deceased persons

All natural persons may be subjected to income taxes whilst they are alive and immediately after they have died. Prior to their deaths all natural persons are classified as taxpayers in terms of section 1 of the Income Tax Act. The relevant provisions in this respect are to be found in the respective definitions of the terms 'taxpayer' and 'person' in section 1 of the Act. After a person has died he/she ceases to be a legal person for all general legal purposes. This means that a deceased person cannot be classified as a person in terms of section 1 of the Income Tax Act. According to Stiglingh, Koekemoer, van Schalkwyk, Wilcocks and de Swardt (2012), the fact that a deceased person ceases to exist as a taxpayer does not mean

that any normal tax that had been payable on the income derived by a deceased person prior to his/her death will also cease to exist. Such normal taxes continue to exist as tax liabilities. Since these tax liabilities cannot be settled by a deceased taxpayer, the burden of settling the outstanding tax liabilities falls on the estate of the deceased taxpayer.

Although a deceased estate is not a legal person in the strictest legal sense, deceased estates have been afforded such legal personality for tax purposes in order to facilitate the collection of tax liabilities that are owed by deceased taxpayers at the point of their deaths, in terms of the definition of the term ‘person’ in section 1 of the Income Tax Act and the classification of deceased estates as taxpayers. Paragraph (e) of the definition of a ‘representative taxpayer’ in section 1 of the Income Tax Act recognises the executor or administrator of a deceased estate as the representative taxpayer in respect of the income received by or accrued to any deceased person during his/her lifetime as well as the income received by or accrued to the estate of any deceased person after the person’s death.

The provisions of paragraph (e) of the definition of a ‘representative taxpayer’ in section 1 of the Income Tax Act are supplemented by the provisions of sections 153 and 154 of the Tax Administration Act. Section 153(1) offers its own definition of a “representative taxpayer”. This definition includes any person appointed as a representative taxpayer in terms of the Income Tax Act. Paragraph (e) of the definition of a “representative taxpayer” in section 1 of the Income tax Act and section 153(1) of the Tax Administration Act are to be read together. This results in the classification of the executors of deceased estates as the representative taxpayers of deceased estates. Section 154 of the Tax Administration Act makes it clear that the executor of a deceased estate would not be subject to taxation in his/her personal capacity but rather in his/her capacity as the representative taxpayer of a deceased estate.

In addition to the normal tax consequences there are capital gains tax consequences which arise as a result of the death of a taxpayer. In terms of paragraph 40(1) of the Eighth Schedule of the Income Tax Act a deceased person must be treated as having disposed of his/her assets for an amount received or accrued that is equal to the market value of those assets at the date of that person’s death. Paragraph 40(1A) of the Eighth Schedule of the Income Tax Act adds clarity to the provisions of paragraph 40(1) by identifying the parties to whom such deemed

disposals are made namely the estate of a deceased person and the heirs or legatees of a deceased taxpayer.

4.2.2 Debt reduction, income taxation and the administration of deceased estates

The nature of debt reduction within the context of the administration of estates has already been addressed in chapter three. In the discussion it was pointed out that under normal circumstances debt reduction takes place at the moment a person dies or when an executor of a deceased estate ultimately receives his/her discharge from the Master of the High Court. Each of these two modes of debt reduction occurs at different stages of the administration process. The former occurs at the very beginning whilst the latter at the very end. When debt reduction takes place at the point of a taxpayer's death the subsequent tax consequences are associated with the deceased taxpayer. The income derived or deemed to have been derived from the debt reduction is included in taxable income that was received by or which accrued to a deceased taxpayer before his/her death. When debt reduction takes place when an executor of a deceased estate receives his/her discharge from the Master of the High Court, the subsequent tax consequences are associated with the deceased estate. This means that such debt reduction is included in the taxable income of the estate.

The lack of sufficient assets to meet the liabilities of a deceased estate introduces another dimension into the issue of debt reduction and the subsequent income taxes. If the creditors of a deceased estate reduce their claims against the estate sufficiently in order to keep the deceased estate solvent the reduced claims constitute reduced debts. The debt reduction takes place after the death of a taxpayer but prior to the discharge of the executor of the deceased taxpayer's estate. The income tax consequences of such debt reduction are borne by the deceased estate of the deceased taxpayer.

4.3 INCOME TAXATION AND THE INSOLVENCY OF NATURAL PERSONS

4.3.1 The income tax consequences

The income tax consequences of the insolvency of natural persons are a result of the interaction of the provisions of sections 1 and 66(13)(a) of the Income Tax Act, sections 153 and 154 of the Tax Administration Act as well as sections 99(1)(b) and 101 of the Insolvency

Act.[25] Collectively these provisions regulate the taxation of income attributable to insolvent debtors (prior to the commencement of sequestration as solvent debtors and after the commencement of sequestration as insolvent debtors) as well as insolvent estates. The provisions apply to the period that occurs prior to sequestration up to the moment when an insolvent estate is finally wound up.

The provisions of the Income Tax Act create two distinctions between different taxpayers. The first distinction relates to the recognition of debtors prior to and after the period following sequestration as two separate taxpayers. The second distinction relates to the recognition of insolvent estates as persons for the purpose of the Income Tax Act that exist independently of insolvent debtors. The separation of the tax *persona* of debtors is accomplished through the application of the provisions of sections 1 and 66(13)(a) of the Income Tax Act and sections 153 and 154 of the Tax Administration Act.

The Income Tax Act makes a distinction between the legal *persona* of taxpayers who undergo sequestration. Once sequestration has commenced the Income Tax Act treats an insolvent debtor as a separate taxpayer from the one that is recognised prior to the commencement of sequestration. In terms of the definition of the term ‘taxpayer’ read with the definition of the term ‘person’ in section 1 of the Income Tax Act, all legal persons are classified as taxpayers. The application of these two definitions does not change after sequestration has commenced. The separation in the legal *persona* of an insolvent debtor is accomplished by the provisions of section 66(13)(a)(b) of the Income Tax Act which regulate the submission of tax returns by taxpayers. In terms of section 66(13)(a)(b) of the Income Tax Act separate returns must be submitted for the period preceding the date of sequestration on the one hand and the period commencing on the date of sequestration on the other hand. As a result of the provisions of section 66(13)(a)(b)(i) of the Income Tax Act a debtor – whilst still classified as a solvent debtor – submits tax returns up to the date on which his or her estate is sequestrated. Following the sequestration date the same debtor – having been classified as an insolvent debtor – must now submit a separate set of tax returns in terms of

[25] Although the provisions of sections 79B(1A) and 20(1)(a)(i) of the Income Tax Act also apply after sequestration has commenced such application only arises if sequestration is set aside prior to the winding up of an insolvent estate. As a result these provisions are inapplicable in instances where sequestration culminates in rehabilitation.

section 66(13)(a)(b)(ii) of the Income Tax Act, for the period commencing on the date of sequestration until the end of that tax year.

The SARS considers the submission of tax returns made in terms of section 66(13)(a)(b)(i) of the Income Tax Act on the one hand and section 66(13)(a)(b)(ii) of the Income Tax Act on the other hand as submissions made by two different taxpayers. This is clear from the provisions of paragraph 3.1 of Interpretation Note No. 8 (SARS: 2013) issued in relation to the Income Tax Act, which addresses the assessment of insolvent persons for tax purposes prior to and following the commencement of sequestration. According to paragraph 3.1 of the Interpretation Note an insolvent person will be assessed as a natural person for the period prior to insolvency as well as for the period subsequent to insolvency, should any income accrue to him or her in his or her personal capacity. The SARS' interpretation in this regard resembles the distinction that the Insolvency Act makes between a debtor prior to and following the commencement of sequestration. The primary difference between the approach adopted in the Income Tax Act and the Insolvency Act in this regard lies in the fact that, unlike the Income Tax Act, the Insolvency Act, whilst recognising a change in the solvency of a debtor as a result of sequestration, does not go as far as to regard the same debtor in these two time periods as two different legal persons.

The Income Tax Act also differs from the Insolvency Act in the manner in which it treats the insolvent estate. In terms of the Income Tax Act the insolvent estate is regarded as a legal person. The recognition of insolvent estates as legal persons is a deviation from the normal practice in law. Such recognition is made possible through various provisions in the Income Tax Act. Firstly, the term insolvent estate as defined in section 1 of the Income Tax Act is the same as the definition that is given in section 2 of the Insolvency Act. Secondly, the definition of the term 'person' in section 1 of the Income Tax Act includes insolvent estates within its ambit. Since all 'persons' are categorised as taxpayers in terms of the definition of the term 'taxpayer' in section 1 of the Income Tax Act, this categorisation effectively classifies insolvent estates as taxpayers separate from their insolvent debtors. This is confirmed by the provisions of paragraph 3.2 of Interpretation Note No. 8 (SARS: 2013) issued in relation to the Income Tax Act in terms of which an insolvent estate must be registered for income tax purposes as a separate entity.

The existence of an insolvent estate as a legal person for tax purposes is further enhanced by the provisions of section 66(13)(a)(b) of the Income Tax Act, which have the effect of separating the estate of a solvent debtor prior to sequestration from the debtor's insolvent estate following the commencement of sequestration. The provisions of section 66(13)(a)(b) of the Income Tax Act apply to the time period occurring prior to as well as after the commencement of sequestration. Sub-section (13)(a)(b)(i) of the Income Tax Act covers the time-period that occurs prior to the commencement of sequestration, while sub-section (13)(a)(b)(ii) of the Income Tax Act covers the time-period that occurs after sequestration has commenced. An insolvent estate is only separated from a legal person upon the commencement of sequestration and can only come into being as a person for tax purposes once sequestration has commenced. In terms of section 66(13)(a)(b)(ii) of the Income Tax Act an insolvent estate must submit a set of tax returns for the period commencing on the date of sequestration until the end of that tax year. The provisions of section 66(13)(a)(b)(ii) of the Income Tax Act are supplemented by the provisions of paragraph 3.5 of Interpretation Note No. 8 (SARS: 2013) issued in relation to the Income Tax Act, according to which submissions of tax returns must be made by a trustee on behalf of an insolvent estate for the period covering the date of sequestration up to the date on which the estate is finally wound up.

Since the provisions in sections 1 and 66(13)(a)(b)(ii) of the Income Tax Act as well as paragraph 3.5 of Interpretation Note No. 8 serve the purpose of separating the estate of a solvent debtor in the period prior to sequestration from the debtor's insolvent estate following the commencement of sequestration this necessitates a tax collection mechanism that can accommodate these two separate estates. This is necessary in light of the fact that section 66(13)(a)(b)(i) of the Income Tax Act only permits a debtor to submit tax returns up to the date on which his or her estate is sequestrated. After this date the solvent debtor – as he or she existed prior to sequestration – ceases to exist as a taxpayer. Nevertheless the taxes for which such a debtor would have been assessed up to the date of sequestration must be paid – even though from a practical point of view the taxes would be owed by a taxpayer who would no longer exist once sequestration has commenced. The taxes assessed up to the date of sequestration become a tax liability owed to the SARS. The responsibility of settling this liability falls on the trustee of an insolvent estate.

In terms of paragraph (f) of the definition of a "representative taxpayer" in section 1 of the Income tax Act, a trustee of an insolvent estate is a 'representative taxpayer' in respect to the income that has either been received by or has accrued to the insolvent estate in question. This bestows upon a trustee the responsibility of paying taxes on behalf of an insolvent estate. The responsibilities of a trustee of an insolvent estate are further supplemented by the provisions of sections 153 and 154 of the Tax Administration Act. Section 153(1) offers its own definition of a "representative taxpayer". This definition includes any person appointed as a representative taxpayer in terms of the Income Tax Act. Paragraph (f) of the definition of a "representative taxpayer" in section 1 of the Income tax Act and section 153(1) of the Tax Administration Act are to be read together. This results in the classification of the trustees of insolvent estates as the representative taxpayers of insolvent estates. Section 154 of the Tax Administration Act makes it clear that the trustee of an insolvent estate would not be subject to taxation in his/her personal capacity but rather in his/her capacity as a representative taxpayer.

In terms of the responsibilities bestowed upon him or her, a trustee of an insolvent estate must submit tax returns that cover the affairs of the two estates being administered. These tax returns must be submitted for the period covering the date of sequestration up to the date on which the estate is finally wound up. The date on which an insolvent estate is finally wound up is more than just an indicator of the last day of the period that tax returns submitted on behalf of an insolvent estate must cover, it also marks the finalisation of the distribution of proceeds derived from the realisation of the assets belonging to the insolvent estate.

4.3.2 Winding up of an insolvent estate

The extent to which proceeds are distributed amongst the creditors of an insolvent estate is determined by the relationship that exists between the value of the assets and liabilities of an insolvent estate. In other words the extent of the distribution is determined by the proceeds that are available for distribution. This is in turn influenced by the presence of a surplus or deficit in an insolvent estate's accounts. A surplus in the estate leads to the full settlement of claims against an insolvent estate and the tax liabilities that are owed to the SARS are also settled in the process. An insolvent estate can thereafter cease to exist for tax purposes, and tax returns are no longer submitted on behalf of an insolvent estate.

Where there is a deficit in the estate it is impossible to fully settle all the claims against the insolvent estate. There is no guarantee that the SARS will receive any taxes that were owed by an insolvent estate that experiences a deficit, as there are other liabilities that rank ahead of tax liabilities owed to the SARS in terms of the order of preferences determined in terms of the provisions of the Insolvency Act. The SARS is ranked as a preferent creditor, but the SARS' claims against insolvent estates rank below any secured creditors' claims. In addition to this there are other preferent claims that rank ahead of the SARS' claims against insolvent estates. These claims are: funeral and death-bed expenses (in terms of section 96 of the Insolvency Act); costs of sequestration (in terms of section 97 of the Insolvency Act); costs of execution (in terms of section 98 of the Insolvency Act); and the salaries or remuneration of employees (in terms of section 98A of the Insolvency Act).

The presence of a deficit does not prevent an insolvent estate from being wound up, even though a portion of the claims against such insolvent estates remains unsettled. Such insolvent estates can no longer exist for tax purposes since any unpaid taxes cannot be recovered. Therefore, as is the case of surpluses, following the date on which an insolvent estate has been wound up, tax returns are no longer submitted on behalf of an insolvent estate that has experienced a deficit.

There are other tax implications that should arise from the failure to fully settle all the claims against an insolvent estate as a result of a deficit. These tax implications arise once creditors of the insolvent deceased estate accept an offer of composition in terms of the Insolvency Act or once an insolvent debtor has been rehabilitated.

4.3.3 Composition

The debt reduction brought about by statutory composition has tax implications. Not only do composition agreements lead to debt reduction but such debt reduction in turn ultimately gives rise to income tax consequences in terms of the provisions of the Income Tax Act. This means that the reduction of any debts owed to creditors by an insolvent estate is followed by an increase in the estate's income tax liability.

4.3.4 Rehabilitation

Whenever a deficit has arisen, rehabilitation has the effect of providing an insolvent debtor with debt relief in terms of the provisions of section 129(1)(b) of the Insolvency Act, which have the effect of discharging any debts that an insolvent estate fails to settle as a result of a deficit. This implies that debts reduced as a result of rehabilitation should lead to the successful imposition of income taxes. Reduced debts have been defined as complete or partial reductions of the legal duties that require debtors to render performance to creditors through the payment or repayment of money. The provisions of sections 119 and 129(1)(b) of the Insolvency Act have the effect of reducing (either partially or completely) the legal duties that require debtors to render performance to creditors through the payment or repayment of money. As such these provisions give rise to reduced debts.

4.3.5 The effect of the separate legal personalities

The provisions of sections 1 and 66(13)(a) of the Income Tax Act and sections 153 and 154 of the Tax Administration Act create a distinction between insolvent estates and insolvent persons. Insolvent estates are treated as taxpayers and come into existence following the commencement of sequestration. Unlike in the case of the Insolvency Act, however, whereby insolvent estates cease to exist when rehabilitation takes place, the SARS treats the termination of the existence of insolvent estates in a different manner.

The manner in which the SARS treats insolvent estates is outlined in the SARS' Interpretation Note No. 8 (SARS: 2013) issued in relation to the Income Tax Act, in terms of which insolvent estates cease to exist for income tax purposes before rehabilitation even takes place. According to paragraph 3.5 of Interpretation Note No. 8 insolvent estates cease to exist for tax purposes on the day on which the estates are finally wound up. The result of the SARS' practice in this regard is that the rehabilitation of insolvent debtors takes place in terms of the Insolvency Act after their insolvent estates have already ceased to exist for income tax purposes.

4.4 CONCLUSION

The purpose of this chapter was to discuss debt reduction in the context of the administration of deceased estates and the insolvency of natural persons. Whilst the preceding chapter

discussed the aspects of each of these two debt reduction methods, it did not deal with the aspects which are regulated by the provisions of the Income Tax Act.

The income tax consequences of debt reduction stemming from the death of a taxpayer as well as the insolvency of a natural person were analysed in detail. The reduction of debts through the death of a taxpayer has tax consequences which are either attributed to a deceased person in the year of his/her death or the deceased person's estate following his/her death. The tax consequences which take place as a result of the death of a taxpayer are influenced by the nature of debt reduction in the context of death. This means the relevant tax consequences arise either at the point of death or after the occurrence of death. If the debt cancellation in question takes place at the point of a taxpayer's death the tax consequences which arise are attributed to the deceased person in the year of his/her death. Conversely if debt cancellation takes place after the death of a taxpayer the respective tax consequences are attributed to the deceased person's estate. Under such circumstances the outcome itself is regulated by a few provisions from the Income Tax Act and the Tax Administration Act which can be summarised in the following manner:

- the definitions of the terms "person" and "taxpayer" in section 1 of the Income Tax Act which collectively recognise deceased estates as legal persons; and
- paragraph (e) of the definition of a 'representative taxpayer' in section 1 of the Income Tax Act and sections 153 and 154 of the Tax Administration Act which recognise the executor of an insolvent estate as a representative taxpayer acting on behalf of a deceased estate.

The reduction of debts through the the insolvency of natural persons is only attributed to the insolvent estate. This is in accordance with certain provisions of the Income Tax Act which can be summed up as follows:

- the definitions of the terms "insolvent estate" "person" "taxpayer" in section 1 which collectively recognise insolvent estates as legal persons;
- paragraph (f) of the definition of a 'representative taxpayer' in section 1 which recognises the trustee of an insolvent estate as a representative taxpayer acting on behalf of an insolvent estate; and

- section 66(13)(a)(b)(ii) in terms of which insolvent estates must submit their own set of tax returns for the period covering the commencement of sequestration till the end of the tax year in which they are finally wound up.

Although the discussion in this chapter provided a more holistic picture of the nature of debt reduction through death or the insolvency of natural persons, this discussion is still incomplete as it has not fully addressed the tax consequences that arise from the reduction of debts.

A clear explanation of the tax consequences of debt reduction can be constructed through a detailed analysis of the relevant tax laws that apply to the reduction of debts. In this respect there are two pieces of legislation that are relevant: the Income Tax Act, which applies to the income tax consequences of debt reductions, and the Value-Added Tax Act, which applies to the value-added tax consequences of debt reductions. In the chapter which follows the income tax consequences of debt reductions will be subjected to a detailed analysis. The analysis of the value-added tax consequences of debt reductions will be presented in the seventh chapter.

CHAPTER 5: THE INCOME TAX CONSEQUENCES OF DEBT REDUCTION

5.1 INTRODUCTION

The preceding chapter discussed debt reduction in the context of the administration of deceased estates and the insolvency of natural persons. In the process a more holistic picture of the nature of these two methods of debt reduction was developed through the explanation of the specific provisions of the Income Tax Act which apply to the administration of deceased estates and the insolvency of natural persons. The income tax consequences arising from the reduction of debts are addressed by specific debt reduction provisions. The so-called debt reduction provisions are found in sections 8(4)(a), 11(i), 19, 54, 55(1), 55(3), 59 and 60 as well as paragraphs 12A, 35(1)(a), 35A and 56 of the Eighth Schedule to the Income Tax Act.

The purpose of this chapter is to provide an explanation of the income tax consequences that currently apply to the different methods of debt reduction. After furnishing a general overview of the income tax consequences of debt reduction the discussion in the present chapter will proceed to provide an explanation of the nature of these tax consequences, through a detailed analysis of the debt reduction provisions. The analysis in this chapter takes cognisance of the fact that the recent amendments to the Income Tax Act deleted some of the debt reduction provisions from the Act and subsequently replaced them with new provisions. In terms of the recent amendments sections 8(4)(m) and 20(1)(a)(ii) as well as paragraphs 12(5) and certain portions of 13(1)(g)(ii) of the Eighth Schedule were deleted from the Income Tax Act. These provisions were replaced by section 19, paragraph 12A of the Eighth Schedule and certain portions of section 8(4)(a).

The new provisions which have been added to the Income Tax Act are discussed in conjunction with the deleted provisions. The discussion is divided in accordance with the tax consequences experienced by the two sets of persons that serve as parties to credit transactions – namely, debtors and creditors. The provisions relating to debt reduction do not apply uniformly to debtors and credit providers. The discussion of the debt reduction provisions has been further sub-divided on the basis of the nature of the capital or revenue nature of the debts that are reduced and the discussion of the debt reduction provisions has

been divided into provisions which fall within the ambit of normal tax and those which fall within the scope of capital gains tax.

The effects of the old and new provisions will be discussed in the context of two categories into which the recent amendments fall – namely, the terminology used in order to refer to reduced debts and the nature of the tax relief granted to financially distressed debtors who had experienced debt reduction.

5.2 THE INCOME TAX CONSEQUENCES OF DEBT REDUCTION

The taxes imposed in terms of the Income Tax Act are imposed on taxable income, which in terms of section 1 of the Income Tax Act is defined as an aggregate of two types of amounts, namely:

(1) the amount that remains after certain amounts have been deducted from a person's income on the one hand; and

(2) all other amounts that are expressly included or deemed to be included in the taxable income of any person on the other hand.

Swart (2003) refers to the taxable income definition as a statutory formula comprised of certain basic elements. The basic elements of this statutory formula are gross income, permissible exemptions, deductions, allowances, assessed losses and amounts that are expressly included (by provisions of the Income Tax Act) within the ambit of taxable income, including capital gains. Therefore, in order for income to be subjected to tax it must be capable of being classified as either gross income or an amount that is expressly included within the ambit of taxable income.

This statutory formula for determining taxable income can be applied to the taxation of reduced debts. In this respect it is possible to determine whether reduced debts are classified as gross income or as amounts expressly included within the ambit of taxable income. The income tax consequences which apply to the different methods of debt reduction arise in terms of the provisions of sections 8(4)(a), 11(i), 19, 54, 55(1), 55(3), 59 and 60 as well as paragraphs 12A, 35A, 35(1)(a) and 56 of the Eighth Schedule to the Income Tax Act. These

provisions do not apply uniformly to debtors and credit providers. Whereas sections 8(4)(a), and 19 as well as paragraphs 12A and 35(1)(a) of the Eighth Schedule of the Income Tax Act apply to debtors; sections 11(i), 54, 55(1), 55(3), 59, 60 as well as paragraphs 35A and 56 of the Eighth Schedule of the Income Tax Act apply to creditors.

5.3 TAX CONSEQUENCES ASSOCIATED WITH DEBTORS

The provisions of sections 8(4)(a) and 19 as well as paragraphs 12A and 35(1)(a) of the Eighth Schedule of the Income Tax Act are applicable to debtors. The provisions of sections 8(4)(a) and 19 of the Income Tax Act only apply to debts which have been incurred in relation to deductible expenditure.[26] In contrast the provisions of paragraphs 12A and 35(1)(a) of the Eighth Schedule of the Income Tax Act apply to reduced debts even if such debts have not been incurred in relation to deductible expenditure.

Some of the debt reduction provisions have been affected by the recent amendments to the Income Tax Act. Due to the significance of these changes the new provisions which have been added to the Income Tax Act have been discussed in conjunction with the deleted provisions.

5.3.1 The provisions relating to normal tax

The relevant provisions in sections 8(4)(a) and 19 which relate to reduced debts are new additions to the Income Tax Act. The precursors to these sections that were deleted by the provisions of the Taxation Laws Amendment Act, 2012 are sections 8(4)(m) and 20(1)(a)(ii). Although the Taxation Laws Amendment Act, 2012 was officially promulgated on the 1st February 2013 the amendments brought about by the Act actually came into operation retrospectively on the 1st January 2013.

5.3.1.1 Section 8(4)(m) of the Income Tax Act

The provisions of section 8(4)(m) of the Income Tax Act applied to recoupments that arose when debtors were relieved (either partially or in full) of the legal duty to make payment for any expenditure that had been incurred during a year of assessment. In order for these

[26] This is expenditure in terms of which a tax deduction or capital allowance has been allowed in terms of the provisions of the Income Tax Act.

provisions to apply the debt-relief in question had to stem from the cancellation, termination or variation of an agreement, prescription, waiver or the release of a claim for payment. Whenever any of the different causes of debt-relief took place debtors were deemed to have recovered or recouped an amount that was equal to the amount of a debt that had been subjected to debt relief if the following two requirements were met:

1. if the expenditure in question had not yet been repaid at the moment that the debt relief took place; and
2. if a deduction from income for the expenditure or an allowance in relation to the expenditure had been allowed in the current or any previous year of assessment.

In order to prevent an overlap with the provisions of section 20(1)(a)(ii) of the Income Tax Act the provisions of section 8(4)(m) of the Income Tax Act were subject to the provisions of section 20(1)(a)(ii) of the Income Tax Act. Since the provisions of sections 20(1)(a)(ii) and 8(4)(m) of the Income Tax Act were mutually exclusive the provisions of section 8(4)(m) of the Income Tax Act were only applicable under the following conditions:

1. when the cancellation of a debt occurred in the absence of an assessed loss; or

2. when an assessed loss existed, the amount of the assessed loss had to be smaller than the reduced debt. If this was the case a recoupment would still take place even after an assessed loss had been eliminated in terms of the provisions of section 20(1)(a)(ii) of the Income Tax Act.

If an assessed loss happened to be greater than a reduced debt then the reduced debt would prove to be insufficient for the purposes of eliminating the assessed loss. Under such circumstances it would not have been possible for the provisions of section 8(4)(m) of the Income Tax Act to become applicable.

5.3.1.2 Section 20(1)(a)(ii) of the Income Tax Act

The provisions of section 20(1)(a)(ii) of the Income Tax Act applied to the reduction of assessed losses when compromises were arrived at by creditors and debtors or when

concessions were granted by creditors to their debtors.[27] These provisions become applicable when a debtor benefited from the reduction or extinction of a debt by creditors. As a result of the application of the provisions of section 20(1)(a)(ii) of the Income Tax Act, assessed losses were reduced by an amount that was equal to the amount of a debt that had been reduced or extinguished.

The provisions of section 20(1)(a)(ii) themselves were subject to the provisions of sub-paragraphs (aa) and (bb). Section 20(1)(a)(ii)(aa) of the Income Tax Act restricted the set-off of assessed losses to amounts advanced by creditors which were used, directly or indirectly, by debtors in order to fund expenditure or the acquisition of an asset. Section 20(1)(a)(ii)(bb) of the Income Tax Act added another restriction by requiring that a tax deduction be allowed in terms of section 11 of the Income Tax Act in relation to such expenditure or acquisition of an asset before the set-off of assessed loss could be permitted.

Compromise benefits could only be set-off against the balance of assessed losses at the end of the year during which a compromise had taken place. This principle was formulated in the Appellate Division case of Commissioner of Inland Revenue v Louis Zinn Organization (Pty) Ltd 1958 (4) SA 477 (A). In this case the court held that a compromise benefit received by a taxpayer in one year could only be used in order to reduce the balance of assessed loss that still existed at the end of that particular year.

The provisions of section 20(1)(a)(ii) contain the following elements that were set out as follows by De Koker and Williams (2012):

1. There had to be a benefit;
2. The benefit must have had a value or amount;
3. The benefit must have been received by or accrued to the person concerned;
4. The benefit must have resulted from a concession granted or a compromise made with creditors;

[27] It should be pointed out that the term concessions may be used interchangeably with the term waivers since both terms involve a unilateral action in terms of which a creditor undertakes to release a debtor of the duty to render contractual performance through payment.

5. The concession or compromise must have resulted in the taxpayer's liabilities to the creditor being reduced or extinguished; and
6. The liabilities so reduced or extinguished must have arisen in the ordinary course of trade.

The term 'benefit' was defined in ITC 1613 (1996) 59 SATC 187. In this case the court held that the term 'benefit', as used in the provisions of section 20(1)(a)(ii) of the Income Tax Act, related to the reduction or extinction of a debt.

In addition to the term 'benefit', the term 'value' was also defined in ITC 1613. In this regard the court held that the term 'value', as used in the provisions of section 20(1)(a)(ii) of the Income Tax Act, denoted a monetary value.

The meaning that was to be attributed to the expression 'received by or accruing to' as used in the provisions of section 20(1)(a)(ii) of the Income Tax Act can be extracted from the definition of the term 'gross income' in section 1 of the Income Tax Act. According to De Koker and Williams (2012) the expression used in section 20(1)(a)(ii) was similar to the reference in the definition of the term 'gross income' in section 1.

Section 20(1)(a)(ii) refers to a 'concession' and a 'compromise' and these terms need to be defined from a legal point of view. Neither of these terms is defined in the Income Tax Act. Of these two terms only the term 'compromise' has been defined in case law. According to De Koker and Williams (2012) the terms 'concession' and 'compromise' are not similar concepts. As legal authority De Koker and Williams cite an unreported Special Court decision in which the presiding officer Melamet J made a ruling to this effect. The implication of this unreported judgment is that the term 'concession' will have to be defined in accordance with its ordinary grammatical meaning. The ordinary grammatical meaning of the term 'concession' can be found in *The Shorter Oxford English Dictionary* (Little, Fowler & Coulson: 1973: 389) where the term 'concession' is defined as 'the action of conceding (anything asked or required)'. De Koker and Williams offer a commentary on this definition. By linking the definition of the term 'concession' with the definition of the term 'concede' De Koker and Williams (2012: 8 – 344–1) define the term concession as "a thing that is

conceded, surrendered or yielded". In this respect De Koker and Williams (2012) contend that the ordinary grammatical meaning of the term concession implies that creditors have waived some of their rights for an amount of consideration having a lower value.

The term 'compromise' has been defined in two cases namely, Cachalia v Harberer& Co 1905 TS 457 and Vena v Port Elizabeth Divisional Council 1933 EDL 75. In the *Cachalia* case the court defined the term 'compromise' as an agreement whereby each party abates some of his/her/its previous demands and subsequently recedes to some extent from the position formerly taken up. The *Vena* case provided a slightly different definition in which the term 'compromise' was defined as an adjustment of claims and disputes by mutual concession, either without resort to legal proceedings or on condition of abandoning such proceedings if already commenced.

In terms of section 20(1)(a)(ii) a concession or compromise had to actually reduce or extinguish a taxpayer's liabilities to a creditor.

In terms of section 20(1)(a)(ii) a concession or compromise can only affect a taxpayer's assessed loss if the liabilities which have been reduced or extinguished have arisen in the ordinary course of trade (De Koker & Williams: 2012). This issue was addressed in the case of A v Commissioner of Taxes 1969 (2) SA 689 (R). The presiding officer Goldin J quoted with approval a passage from the case of Downs Distributing Co. (Pty.) Ltd v Associated Blue Star Stores (Pty.) Ltd., C.L.R. 463. In the Downs Distributing case the presiding officer Rich J, had made the following statement:

> [The expression during the 'ordinary course of trade'] means that the transaction must fall into place as part of the undistinguished common flow of business done, that it should form part of the ordinary course of business as carried on, calling for no remark and arising out of no special or particular situation.

Furthermore, Goldin J went on quote with approval a test which had been postulated by Dr Silke in the text book *South African Income Tax*. According to this test the expression 'liabilities that arise in the ordinary course of trade' relates to liabilities incurred on income or revenue account. The expression does not, however, include liabilities incurred on capital account. The learned judge stressed that effect be given to the word 'ordinary'. This should

be done in order to ensure that qualifying liabilities should arise ordinarily during the course of trade.

The provisions of both sections 8(4)(m) and 20(1)(a)(ii) are no longer applicable as they were repealed in terms of the recent amendments to the Income Tax Act. The repealed provisions were replaced by the provisions of section 19 and certain amendments to the provisions of section 8(4)(a) which now apply to the normal tax consequences of debt reduction.

5.3.1.3 Section 19 of the Income Tax Act

The provisions of section 19 apply to the reduction of debts. This essentially means that the provisions of this section only apply to the reduced portions of debts – that is any amount by which a debt is reduced, less any amount that has already been paid by a debtor as consideration. The section itself is divided into eight sub-sections.

Section 19(1) of the Income Tax Act

This sub-section contains a set of definitions for four different terms that the legislature defined within the ambit of section 19. The four terms that are defined in this case are: “allowance asset”, “capital asset”, “debt” and “reduction amount”.

The term “allowance asset” is defined as, “a capital asset in terms of which a deduction or allowance is allowable in terms the Income Tax Act for purposes other than the determination of any capital gain or capital loss”. A “capital asset” is defined as, “an asset as defined in paragraph 1 of the Eighth Schedule that is not trading stock”. This definition is comprised of two components. The first component relates to the definition of the term “asset” and the second component relates to the definition of the term “trading stock”.

The term “asset” is defined in paragraph 1 of the Eighth Schedule. The definition places assets into two categories. The assets that fall into the first category are defined as property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum. The assets falling into the second category are defined as rights or interests of whatever nature to or in the property that falls in the first category of assets.

The term "trading stock" is defined in section 1 of the Income Tax Act. This definition applies to three broad categories:

- Anything produced, manufactured, constructed, assembled, purchased or in any other manner acquired by a taxpayer for the purposes of manufacture, sale or exchange by the taxpayer or on behalf of the taxpayer.
- Anything that when disposed gives rise to income which forms a part of a taxpayer's gross income. There are certain types of income that are excluded from this category. Firstly, income that is included in a taxpayer's gross income in terms of paragraph (j) or (m) of the definition of "gross income".[28] Secondly, income that is included in a taxpayer's gross income in terms of paragraph 14(1) of the First Schedule.[29] Thirdly, income that is included in a taxpayer's gross income as a recovery or recoupment contemplated in section 8(4) which is included in gross income in terms of paragraph (n) of the definition of "gross income".[30]
- Any consumable stores and spare parts acquired by a taxpayer to be used or consumed in the course of the taxpayer's trade.

Furthermore the broad definition of the term "trading stock" specifically excludes foreign currency option contracts and forward exchange contracts as defined in section 24I(1).

Capital assets which qualify as allowance assets are those in terms of which a deduction or allowance is allowable in terms the Income Tax Act for purposes other than the determination of any capital gain or capital loss. The relevant provisions, in terms of which deductions or allowances are allowable for purposes other than the determination of any capital gain or capital loss, can be found in sections 11 – 18 of the Income Tax Act.

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[28] Paragraphs (j) and (m) apply to different categories of income. Paragraph (j) applies to, the sum of any amounts received or accrued during any year of assessment in respect of the disposals of allowance assets by any mine under section 15(a) of the Income Tax Act or the corresponding provisions of any previous Income Tax Act, as exceeds the sum of so much of any capital expenditure as determined before applying the definition of "capital expenditure incurred in section 36(11). Paragraph (m) applies to, "any amount received or accrued in respect of a policy of insurance of which the taxpayer is the policyholder, where the policy relates to the death, disablement or severe illness of an employee or director (or former employee or director) of the taxpayer, including by way of any loan or advance". Paragraph (m) will only apply to the extent that any received or accrued amounts shall be reduced by the amount of any such loan or advance which is or has been included in a taxpayer's gross income.

[29] Paragraph 14(1) of the First Schedule relates to any amount received by or accrued to a farmer in respect of the disposal of any plantation.

[30] Income falling into this category is classified as recouped income in terms of section 8(4)(a). This section will be discussed in more detail below.

The term “debt” is not actually defined but “tax debts” as defined in section 1 of the Tax Administration Act 28 of 2011 are excluded for the term “debt”. In terms of section 1 of the Tax Administration Act a tax debt is defined as an amount of tax due by a person in terms of a Tax Act.

The term “reduction amount” is defined as any amount by which a debt owed by a person is reduced less any amount applied by that person as consideration for that reduction.

The provisions of section 19(2) are subject to the provisions of section 19(8). The provisions of section 19(8) should therefore be considered first before continuing with the analysis of the provisions of section 19(2).

Section 19(8) of the Income Tax Act

Section 19(8) contains provisions which exclude certain debt reductions from the ambit of section 19. In this respect there are three specific forms of debt reduction which are excluded from falling within the ambit of section 19:

- Debts owed by an heir or legatee of a deceased estate.
- Debts reduced by way of donations as defined in section 55(1) of the Income Tax Act as well as transactions to which the provisions of section 58 of the Act apply.
- Debts owed by employees to their employers – provided that such debt reduction falls within the ambit of paragraph 2(h) of the Seventh Schedule of the Income Tax Act.

The exclusion of debts owed by an heir or legatee of a deceased estate is only applicable in cases where a deceased estate reduces a debt that is owed to it by an heir or legatee. Furthermore the reduced debt must actually form a part of the property of the deceased estate for the purposes of the Estate Duty Act.

The provisions of both 55(1) and 58 relate to Donations Tax. Section 55(1) provides the definition of the term “donation”. According to section 55(1) of the Income Tax Act the term donation is defined as any gratuitous disposal of property including any gratuitous waiver or renunciation of a right. Transactions that do not fall within the scope of this definition can still be deemed to be donations in terms of section 58. The provisions of section 58 identify

two types of transactions that are deemed to be donations. The first type of transaction identified in section 58(1), relate to the disposal of property for an amount of consideration which in the opinion of the Commissioner is not an adequate amount for the property in question. The other type of transactions, set out in section 58(2), refers to the disposal of restricted equity instruments under the circumstances contemplated in section 8C(5)(a) or (b) of the Income Tax Act. Thus the exclusion of debt reduced by way of section 55(1) and 58 relates to debt reduction which arises by means of either donations or deemed donations.

Debts owed by employees to their employers may be reduced if an employer fails to recover a debt owing by an employee. The provisions of paragraph 2(h) of the Seventh Schedule may apply to such debt reduction if certain requirements are satisfied and the benefit arising from the failure to recover the debt is included in the employee's gross income in terms of paragraph (i) of that definition.

Section 19(2) of the Income Tax Act

Section 19(2) sets out the parameters within which the rest of the provisions of section 19 – barring section 19(8) – apply. Generally speaking there are three conditions that need to be satisfied in order for the provisions of section 19(2) to become applicable:

- a debt that is owed by a person should be reduced by any amount;
- the debt in question should represent an amount that was used, directly or indirectly, to fund any expenditure in respect of which a deduction or allowance was granted in terms of the Income Tax Act; and
- the amount of the debt reduction which takes place should exceed any amount applied by the debtor as consideration for the reduction.

The provisions of section 19(2) are framed broadly and do not stipulate the nature the expenditure incurred must take. No distinction is drawn between expenditure incurred in relation to the acquisition of services or goods, which can also be of a revenue or capital nature. The provisions apply to direct as well as indirect methods through which expenditure can be funded. Expenditure can be incurred directly by a debtor if a service is rendered to a debtor by a credit provider; or if a debtor acquires either trading stock or capital assets from a credit provider. Expenditure can be incurred indirectly by a debtor if a credit provider

provides a debtor with a loan that is used in order pay a third party for the provision of a service, trading stock or a capital asset.

Section 19(3) of the Income Tax Act

The provisions of section 19(3) apply to a debt reduction that is contemplated in section 19(2). Moreover the reduced debt in question must be represent an amount of expenditure that was incurred by a person in the acquisition of trading stock that was still held and had therefore not been disposed of at the time of the debt reduction. Section 19(3) has the effect of reducing the cost or value of trading stock on hand. The cost or value of the trading stock on hand that is considered for these purposes is the amount that is taken into account in terms of either section 11(a) or 22(1) or 22(2). Before determining the specific manner in which the cost or value of trading stock on hand is reduced the cost or value of trading stock that is taken into account in terms of either section 11(a) or 22(1) or 22(2) must be established.

Section 11(a) permits general deductions to be made in the determination of the taxable income. These provisions are subject to the preamble to section 11 of the Income Tax Act. The preamble itself reads as follows:

> For the purpose of determining the taxable income derived by any person from *carrying on any trade*, there shall be allowed as deductions from the income of such person so derived…

In terms of the preamble to section 11 of the Income Tax Act, taxpayers are only permitted to make deductions in terms of the provisions of section 11 if they are engaged in the carrying on of a trade. The provisions of section 11(a) permit taxpayers to deduct from their taxable income any expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature. The cost of trading stock is therefore deductible in terms of section 11(a).

Section 22 relates to amounts that are to be taken into account in respect of the value of trading stock. The amounts in question are used in the determination of the taxable income derived by any person during any year of assessment from carrying on any trade – other than farming. Whereas section 22(1) identifies the amounts which are taken into account in respect of the value of any trading stock held and not disposed of by a person at the end of a year of

assessment section 22(2) applies to amounts which are taken into account in respect of the value of any trading stock held and not disposed of by him at the beginning of any year of assessment.

Section 22(1)(a) establishes that the value of trading stock is the cost price incurred in acquiring the trading stock reduced by the amount by which the value of trading stock has been diminished as a result of:

- damage;
- deterioration;
- change of fashion;
- decrease in the market value; or
- any other reason satisfactory to the Commissioner.

The provisions of section 22(1)(a) do not apply to financial instruments or any other type of trading stock contemplated in section 22(1)(b). Section 22(1)(b) deals with any instrument, interest rate agreement or option contract in respect of which a company dealing in these instruments has made an election in terms of section 24J (9). The market value of instruments, interest rate agreements and option contracts is determined in accordance with a commercially accepted practice which is applied consistently for financial reporting purposes to the company's shareholders.

The provisions of section 22(2)(a) determine the value of trading stock which formed part of the trading stock of a person at the end of the immediately preceding year of assessment as the amount which was, in the determination of the taxable income of such person for such preceding year of assessment, taken into account in respect of the value of such trading stock at the end of such preceding year of assessment. Section 22(2)(b) applies to trading stock which did not form part of the trading stock of such a person at the end of the immediately preceding year of assessment and values this trading stock at the cost price of the trading stock in question.

Section 19(4) of the Income Tax Act

Section 19(4) provides that the amount remaining of the debt reduction after reducing the value of trading stock to zero is deemed to be an amount that has been recovered or recouped,

in terms of section 8(4)(a), for the year of assessment in which the debt is reduced. This deemed tax liability will only arise if a deduction or allowance is granted, in terms of the Act, to a person in respect of the expenditure incurred in the acquisition of trading stock.

Section 19(5) of the Income Tax Act

In terms of section 19(5)(a) the provisions of section 19(5) will only be applicable if a debt has been reduced in the manner contemplated in section 19(2). Section 19(5)(b) excludes debt reductions that were incurred in order to fund expenditure incurred in respect of:

- the acquisition trading stock that is held and not disposed of by a person at the time of the reduction of a debt; and
- the acquisition, creation or improvement of an allowance asset.

The subsection therefore applies to the reduction of debts incurred in relation to the acquisition of goods or services for which a deduction was granted in terms of the Income Tax Act; thus the acquisition of goods or services of a revenue nature. As section 19(2) provides for both direct and indirect expenditure to which the debt reduction applies, the reduction of an amount owing in respect of a loan used to fund the expenditure is also included. The debt reduction in terms of section 19(5) is deemed to be an amount that is recovered or recouped (in terms of section 8(4)(a)) during the year of assessment in which the debt was reduced.

Section 19(6) of the Income Tax Act

Section 19(6) is subject to two requirements. The first requirement stipulates that a debt must be reduced in the manner contemplated in section 19(2). The second requirement states that the reduced debt in question should be a debt that was used in order to fund expenditure incurred in the acquisition, creation or improvement of an allowance asset. The debt reduction is deemed to be an amount that has been recovered or recouped by a person for the year of assessment in which the debt is reduced for the purposes of section 8(4)(a). The reduction amount is only deemed to have been recovered or recouped if two criteria are met:

- in the first place a deduction or allowance must be granted, in terms of the Income Tax Act, to a person in respect of the expenditure in question; and
- in the second place, paragraph 12A of the Eighth Schedule should have already been applied to reduce the amount of expenditure, incurred in relation to the allowance asset, in its entirety.

Paragraph 12A of the Eighth Schedule to the Income Tax Act (discussed below) therefore takes precedence over section 19(6) and only the amount remaining after this paragraph has been applied is taken into account in terms of section 19(6).

Section 19(7) of the Income Tax Act

Section 19(7) addresses the manner in which debt reduction affects the aggregate amount of the deductions and allowances granted to a person in respect of an allowance asset and limits the deductions or allowances that may be claimed in respect of an allowance asset to the cost of acquisition, less the aggregate of the debt reduction amount and all deductions and allowances previously granted in respect of the asset.

5.3.1.4 Section 8(4)(a) of the Income Tax Act

It is apparent from the provisions of sections 19(4) and 19(6) of the Income Tax Act that there is an interaction between the provisions of section 19 and 8(4)(a). Section 8(4)(a) is a general recoupment section which includes in a taxpayer's income all amounts that have been deducted or set off in the current or a previous year of assessment that have been recovered or recouped in the current year of assessment. All amounts that are required to be included in a taxpayer's income in terms of section 8(4) are included in the taxpayer's gross income by virtue of the provisions of paragraph (n) of the definition of the term 'gross income' in section 1 of the Income Tax Act. These amounts are deemed to have been received by or accrued to the taxpayer in question from a source within South Africa. This is the case even if the amounts in question are actually recouped or recovered outside South Africa.

Section 8(4)(a)(ii) excludes from the ambit of the section any amount that has been applied to reduce any cost or expenditure incurred by a taxpayer in terms of section 19. This ensures that where the cost of trading stock still on hand has been reduced by the amount of the debt reduction, it will not be recouped again in terms of section 8(4)(a).

5.3.2 The provisions relating to capital gains tax

The provisions relating to capital gains tax are not all new additions to the Income Tax Act. The only new provisions that were added to the Income Tax Act by the Taxation Laws Amendment Act, 2012 are found in paragraph 12A of the Eighth Schedule to the Income Tax Act. The precursor to this paragraph is paragraph 12(5) which was to be read in conjunction

with paragraph 13(1)(g)(ii) of the Eighth Schedule. Paragraph 35(1)(a) of the Eighth Schedule, which also relates to the capital gains tax consequences affecting debtors, has not been affected by the amendments brought about by the Taxation Laws Amendment Act, 2012.

5.3.2.1 Paragraph 12(5) of the Eighth Schedule to the Income Tax Act

Prior to the recent amendments that were made in terms of the Taxation Laws Amendment Act, 2012 reduced debts, stemming from debts that were not incurred in relation to deductible expenditure, were subjected to taxation in terms of the provisions of paragraph 12(5) of the Eighth Schedule to the Income Tax Act. The tax imposed in terms of the Eighth Schedule takes the form of a capital gains tax. In terms of the provisions of paragraph 12(5) reduced debts were treated as deemed disposals. Deemed disposals treat certain events/transactions as disposals of assets even though these events would not normally be regarded as disposals in the ordinary sense. By treating reduced debts as deemed disposals the provisions of paragraph 12(5) of the Eighth Schedule treated the reduction of a debt as a disposal of an asset even though such a disposal did not actually take place in accordance with the definition of the term 'disposal' in paragraph 11 of the Eighth Schedule.

The relevant provisions of paragraph 12(5) of the Eighth Schedule that applied to reduced debts could be found in sub-paragraphs (a) and (b) of the paragraph. Paragraph 12(5)(a) applied to debts that had been reduced or discharged. If no consideration was given in exchange for the discharge of a debt the provisions of paragraph 12(5)(a)(i) would be applied. If, however, a certain amount of consideration was given in exchange for the discharge of a debt, the provisions of paragraph 12(5)(a)(ii) would be applicable. The application of the provisions of paragraph 12(5)(a)(ii) were restricted to amounts of consideration which were less than the amount by which the face value of a debt had been reduced or discharged.

The provisions of paragraph 12(5)(a) of the Eighth Schedule were subject to the provisions of paragraph 67 of the Eighth Schedule. The provisions of paragraph 67 relate to the transfer of assets between spouses and disregard any capital gain or capital loss in respect of the disposal of an asset to a person's spouse. The provisions of paragraph 12(5)(a) therefore apply to all but one category of deemed disposal arising from a debt reduction – that of inter-spousal debt reductions.

Furthermore there were certain circumstances under which the provisions of paragraph 12(5)(a) of the Eighth Schedule did not apply. In terms of paragraph 12(5)(a)(aa) the discharged or reduced portions of a debt would not be subjected to the provisions of paragraph 12(5)(a) under two circumstances:

1. If the reduced or discharged amounts constituted capital gains in terms of paragraph 3(b)(ii) of the Eighth Schedule: this paragraph relates to amounts that were taken into account in the base cost of an asset, that have been recovered in the current year of assessment.
2. Reduced or discharged amounts that had already been taken into account in terms of the provisions of sections 8(4)(m), 20(1)(a)(ii) (these two provisions were discussed earlier in the chapter) or paragraph 20(3)of the Eighth Schedule (which excludes from the base cost of a capital asset any expenses deducted in determining the taxable income of a person; expenses that have been recovered or reduced and not included in income and certain government grants that are exempt from tax).

In terms of paragraph 12(5)(a)(bb), the provisions of paragraph 12(5)(a) of the Eighth Schedule were not applicable to debtors who were members of the same group of companies as their creditors, unless

- the debt had been acquired directly or indirectly from a person who was not a member of that group of companies; or
- a debtor and creditor became members of the same group of companies after the debt in question (or any substituted debt) had already arisen,

and these transactions were part of a scheme to avoid any tax otherwise imposed by the Income tax Act.

In terms of paragraph 12(5)(a)(cc), the provisions of paragraph 12(5)(a) were also not applicable to debtors who were companies that were connected persons of their creditors and the debt reduction in question was made in anticipation of the liquidation, winding up, deregistration or final termination of the corporate existence of that company. This exclusion was applicable to the extent that the amount of the debt reduction or discharge did not exceed the amount of the creditor’s expenditure contemplated in paragraph 20 at the time of that reduction or discharge. This exclusion was not applicable–

- where a company and creditor had become connected persons after the debt in question (or any substituted debt) had already arisen; and
- where the debt reduction in question was part of a scheme to avoid any tax otherwise imposed by virtue of the provisions of the Income Tax Act.

Paragraph 12(5)(b) of the Eighth Schedule of the Income Tax Act categorised reduced debts as deemed disposals and ascribed a particular value to reduced debts. Reduced debts were deemed to be disposals by simultaneously acquiring and disposing of claims equal to the portion of debts that have been reduced for no consideration. The value of these claims was equal to the amount by which the debts in question had been reduced. The base cost ascribed to reduced debts in terms of paragraph 12(5)(b)(i) was equal to nil.

This meant that the amount referred to in paragraph 12(5)(b)(ii) of the Eighth Schedule of the Income Tax Act was always bound to have a value that represented the amount of a debt that had been reduced.

Paragraph 12(5) of the Eighth Schedule to the Income Tax Act, therefore, subjects all debt reductions that fall within the provisions of the paragraph to capital gains tax. Where an assessed capital loss exists, this will be reduced or extinguished by the resulting capital gain. The excess of the capital gain over the assessed capital loss or the capital gain where no assessed capital loss exists will therefore always be subject to capital gains tax.

5.3.2.2 Paragraph 13(1)(g)(ii) of the Eighth Schedule to the Income Tax Act

The provisions of paragraph 13(1)(g)(ii) of the Eighth Schedule prescribed the exact point in time at which deemed disposals arising in terms of paragraph 12(5) could be said to have occurred. This exact point in time was the date on which a deemed disposal occurred. Stated otherwise the date on which a debt or a portion of a debt was regarded as having been discharged was the exact point in time at which the deemed disposal occurred.

5.3.2.3 Paragraph 12A of the Eighth Schedule to the Income Tax Act

The provisions of both paragraphs 12(5) and 13(1)(g)(ii) of the Eighth Schedule Act are no longer applicable. These provisions were repealed in terms of the recent amendments to the

Income Tax Act. According to these amendments paragraph 12(5) was repealed in its entirety. The repeal of paragraph 12(5) had an impact on the provision of paragraph 13(1)(g)(ii) of the Eighth Schedule since these provisions of had to be read in conjunction with the provisions of paragraphs 12(5). Consequently the relevant portions of paragraph 13(1)(g)(ii) which made reference to paragraph 12(5) had to also be repealed. The repealed provisions from paragraphs 12(5) and 13(1)(g)(ii) were replaced by the provisions of paragraph 12A which now apply to the capital gains tax consequences of debt reduction.

The provisions of paragraph 12A(1) of the Eighth Schedule of the Income Tax Act make it clear that the provisions of this section will only apply to the reduced portions of debts – that is any amount by which a debt is reduced less any amount that has already been paid by a debtor as consideration. The section itself is divided into eight different sub-sections.

Paragraph 12A(1) of the Eighth Schedule to the Income Tax Act

Paragraph 12A(1) defines an “allowance asset”, a “capital asset”, a “debt” and a “reduction amount” in the same way as section 19(1).

Paragraph 12A(6) of the Eighth Schedule to the Income Tax Act

The provisions of paragraph 12A(2) are subject to the provisions of paragraph 12A(6). Therefore, before proceeding any further the provisions of paragraph 12A(6) should be considered first. Paragraph 12A(6) provides for the categories of debt reduction to which paragraph 12A will not apply. The provisions of paragraph 12A(6) are divided into five sub-paragraphs of which the first three are the same as three sub-sections of section 19(8), namely: donations, debts forgiven by the executors of deceased estates and debts forgiven in the context of employer/employee relationships. In addition to paragraphs 12A(6)(a) – (c), exclusions are also extended to companies in terms of paragraphs 12A(6)(d) and (e). Sub-paragraph (6)(d) of paragraph 12A precludes the application of the paragraph to the reduction of debts in terms of which the creditors and debtors are companies that form part of the same group of companies as defined in section 41(1) of the Income Tax Act.

Paragraph 12A(6)(d) applies to credit transactions that take place within a group of companies, the effect of which is to subject these transactions to the debt reduction provisions in paragraph 12A(2) to (5) despite the fact that the companies form part of the same group of

companies. Sub-paragraph (6)(d) stipulates that paragraph 12A does not apply to credit transactions in which the debtors and creditors involved are companies that form part of the same group of companies as defined in section 41 of the Income Tax Act.[31] There are two exceptional circumstances under which paragraph 12A will apply to credit transactions in which the debtors and creditors involved are companies that form part of the same group of companies. These two exceptional circumstances are set out in the provisions of sub-paragraphs (6)(d)(i) and (6)(d)(ii) as follows:

- where a debt (or a debt issued in substitutions of that debt) is acquired directly or indirectly from a person who does not form a part of that group of companies; and
- where two or more companies only become part of the same of group of companies after having entered into a credit transaction.

When either one of these two exceptional circumstances arise as part of any credit transaction, operation or scheme entered into (by companies that form part of the same group of companies) in an effort to avoid any tax imposed by the Income Tax Act, the provisions of paragraph 12A will apply to such a credit transaction, operation or scheme as an anti-avoidance measure.

Sub-paragraph (6)(e) of paragraph 12A precludes the application of paragraph 12A(2) to (5) to certain companies that satisfy two criteria. Firstly, the companies should experience debt reduction in the course, or in the anticipation of liquidation, winding up, deregistration or final termination. Secondly, the creditor to whom the reduced debt was owed should be a connected person in relation to that company. The application of paragraph 12A(6)(e) is limited to the amount that does not exceed the amount of expenditure incurred in respect of that debt as contemplated in paragraph 20 (the base cost of the asset). The exclusion in paragraph 12A(6)(e) does not apply (and therefore the debt reduction provisions in paragraph 12A(2) to (5) will apply) where a debt is reduced as part of an attempt to avoid the payment

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[31] The definition ascribed to the term 'group of companies' in section 41 of the Income Tax Act is based upon the definition that is set out in section 1. This definition reads as follows:

> [t]wo or more companies in which one company (hereinafter referred to as the '<u>controlling group company</u>') directly or indirectly holds shares in at least one other company (hereinafter referred to as the 'controlled group company'), to the extent that -
>
> a) at least 70 per cent of the equity shares in each controlled group company are directly held by the controlling group company, one or more other controlled group companies or any combination thereof; and
>
> b) the controlling group company directly holds at least 70 per cent of the equity shares in at least one controlled group company.

of taxes and the transaction was entered into between a company and a person in relation to whom the company became a connected person after a debt had already arisen. The exclusion will also not apply under various circumstances where a company that was on the verge of being liquidated, wound up, deregistered or finally terminated takes steps to avoid these outcomes.

Paragraph 12A(2) of the Eighth Schedule to the Income Tax Act

Now that the provisions of paragraph 12A(6) have been considered in detail it is possible to complete the analysis of paragraph 12A(2). Paragraph 12A(2) sets out the parameters within which the rest of the provisions of paragraph 12A – barring paragraph 12A(6) – apply. Paragraph 12A(2) applies where:

- a debt that is owed by a person is reduced by any amount;
  the debt in question should represent an amount that was used, directly or indirectly, to fund any expenditure
  -other than expenditure in respect of which a deduction or allowance was granted in terms of the Income Tax Act; or
  -incurred in the acquisition, creation or improvement of an allowance asset; and
- the amount of the debt reduction exceeds any amount applied by the debtor as consideration for the reduction.

Paragraph 12A(3) of the Eighth Schedule to the Income Tax Act

The provisions of paragraph 12A(3) are framed within the context of paragraph 12A(2)(a) – that is a capital asset other than an allowance asset. Paragraph 12A(3) deals with assets still held by a person whose debt is reduced at the date of the debt reduction. Whenever the provisions of paragraph 12A(3) are applicable the amount of expenditure incurred in respect of an asset (the base cost of the asset in terms of paragraph 20 of the Eighth Schedule) must be reduced by the reduction amount applicable to a respective debt.

Paragraph 12A(4) of the Eighth Schedule to the Income Tax Act

The provisions of paragraph 12A(4) are built upon the provisions of paragraph 12A(2) and (3). Consequently paragraph 12A(4) will only be applied if paragraph 12A(2) is applicable

and after paragraph 12A(3) has already been applied (that is, the base cost of the asset has been reduced by the amount of the debt reduction). The provisions of paragraph 12A(4) are only applicable to assets that are not classified as allowance assets. Assets fall into this category if the expenditure incurred in the process of acquiring them do not qualify for any tax deductions or capital allowances in terms of the Income Tax Act. Paragraph 12A(4) applies to expenditure incurred in relation to assets that are still held by a person at the time of debt reduction as well as assets which are no longer held. In cases where the assets in questions are no longer held the application of the provisions of paragraph 12A(4) must lead to the reduction of any assessed capital loss incurred by a taxpayer for the year of assessment in which debt reduction takes place. The relevant assessed capital losses are reduced by the reduction amount applied in respect of a debt, less any amount that has been applied to reduce any amount of expenditure as contemplated in subparagraph (3). This essentially means that assessed capital losses are reduced by the reduction amount less the base cost of an asset.

Paragraph 12A(5) of the Eighth Schedule to the Income Tax Act

The provisions of paragraph 12A(5) relate to pre-valuation date assets and are subject to the applicability of the provisions of paragraph 12A(3) and (4). Paragraph 12A(5) determines the date of acquisition of assets as well as the amount of expenditure incurred by a person in relation to assets. The person whose debt has been reduced is treated as having disposed of the asset immediately before the date of the debt reduction at its market value on that date and immediately re-acquired it at the market value, less any capital gain or increased by any capital loss that would have been determined had the asset been disposed of at its market value on that date. The date of acquisition that is adopted for the purposes of paragraph 12A(5) is the date on which the respective debt reduction takes place.

Paragraph 12A(7) of the Eighth Schedule to the Income Tax Act

Paragraph 12A(7) is directly linked to the provisions of paragraph (bb) of the proviso to sub-paragraph (6)(e). These provisions refer to circumstances under which a company that was on the verge of being liquidated, wound up, deregistered or finally terminated takes steps to avoid these outcomes. Paragraph 12A(7) stipulates that any tax which becomes payable under such circumstances must be recovered from a company and any connected persons

contemplated in sub-paragraph 6(e). The company and any connected person must be held jointly and severally liable for the tax liability that arises.

5.3.2.4 Paragraph 35 of the Eighth Schedule to the Income Tax Act

The provisions of paragraph 35 of the Eighth Schedule identify the amounts to which the term 'proceeds' applies. Paragraph 35(1)(a), in particular, includes within the ambit of "proceeds" any amount by which any debt owed by a person has been reduced or discharged.

5.4 TAX CONSEQUENCES ASSOCIATED WITH CREDIT PROVIDERS

The provisions of sections 11(i), 54, 55(1), 55(3), 59, 60 of the Income Tax Act and paragraph 56 of the Eighth Schedule to the Act may apply to credit providers. Section 11(i) of the Income Tax Act permits credit providers to claim tax deductions in relation to any bad debts that have been incurred. Paragraph 56 of the Eighth Schedule, on the other hand, limits the extent to which capital losses can be deducted by credit providers. The provisions of sections 54, 55(1), 55(3), 59 and 60 of the Income Tax Act impose a donations tax[32] on credit providers.

5.4.1 Section 11(i) of the Income Tax Act

The provisions of section 11(i) of the Income Tax Act enable credit providers to deduct amounts by which debts are reduced from their income. These provisions are subject to the preamble to section 11 of the Income Tax Act. The preamble itself reads as follows:

> "For the purpose of determining the taxable income derived by any person from *carrying on any trade*, there shall be allowed as deductions from the income of such person so derived…"

In terms of the preamble to section 11 of the Income Tax Act, taxpayers are only permitted to make deductions in terms of the provisions of section 11 if they are engaged in the carrying on of a trade.

[32] The term donation is defined by section 55(1) of the Income Tax Act as any gratuitous disposal of property including any gratuitous waiver or renunciation of a right.

In order for amounts that have been subjected to debt reduction to qualify for deduction in terms of section 11(i) of the Income Tax Act the amounts should satisfy the following criteria:

1. the deducted amounts should be amounts that were actually due to be paid to a credit provider;
2. the debts should have become bad during the particular year of assessment for which a tax deduction is claimed; and
3. the amount should have been included in the credit provider's income in either the preceding or the particular year of assessment.

It is interesting to note that the manner in which the criteria in section 11(i) is set out gives the impression that the provisions of this section only apply to bad debts. Debt reduction does not always stem from the occurrence of bad debts. Indeed debt reduction can take place even though the underlying debts in question could have still been collected. This observation may be made particularly in relation to the different methods of debt reduction that occur through the operation of the law. The result is that the wording of section 11(i) may deny some creditors of the opportunity to make tax deductions in relation to reduced debts. This raises the possibility of unfairness.

Where a particular debt owed to a creditor would not qualify for deduction as a bad debt in terms of section 11(i) because it did not arise in the course of its creditor's trade, had not become bad or the income flowing from the transaction to which the debt relates was not included in the income of the creditor, the amount would still qualify for the purpose of the Eighth Schedule to the Income Tax Act. The proceeds would be nil and the amount of the debt the base cost.

5.4.2 Paragraph 56 of the Eighth Schedule to the Income Tax Act

The provisions of paragraph 56 of the Eighth Schedule (as it now stands) limit the extent to which capital losses can be deducted by credit providers. In terms of paragraph 56(1), losses incurred by creditors as a result of the disposal of claims owed by debtors are only recognised

as capital losses if the creditors and debtors in question are not connected persons in relation to one another.

The limitation stemming from paragraph 56(1) does not apply absolutely. According to paragraph 56(2) there are four types of amounts to which the limitation in paragraph 56(1) does not apply:

1. any amounts which are applied in order to reduce either the base cost of an asset belonging to a debtor or any aggregate capital loss of a debtor in terms of paragraph 12A of the Eighth Schedule of the Income Tax Act;

2. amounts which a creditor proves must be or were included in the gross income of any acquirer of that claim;

3. amounts that were included in the gross income or income of the debtor or taken into account in the determination of the balance of assessed loss of the debtor in terms of section 20(1)(a)(ii) of the Income Tax Act; or

4. capital gains which a creditor proves must be or were included in the determination of the aggregate capital gain or aggregate capital loss of any acquirer of the claim.

Therefore where the debtor whose debt has been reduced has accounted for the reduction in terms of paragraph 12A of the Eighth Schedule or section 20(1)(a)(ii) (debts reduced prior to the amendments to the debt reduction regime), the creditor will not be precluded from claiming the capital loss in respect of the debt reduction.

5.4.3 Donations tax

Donations tax is levied on debt reductions as these debt reductions amount to donations in terms of the common law. Donations are taxable in terms of the provisions of the Income Tax Act. According to section 54 of the Income Tax Act a tax known as donations tax is levied on the value of any property disposed of under any donation. The provisions of section 55(1) of the Income Tax Act identify the type of disposals which are categorised as disposals. According to section 55(1) the term donation is defined as any gratuitous disposal of property including any gratuitous waiver or renunciation of a right. Debts that are reduced through acts committed by contracting parties, amount to donations by virtue of their categorisation as

either gratuitous waivers or renunciations of rights.[33] The term "gratuitous", however, has been defined in the Collins English Dictionary (2003: 712) as "*Law* given or made without receiving any value in return".

Haupt (2012: 735) submits that "a disposal of property in terms of an *obligation* is not a donation, even if nothing is received in return." He explains (2012:736) that in Welch's Estate v Commissioner of South African Revenue Service (2004) All SA 586 (SCA), the Supreme Court held that the term as defined in section 55(1) ". . . requires a motive of sheer liberality or *disinterested benevolence*". This case dealt with the settlement by the taxpayer of assets on a trust in terms of an agreement in a divorce order. In the case of insolvency, either of a natural person or his or her deceased estate, it can be conclusively argued that a creditor who is unable to recover a debt does not reduce or cancel the debt from "a motive of sheer liberality or *disinterested benevolence*" and it would appear therefore that there would be no donations tax liability where a debt is reduced due to insolvency. Debt reductions for reasons other than insolvency, however, may amount to donations.

5.5 THE DIFFERENCE BETWEEN THE OLD AND NEW DEBT REDUCTION PROVISIONS

The recent reforms relating to the tax consequences of debt reductions were implemented through the adoption of the following measures:

- the removal of certain provisions, such as sections 8(4)(m) and 20(1)(a)(ii) as well as paragraph 12(5) of the Eighth Schedule, from the Income Tax Act;
- the amendment of provisions, such as section 8(4)(a) and paragraph 13(1)(g)(ii) of the Eighth Schedule, which would be affected by the removal of provisions from the Income Tax Act; and
- the addition of new provisions, in the form of section 19 and paragraph 12A of the Eighth Schedule, to the Income Tax Act.

[33] Christie (2011) argues that in terms of contract law the gratuitous waiver of a right conferred onto a legal subject by the terms of a contract amounts to a donation. As legal authority for this argument Christie cites the Appellate Division case of Coronel's Curator v Coronel's Estate 1941 AD 323.

The effects of the recent amendments will be analysed in the context of the terminology used to refer to reduced debts and the nature of the tax relief granted to financially distressed debtors who had experienced debt reduction.

5.5.1 The terminology used in referring to reduced debts

Prior to the recent amendments the terms adopted in sections 8(4)(m), 20(1)(a)(ii) as well as paragraphs 12(5) of the Eighth Schedule led to a discrepancy between the provisions of the Income Tax Act and the various debt reduction methods. The terminology problem was addressed by the recent amendments to the Income Tax Act through the use of standard terminology relating to the different methods of debt reduction. This result was accomplished through the use of the standardised term “reduction amount” defined in the provisions of both section 19 and paragraph 12A of the Eighth Schedule to the Income Tax Act. The definition of a “reduction amount” incorporates all forms of debt reduction within the ambit of the new debt reduction provisions of the Income Tax Act.

5.5.2 The nature of the tax relief granted to financially distressed debtors

Prior to the amendments to the Income tax Act, debt reductions would have been taxed in full, either as a recoupment or a capital gain, or would have reduced an existing assessed loss. The tax relief that was provided as a result of the recent amendments relates to both capital debt relief and ordinary debt relief. Capital debt relief entails the reduction of:

- the base cost incurred in the acquisition, creation or improvement of an allowance asset; and
- any assessed capital losses associated with an allowance asset in relation to which a debt has been reduced.

Capital debt relief provides complete tax relief for taxpayers – for any capital amounts that still remained after the reduction of the base cost and assessed losses are to be disregarded for capital gains tax purposes.

Ordinary debt relief is granted, firstly, though the reduction of the cost or value of trading stock. To the extent that the debt reduction exceeds the value of the trading stock, the excess

is taxed as a recoupment and included in income and taxable income. Only when the trading stock is sold, will the effect of the debt reduction be reflected in taxable income (as the value of the trading stock will have been partially or fully reduced), thus creating a cash-flow advantage. Secondly, in the case of a debt reduction that relates to an expense that was deducted in terms of the Income Tax Act, the debt reduction will also be taxed as a recoupment. This does not provide any tax relief, however. By including the debt reduction or excess reduction in income as a recoupment, any assessed loss would automatically be reduced.

Thirdly, in the case of allowance assets where the asset is still held, the base cost of the asset will be reduced and to the extent that the reduction amount exceeds the base cost, the excess will be taxed as a recoupment. Again this affords debt relief as the full debt reduction amount is not included in income.

The final type of debt relief granted in terms of the amendments to the Income Tax Act, is the exclusion from the debt reduction provisions of a tax debt. Where tax debts are reduced due to inability to pay the tax liability owing, this will not, in turn, create a further tax liability.

5.6 CONCLUSION

This chapter set out to provide an explanation of the income tax consequences that currently arise from the provisions of the Income Tax Act which apply to the different methods of debt reduction. The chapter was divided into sections comprising of a general overview of the income tax consequences of debt reduction, an explanation of the nature of these tax consequences through reference to the debt reduction provisions of the Income Tax Act and a discussion of the fundamental differences between the effects of the old and new provisions of the Act.

The findings revealed that the income tax consequences of debt reduction affect debtors and creditors in different manners. This was attributed to the different provisions which are applicable to debtors on the one hand and creditors on the other hand. Both debtors and creditors experience normal and capital gains tax consequences.

Debtors experience the normal tax consequences of debt reduction in terms of sections 8(4)(a) and 19 of the Income Tax Act. These provisions only apply to debts which have been incurred in relation to deductible expenditure. The two provisions have the effect of either granting debtors ordinary debt relief or imposing a tax liability on debtors. The ordinary debt relief that is granted is partial in nature. It is granted through the reduction of the cost or value of trading stock as well as through the exclusion of tax debts from the ambit of debts as defined in section 19 of the Income Tax Act. Any excess amounts that still remain after the application of any debt relief are taxed as recoupments.

The capital gains tax consequences arise in terms of paragraphs 12A and 35(1)(a) of the Eighth Schedule of the Income Tax Act. Unlike sections 8(4)(a) and 19 of the Income Tax Act these provisions apply to reduced debts even if such debts have not been incurred in relation to deductible expenditure. The capital gains tax provisions do not impose any tax liabilities on debtors. Rather they grant complete capital debt relief to debtors. Such debt relief entails three components. Firstly, tax debts are excluded from the ambit of debts as defined in paragraphs 12A of the Income Tax Act. Secondly, the base costs are reduced, as well as any assessed capital losses associated with allowance assets in relation to which debt reduction has taken place. Thirdly, any capital amounts that still remain after the reduction of the base cost and any assessed losses are disregard for capital gains tax purposes.

Credit providers experience normal tax, donations tax and capital gains tax consequences of debt reduction. The normal tax consequences arise in terms of section 11(i) which permits credit providers to claim tax deductions in relation to any bad debts that have been incurred. Although section 11(i) only applies to bad debts that have become bad and where the income was included in the taxable income of the creditor, this does not necessarily mean that credit providers would be prevented from claiming any tax deductions. Under such circumstances amounts can still be deducted in terms of the Eighth Schedule of the Income Tax Act as capital losses. The extent to which capital losses can be deducted by credit providers is limited by paragraph 56 of the Eighth Schedule. In the case of the disposal of debts owing by connected persons, the capital loss is disregarded, except where the base cost or the aggregate capital loss of the debtor is reduced in terms of the debt reduction provisions in the Act.

Credit providers may be exposed to donations tax in terms of the provisions of sections 54 read with section 55(1) of the Income Tax Act. This tax liability arises by virtue of the fact that debt reductions fall within the scope of donations as either gratuitous waivers or renunciations of rights. As the tax is levied on taxpayers who/that make a gratuitous waiver or renunciation of a right to a claim, the tax burden for the donations tax is borne by credit providers. However, where creditors have no option but to reduce (or cancel) debts due to the insolvency of the debtor, it cannot be said that this constitutes a donation, which is defined in section 55(1) as a "gratuitous disposal of property including any gratuitous waiver or renunciation of a right".

The analysis in this chapter leads to the conclusion that the legislature has provided a measure of relief to financially distressed debtors who experience debt reduction. It should be pointed out that there are some crucial aspects that have not been addressed by the recent amendments. The type of relief granted does not, unfortunately address remaining problems that arise with debt reductions in the context of death or insolvency of natural persons. This will be discussed in the next chapter.

CHAPTER 6: ADEQUACY OF THE LAWS GOVERNING THE TAX CONSEQUENCES OF REDUCED DEBTS

6.1 INTRODUCTION

The preceding chapter provided an explanation of the income tax consequences that currently arise from the provisions of the Income Tax Act which apply to the different methods of debt reduction. The chapter provided an explanation of the differences between the effects of the old and new provisions of the Act. The analysis in the previous chapter led to the conclusion that that the legislature has succeeded in granting a greater degree of debt relief to financially distressed debtors who experience debt reduction. In spite of the recent amendments to the Income Tax Act they have only been partially effective. This partial effectiveness can be attributed to the failure on the part of the recent amendments to address the disjuncture between the timing of the debt reductions which occur within the context of the insolvency of natural persons and the problem that still exists in relation to insolvent and deceased estates. The legal anomaly arising due to inconsistencies between the Income Tax consequences of insolvency of a natural person and the Insolvency Act had already existed prior to the enactment of the recent amendments. This chapter will also discuss certain issues pertaining to the tax consequences of debt reduction arising within the context of death and insolvent and deceased estates.

6.2 ISSUES RELATING TO DEBT REDUCTION IN THE CONTEXT OF DEATH

The relevant issues that will be explored relate to the tax consequences of debt cancellation which takes place at the point of a taxpayer's death. Within this context there are three issues that arise:

- The reduction of debts through the wills of deceased persons;
- the lack of tax relief for deceased estates; and
- the reduction of funds available to pay the creditors of deceased estates.

6.2.1 Reduction of debts through the wills of deceased persons

This issue relates to the reduction of debts owed by an heir or legatee of a deceased person where the debts in question are cancelled in terms of the provisions of the will of a deceased person. Under such circumstances the actual reduction of a debt takes at the moment that deceased person's will comes into operation namely at the point of the deceased's death. There is a certain implication that flows from the reduction of a debt at the moment that a

deceased person dies and his/her will comes into operation. It appears that a debt that was owed to a deceased person but reduced through the deceased person's will does not form a part of the deceased's estate. The particular manner in which debt reductions through a deceased's will takes place appears to prevent such debt reductions from falling within the ambit of the exclusions set out in the provisions of sections 19(8) and paragraph 12A(6) of the Eighth Schedule of the Income Tax Act. As has already been discussed earlier in chapter five of this thesis, the application of the provisions of sections 19(8) and paragraph 12A(6) of the Eighth Schedule is subject to certain criteria. The provisions in question only apply to cases where a deceased estate reduces a debt that is owed to it by an heir or legatee. Furthermore, the reduced debts must actually form a part of the property of the deceased estate for the purposes of the Estate Duty Act. In other words the reduced debts must constitute assets owned by a deceased person's estate.

The criteria set out by the provisions of sections 19(8) and paragraph 12A(6) of the Eighth Schedule cannot be satisfied by debts that are reduced through a deceased person's will. Insofar as the first criterion is concerned it can be observed that debts reduced through a will are reduced before a deceased estate comes into existence. As such it is impossible for a deceased estate (through its executor) to actually reduce such debts. The second criterion cannot be met due to a different set of circumstances. When debt reduction takes place through a deceased person's will any liabilities that were owed to the deceased person are extinguished at the moment of the deceased person's death. This extinction of the debts at this point in time makes it impossible for such debts to ever constitute property that is owned by a deceased person's estate for the purposes of the Estate Duty Act. Consequently these circumstances prevent the second criterion set out by the provisions of sections 19(8) and paragraph 12A(6) of the Eighth Schedule from being satisfied.

The fact that debts reduced through a deceased person's will do not fall within the ambit of the exclusions set out in the provisions of sections 19(8) and paragraph 12A(6) of the Eighth Schedule of the Income Tax Act means that such reduced amounts may give rise to tax liabilities. Such tax liabilities arise in terms of the provisions of sections 8(4)(a) and 19 and paragraph 12A of the Eighth Schedule to the Income Tax Act. This means that in spite of the recent amendments to the Income Tax Act, debt reductions through the wills of deceased persons could lead to the imposition of a tax burden upon the heirs and/or legatees of

deceased taxpayers. The nature of the tax liability in the hands of the heirs or legatees depends upon the underlying *causa* of the debt. In most instances the debt will be a personal debt owing by the heir or the legatee, in which case the reduction amount will be set off against any assessed capital loss that the heir or legatee may have (par. 12Aof the Eighth Schedule). To the extent that the reduction amount exceeds the assessed capital loss, or where there is no assessed capital loss, there are no tax consequences. Where the debt was used to fund expenditure incurred in the production of income from a trade, the reduction amount will be dealt with in terms of section 8(4)(a), section 19 and paragraph 12A of the Eighth Schedule. The reduction amount is unlikely to be deductible as a bad debt in terms of section 11(i) in the tax return of the deceased person up to the date of death, unless it relates to a trading debt.

6.2.2 Lack of Complete Tax Relief for Deceased Estates

This problem can be explained by considering the position of deceased estates. Deceased estates can be grouped into two categories, the estates of deceased taxpayers who did not carry on some form of a business and the estates of deceased taxpayers who did carry on some form of a business.

The estate of a deceased taxpayer who did not carry on business is unlikely to have an assessed loss or an assessed capital loss unless the person incurred a loan in order to purchase capital investments which eventually gave rise to capital losses. The problem of a recoupment in terms of sections 8(4)(a) and 19 of the Income Tax Act is therefore unlikely to arise. As the new tax provisions ensure that no capital gains tax liability can arise, the issue of a tax on a debt reduction is unlikely to be a problem.

In contrast, it is possible for the estate of a deceased taxpayer who carried on business to have an assessed loss (as well as an assessed capital loss relating to the disposal of non-depreciable capital business assets). On the date on which a taxpayer, who carries on business, dies the person would have trading stock on hand and allowance assets, as well as other capital business assets. In the process of winding up the deceased person's estate, certain creditors may voluntarily reduce the debts owing to them, at which stage a recoupment may arise. There are, however, no capital gains which arise.

The tax relief which is granted after the death of a taxpayer accrues to the taxpayer's deceased estate. Such tax relief can be diminished as a result of debt reduction under two particular instances: firstly, if the death of a taxpayer leads to debt reduction in terms of a contract that had been entered into by the deceased taxpayer prior to his/her death; and secondly, if the creditors of a deceased estate reduce their claims against the estate sufficiently in order to keep the deceased estate solvent the reduced claims constitute reduced debts. The debt reductions which take place at this point lead to recoupments and thereby give rise to income tax liabilities in terms of section 8(4)(a) and section 19 of the Income Tax Act.

The taxation of debts discharged as a result of the death of a taxpayer or during the winding up process contradicts the legislature's intention to grant debt relief to financially distressed taxpayers through the enactment of section 19 and paragraph 12A of the Eighth Schedule of the Income Tax Act. Although some form of tax relief arises from these provisions such relief is partial in nature. The provisions of paragraph 12A provide capital gains tax relief by disregarding any capital gains which could arise through the reduction of debts during the process of winding up deceased estates. In contrast to the provisions of paragraph 12A, section 19 still permits normal tax liabilities to arise in terms of its own sub-sections or in the form of a section 8(4)(a) recoupment. These tax liabilities place a tax burden as opposed to tax relief upon deceased estates when debt reduction takes place during the winding up process.

6.2.3 Reduction of funds available to pay creditors

If the reduction of debts during the winding up process gives rise to an income tax liability in terms of sections 8(4)(a) and 19 of the Income Tax Act this has the result of increasing the amount of the SARS' claim against a respective deceased estate. Not only does this have the effect of increasing the total creditors' claims but it also has the effect of increasing the SARS' proportionate share of the total creditors' claims against a respective deceased estate. The increase in the SARS' proportionate share of the total creditors' claims reduces the amount of funds that are available for distribution to the other creditors, which in its turn creates further debt reduction, in an ever-recurring process.

6.3 ISSUES RELATING TO DEBT REDUCTION IN THE CONTEXT OF THE INSOLVENCY OF NATURAL PERSONS

Many of the adverse consequences that relate to insolvent deceased estates, also apply to insolvent living persons and these are addressed in this section. There were three key problems that still arise in connection with debt reduction in the context of the insolvency of natural persons:

- the lack of tax relief for insolvent estates;
- the reduction of funds available to pay the creditors of insolvent estates; and
- the disjuncture that existed between the provisions of the Income Tax Act and the Insolvency Act in relation to the tax treatment of reduced debts.

6.3.1 Lack of Complete Tax Relief for Insolvent Taxpayers

This problem is similar to the lack of complete of tax relief that is experienced by deceased estates. The key differences that exist do not stem from the provisions of the Income Tax Act. As such it unnecessary to discuss this problem in great detail as this will lead to a duplication of the discussion of the lack of complete tax relief experienced by deceased estates. It suffices to point out that the key differences that exist do not stem from the provisions of the Income Tax Act. Such differences relate to the winding up process that takes place in relation to deceased estates on the one hand and insolvent estates on the other hand.[34] As such the tax consequences are virtually similar.

The debt reduction which arises during the winding up of an insolvent estate is associated with partial debt relief by virtue of the provisions of paragraph 12A of the Eighth Schedule Income Tax Act and a normal tax liability arising in terms of sections 8(4)(a) and 19 of the Income Tax Act. As a result insolvent taxpayers only experience a partial form of tax relief.

6.3.2 Reduction of funds available to pay creditors

As was the case with the problem addressed in the previous section this problem is also similar to the problem experienced by deceased estates. That is to state that in both the winding up of insolvent estates and deceased estates there is a reduction of funds that are available to pay creditors. This means that when debt reduction takes place during the

[34] As the winding up of deceased estates is regulated by the Administration of Estates Act whilst the winding up insolvent estates is regulated by the Insolvency Act there some terminological and procedural differences that arise in the winding up of these two types of estates.

winding up of insolvent estates it leads to a further tax liability which again reduces the amount available for distribution to creditors – an ever recurring process. This position is untenable. Administrators of estates have probably adopted a pragmatic approach to this problem[35], but such an approach would not be consistent with the provisions of the Income Tax and Insolvency Acts.

A further problem that used to exist was that any part of the tax liability that could not be paid to the SARS would give rise to a further debt cancellation. This problem has, however, been addressed by excluding a "tax debt" from the definition of a "debt".

6.3.3 The disjuncture between the Income Tax Act and the Insolvency Act

Insofar as the tax treatment of reduced debts is concerned there is a disjuncture that exists between the provisions of the Income Tax Act and the Insolvency Act.

The disjuncture between the Income Tax Act and the Insolvency Act arises from two main aspects:

1. A distinction is drawn between the legal personality of insolvent debtors prior to sequestration and insolvent estates following the commencement of sequestration. After sequestration has commenced the Income Tax Act treats an insolvent debtor as a separate taxpayer from the one that is recognised prior to the commencement of sequestration. The separation in the legal personality of a taxpayer is accomplished by the provisions of section 66(13)(a)(b) of the Income Tax Act. In terms of these provisions insolvent debtors and insolvent estates must submit separate tax returns as if they were two different legal persons. In contrast to the provision of the Income Tax Act the Insolvency Act does not recognise insolvent debtors as new legal persons once sequestration has commenced. Whilst the Insolvency Act does recognise the divestment of the insolvent estate from an insolvent debtor the estate itself does not acquire any legal personality in terms of the Insolvency Act.

2. A discrepancy exists between the life-span of the insolvent estate as recognised by the Insolvency Act on the one hand and the Income Tax Act on the other hand. According to sections 25(1) and 129(2) of the Insolvency Act, insolvent estates exist from the

[35] This aspect is not addressed in the present thesis.

commencement of sequestration until the moment at which either a composition is implemented or rehabilitation takes place.[36] In contrast, the Income Tax Act recognises the existence of insolvent estates from the commencement of sequestration until the date on which an insolvent estate is finally wound up. The commencement of the existence of insolvent estates may be attributed to the provisions of section 66(13)(a)(b)(ii) of the Income Tax Act. The termination of such existence is not attributed to any express provisions in the Income Tax Act. Instead such recognition may be attributed to the provisions of paragraph 3.5 of Interpretation Note No. 8 (SARS: 2013) issued in relation to the Income Tax Act.[37]

This disjuncture between the Income Tax Act and the Insolvency Act affects the tax consequences of debts that are reduced as a result of the insolvency of natural persons.

6.3.4 Effects of the Disjuncture between the Income Tax Act and the Insolvency Act

When debt reduction takes place during the winding up process the personal rights in terms of which creditors can claim performance from an insolvent estate through the payment or repayment of an amount are extinguished. In the absence of any claims against it an insolvent estate no longer has a duty to render performance to its creditors through the payment or repayment of debts. Since the reduced debts constitute income in terms of the Income Tax Act an income tax liability may arise according to the provisions of sections 8(4)(a) and 19 of the Income Tax Act in terms of which an insolvent estate would be required to render performance to the SARS through the payment of its tax debt.

There is a contrast between the legal entities that are recognised by the Income Tax and Insolvency Acts at the point of rehabilitation. Whereas the Income Tax Act recognises the existence of insolvent debtors up the point that their estates have been sequestrated and recognises the person as a new taxpayer from that date, the Insolvency Act actually continues

[36] Section 25(1) of the Insolvency Act stipulates that the estate of an insolvent shall remain vested in the trustee of an insolvent estate until an insolvent debtor has been reinvested with the estate pursuant to a composition as in section 119 of the Insolvency Act or until the rehabilitation of the insolvent debtor in terms of section 127 or 127A of the Insolvency Act. Upon being granted an order of rehabilitation section 129(2) of the Insolvency Act reinvests insolvent debtors with their previously insolvent estates.

[37] It should be noted that technically speaking the provisions of interpretation notes do not create law. Nevertheless SARS' conduct in this case is based upon the contents of this interpretation note. As a result the provisions of paragraph 3.5 of Interpretation Note No. 8 contribute to the legal anomaly when they are read with the provisions of section 66(13)(a)(b)(ii) of the Income Tax Act.

to recognise insolvent debtors as well as their insolvent estates up to the point of rehabilitation. Insofar as the insolvency law is concerned any portion of the claims of creditors, including the SARS' claim, against an insolvent estate which are not settled constitute unpaid debts at the point of rehabilitation. According to section 129(1)(b) of the Insolvency Act such debts are reduced as a result of the rehabilitation of an insolvent debtor. Such debt reduction does not, however, give rise to any income tax consequences as the provisions of section 19 and paragraph 12A of the Eighth Schedule of the Income Tax Act are applied when the estate is wound up in terms of the Income Tax Act.

6.4 CONCLUSION

The purpose of this chapter was to identify and describe the specific problems and the legal anomaly which currently plague the taxation of reduced debts in South Africa. The discussion was provided in the context of the specific problem areas that continue to exist in relation to debt reduction in the context of death or the insolvency of natural persons. For the purposes of conducting the analysis four key specific problem areas were identified:

- reduction of debts through the wills of deceased persons;
- the lack of tax relief for deceased estates and insolvent estates;
- the reduction of funds available to pay the creditors of both deceased estates and insolvent estates;
- the disjuncture that exists between the provisions of the Income Tax Act and the Insolvency Act in relation to the timing of the reduction of the debts.

The reduction of debts owed by an heir or legatee of a deceased person in terms of the provisions of the will of a deceased person gives rise to certain tax consequences. Such debt reductions do not fall within the ambit of the exclusions set out in the provisions of sections 19(8) and paragraph 12A(6) of the Eighth Schedule of the Income Tax Act. Consequently debt cancellations of this nature give rise to income tax liabilities in terms of sections 8(4)(a) and 19 of the Income Tax Act – the tax liabilities themselves being borne by the heirs and/or legatees of the deceased.

In the case of both the administration of deceased estates as well as the insolvency of natural persons the reduction of debts during the winding up process gives rise to an income tax liability in terms of sections 8(4)(a) and 19 of the Income Tax Act. This debt reduction has

the result of increasing the amount of the SARS' claim against a deceased or insolvent estate. Not only does this have the effect of increasing the total creditors' claims but it also has the effect of increasing the SARS' proportionate share of the total creditors' claims against a respective deceased or insolvent estate. The increase in the SARS' proportionate share of the total creditors' claims reduces the amount of funds that are available for distribution to the other creditors of the deceased or insolvent estate, giving rise to further debt reductions.

Insofar as the tax treatment of reduced debts is concerned there is a disjuncture that exists between the provisions of the Income Tax Act on the one hand and the Insolvency Act on the other hand. The disjuncture between the Income Tax Act and the Insolvency Act is comprised of two components. Firstly, there exists a distinction between the legal personality of insolvent debtors prior to sequestration and insolvent estates following the commencement of sequestration. Even though the Income Tax Act treats an insolvent debtor as a separate taxpayer from the one that is recognised prior to the commencement of sequestration the Insolvency Act does not recognise insolvent debtors as new legal persons once sequestration has commenced.

Secondly, a discrepancy exists between the life-span of the insolvent estate as recognised by the Insolvency Act on the one hand and the Income Tax Act on the other hand. Although the Insolvency Act recognises the existence of insolvent estates from the commencement of sequestration until the moment at which either a composition is implemented or rehabilitation takes place the position under the Income Tax Act differs. The Income Tax Act only recognises the existence of insolvent estates from the commencement of sequestration till the date on which an insolvent estate is finally wound up.

This chapter has identified and described the specific problems and legal anomaly which currently plague the taxation of reduced debts in South Africa. The analysis in this chapter served as a culmination of the work that has been addressed so far in this thesis. Thus far the focus has been placed on the reduction of debts in the context of income taxes. But as has been pointed out in the first chapter as well as the conclusion of the fourth chapter, the provisions of the Income Tax Act are not the only tax provisions that are applicable to the reduced debts. Another set of tax provisions – namely those found in the Valued-Added Tax Act – are also applicable to reduced debts. In order for this the investigation of the tax

consequences of debt reductions in South Africa to be holistic the provisions of the provisions of the Value-added Tax Act must also be analysed. An analysis of the provisions of the Value-Added Tax Act will be undertaken in the next chapter.

CHAPTER 7: THE VALUE-ADDED TAX CONSEQUENCES OF DEBT REDUCTION

7.1 INTRODUCTION

Up to this point, only the income tax and donations tax consequences of reduced debts have been discussed. Since Value-Added Tax is also applicable to the reduced debts, a holistic investigation of the tax consequences of debt reduction in South Africa can only be conducted if it takes into consideration the provisions of both the Income Tax Act and the Value-Added Tax Act.

The purpose of this chapter is therefore to provide an explanation of the value-added tax consequences of reduced debts. This discussion is divided into three main sections. Firstly, the discussion starts off with a very general overview of the application of the Value-Added Tax Act. Secondly, a more detailed analysis is undertaken. This analysis will address the value-added tax consequences of debt reduction. Thirdly, the interaction between the Taxation Laws Amendment Act, 2012 and the Value-Added Tax Act will be explored.

7.2 VALUE-ADDED TAX CONSEQUENCES

Value-Added Tax is a consumption tax that is levied on the consumption of goods and services. The goods and services subject to value-added tax are known as taxable supplies.[38] Taxable supplies are subject to Value-Added Tax in terms of the provisions of section 7(1)(a) of the Value-Added Tax Act, which provides for the levying of value-added tax on the supply of goods or services. The imposition of Value-Added Tax on taxable supplies is not absolute and is subject to exemptions, exceptions, deductions and adjustments.[39]

Value-Added Tax is levied specifically on legal persons classified as vendors.[40] The terms 'persons' and 'vendors' are both defined in section 1 of the Value-Added Tax Act. The term 'person' as defined in section 1 of the Value-Added Tax Act includes any public authority, municipality, company, body of persons (corporate or unincorporated), the estate of any deceased or insolvent persons, trust fund and foreign donor funded project. Vendors are

[38] Section 1 of the Value-Added Tax Act defines the term 'taxable supply' as any supply of goods or services which is chargeable with tax under the provisions of section 7(1)(a) of the Value-Added Tax Act.

[39] This proviso is stipulated in section 7(1) of the Value-Added Tax Act.

[40] In this sense vendors collect Value-Added Tax on behalf of the SARS.

defined in section 1 of the Value-Added Tax Act as any persons who are or are required to be registered under the Value-Added Tax Act.

For the purposes of collecting value-added taxes vendors are required to register with the SARS in terms of the provisions of section 23 of the Value-Added Tax Act. Provided that certain requirements are met such registration may be either compulsory (in terms of section 23(1) of the Value-Added Tax Act) or voluntary (in terms of section 23(3) of the Value-Added Tax Act). Value-added tax only applies to persons who make supplies in the course of carrying on an enterprise. The term 'enterprise' is defined in section 1 of the Value-Added Tax Act as any enterprise or activity which is carried on continuously or regularly by any person in the Republic or partly in the Republic and in the course or furtherance of which goods or services are supplied to any other person for a consideration, whether or not for profit. Generally speaking juristic persons are created with the intention of conducting some form of enterprise or trade and would fall under the category of persons who need to register for value-added taxes. Natural persons may not always be involved in activities that would qualify as enterprise and the value-added tax provisions would only be applicable to natural persons to the extent that they carry on some form of enterprise as vendors.

The manner in which value-added taxes are collected may be summarised in the following manner. Suppliers of taxable supplies collect value-added taxes and pay them over to the Receiver of Revenue in the form of an output tax. The vendors to whom taxable supplies are supplied deduct the amounts paid as value-added taxes in respect of such supplies. Such taxes – which are regarded as input taxes – are deducted in terms of the provisions of section 16(3) of the Value-Added Tax Act.

7.3 THE VALUE-ADDED TAX CONSEQUENCES OF DEBT REDUCTION

The value-added tax consequences of reduced debts arise in terms of sections 22(1) and 22(3) of the Value-Added Tax Act. Whilst some of these provisions apply generally to all methods of debt reduction some of them only apply to specific methods of debt reduction. The value-added tax consequences arising through provisions of general application arise in terms of the provisions of sections 22(1) and 22(3) of the Value-Added Tax Act. In contrast the value-added tax consequences arising through provisions of specific application arise in terms of section 22(3)(b)(ii) which is to be read in conjunction with ancillary provisions found in

sections 8(2), 46(g), 46(h), 53(1)(a) and 53(1)(b) of the Value-Added Tax Act. In the process of considering the relevant provisions of the Value-Added Tax Act the effects experienced by creditors will be separated from those that are experienced by debtors.

7.3.1 Provisions of general application

Value-added tax consequences arising through provisions of general application arise in terms of the provisions of sections 22(1) and 22(3) of the Value-Added Tax Act. Whereas the provisions of section 22(1) of the Value-Added Tax Act are applicable to vendors who occupy the position of creditors in credit transactions; the provisions of section 22(3) of the Value-Added Tax Act are applicable to vendors who occupy the position of debtors.

7.3.1.1 Section 22(1) of the Value-Added Tax Act

The provisions of section 22(1) of the Value-Added Tax Act permit creditors to deduct input tax in respect of amounts that have been subjected to debt reduction. In terms of section 22(1) of the Value-Added Tax Act, if a debt is reduced a vendor providing a taxable supply may write off the value-added tax component of the reduced debt and deduct the amount, in terms of section 16(3) of the Value-Added Tax Act, as a deemed input tax. The value-added tax deduction can arise in this case under two particular circumstances:

a) firstly, when debt reductions take place; or
b) secondly, once a debt has been recognised as a bad debt and been written off for income tax and value-added tax purposes.

The value-added tax component of a reduced debt that is deducted is equal to the amount of consideration that is written off as an irrecoverable amount. Sometimes a vendor may transfer the account receivable relating to a taxable supply at face value to another vendor instead of writing the debt off. Under such circumstances section 22(1A) of the Value-Added Tax Act stipulates that the deductible value-added tax component is equal to the tax fraction (applicable at the time such taxable supply is deemed to have been made) of the face value of the transferred account receivable.

7.3.1.2 Section 22(3) of the Value-Added Tax Act

The provisions of section 22(3) of the Value-Added Tax Act stipulate that if a vendor makes a deduction in terms of section 16(3) of the Value-Added Tax Act in respect of taxable supplies but fails to pay the full consideration in respect of such a taxable supply, the vendor will be liable to pay a deemed output tax. The provisions of section 22(3) of the Value-Added Tax Act only become applicable if two criteria are met:

a) Firstly, in terms of section 22(3)(a) of the Value-Added Tax Act a vendor must have made a deduction in terms of section 16(3) of the Value-Added Tax Act in respect of taxable goods and or services supplied; and

b) Secondly, in terms of section 22(3)(b) of the Value-Added Tax Act, having made a deduction in terms of section 16(3) of the Value-Added Tax Act, the vendor in question must have failed to pay the full consideration in respect of such a taxable supply. This provision will only apply if the vendor has failed to pay the full consideration within a specific time period. The time period stipulated in section 22(3)(b) of the Value-Added Tax Act is a period of twelve months following the expiry of the tax period within which a deduction had been made in terms of section 16(3) of the Value-Added Tax Act.

In the event that the two criteria stipulated in sections 22(3)(a) and 22(3)(b) of the Value-Added Tax Act are met the portion of the consideration which has not yet been paid by a vendor shall be subjected to a deemed tax. This tax shall be deemed to be a tax charged in respect of a taxable supply made in the tax period which follows the expiry of the twelve month period during which a deduction had been made in terms of section 16(3) of the Value-Added Tax Act. The practical imposition of this deemed tax is subject to certain provisions found in sections 22(3)(b)(i), 22(3)(b)(ii) and 22(3)(b)(iii) of the Value-Added Tax Act.

In terms of section 22(3)(b)(i) of the Value-Added Tax Act, the twelve month period in which a vendor must pay the full consideration in respect of a taxable supply may be extended by means of a contractual agreement. In terms of these provisions this is possible if a contract, in terms of which a taxable supply has been made, specifically provides for the payment of consideration (be it partially or in full) to take place after the expiry of the twelve month tax period within which consideration must be paid under normal circumstances.

Under these circumstances, the consideration in question only becomes due at the end of the month within which the date of payment – stipulated in the contract – falls.

The provisions of sections 22(3)(b)(i) and 22(3)(b)(ii) of the Value-Added Tax Act are mutually exclusive. The provisions of section 22(3)(b)(iii) state that subparagraph (ii) shall not be applicable where a vendor has already accounted for tax payable in accordance with this sub-section, the sub-section referred to in this case being sub-section (3).

7.3.2 Provisions of Specific Application

Value-added tax consequences arising through provisions of specific application arise in terms of the provisions of section 22(3)(b)(ii). This section is to be read with certain ancillary provisions, namely sections 8(2), 46(g), 46(h), 53(1)(a) and 53(1)(b) of the Value-Added Tax Act. The provisions of specific application can be divided into two categories:

1. provisions pertaining to output or input tax liabilities; and
2. provisions pertaining to the legal personality of vendors.

The provisions of section 23(3)(b)(ii) of the Value-Added Tax Act apply to insolvent as well as deceased vendors. Under the discussion of the provisions of general application it was pointed out that the provisions of section 22(3) of the Value-Added Tax Act stipulate that if a vendor makes a deduction in terms of section 16(3) of the Value-Added Tax Act in respect of taxable supplies but fails to pay the full consideration in respect of such a taxable supply, the vendor will be liable to pay a deemed output tax. This deemed output tax must be paid within the twelve month period which follows the expiry of the tax period during which a deduction has been made in terms of section 16(3) of the Value-Added Tax Act.

Certain events may hamper the successful payment of consideration. Section 22(3)(b)(ii) of the Value-Added Tax Act lists the events that fall under this category as follows:

1. where the estate of a vendor is sequestrated, whether voluntarily or compulsorily;
2. where a vendor is declared insolvent;

3. where a vendor enters into a compromise or an arrangement in terms of section 311 of the Companies Act 61 of 1973 (referred to as "the old Companies Act"), or a similar arrangement with creditors; and
4. where a vendor ceases to be a vendor as contemplated in section 8(2) of the Value-Added Tax Act.

Section 22(3)(b)(ii)(bb) of the Value-Added Tax Act applies to vendors who have been declared insolvent. It should be noted that in terms of the Insolvency Act the declaration of insolvency and sequestration occur almost simultaneously. Declarations of insolvency are made by the courts. Recognition of this insolvent status is affirmed through the granting of a sequestration order in terms of section 12(1) of the Insolvency Act. In this regard it can be seen that sequestration always follows a declaration of insolvency.

The provisions of section 311 of the old Companies Act are applicable to solvent as well as insolvent corporations. The compromises or arrangements made in terms of this section are made between companies or their members on the one hand and the creditors of the companies on the other hand. The compromises or arrangements in question have the effect of reducing debts.

Section 8(2) of the Value-Added Tax Act applies to vendors who have ceased to be vendors. In terms of this section if a vendor ceases to be a vendor any goods or rights (capable of assignment, cession or surrender) which form part of the assets of the vendor's enterprise are deemed to have been supplied by the vendor in the course of the vendor's enterprise immediately before he/she ceased to be a vendor. This deemed provision is subject to a particular exception. If the enterprise previously carried on by a vendor, whose existence has come to an end, is carried on by a person who is deemed to be a vendor in terms of section 53 of the Value-Added Tax Act the provisions of section 8(2) will not apply.

The provisions of section 53 of the Value-Added Tax Act classify certain legal entities as vendors. There are two legal entities in particular which are deemed to be vendors – namely insolvent and deceased estates. In terms of the provisions of section 53(1)(a) of the Value-

Added Tax Act insolvent and deceased estates are deemed to be vendors in respect of any enterprise previously carried on by an insolvent or deceased debtor. The application of this provision is subject to certain conditions. Firstly, any enterprise previously carried on by a vendor must continue to be carried on by or on behalf of the trustee of an insolvent estate or the executor of a deceased estate. Secondly, the provisions will apply if anything is done in connection with the termination of the enterprise that was previously carried on by a vendor. Furthermore the provisions of section 53(1)(b) of the Value-Added Tax Act deem insolvent and deceased vendors to be one and the same vendors as their respective estates.[41]

As their existence is artificial by nature, deceased and insolvent estates are not capable of paying any value-added taxes in their own personal capacities. In order to address this issue the Value-Added Tax Act makes provision for representative vendors in sections 46(g) and 46(h). In the case of section 46(g) the executor or administrator of a deceased estate is recognised as the representative vendor of a deceased estate. Similar provisions also apply to insolvent estates in terms of section 46(h). According to these provisions the trustee or administrator of an insolvent estate is recognised as the representative vendor of an insolvent estate. The provisions of section 46 impose a duty upon representative vendors to settle any tax liabilities that are imposed by the Value-Added Tax Act on behalf of the legal persons that they represent.

When the provisions of section 8(2) are read with the provisions of sections 46 and 53 of the Value-Added Tax Act it becomes apparent that vendors cease to be vendors in terms of section 8(2) under two circumstances – namely through insolvency on the one hand and through death on the other hand.

If the four events listed in section 22(3)(b)(ii) of the Value-Added Tax Act take place, during the twelve month tax period within which consideration must be paid before consideration has actually been paid in full, a vendor must account for an amount of output tax that is equal to the portion of the consideration which remains unpaid when these four listed events take place. Section 22(3)(b)(ii) of the Value-Added Tax contains two provisos that stipulate the

[41] The provisions of section 53(1)(b) of the Value-Added Tax Act only apply in instances where the provisions of section 53(1)(a) of the Value-Added Tax Act are applicable.

conditions under which the provisions of sub-paragraph (ii) will apply. These two provisos are found in sections 22(3)(b)(ii)(AA) and 22(3)(b)(ii)(BB) of the Value-Added Tax Act.

In terms of section 22(3)(b)(ii)(AA) sub-paragraph (ii) will apply if consideration has not been paid in full at:

1. the commencement of sequestration;
2. the declaration of insolvency;
3. the date on which a compromise or similar arrangement is entered into; or
4. the date on which a vendor ceases to be a vendor either through death or insolvency.

The proviso in section 22(3)(b)(ii)(BB) of the Value-Added Tax Act explicitly states that sub-paragraph (ii) will apply if consideration has not been paid in full immediately before a vendor has ceased to be a vendor as contemplated in section 8(2) of the Value-Added Tax Act. It is apparent that section 22(3)(b)(ii)(BB) applies in circumstances under which section 8(2) has also been applied. Section 8(2) does not apply to persons who are deemed to be vendors in terms of section 53 – namely deceased and insolvent estates. When section 22(3)(b)(ii)(BB) is read in conjunction with sections 8(2) and 53 the conclusion is that section 22(3)(b)(ii)(BB) does not apply to deceased and insolvent estates.

The practical application of the provisions of sections 22(3)(b)(ii) and 22(3)(b)(ii)(AA) of the Value-Added Tax Act can be summarised in the following manner. If a vendor makes a deduction in terms of section 16(3) of the Value-Added Tax Act in respect of taxable supplies but fails to pay the full consideration in respect of such taxable supplies the vendor must account for a deemed output tax at the moment at which any of the four events, listed in section 22(3)(b)(ii) of the Value-Added Tax Act takes place. If, however, the twelve month period expires before any of the four events, listed in section 22(3)(b)(ii) of the Value-Added Tax Act take place the debtor will be liable to account for an output tax at that stage. The debtor will be liable to account for an output tax upon the expiry of the twelve month period. Whether the debt reduction takes place as a result of one of the four events, the deemed output tax liability would form a part of the SARS' claim against a vendor.

Under circumstances where a vendor has died or experienced insolvency, the extent to which a trustee, liquidator or executor can meet the value-added tax liabilities of an insolvent estate or deceased estate would be dependent upon the asset-to-liability ratio of the underlying estate. If the representative vendor's assets do not exceed his/her/its liabilities then it is not possible for the output tax liability to be met in its entirety. Subsequently the remaining balance of the output tax liability would be reduced either as a result of the winding up of an insolvent estate or as a result of the discharge of an executor of a deceased estate – in which case reduced debt tax consequences would arise.

7.4 INTERACTION BETWEEN THE TAXATION LAWS AMENDMENT ACT, 2012 AND THE VALUE-ADDED TAX ACT

The recent amendments brought about by the Taxation Laws Amendment Act, 2012 will have an impact on the tax debt arising in terms of sections 22(3)(b)(ii) and 22(3)(b)(ii)(AA) of the Value-Added Tax Act in relation to insolvent and deceased estates. The link between the Taxation Laws Amendment Act, 2012 and the Value-Added Tax Act can found in the provisions which were added to the Income Tax Act in terms of the recent amendments in the form of the definition of the term "debt" in section 19(1) as well as paragraph 12A(1) of the Eighth Schedule of the Income Tax Act. As was explained in chapter five, the definition of the term "debt" in section 19(1) as well as paragraph 12A(1) of the Eighth Schedule explicitly excludes "tax debts" as defined in section 1 of the Tax Administration Act. According to section 1 of the Tax Administration Act tax debts are defined as amounts of taxes due by a person in terms of a Tax Act. It is evident that the definition of the term "tax debts", as defined in section 1 of the Tax Administration Act, is wide enough to cover "tax debts" that arise in terms of the Value-Added Tax Act. This means that value-added tax liabilities that remain unpaid at either the point of an executor's discharge or the point of rehabilitation would be classified as tax debts. Such classification would place these value-added tax liabilities outside the scope of section 19 and paragraph 12A of the Eighth Schedule of the Income Tax Act.

7.5 CONCLUSION

The purpose of this chapter was to provide an explanation of the value-added tax consequences of reduced debts. This explanation was provided through a detailed analysis of the provisions of the Value-Added Tax Act which apply to the reduction of debts. After providing a general overview of the application of the Value-Added Tax Act a more detailed

analysis of the value-added tax consequences of debt reduction was undertaken. Finally, the interaction between the Taxation Laws Amendment Act, 2012 and the Value-Added Tax Act was explained.

The value-added tax consequences arising through provisions of general application arise in terms of the provisions of sections 22(1) and 22(3) of the Value-Added Tax Act. These provisions of general application are applicable to both debtors and creditors. The provisions of section 22(1) permit creditors to deduct an input tax in respect of amounts that have been subjected to debt reduction. The provisions of section 22(3) give rise to a deemed output tax liability. This deemed output tax becomes payable if a vendor makes a deduction in terms of section 16(3) of the Value-Added Tax Act in respect of taxable supplies but fails to pay the full consideration in respect of such a taxable supply.

The provisions of section 22(3)(b)(ii) address the value-added tax consequences that apply specifically to debt reduction that arises in the context of the administration of deceased estates and the insolvency of persons. These provisions are read in conjunction with ancillary provisions found in sections 8(2), 46(g), 46(h), 53(1)(a) and 53(1)(b) of the Value-Added Tax Act. Section 22(3)(b)(ii) will apply if consideration has not been paid in full at the particular moments:

1. the commencement of sequestration;
2. the declaration of insolvency; or
3. the date on which a vendor ceases to be a vendor either through death or insolvency.

As a result if a vendor makes a deduction in terms of section 16(3) of the Value-Added Tax Act in respect of taxable supplies but fails to pay the full consideration in respect of such taxable supplies the vendor must account for a deemed output tax at the moment at which any of the three events listed in section 22(3)(b)(ii) take place. Under certain exceptional circumstances a vendor may be exempted from accounting for such an output tax at the moment at which any of the three events listed in section 22(3)(b)(ii) take place. This would be the case if the twelve month period were to expire before any of the listed events.

Assuming that this was the case, a debtor would be liable to account for the output tax in question upon the expiry of the twelve month period.

Insofar as the interaction between the Taxation Laws Amendment Act, 2012 and the Value-Added Tax Act is concerned it was found that the amendments brought about by the Taxation Laws Amendment Act, 2012 will have an impact on the tax debt arising in terms of sections 22(3)(b)(ii) and 22(3)(b)(ii)(AA) of the Value-Added Tax Act in relation to insolvent estates. As a result any value-added tax liabilities that remain unpaid at the point of an executor's discharge or at the point of rehabilitation would fall outside the scope of section 19 and paragraph 12A of the Eighth Schedule of the Income Tax Act.

The discussions up to this point have achieved most of the goals of this research as set out in chapter one. There is, however, one goal which has not yet been addressed – that is the recommendation of suitable amendments aimed at remedying the problems and legal anomaly that currently plague the taxation of reduced debts. In this respect such recommendations will be addressed at length in the chapter that follows.

CHAPTER 8: COMPARATIVE LEGAL ANALYSIS AND PROPOSED REFORMS

8.1 INTRODUCTION

The preceding chapter provided an explanation of the value-added tax consequences of reduced debts. This explanation supplemented the explanations of the income-tax consequences of reduced debts that had been collectively provided in chapters four and five. Furthermore the explanation also supplemented the discussion in chapter six which pertained to the specific problems and legal anomaly which currently plague the taxation of reduced debts in South Africa. The analysis in the preceding chapter came to the conclusion that, unlike the Income Tax Act, the Value-Added Tax is not plagued by any similar problems. Any recommendations which are made are therefore only made in relation to the income tax consequences of reduced debts.

The recent amendments to the Income Tax Act were enacted in order to remedy the previous practice which failed to grant relief to debtors in financial distress. Owing to the failure (on the part of the amendments) to address debt reduction which arises in the context of the death or the insolvency of natural persons the recent amendments have been only partially effective. This partial effectiveness has given rise to certain problems and a legal anomaly which manifest themselves in the following manner:

- the lack of tax relief for deceased estates and insolvent estates;
- the reduction of funds available to pay the creditors of both deceased estates and insolvent estates;
- the disjuncture that existed between the provisions of the Income Tax Act, on the one hand, and the Insolvency Act, on the other hand, in relation to the point in time at which the debt reduction occurs.

The purpose of this chapter is to formulate suitable recommendations for amendments aimed at simultaneously remedying the existing problems and the legal anomaly that forms the subject-matter of this research. This chapter is divided into three sections. The first section is comprised of a brief examination of the relevant components of a selected foreign jurisdiction.

The foreign jurisdiction that has been selected for such purposes is Australia. The analysis of the Australian legal system will be presented with specific attention being paid to the tax treatment of reduced debts which arise within the context of death and the insolvency of natural persons in the Australia.

The second section is comprised of a comparative legal analysis which has been conducted for the purposes of deriving some form of legal precedent upon which the proposed reforms to be made in this chapter can be based. In this section the relevant components of the Australian and South African legal system will be compared to one another. This comparison will focus on the debt reduction methods arising within the context of death and the insolvency of natural persons. Thereafter the relation between these debt reduction methods and their tax treatment under the Australian legal system will be explored. The findings produced from this analysis will form the underlying basis or precedent upon which proposed legal reforms can be made.

The third section discusses the proposed reforms as they pertain to the administration of deceased estates on the one hand and the insolvency of natural persons on the other hand. The analysis in this section synthesises various aspects from the analysis in the first section and utilises these elements as the basis for recommending suitable reforms. The analysis takes into account two important factors, namely the laws regulating the different methods of debt reduction and the intentions of the legislature. In the process a number of potential reform measures will be examined in order to determine their suitability. From these a set of recommendations will be selected. The overriding criteria which will determine the suitability of these prospective reform measures is their capacity to satisfy two principle requirements. Firstly, the prospective reform measures must be capable of seamlessly merging with the laws regulating the reduction of debts arising within the context of death and the insolvency of natural persons. Secondly, they must also be able to successfully address the existing problems and the legal anomaly without contradicting the legislature’s intention to grant debt relief to financially distressed debtors.

8.2 ANALYSIS OF AUSTRALIAN LEGAL SYSTEM

In the process of examining the Australian legal system the following aspects of the legal system will be analysed:

1. the tax treatment of reduced debts;
2. the manner in which the death of a debtor affects contracts;
3. the effects of the discharge of an executor of a deceased estate from his/her duties;
4. the effects of rehabilitation from insolvency; and
5. the tax treatment of debt reductions emanating from rehabilitation.

There are a number of similarities between the manner in which reduced debts are treated for tax purposes under the Australian tax system on the one hand and the South African tax system on the other hand. Reduced debts are subjected to taxation in the Australian tax system in terms of an income tax as well as a consumption tax. The respective legislation that apply are the Income Tax Assessment Act 1997 (hereafter referred to as the "Australian Income Tax Assessment Act") and the Goods and Services Tax Act 1999 (hereafter referred to as the "Australian Goods and Services Act").

8.2.1 Provisions of the Australian Income Tax Assessment Act

The Australian Income Tax Assessment Act contains various provisions that address the taxation of reduced debts (which are known as forgiven debts under the Australian tax system). These provisions are found in divisions 40.90, 230.470, and the various sub-divisions of division 245 of the respective Act.[42]

Division 40.90 of the Australian Income Tax Assessment Act

According to division 40.90(1) the provisions of division 40.90 are applicable if the amount by which a debt has been reduced is applied to the reduction of expenditure incurred in relation a depreciating asset during an income year (year of assessment in South African Income Tax terms). Division 40.90(2) stipulates that reduced debts can be applied to the reduction of the cost of depreciating assets. Furthermore in terms of division 40.90(3)

[42] Whereas legislative provisions are referred to as sections or paragraphs in the South African legal system legislative provisions are referred to as divisions in the Australian legal system.

reduced debts can be applied to the reduction of the opening adjustable value of a depreciating asset. This reduction is, however, subject to the requirement that the income year in which such debt reduction takes place commences after the start time of the asset in question.[43]

Division 230.470 of the Australian Income Tax Assessment Act

The provisions of division 230.470 relate to the forgiveness of commercial debts. These provisions apply to debt reductions that are subject to the provisions of sub-divisions 245-C to 245-G.[44] According to division 230.470 if a gain that is made from a financial arrangement arises from the forgiveness of a debt the gain in question will be reduced by one of the following factors:

- the debt's provisional net forgiven amount as determined in terms of division 245-90;[45] or
- the debt's net forgiven amount (if the provisions of division 245-90 do not apply).

Division 245 of the Australian Income Tax Assessment Act

In terms of division 245 the reduced portion of a debt gives rise to certain tax consequences. The portions of a debt that have been reduced are used in order to off-set certain amounts which are listed in division 245.1 as follows:

- tax losses and net capital losses;
- capital allowances and some similar deductions; and
- the base costs of capital gains tax assets.

The application of the above-mentioned amounts has the effect of reducing the reduced portion of a debt. If any portion of a reduced debt still remains after the relevant reductions

[43] The start time of a depreciating asset is defined in division 40.60 as the time when a depreciating asset starts to decline in value.

[44] The relevant subdivisions of division 245 can be summarized as follows-

- sub-division 245-C: contains provisions that address the calculation of the gross forgiven amount of a debt;
- sub-division 245-D: contains provisions that address the calculation of the net forgiven amount of a debt;
- sub-division 245-E: contains provisions that address the application of net forgiven amounts;
- sub-division 245-F: contains provisions that address special rules relating to partnerships; and
- sub-division 245-G: contains provisions that address the keeping and retaining of records.

[45] Division 245.90 relates to agreements between companies under common ownership in terms of which the creditor forgoes any capital losses or deductions.

have been made this remaining portion is disregarded in terms of division 245.195.[46] This effectively provides debt relief to debtors.

Sub-division 245.2 provides a simplified outline of the provisions of division 245. According to sub-division 245.2(1) the provisions of division 245 only apply to commercial debts that are forgiven – either entirely or partially. A detailed list is provided of all the forgiven debts to which the provisions of division 245 do not apply. The forgiven debts to which division 245 does not apply are listed as follows:

- waived debts that constitute a fringe benefit;
- forgiven amounts that have already been or will be included in a taxpayer's assessable income;
- debts that are forgiven under an Act relating to bankruptcy;
- debts forgiven by means of a will;
- debts forgiven for reasons of natural love and affection; and
- forgiven debts that are related to a tax liability.

From these exceptions it is clear that tax relief is granted in the case of bankruptcy, in respect of unpaid debts, as well as tax debts that are reduced.

For tax purposes it is the net forgiven amount and not the gross forgiven amount that is taken in account. The net forgiven amount of each debt is calculated, in terms of sub-division 245.2(2), through the reduction of the value of a forgiven debt by the following amounts:

- any consideration that a taxpayer provides for the debt forgiveness; and
- any amounts that have already been brought to account by the Australian Income Tax Assessment Act because of such debt forgiveness.

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[46] Division 245.195(1) disregards any part of the total net forgiven amount that remains after the application of the amount to the reduction of a taxpayer's total assessable income. It is important to note that division 245.195 is subject to the provisions of division 245.215 which apply specifically to partnerships. According to division 245.215 any part of the total net forgiven amount that remains after the application of amounts to the reduction of a partnership's total assessable income is transferred to the partners of whom the partnership is comprised.

After the provisions of sub-division 245.2(2) have been applied the net forgiven amounts of all of a taxpayer's debts are applied to the reduction of certain amounts which are set out in terms of sub-division 245.2(3). In the process a taxpayer's net forgiven amounts in an income year are added together in order to yield a total net forgiven amount. This total net forgiven amount is then applied to the reduction of the following amounts: tax losses and net capital losses from previous income years;

1. deductions linked to expenditure incurred in a previous year; and
2. the base costs of capital gains tax assets.

There are two more important issues that are addressed by division 245.2. Firstly, in terms of sub-division 245.2(4) any unapplied total net forgiven amount is to be disregarded. Secondly, in terms of sub-division 245.2(5) there are special rules that apply to the debts of partnerships. These special rules are applicable in terms of division 245-F. The effect of division 245-F is to transfer any unapplied total net forgiven amount of a partnership to the partners of whom the partnership is comprised.

8.2.2 Provisions of the Australian Goods and Services Act

In Australia the reduced debt aspects pertaining to consumption taxes are regulated by the Australian Goods and Services Act. The consumption tax consequences only arise in the context of commercial transactions. The relevant provisions that apply to reduced debts are to be found in division 21.1 read with divisions 21.5 and 21.15 of the Act.

According to division 21.1 if debts are written off as bad debts certain adjustments are made to a taxpayer's net amounts. The net amounts in this case are the amounts that are subjected to taxation in terms of the Australian Goods and Services Act. If bad debts are written off an adjustment is made to a taxpayer's net amount. There are two types of adjustments that can arise, namely decreasing and increasing adjustments. Decreasing adjustments, which arise in terms of division 21.5, have the overall effect of decreasing the net amount or tax liability owed by taxpayers in terms of the Australian Goods and Services Act. In contrast the opposite is true for increasing adjustments. Increasing adjustments, which arise in terms of division 21.15, have the overall effect of increasing the net amount or tax liability owed by taxpayers in terms of the Australian Goods and Services Act. For all practical purposes the application of a decreasing adjustment to a taxpayer's net amount virtually amounts to a form

tax relief through the deduction of the amount of a reduced debt from the taxpayer's taxable income. The application of an increasing adjustment to a taxpayer's net amount virtually amounts to the taxation of a reduced debt.
As is evidenced from the provisions of divisions 21.5 and 21.15 the nature of the specific adjustments that are made is dependent upon a taxpayer's status as either a debtor or creditor. Whilst decreasing adjustments are made by creditors, increasing adjustments are made by debtors. The application of both divisions 21.5 and 21.15 is subject to the satisfaction of certain criteria.

Division 21.5 will only apply if four requirements are met. Firstly, a taxpayer must make a taxable supply. Secondly, the taxpayer should fail to receive consideration for the taxable supply – be it partially or the full amount. In terms of the third requirement it must be shown that the amount of consideration still owed to the taxpayer has been written off as a bad debt or that this amount has been overdue for a period of twelve or more months. The amount of the decreasing adjustment itself is equal to one-eleventh of either the amount written off or the amount that has been overdue for a period of twelve or more months. Fourthly, the taxpayer in question should not account on a cash basis.

The consumption tax consequences that arise in terms of division 21.15 also come into operation if certain requirements have been satisfied. Firstly, the taxpayer in question should make an acquisition (known as a creditable acquisition) for which a tax credit can be deducted. Secondly, the taxpayer should actually fail to pay the consideration that is due in relation to this acquisition – in which case the debt would be written off. A taxpayer would fail to pay consideration that is due if a supplier were to reduce a debt – be it partially or in full – or if the whole or a part of a debt had been overdue for twelve months or more. Once debts have been written off under such circumstances an adjustment (known as an increasing adjustment) must be made in order to reflect the fact that debt reduction has taken place. In other words the adjustment is made in order to reverse the amount that a taxpayer would have deducted in terms of a tax credit related to a creditable acquisition. The actual amount of the increasing adjustment itself is equal to one-eleventh of either the amount written off or the amount that has been overdue for a period of twelve or more months. It is important to note that just like the decreasing adjustment; the increasing adjustment cannot be made by taxpayers who account on a cash basis.

From this it appears that the Australian provisions relating to forgiven debts in terms of the Goods and Services Act are similar to those in the South African Value-Added Tax Act and do not give rise to any tax problems.

Now that is has been established that reduced debts give rise to income and consumption tax consequences under the Australian legal system there are three other aspects that need to be determined:

1. whether the Australian law relating to the administration of deceased estates makes provision for the discharge of debts;
2. whether the Australian insolvency regime makes provision for the discharge of debts; and
3. if such discharge does take place, whether or not such discharge gives rise to tax consequences.

8.2.3 Australian Law of the Administration of Deceased Estates

There are two specific aspects of the Australian law pertaining to the administration of deceased estates which will be considered. Firstly, the manner in which the death of a debtor affects contracts will be considered, followed by an analysis of the effects of the discharge of an executor or administrator of a deceased estate from his/her duties. Whereas the former will be discussed within the context of the Australian common law of contract the latter will be confined to an examination of the statute-based Australian law which regulates the administration of deceased estates.

8.2.3.1 The manner in which the death of a debtor affects contracts

The manner in which the death of a debtor affects contracts is different under South African and Australian laws. Under Australian law this outcome is also determined in terms of the common law of contract. The Australian law on this matter was set out in the case of Laybutt v Amoco (1974) 132 CLR 57. In this judgment presiding officer, Gibbs J, stated that in terms of the general rule the death of a debtor does not lead to the cancellation of contractual obligations. Rather, the death of a debtor has the effect of passing the deceased debtor's liabilities to his/her personal representatives. It should be pointed out that an exception to this general rule applies if the contract in question had been entered into for personal services

which require the exercise of personal skill and judgment. In South Africa, the Income Tax Act and the Administration of estates Act also pass the deceased person's liabilities to his or her representative – the administrator of the estate.

It is common cause that following his/her death a deceased debtor is represented by either the administrator or executor of his/her deceased estate. Both administrators and executors are appointed in terms of the provisions of the Administration and Probate Act 1958 (hereafter referred to as the "Australian Administration and Probate Act"). Whilst administrators of a deceased estate are appointed in the absence of a valid will according to the provisions of division 19, executors are appointed in the presence of a valid will in accordance with the provisions of division 27 of the Act.

8.2.3.2 The Discharge of an Executor or Administrator of a Deceased Estate

The discharge of an executor or administrator of a deceased estate takes place in terms of division 34 of the Administration and Probate Act 1958. Division 34.1 sets out the different circumstances under which an executor or administrator may be discharged of his/her duties. The exact implication of such discharge is explained in division 34.3. According to this sub-division discharge has the effect of absolving an executor or administrator of any (personal) liability for acts and things done in relation to a deceased estate after that date. As debts resulting from bankruptcy are granted tax relief in terms of division 245 of the Australian Income tax Assessment Act, the discharge of the executor or administrator will have no tax consequences for the deceased estate.

8.2.4 Provisions of the Australian Bankruptcy Act

Under Australian law insolvency takes place in terms of the provisions of the Bankruptcy Act 1966 (hereafter referred to as the "Australian Bankruptcy Act"). The term bankruptcy is used in reference to what is referred to as insolvency under the South African legal system. According to the Australian Bankruptcy Act debt forgiveness can take place within the context of bankruptcy under two circumstances. Firstly, upon the conclusion of a debt agreement and secondly, upon the rehabilitation of a bankrupt person from bankruptcy.

Debt agreements are concluded between bankrupt debtors and their creditors in order to settle any outstanding debts. Debt agreements are defined by the Australian Bankruptcy Act as

agreements concluded in terms of division 185H as a result of the acceptance of a debt agreement proposal. From this definition it is clear that the nature of debt agreements is influenced by debt agreement proposals. As such the nature of debt agreements will have to be analysed within the context of debt agreement proposals.

The Australian Bankruptcy Act defines debt agreement proposals as written proposals which are referred to in division 185C(1). The provisions of division 185C(1) set out debt agreement proposals as written proposals for debt agreement which are submitted by insolvent debtors to the Official Receiver. Debt agreement proposals can only be accepted if two conditions have been satisfied in terms of division 185EC. In terms of the first condition the Official Receiver must write to the affected creditors of a debtor and inform them about the details of the debt agreement proposals. The second condition that must be fulfilled requires the acceptance of a debt agreement proposal by a majority in value of the creditors who respond to the proposal before a specified deadline.

If a debt agreement proposal is accepted there are two types of debt agreements that can come into existence. These two types of debt agreements are set out in division 185H as unconditional and conditional debt agreements. Whilst unconditional debt agreements arise in terms of division 185H(2), conditional debt agreements arise in terms of division 185H(3). The defining characteristic that distinguishes unconditional debt agreements from conditional ones is the absence or presence of a requirement that a debt agreement proposal be subjected to the occurrence of a specified event within a specified period after the proposal has been accepted. Whereas unconditional debt agreements are characterised by an absence of this requirement conditional debt agreements are in contrast characterised by the presence of such a requirement. In the event that a bankrupt debtors debts cannot be collected in their entirety as a result of the debt agreement the uncollected portions of the debts in question are essentially forgiven.

Rehabilitation:

Insofar as the concept of rehabilitation is concerned there are some slight differences between the South African Insolvency Act and the Australian Bankruptcy Act. Although the Australian Bankruptcy Act does not make specific reference to the term rehabilitation, it does

make provision for the rehabilitation of insolvent debtors – primarily through their discharge from bankruptcy. In terms of the Australian Bankruptcy Act bankruptcy runs for a period of three years. After this three-year period has lapsed a bankrupt person is discharged from bankruptcy. In terms of division 153(1) of the Australian Bankruptcy Act the discharge from bankruptcy serves to release a debtor from all of his or her debts. Although this division makes reference to all of a debtor's debts, there are some debts that are actually not discharged when bankruptcy comes to an end. These debts are listed in division 153(2) of the Act. Nevertheless the discharge from bankruptcy in terms of the Bankruptcy Act resembles the discharge from insolvency that takes place in the South African legal system in terms of the Insolvency Act.

8.2.5 Overlap between the Administration of Deceased Estates and Bankruptcy

Under certain circumstances the administration of deceased estates can overlap with the bankruptcy of natural persons. This overlap can arise under two particular circumstances. In the first place, a person who has been declared bankrupt can die before the bankruptcy process has reached its finality. Secondly, during the process of administering a deceased estate the legal representative (executor or administrator) administering an estate may come to the conclusion that the estate is actually bankrupt. The Administration and Probate Act contains provisions which address the insolvency of deceased estates. These provisions are found in the first part of schedule two of the Act. The relevant provisions do not constitute a comprehensive guide of the manner in which insolvent deceased estates are to be treated. Instead the provisions are merely rules that set out the manner in which payments of debts are to be made where an estate is not solvent. The provisions are simply a list of the order of preference that is to be adopted in the settlement of claims owed by an insolvent deceased estate. The Act is, however, silent with regard to the effects that arise when the assets, from which these claims can be settled, become depleted.

Possibly the problem relating of insufficient funds can be resolved by the Bankruptcy Act. Like the Administration and Probate Act, the Bankruptcy Act also contains provisions which address the insolvency of deceased estates. These provisions are found in Part XI of the Act which regulates the administration of the estates of deceased persons in bankruptcy. There are two circumstances under which an insolvent deceased estate can be administered in terms of the provisions of Part XI of the Bankruptcy Act. Generally speaking if a deceased person

had been unable to pay his or debts as they became due on the day of his or her death the deceased person's remaining estate will be insolvent. In this case the deceased person dies before being officially declared bankrupt. Technically speaking this means that a deceased person who dies under such circumstances can only be declared bankrupt after the date of his or her death. In spite of this the Bankruptcy Act does not recognise the bankruptcy of a deceased person posthumously. The matter itself is addressed by the provisions of division 247A which recognise the bankruptcy of a deceased person either on or before the day on which the deceased person died. Insolvent deceased estates can also come into being if a bankrupt person dies during the winding up of his or her estate, thus after being officially declared bankrupt.

Insofar as the practical aspects of declaring a deceased person bankrupt are concerned there are two particular methods in terms of which a deceased person may be declared bankrupt. In the first instance a petition may be presented to a court by one or more creditors of the deceased estate, in terms of division 244, in order to declare the deceased person bankrupt. The other method through which a deceased person can be declared bankrupt is if a petition is presented to a court, in terms of division 247, by the legal representative responsible for the administration of a deceased person's estate.

The scope of the administration of insolvent deceased estates in terms of the Bankruptcy Act is wide enough to encompass any debt reduction which occurs as a result of the winding up of an estate. The administration process itself is undertaken by the trustee of the estate and not the legal representative a deceased estate. Any debt reduction which arises as a result of the winding up process is addressed in terms of the Bankruptcy Act in the same manner that it would be in the case of a bankrupt person who was still alive. Accordingly, any debts which remain unsettled at the moment at which an insolvent deceased estate is released from bankruptcy are discharged in terms of division 153(1). This discharge amounts to the forgiveness of debts and gives rise to certain tax consequences in terms of the Australian Income Tax Assessment Act as well as the Goods and Services Act. The tax consequences associated with insolvent deceased estates are the same as those which are normally associated with all other insolvent estates.

8.3 COMPARATIVE LEGAL ANALYSIS

The purpose of analysing the Australian Legal System was to derive some form of legal precedent upon which proposed legal reforms to the South African legislation can be made. The search for any precedent for the proposed reforms to be made to the South African tax laws necessitates the adoption of a comparative analysis of the South African and Australian legal systems. This comparison will focus on specific aspects of these two legal systems namely:

- debt reduction in the context of death;
- debt reduction in the context of insolvency;
- the overlap between debt reduction in the context of death and insolvency; and
- the tax consequences of debt reduction.

8.3.1 Debt reduction in the context of death

The comparative analysis of debt reduction which arises in the context of death has been summarised in **Table 2**:

South African Legal System	**Australian Legal System**
The death of a debtor leads to debt reduction if a contract entered into by the debtor provides for such debt reduction.	The death of a debtor does not lead to debt reduction in terms of the Australian law of contract. The only exception to this is if the debtor was required to render a personal service in terms of the contract in question.
Debt reduction occurs if the creditors of a deceased estate reduce their claims against the estate sufficiently in order to keep the deceased estate solvent.	
Debt reduction can take place upon the discharge of the executor of a deceased estate in terms of section 56(2) of the Administration of Estates Act.	Debt reduction takes place upon the discharge of the executor of a deceased estate in terms of division 34.3 of the Administration and Probate Act 1958. These debts have no tax consequences (division 245 of the Income Tax Assessment Act).

Own formulation

8.3.2 Debt reduction in the context of insolvency

The comparative analysis of debt reduction which arises in the context of insolvency has been summarised in **Table 3**:

South African Legal System	**Australian Legal System**
Debt reduction takes place once the creditors of an insolvent estate have accepted an offer of composition in terms of the section 119 of the Insolvency Act.	Debt reduction takes place once the creditors of a bankrupt debtor have accepted a proposal for a debt agreement in terms of division 185H of the Australian Bankruptcy Act.
Debt reduction also takes place according to section 129(1)(b) of the Insolvency Act once an insolvent debtor has been rehabilitated in terms of either section 124 or section 127A of the Act. These two provisions have stipulated time-periods after which rehabilitation takes place. In terms of section 124(2) rehabilitation can take place if a three-year period lapses from the moment of the confirmation of a trustee's first (liquidation) account. According to section 127A rehabilitation takes place automatically following the expiration of a period of ten years from the date of the sequestration of an insolvent debtor's estate.	Debt reduction takes place in terms of division 153(1) of the Australian Bankruptcy Act when the three-year period of bankruptcy finally lapses.

Own formulation

8.3.3 The overlap between debt reduction in the context of death and insolvency

The comparative analysis of the overlap between debt reduction arising in the context of death on the one hand and debt reduction arising within the context of insolvency on the other hand has been summarised in **Table 4**:

South African Legal System	Australian Legal System
Insolvent deceased estates can be administered under the Administration of Estates Act or the Insolvency Act.	Insolvent deceased estates are only administered under the Bankruptcy Act.
Debt reduction can take place in terms of the law of contract or section 56(2) of the Administration of Estates Act.	
Debt reduction can also take place in terms of sections 119 and 129(1)(b) of the Insolvency Act.	Debt reduction takes place in terms of division 153(1) of the Australian Bankruptcy Act.

Own formulation

8.3.4 Tax consequences of debt reduction

Insofar as the tax treatment of reduced or forgiven debts is concerned there are a number of things that can be learned from an examination of the Australian legal system. In the first place, there are no direct income tax exemptions that apply to debt reductions arising within the context of death. On its own this would seem to imply that such debt reductions are to be subjected to taxation. This however may not necessarily be the case as debt reduction can only take place within the context of death if a deceased estate happens to be bankrupt. Under such circumstances insolvent deceased estates are administered in terms of the Australian Bankruptcy laws. Therefore insolvent deceased estates are treated in the same manner as any other insolvent/bankrupt estates.

According to the Australian legal system insolvent/bankrupt estates are not subjected to income taxes as a result of debt reduction. The Australian Income Tax Assessment Act contains certain exemptions which explicitly preclude the application of debt reduction provisions to debt reductions arising within the context of the insolvency of natural persons. The scope of these exemptions is wide enough to encompass insolvent deceased estates. The

exemptions themselves apply to the forgiveness of commercial debts but do not extend to the forgiveness of debts that are associated with depreciating assets.

Under the Australian legal system the income tax exemptions stemming from the Australian Income Tax Assessment Act do not extend to the consumption tax provisions found in the Australian Goods and Services Act. The Australian Goods and Services Act does not contain any express provisions which prevent the imposition of taxes on debt reductions arising within the context of the bankruptcy of a natural person. As such debt reductions arising within the context of death and/or the bankruptcy of a natural person are subjected to consumption taxes under the Australian legal system.

8.4 PROPOSED REFORMS

The precedent derived from the comparative analysis of the Australian and South African legal systems paves the way for the recommendation of suitable reforms. The recommended reforms must take into account the the common law of contract and the provisions of the Administration of Estates Act as well as the Insolvency Act in South Africa on the one hand, as well as the intention of the legislature on the other hand.

8.4.1 The relevant laws regulating debt reduction

Under the South African law the administration of insolvent deceased estates can take place in terms of either the Administration of Estates Act or the Insolvency Act. This position differs from the Australian legal system where such administration can only take place in terms of the bankruptcy laws. As a result of the practice followed under the South African law the unsettled debts of insolvent deceased estates can be reduced in terms of the law of contract as well as the provisions of the Administration of Estates Act and the Insolvency Act.

The position relating to the insolvent estates of living persons is similar to the position adopted under the Australian legal system. In this instance the administration of such insolvent estates takes place in terms of the Insolvency Act. Subsequently, any debt reduction that takes place within this context takes place in terms of the provisions of the Insolvency Act.

If the tax treatment of reduced debts under the South African legal system is to take into account the laws regulating the different methods of debt reduction such laws must take into account the overlap between the laws pertaining to the administration of deceased estates and insolvency. This means that any suitable proposed reforms must address debt reduction arising in the context of death on the one hand as well as debt reduction arising in the context of insolvency on the other hand. This would have the combined effect of also addressing debt reduction pertaining to insolvent deceased estates.

8.4.2 The fulfilment of legislature's the intention

The proposed reforms must be designed to fulfill the intentions of the legislature as it forms the cornerstone of any suitable recommendations made in relation to the South African legal system. The proposed reforms must be framed around the specific problems that are currently being faced within the South African legal system. These problems can be ascertained through an examination of the legislature's intention in enacting the recent amendments in terms of the Taxation Laws Amendment Act, 2012. The legislature's intention behind these respective amendments can be gathered from the Explanatory Memorandum (National Treasury: 2012). According to the Explanatory Memorandum the legislature's intention in enacting the recent amendments was to grant tax relief to financially distressed debtors. In order to fulfill this intention the proposed reforms must be geared towards eliminating the problems that currently continue to exist.

As has already been discussed in chapter six the taxation of reduced debts stemming from the death or insolvency of natural persons in South Africa is currently plagued by a legal anomaly and certain other issues. In this respect there are at least four key specific problem areas that have been identified:

- the reduction of debts through the wills of deceased persons;
- the lack of tax relief for deceased estates and insolvent estates;
- the reduction of funds available to pay the creditors of both deceased estates and insolvent estates;
- the disjuncture that exists between the provisions of the Income Tax Act and the Insolvency Act in relation to the point of time at which a debt is reduced.

- Recommendations Relating to the Reduction of Debts through the Wills of Deceased Persons

The most appropriate recommendation that can solve this problem is the granting of complete tax relief to the heirs and/or legatees of a deceased estate. This objective could be accomplished if the tax liabilities that arise in terms of sections 8(4)(a) and 19 of the Income Tax Act could be prevented from arising when debt reduction takes place through the will of a deceased person.

- Recommendations Relating to the Lack of Complete Tax Relief

This issue could be resolved by granting complete tax relief to deceased estates and insolvent estates. This can be accomplished if the tax consequences that stem from the reduction of debts as a result of the death or insolvency of natural persons could be disregarded.

- Recommendations Relating to the Reduction of Funds Available to Pay the Creditors

If complete tax relief was to be granted to deceased estates and insolvent estates in the context of debt reduction stemming from the death or insolvency of natural persons, this would prevent the diminution of any funds available to pay the creditors of deceased or insolvent estates.

- Recommendations Relating to the Insolvency of Natural Persons

Any policy changes disregarding the tax consequences that stem from the reduction of debts as a result of the insolvency of natural persons would have the effect of rendering the disjuncture between the provisions of the Income Tax Act and the Insolvency Act irrelevant for tax purposes owing to an absence of tax consequences arising from the reduction of debts stemming from the insolvency of a natural person.

8.4.3 Consolidation of the Proposed Reforms

The close link between the nature of the recommendations relating to the four existing problems indicates that a few solutions will suffice in order to resolve all of the individual problems. These solutions would have to take the form of the amendment of the Income Tax Act. The provision in the Income Tax Act which could be amended for the purposes of implementing the reforms can be found in section 19 of the Income Tax Act. Section 19 contains provisions which exclude certain debt reductions from their ambit of application. These provisions are found in sub-section 19(8) of the Act. Exclusion provisions can be

added to sub-section 19(8) in order to ensure that debt reductions emanating from the death or insolvency of natural persons are excluded from falling within the ambit of this section.

The proposed amendments to be made to sub-section 19(8) of the Income Tax Act can be separated into two categories, which encompass the four key legislative problems that have been identified thus far. The first category pertains to recommendations which aim to address the first key problem - debts reduced through the wills of deceased persons. The second category relates to the remaining key problems: (1) the lack of complete debt relief for insolvent as well as deceased estates; (2) the reduction of funds available to pay the creditors of insolvent as well as deceased estates; and (3) the insolvency of natural persons.

Any reforms intended to address the first key problem would have to prevent a tax liability from arising in terms of sections 8(4)(a) and 19 of the Income Tax Act whenever debt reduction takes place through the will of a deceased person. This would entail the addition of provisions to the Income Tax Act that would have the effect of exempting such debt reduction from falling within the ambit of section 19. Such provisions could be added to the sub-section 19(8) which already contains other exemption provisions. Exemptions which prevent the application of section 19 would also have the effect of nullifying the application of section 8(4)(a). This arises from the fact that the application of section 8(4)(a), within the context of reduced debts, stems from the application of section 19. As such the provisions of section 8(4)(a) cannot be applied in isolation and can only serve to supplement the provisions of section 19. This means that it is sufficient to simply focus on amending the provisions of section 19 without necessarily amending the provisions of section 8(4)(a) as well in order to achieve a desired outcome. The actual provisions themselves could be phrased in the following manner:

> This section [section 19(8)] must not apply to any debt owed by a natural person –
>
> - if the debt in question is reduced or cancelled by a deceased person through the provisions of the deceased person's last will and testament.

The remaining three key problems can be addressed if the debt reductions arising within the context of the death or insolvency of a natural person are excluded from falling within the ambit of the debt reduction provisions of section 19 of the Income Tax Act. This could be

accomplished through the addition of exclusion provisions to section 19(8). The respective amendment to the provisions of section 19(8) of the Income Tax Act could be framed in the following manner:

> This section [section 19(8)] must not apply to any debt owed by a natural person –
>
> - as a result of that person's death or insolvency.

If these proposed remedies could be implemented they would eliminate the existing problems and the legal anomaly pertaining to the tax consequences that follow debt reduction which arises through the death or insolvency of natural persons. Not only would debt reductions arising within the context of the death or insolvency of a natural person be excluded from falling within the ambit of the debt reduction provisions of the Income Tax Act but they would also be (indirectly) excluded from falling within the scope of the debt reduction provisions of the Value-Added Tax Act.

8.5 CONCLUSION

The purpose of this chapter was to formulate suitable recommendations for amendments aimed at simultaneously remedying the existing problems and the legal anomaly that form the subject-matter of this research. This chapter was divided into three sections.

The first section was comprised of a brief examination of the relevant components of a selected foreign jurisdiction. The foreign jurisdiction that was selected for such purposes is the Australian legal system. The relevant components of the Australian legal system which were examined are the Australian Income Tax Assessment Act, the Australian Goods and Services Act, the Bankruptcy Act, the Administration and Probate Act as well as certain common law principles emanating from the Australian law of contract. Collectively these components of the Australian legal system provided an explanation of the tax consequences of debt reduction through the death or bankruptcy of a natural person under the Australian legal system.

After the examination of the Australian legal system had been concluded the second section of this chapter conducted a comparative legal analysis between the Australian and South

African legal systems. This analysis was conducted for the purposes of deriving some form of legal precedent upon which proposed reforms could be made.

Finally the third section proceeded to discuss the proposed reforms to the South African situation as it pertains to the administration of deceased estates on the one hand and the insolvency of natural persons on the other hand. By using elements from the Australian legal system as precedent suitable legal reforms were proposed. In terms of such reforms it was proposed that two sets of amendments should be made. The first proposal advocated for the elimination of the tax liability which arises in terms of sections 8(4)(a) and 19 of the Income Tax Act whenever debt reduction takes place through the will of a deceased person, by the addition of a provision to section 19(8) of the Income Tax Act, which would have the effect of exempting debt reductions of this nature from falling within the ambit of section 19. The second set of amendments to nullify the tax consequences of debt reductions which arise as a result of the death or insolvency of a natural person would encompass the express exclusion of debts reduced as a result of the death or insolvency of a natural person from the provisions of section 19 of the Income Tax Act.

The analyses in this chapter have brought to an end the enquiry that was undertaken in relation to the income tax and value-added tax consequences of reduced debts arising in the context of death or the insolvency of natural persons in South Africa. The conclusion of the discussions in all of the preceding chapters will be set out in the next chapter.

CHAPTER 9: CONCLUSION

9.1 INTRODUCTION

The research in this thesis was based upon an enquiry into the tax consequences of reduced debts, arising in the context of death or the insolvency of natural persons in South Africa. The research was also conducted in an effort to address the legal problems and anomaly that still exist in spite of the recent legislative amendments which were enacted in terms of the Taxation Laws Amendment Act, 2012. These recent legislative amendments represented an attempt on the part of the National Treasury to counteract certain negative tax consequences associated with debt reduction. Although the respective amendments did succeed in addressing most of these negative tax consequences, there were some tax consequences that were left unaddressed. Such tax consequences relate to the death as well as the insolvency of natural persons. In spite of these tax problems, there is no existing research that addresses this issue in a comprehensive manner. As such the present research sought to critically analyse the nature of these negative consequences and thereafter formulate recommendations that could rectify the existing legislative problems.

Prior to the enactment of the recent amendments to the Income Tax Act reduced debts gave rise to ordinary income, capital gains as well as donations tax consequences. In terms of the previous practice the reduction of debts gave rise to yet another debt – one that was owed to the SARS by virtue of the reduction of a debt. The National Treasury expressed concern over the previous practice which failed to grant relief to debtors in financial distress. In order to remedy this situation the tax laws relating to reduced debts were restructured through the amendment of certain provisions of the Income Tax Act. Such amendments took on the following form:

- the removal of certain provisions: sections 8(4)(m) and 20(1)(a)(ii) as well as paragraph 12(5) of the Eighth Schedule, from the Income Tax Act;
- the amendment of provisions: section 8(4)(a) and paragraph 13(1)(g)(ii) of the Eighth Schedule, which would be affected by the removal of provisions from the Income Tax Act; and
- the addition of new provisions: section 19 and paragraph 12A of the Eighth Schedule, to the Income Tax Act.

The reason for the recent amendments was a desire to streamline the tax treatment of reduced debts and to grant debt relief to financially distressed debtors. Based upon these objectives the recent amendments can be divided into two broad categories:

- amendments which standardised the terminology used in order to refer to reduced debts; and
- amendments which granted tax relief to financially distressed debtors who experience debt reduction.

In spite of the recent amendments there are certain problems and a legal anomaly which still currently plague the taxation of reduced debts in South Africa. These problems and legal anomaly are the result of the failure on the part of the recent amendments to successfully address debt reduction which arises in the context of two particular instances of debt reduction, namely death and the insolvency of natural persons. These problems and legal anomaly can be summarised in the form of four key points:

- the lack of tax relief for deceased estates and insolvent estates;
- the reduction of funds available to pay the creditors of both deceased estates and insolvent estates;
- the reduction of debts through the wills of deceased persons; such debt reductions place a tax burden upon the heirs and/or legatees of deceased taxpayers; and
- the disjuncture that existed between the provisions of the Income Tax Act, on the one hand, and the Insolvency Act, on the other hand, in relation to the date on which debt reduction occurs.

These problems give rise to the questions with which the present research was concerned: what is the nature of the tax consequences of reduced debts arising in the context of death and the insolvency of natural persons and how can the problems and legal anomaly associated with these tax consequences be rectified?

The research proceeded as follows:
An explanation was provided of the nature of the subject-matter which lies at the core of this research – namely reduced debts. Particular emphasis was placed on explaining the nature of debt reduction in the context of death and the insolvency of natural persons. These two

methods of debt reduction were placed in the context of the laws which apply to the administration of deceased estates as well as the insolvency of natural persons. The tax consequences that arise through the different modes of debt reduction were then explained with specific emphasis being placed on debt reduction which arises in the context of death and the insolvency of natural persons. This explanation encompassed the identification of the specific legislative provisions that are responsible for the tax consequences in question. The problems associated with the application of the tax provisions relating to reduced debts in the case of the death or insolvency of natural persons were identified. Finally suitable reforms were proposed, which aimed at addressing these problems and remedying the legal anomaly that currently plagues the tax treatment of reduced debts arising in the context of the death or insolvency of natural persons.

9.2 GOALS OF THE RESEARCH

The goal of this research was to investigate the legal anomaly which still currently plagues the taxation of debts reduced as a result of death or the insolvency of natural persons in South Africa. This involved the following sub-goals:

- providing an understanding of the various laws pertaining to the reduction of debts;
- the analysis of the various laws that govern the reduction of debts in the context of death or the insolvency of natural persons;
- an examination of the specific laws that apply to the administration of deceased estates as well as the insolvency of natural persons – in the context of debt reduction;
- evaluating the adequacy of the laws governing the tax consequences of debt reduction in the context of the death or insolvency of natural persons; and
- conducting a comparative analysis of the Australian legal system with specific focus on the tax consequences of debt reduction in the context of death or the insolvency of natural persons. The results of this analysis will then be used as the basis for the recommendation of changes to the relevant South African laws governing the tax consequences of debt reduction in the context of death or the insolvency of natural persons.

9.3 RESEARCH METHODOLOGY

The research design, which was derived directly from the objectives of the research, adopted a qualitative orientation. This design was applied within the framework of an interpretive paradigm. In order to produce optimum results the research employed the use of a mixed methodology approach based upon a format that was originally adopted in the Arthurs Report (1983, in Chynoweth, 2008). This format entailed the use of two methodologies, namely the interdisciplinary and the doctrinal methodologies. Both the doctrinal methodology and the interdisciplinary methodology were applied in an applied form. As a result two separate research methods were utilised in the process. These research methods are the expository and legal reform research methods.

9.4 FINDINGS

The research evaluated the adequacy of the laws governing the tax consequences of debt reduction in the context of the death or insolvency of natural persons and formulated suitable recommendations for amendments aimed at simultaneously remedying these existing problems and legal anomaly. The findings of the research will now be briefly summarised.

- Evaluation of the Adequacy of the Relevant Laws

The evaluation of the adequacy of the relevant laws investigated certain problems and a legal anomaly that still currently plague the taxation of reduced debts in South Africa in spite of the recent amendments.

- Reduction of debts through the wills of deceased persons

This problem relates to the reduction of debts owed by an heir or legatee of a deceased person, in terms of the provisions of the will of a deceased person. The reduction of debts owed by an heir or legatee of a deceased person in terms of the provisions of the will of a deceased person gives rise to certain tax consequences. Such debt reductions do not fall within the ambit of the exclusions set out in the provisions of sections 19(8) and paragraph 12A(6) of the Eighth Schedule of the Income Tax Act. Consequently debt cancellations of this nature give rise to income tax liabilities in terms of sections 8(4)(a) and 19 of the Income Tax Act – the tax liabilities themselves being borne by the heirs and/or legatees of the deceased.

- The lack of complete tax relief

Should debt reduction take place, deceased or insolvent estates will not be granted complete debt relief through the collective application of the provisions of sections 8(4)(a) and 19 as well as paragraph 12A of the Eighth Schedule of the Income Tax Act. Whilst it should be noted that paragraph 12A will grant complete capital debt relief to such deceased or insolvent estates the same cannot be said of sections 8(4)(a) and 19. Some form of ordinary debt relief will be granted to deceased or insolvent estates in terms of section 19. This form of debt relief will, however, only be partial in nature as a tax liability will still arise in terms section 19 itself as well as section 8(4)(a). These tax liabilities would place tax burdens as opposed to tax relief upon deceased or insolvent estates when debt reduction occurs.

- Reduction of funds available to pay creditors

In the case of both the administration of deceased estates as well as the insolvency of natural persons the reduction of debts during the winding up process gives rise to an income tax liability in terms of sections 8(4)(a) and 19 of the Income Tax Act. This debt reduction has the result of increasing the amount of the SARS' claim against a respective deceased or insolvent estate. Not only does this have the effect of increasing the total creditors' claims but it also has the effect of increasing the SARS' proportionate share of the total creditors' claims against a respective deceased or insolvent estate. The increase in the SARS' proportionate share of the total creditors' claims reduces the amount of funds that are available for distribution to the other creditors of the deceased or insolvent estate, which again creates further debt reductions in an ever-recurring cycle

- The disjuncture between the Relevant Legislation

Insofar as the tax treatment of reduced debts is concerned there is a disjuncture that exists between the provisions of the Income Tax Act on the one hand and the Insolvency Act on the other hand. The disjuncture between the Income Tax Act and the Insolvency Act is comprised of two components.

Firstly, there is a distinction between the legal personality of insolvent debtors prior to sequestration and insolvent estates following the commencement of sequestration. Even though the Income Tax Act treats an insolvent debtor as a separate taxpayer from the one that

is recognised prior to the commencement of sequestration the Insolvency Act does not recognise insolvent debtors as new legal persons once sequestration has commenced.

Secondly, a discrepancy exists between the life-span of the insolvent estate as recognised by the Insolvency Act on the one hand and the Income Tax Act on the other hand. Although the Insolvency Act recognises the existence of insolvent estates from the commencement of sequestration until the moment at which either a composition is implemented or rehabilitation takes place, the position under the Income Tax Act differs. The Income Tax Act only recognises the existence of insolvent estates from the commencement of sequestration till the date on which an insolvent estate is finally wound up.

- <u>The Formulation of Suitable Recommendations for Amendments</u>

The formulation of suitable recommendations for amendments placed particular emphasis on the provisions of the Income Tax Act, due primarily to the finding that the Income Tax Act is the only tax legislation that is currently plagued by any problems or legal anomaly relating to the tax consequences of reduced debts. In the process of the formulation of suitable recommendations for amendments, the legal precedent was derived from the Australian legal system, which served as the basis upon which proposed reforms were made. Reform recommendations were based on two considerations:

- the tax treatment of reduced debts should take into account the the common law of contract and the provisions of the Administration of Estates Act as well as the Insolvency Act; and
- the tax treatment of reduced debts should take into consideration the intention of the legislature.

By using certain elements from the Australian legal system as precedent, suitable legal reforms were proposed. In terms of such reforms two sets of amendments were proposed. Firstly, it was proposed that the tax liability which arises when debts are reduced through the wills of deceased persons should be eliminated. Secondly, it was proposed that the reduction of debts which arise as a result of the death or insolvency of a natural person should be prevented from generating tax consequences. Both of these two proposed amendments could be achieved if debts reduced as a result of the death or insolvency of a natural person are

expressly excluded from falling within the ambit of the debt reduction provisions of the Income Tax Act.

The relevant provision which could be targeted for the purposes of implementing such reforms can be found in section 19 of the Income Tax Act. Section 19 contains provisions which exclude certain debt reductions from their ambit of application. These provisions are found in sub-section 19(8) of the Act. Exclusion provisions can be added to sub-section 19(8) in order to ensure that debt reductions emanating from the death or insolvency of natural persons are excluded from falling within the ambit of this section.

The respective amendment to the provisions of section 19(8) of the Income Tax Act could be framed in the following manner:

> This section [section 19(8)] must not apply to any debt owed by a natural person –
>
> - if the debt in question is reduced or cancelled by a deceased person through the provisions of the deceased person's last will of testament.
> - as a result of that person's death or insolvency.

If this proposed remedy could be implemented it would eliminate the existing problems and the legal anomaly pertaining to the tax consequences that follow debt reduction which arises through death or insolvency. Not only would debt reductions arising in the context of the death or insolvency of a natural person be excluded from falling within the ambit of debt reduction provisions of the Income Tax Act but they would also be (indirectly) excluded from falling in the scope of the debt reduction provisions of the Value-Added Tax Act.

9.5 CONCLUSION

This chapter concludes the enquiry into the tax consequences of reduced debts in South Africa. The chapter summarised the findings of the preceding chapters and demonstrated how the goals of the research have been achieved. The goal of this research was to investigate the existing problems and the legal anomaly which still currently plagues the taxation of debts reduced as a result of death or the insolvency of natural persons in South Africa. This topic itself has not received much attention by researchers. As such there was very little literature which related specifically to the topic at hand. The lack of research on the topic constituted a

gap in the available literature. A comprehensive account of the tax consequences of reduced debts, arising within the context of death or the insolvency of natural persons, in South Africa served to fill the gap in the available literature.

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