

TAX AND EXCHANGE CONTROL ALERT

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DEBT REDUCTION AND CAPITALISATION – NEW RULING ISSUED BY SARS

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The Explanatory Memorandum on the Taxation Laws Amendment Bill, 2012 provided the rationale for the amendments as follows:

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

The new provisions were therefore implemented against the background of a very real economic concern and were therefore welcomed by many taxpayers. The main rationale behind the new debt provisions is to provide some sort of tax relief at the time of the debt reduction so as not to negate the intended positive effects of the relevant debt restructuring.

One of the most common transactions resulting in potential debt reduction issues arises in the event of an issue of shares in settlement of debt, where ordinarily the distressed company issues shares and utilises the proceeds from the subscription price to repay the debt. As a result thereof there have been several advance tax rulings issued by SARS since the implementation of the debt reduction rules which have dealt with various forms of the settlement of debt by way of the issue of shares.

The latest ruling issued by SARS in respect of this issue is Binding Private Ruling 246 (Ruling) which dealt with the tax consequences of a proposed settlement of a shareholder's debt and the subsequent issue of preference shares.

The facts on which the Ruling is based were as follows:

An *en commandite* partnership (a limited liability partnership often used as a vehicle in private equity structures) (Partnership) held 64.69% of the ordinary shares in a private company which is tax resident in South Africa (Applicant). The Partnership had several years prior to the application of the Ruling provided funding to the Applicant by way of unsecured, fixed rate debentures (Debentures). As a result of the distressed financial position of the group, of which the Applicant formed part, the Partnership agreed to assist with the

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The issue at hand was whether the transaction had the effect that the redemption of the debentures at full value would be subject to the debt reduction rules



restructuring of the Applicant's debt. The transaction steps are detailed in the Ruling, but can be summarised as follows:

- By utilising bridging finance provided by the bank, the Applicant would redeem the debentures for their full value, including all accrued but unpaid interest, and make transfer of the amount owing to the Partnership.
- The Partnership would then subscribe for preference shares issued by the Applicant and settle the redemption proceeds. The preference shares would be issued to the Partnership as fully paid up shares.
- The Applicant would thereafter repay the external bridging funding, using the subscription price proceeds received from the Partnership.

The issue at hand was whether the transaction had the effect that the redemption of the Debentures at full value would be subject to the debt reduction rules contained in s19 and paragraph 12A of the Eighth Schedule to the Income Tax Act, No 58 of 1962 (Act). SARS ruled that the debt reduction rules would not apply such that, in terms of s19(6) of the Act, the amount so reduced would not be deemed

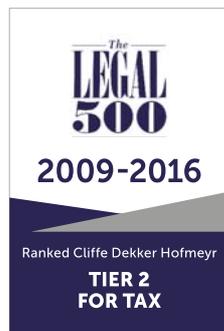
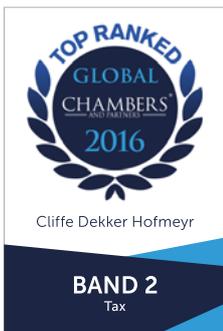
to be an amount received or recouped by the Applicant for purposes of s8(4)(a) of the Act. This was qualified to apply only to the extent that the amount outstanding on the Debentures included interest for which a deduction or allowance was permitted in terms of the Act.

SARS furthermore ruled that in the event of s19 not applying, which it appears would be the case if the transaction did not in fact result in a "reduction amount" in respect of a "debt", then s8(4)(a) of the Act would also not apply in consequence of the redemption of the Debentures for an amount that included accrued but unpaid interest, since there would be no amount to be recovered or recouped by the Applicant.

Interestingly, SARS specifically noted that the Ruling did not cover the application of any general anti-avoidance provision.

The Ruling is a further indication that the debt reduction rules must be applied with a degree of careful consideration and professional advice, particularly in respect of the issue of shares for the settlement of debt which is often a useful tool implemented in practice.

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