



Pitfalls in restructuring debt in business rescue

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Agenda

- What is a debt benefit
- Revenue rules
- CGT rules
- Distribution of cents to the Rand
- Loan capitalisation
- Loan subordination



General rule

A "**debt benefit**" will be taken into account as:

- Ordinary revenue if it funded deductible expenses or allowance; or
- Be subject to capital gains tax rules.

What is a “debt benefit”?

- Applies where there is **"debt benefit"** as a consequence of a **"concession or compromise"**.
- A **"debt benefit"**, depending on the context, means-
 - the amount of debt **waived or cancelled**; or
 - the amount of the face value of the debt which exceeds the **expenditure** incurred in redeeming the debt or acquiring the claim in respect of that debt; or
 - where the debt is exchanged for shares / capitalised-
 - (i) in the case of a new shareholder, the amount by which face value of the debt exceeds the market value of the shares issued;
 - (ii) in the case of an existing shareholder, the amount by which the face value of the debt exceeds the market value of all shares held after the capitalisation, less the market value of all shares held immediately before capitalisation.
- **"Debt"** means any amount that is owed by a person in respect of-
 - (a) expenditure incurred by that person; or
 - (b) a loan, advance or credit that was used, directly or indirectly, to fund any expenditure incurred by that person,(but does not include a tax debt as defined in section 1 of the Tax Administration Act).

Note: Interest is not a requirement

Debt benefit: Revenue rules (section 19)

- **Deductible expenditure** – recoupment in taxable income up to the amount of the "debt benefit" (section 8(4)(a));
- **Trading stock** –
 - (i) reduce the cost of the trading stock if the trading stock is still on hand; or
 - (ii) if the trading stock is partly sold, reduce the cost of the trading stock still on hand and treat the balance as a recoupment in taxable income (section 8(4)(a));
- **Allowance asset – first reduce base cost of asset and remaining balance is recoupment:**
 - (i) if the allowance asset is still on hand, recoup so much of the allowance claimed as a deduction up to the debt benefit and provided that the debt benefit has not been applied i.to. para 12A; or
 - (ii) if allowance asset has been disposed of and the recoupment resulting from the disposal is less than the recoupment that would have resulted from the debt benefit, recoup the difference between those amounts.
- **Exemptions:**
 - Non-trading (section 41) "group company" exemption;
 - Conversion / capitalisation of debt in exchange for shares between (section 41) resident "group companies";
 - "No interest" debt share capitalisation exemption.

Note: Also consider section 24J(4) and section 24J(4A) – adjusted gains and losses



Debt benefit: CGT rules (para 12A)

- Applies where a "**debt benefit**" arises on debt used to fund any expenditure:
 - which did not give rise to deduction or allowance; or
 - funded an allowance asset.
- **Capital asset on hand**
 - reduce base cost;
 - recoup allowance;
 - excess set-off against assessed capital loss.
- **Capital asset no longer on hand**
 - Reduce assessed CGT loss.

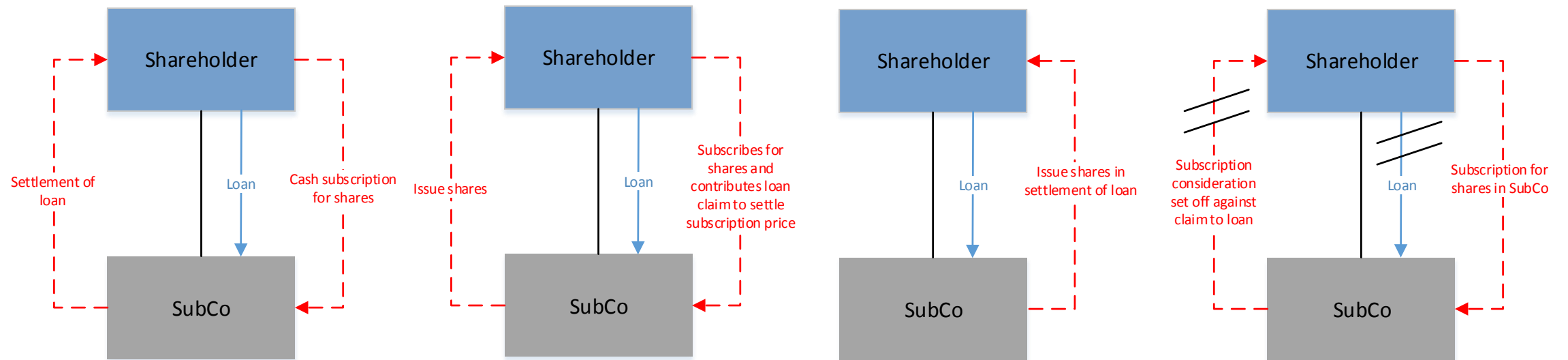
Exemptions

- Broadly similar to section 19 – with addition of "in the course of liquidation, winding-up and deregistration" related exemption;
- Includes the "no-interest" debt capitalisation exemption.

Distributions of cents to the Rand to creditors in business rescue plan

- Suppliers will not receive full payments for their invoices
- Potentially results in a recoupment or reduction in base costs
- Practical issues
 - Debt is reduced when BR plan is finalised, i.e. when actual amount reduced is confirmed and creditor notified
 - Timing mismatches due to payment waterfall?
 - Include the tax arising from the debt benefit in the list of creditors if potential positive cashflows in the next year
 - Do not include if in an assessed loss position as the tax arising from the debt benefit can be absorbed by the assessed losses
 - Budget 2021 – limitation of assessed losses to 80% of taxable income – YA commencing after 1 April 2022

Debt benefit: Loan capitalisation



Loan capitalisation

- Capital amounts capitalised – no issues here
- Interest amounts capitalised
 - Potential recoupments here if company in business rescue claimed interest deductions
 - What is the market value of the shares of a company in business rescue?

Loan subordination

- Type of subordination
 - No repayment of debt until market value is positive
 - potential hybrid debt instrument (section 8F)
 - Interest deemed to be dividend *in specie* for issuer of debt
 - Ranking
 - No repayment until creditor XY is paid in full
 - No section 8F issue
 - Repayment on demand
- The following does not give rise to a debt benefit
 - Payable on demand
 - Not a hybrid debt instrument
 - Change of terms and conditions
 - Interest rate is reduced
 - Repayment terms increased

Questions ?



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She has completed an LLM in Tax Law from the University of Pretoria, an LLM in Corporate Law with distinction from the University of Johannesburg and an LLB degree from the University of Cape Town. She has also completed an Advanced Certificate in Tax Practice with distinction from the University of Pretoria and passed Levels 1, 2 and 3 of the Chartered Financial Analyst (CFA) examinations.



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