KPMG

Tax Alert

October 2018

Retrospective amendments to the debt relief provisions

The Income Tax Act has always contained rules that give rise to tax implications for debtors whose debts are reduced or eliminated for less than the face value of the debt. These provisions are contained in section 19 and paragraph 12A to the Income Tax Act.

Depending on how the proceeds of a debt were utilised or the how the debt arose, the provisions can trigger income tax recoupments, a reduction in the tax cost of assets or both. Subject to exclusions, the debt relief provisions are triggered where there is a 'concession or compromise' in relation to a debt which results in the presence of a 'debt benefit'.

Significant amendments to the provisions were introduced with effect from years of assessment commencing on or after 1 January 2018. The Taxation Laws Amendment Bill ("the Bill") released on 24 October 2018 contains further amendments that will take effect retrospectively from 1 January 2018 (when the 2017 changes took effect) to ensure the 2017 amendments do not negatively affect taxpayers. The Bill also introduces new debt relief rules which will only take effect from 1 January 2019, discussed under cover of the Tax Alert entitled "Changes to the debt relief provisions from 1 January 2019"

Concessions and Compromises and resultant debt benefits

The starting point of any analysis of the debt relief provisions is to determine whether a 'concession or compromise' is present. The mere existence of a concession or compromise is however not sufficient to trigger the provisions of section 19 and paragraph 12A.

The concession or compromise must result in a 'debt benefit'. The table below sets out the events that will trigger a concession or compromise and the method for determining whether or not a debt benefit is present.

Concession or compromise	Debt benefit
Cancellation or waiver of a debt	The amount cancelled or waived
Extinction of a debt claim through redemption i.e. settlement of the claim in respect of the debt by the debtor or by any connected person in relation to the debtor	The amount by which the face value of the claim in respect of the debt prior to redemption exceeds the expenditure incurred in redeeming the debt
Extinction through merger i.e. operation of law by reason of the debtor acquiring the claim in respect of the debt.	The amount by which the face value of the claim in respect of the debt prior to redemption exceeds the expenditure incurred in acquiring the claim in respect of the debt
The direct or indirect settlement of a debt through the conversion to or exchange for shares in the debtor company.	Where acquirer of shares does not hold an effective interest in the shares of the debtor The amount by which the face value of the claim in respect of the debt exceeds the market value of the shares acquired
The direct or indirect settlement of a debt by applying the proceeds from shares issued by the debtor company.	Where acquirer of shares does hold an effective interest in the shares of the debtor The amount by which the face value of the claim in respect of the debt exceeds the amount by which the market value of any effective interest in shares in the debtor company has increased solely as a result of the arrangement

Exclusions to the debt relief provisions

In 2017, two significant new exclusions to the debt relief provisions were introduced. Both exclusions only applied in the context of local group companies.

The first exclusion allowed concessions or compromises in respect of debts owed by dormant companies to fellow group companies. This exclusion is retained and remains unchanged by the Bill.

The second exclusion allowed for the 'capitalisation' of debts through conversion or exchange or through applying the proceeds of a share issue to the settlement of a debt. This exclusion has been amended by the Bill in two respects:

- Capitalisation of accrued unpaid interest

  The definition of debt for purposes of section 19 and paragraph 12A currently excludes interest and taxpayers had to apply the general recoupment provisions contained in section 8(4)(a) of the Income Tax Act to determine whether any interest was recouped. The Bill reintroduces interest into the definition of 'debt' for purposes of the provisions. The waiver or capitalisation of any interest will therefore fall within the provisions of section 19 and paragraph 12A. Importantly, the exclusion in relation to 'capitalisations' does not apply to any portion of the debt which consists of or represents an amount owed by the debtor in respect of interest incurred by the debtor during any year of assessment. Taxpayers will therefore need to apply the debt benefit tests set out above the interest portion of the loan to determine whether any adverse tax consequences are triggered. Loan capital in respect of both interest bearing and interest free loans can however be capitalised without triggering the debt relief provisions.

- Local group of companies exclusion relaxed

  The 'capitalisation' exclusion which allows for the capitalisation of debt will no longer be restricted to local groups of companies but will apply to the capitalisation of all loan capital.

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