Debt capitalisation: An analysis of the application of section 24BA of the Income Tax Act

Pieter Janse van Rensburg
BAcc, LLB, HonsBCompt, MAcc Taxation, Chartered Accountant (SA)
Financial Manager, Campari South Africa (Pty) Ltd

Rudie Nel
BCom Accounting (Hons), MCom Taxation, Chartered Accountant (SA)
Senior lecturer, School of Accountancy, Stellenbosch University

1 Introduction

The combination in which respectively debt and equity are used to finance assets and operations of a company (the so-called capital structure or debt-equity ratio) depends on various factors, of which, the incidence of tax is one of the main influencing factors.¹ This is substantiated by the fact that the Income Tax Act² also acknowledges

1 Van der Linde Legal responses to corporate undercapitalisation: towards a proactive approach? (2011) 8
2 58 of 1962, hereinafter the Act (any reference to a section in this article refers to a section in the Act unless specifically indicated otherwise).
that debt can be akin to equity as a means of funding and contains re-characterisation rules for debt (and interest) and equity (and dividends) in sections 8E, 8EA, 8F and 8FA. Given the potential tax consequences of the funding decision a company could be able to adapt the ratio of debt and equity funding in tax planning. A method through which this can be achieved, is debt capitalisation.3

Debt capitalisation is an arrangement where a shareholder converts debt to equity.4 Stated differently, debt capitalisation is the process whereby the consideration for shares issued by a company takes the form of the discharge of an existing debt.5 Not only shareholder debt but also third party debts can be capitalised in exchange for shares.6 When debt capitalisation occurs, the \textit{quid pro quo} received by the creditor company in exchange for the reduction of the debt is shares in the debtor company.7 Debt capitalisation is not only concluded at the instance of debtor and creditor companies, but can be required by regulation (as illustrated by section 25BB(8) of the Act pertaining to Real Estate Investment Trusts).

Debt capitalisation can be achieved either directly or indirectly8 by applying different methods and the structuring of these methods should be kept in mind for tax purposes. A single transaction could have different tax outcomes than a series of transactions resulting in the same outcome as the single transaction.9 In the context of debt capitalisations the effective outcome can be achieved by means of the following three methods:10

\begin{enumerate}
  \item Direct settlement: issuing shares directly in settlement of the debt;
  \item Set-off: issuing shares and setting off the subscription loan owed by the subscriber against an amount owed by the company; and
  \item Conversion: converting debt to shares in fulfilment of the conversion rights attaching to the debt.
\end{enumerate}

Prior to the effective date of section 19 of the Act and paragraph 12A of the Eighth Schedule to the Act on 1 January 2013, only Binding Private Ruling (‘BPR’) 124 issued on 22 October 2012 dealt with the tax consequences of debt capitalisation. Since then, there has been an increase in the number of BPRs issued by SARS on debt capitalisation which could be indicative of the increased focus on the tax consequences thereof by taxpayers. The initial focus on debt capitalisation has been on

\begin{enumerate}
  \item KPMG “KPMG welcomes debt capitalisation tax proposal” 2015 Taxmail 1.
  \item SARS Interpretation Note 91: Reduction of debt (2016) 10.
  \item \textit{CIR v Datakor Engineering (Pty) Ltd} (1998) (4) SA 1060 (SCA) 8.
  \item SARS supra n 7 at 140.
  \item SARS supra n 7 at 140.
\end{enumerate}
the potential application of the debt reduction provisions, however, in the more recent BPR 246 and BPR 255 the SARS concludes by indicating that the rulings do not cover any general anti-avoidance provision to the proposed transaction. In this regard, a relevant anti-avoidance aspect that emanates from Interpretation Note 91: Reduction of debt, is the potential application of section 24BA of the Act to debt capitalisation.11

Section 24BA is aimed at a transaction in which a company acquires an asset from a person in exchange for the issue by that company to that person of shares in that company. The provisions of section 24BA would then apply, barring the exclusions afforded in section 24BA(4), if the value of the asset and the value of the shares differs. Prior to the promulgation of section 24BA, tax schemes with uneven exchanges allowed for value to be transferred without the appropriate tax consequences.12 These tax consequences arguably include the avoidance of donations tax when value is transferred between taxpayers. The value shifting anti-avoidance rules contained in the Eighth Schedule proved to be ineffective in regards to companies due to the fact that in many anti-avoidance transactions the ‘connected person’ relationship lacked.13 The purpose of section 24BA is to ensure that the value-for-value proposition applies to all asset-for-share transactions14 in cases where ‘connected persons’ as defined is not present.15 Although the section is mainly focused on asset-for-share transactions in terms of the corporate rules contained in section 42 of the Act,16 section 24BA(2)(a) specifically refers to its application to any transaction. The potential application of section 24BA should therefore be considered in all instances where a company issues shares and would therefore include debt capitalisation, especially whether it can be said that the company acquires an ‘asset’ as part of the debt capitalisation which will be addressed in section 3 to section 5 which follows.

The objective of this article is to investigate the potential application of section 24BA to each of the three methods of debt capitalisation. The article aims to conclude on whether the potential tax consequences imposed by the application of section 24BA, could result in a particular method of debt capitalisation being less favourable, compared to other methods. Section 2 of this article considers the three requirements for section 24BA to be applicable, including an analysis of relevant key terms of the three requirements. Section 3 to Section 5 deals with the different methods of debt capitalisation and the potential application of section 24BA to each method based on the three requirements of section 24BA.

13 Ibid.
14 Ibid.
16 Ibid.
2 The requirements of section 24BA

For section 24BA to apply the following requirements should be met:

a. Shares issued as consideration,
b. Asset acquired in exchange for the shares issued, and
c. The value of the shares issued and the value of the asset acquired differs.

2.1 Shares issued as consideration

The first requirement which has to be met is that a company should issue shares as consideration. A key feature of debt capitalisation is the issue of shares by a debtor company in exchange for a release from an obligation to pay debts. The remaining question is whether these shares have been issued as ‘consideration’, a word that is not defined in the Act.

The modern approach to interpretation of documents from the outset considers the context and the language together with neither predominating over the other. This approach to interpretation therefore insists that context be considered in the first instance, especially in the case of general words, and not merely at some later stage when ambiguity might be thought to arise. The Merriam-Webster dictionary, defines the ordinary meaning of ‘consideration’ as the inducement to a contract or other legal transaction; specifically an act or forbearance or the promise thereof done or given by one party in return for the act or promise of another. In terms of the Shorter Oxford English Dictionary on Historical Principles on the meaning of ‘forbearance’ as abstinence from enforcing what is due, especially the payment of a debt. The term ‘forbearance’ would therefore include a situation where the creditor offers the debtor release from its obligation to pay. In the context of debt capitalisation, the creditor gives, and the debtor company accepts, a forbearance of payment of the underlying debt in exchange for the issue of the shares by the debtor company. The amount of debt reduced or forborne by the creditor constitutes the ‘consideration’ for the share issue. The ordinary meaning is also not limited to positive performance only but allows for an interpretation of something forborne in exchange for something else. The ordinary meaning of ‘consideration’ consequently includes the forbearance of a right. In debt capitalisation the creditor’s right to claim payment from the debtor is forborne as quid pro quo for the shares issued by the debtor. This forbearance by the creditor to enforce its debt claim against the debtor should therefore also constitute ‘consideration’ for purposes of section 24BA.

18 K & S Lake City Freighters Pty Ltd v Gordon & Gotch Ltd (1985) 315.
19 SARS supra n 7 at 77.
2.2 Asset acquired in exchange for the shares issued

The issue of shares by the debtor must be in respect of acquiring an ‘asset’ as defined in the Eighth Schedule.\textsuperscript{20} The term ‘asset’ as part of the building blocks of capital gains tax should be interpreted widely.\textsuperscript{21} A specific method of debt capitalisation should thus result in the debtor company acquiring an ‘asset’ during debt capitalisation for the second requirement to be met. The main terms in the definition of ‘asset’ in paragraph 1 of the Eighth Schedule are ‘property’ and ‘a right’ to such property. SARS describes ‘property’ as anything that can be disposed of and turned into money.\textsuperscript{22} ‘A right’ would include both personal rights and real rights. A real right is a badge of ownership and is enforceable against all persons, whereas a personal right is enforceable against a specific person.\textsuperscript{23} The nature of a debt capitalisation transaction, being between a debtor and a creditor in respect of a debt owed between them is therefore submitted as a bundle of personal rights enforceable between the parties concerned and not enforceable against other persons. In debt capitalisation the second requirement for section 24BA to apply would be met only if the debtor receives ‘property’ or ‘a right’ to property that can be enforced against the creditor. This specific aspect is considered in greater detail in section 3 to section 5 below.

2.3 The value of the shares issued and the value of the asset acquired differs

The final requirement for section 24BA to apply is that the ‘consideration’ received by the debtor should be different from the consideration that it would have received if the asset was acquired in exchange for the issue of shares under a transaction between independent persons dealing at arm’s length. This requirement for section 24BA is therefore a value-for-value consideration and requires an analysis of a number of key concepts relating to value. When dealing with the issue of shares in reduction of debt, SARS recognises the distinction between the ‘market value of shares’, the ‘subscription price of shares’ and the ‘face value of debt’.\textsuperscript{24}

2.3.1 The ‘market value of shares’

The ‘market value of shares’ is a complicated matter as a result of valuation which can be controversial and subjective.\textsuperscript{25} Kumleben JA in

\begin{itemize}
\item Section 24BA(1)
\item Olivier “Determining a taxable capital gain or an assessed capital loss: some problems” 2007 Meditari 36.
\item SARS supra n 7 at 39.
\item SARS supra n 7 at 532.
\item SARS supra n 7 at 140.
\end{itemize}
Sarembock v Medical Leasing Services (Pty) Ltd\textsuperscript{26} 1991 1 SA 344 (A) indicated that as a general rule, the value of an article is to be determined with reference to the price such article would fetch in the open market.\textsuperscript{27} Due to the nature of property, and an absence of transactions suitable for comparison there may, however, be cases where the valuation is difficult. In many cases where debt capitalisation occurs, transactions are concluded between connected persons which further complicates the determination of value. The true value of related party debt, and consequently the shares to be issued, may be difficult to determine unless as part of a scheme of arrangements in terms of the Companies Act\textsuperscript{28} (the ‘Companies Act’), or a similar business rescue operation. A related party creditor may therefore have a significant debt claim against a debtor company, but the claim may be worthless in the hands of an unrelated party. This can be due to a variety of factors, including the solvency and liquidity of the debtor, its future prospects or the industry in which the debtor operates. This is substantiated by another argument that there is a contrast between the market value of debt and the book value of debt that is the result of a lack of public quotes for debt and that debt trades infrequently.\textsuperscript{29} This anomaly in determining market value in debt capitalisation could result in potential abuse. Parties may argue that the debt that is capitalised and shares subsequently issued have no market value, since no unrelated party will be willing to purchase the debt at face value and through this manipulate the value and number of shares issued. A possible solution for this may be found in a reference to Wessels JA in Katzenellenbogen Ltd v Mullin,\textsuperscript{30} where the judge indicates that the phrase ‘current value’ may sometimes be more appropriate than the phrase ‘market value’.\textsuperscript{31} When there is no active market which can determine the value of shares, the current value, or book value, may be more appropriate measure of value.

\textbf{2.3.2 The ‘subscription price of shares’}

The ‘subscription price of shares’ requires a distinction between the purchase price of shares and the subscription price. A subscription involves the issue of new shares and the proceeds of those shares go to the company that issued those shares.\textsuperscript{32} The subscription price is a crucial consideration from a Companies Act perspective, as section 40 of the Companies Act requires adequate consideration to be received for the issue of shares. Although in most instances the subscription price

\textsuperscript{26} 1991 1 SA 344 (A).
\textsuperscript{27} Cornelius “Banda v Van der Spuy 2013 4 SA 77 (SCA) – Quantifying a claim with the actio quanti minoris” 2013 De Jure 872.
\textsuperscript{28} 71 of 2008.
\textsuperscript{30} (1977) 4 All SA 818 (A).
\textsuperscript{31} Cornelius supra n 25 at 873.
would be equal to the face value of the debt (the face value of the debt being the *quid pro quo* for the issue of shares) the subscription price is of less importance from a debt reduction taxation point of view. In support of this, SARS has used examples where, despite the value of the subscription price, a ‘reduction amount’ is determined with reference to the market value of the shares and the face value of the debt.\(^{33}\) The subscription price for the shares however remains relevant when determining the potential application of section 24BA, since the ‘asset’ that the debtor acquires during debt capitalisation, is the right to enforce payment of the subscription price against the creditor.

### 233 The ‘face value of debt’

In addition to the values relating to shares the ‘face value of debt’ is the last distinct value in a debt capitalisation transaction. Apart from excluding a tax debt, the Act does not provide a definition or any further guidance on the meaning of ‘debt’ or the ‘face value’ of debt. National Treasury defines ‘debt’ to be a sum owed by one party (the debtor) to another party (the creditor).\(^{34}\) Despite the fact that debt has a market value when traded no indication in the Act that the tax consequences of debt should be determined with reference to the market value of such debt. Paragraph 38 of the Eighth Schedule merely deems a market value for an asset for purposes of calculating a potential capital gain and as result does not alter the value of the underlying debt between the debtor nor deem a market value to such debt. It could also be argued that the provisions of paragraph 38 would not apply where an asset is received in exchange for shares.\(^{35}\) The market value of debt is therefore not submitted as the ‘face value of debt’. Since the term ‘face value of debt’ is not defined and its ordinary grammatical meaning should be ascribed thereto as the context does not indicate otherwise, the face value of debt should only mean the amount that is due by the debtor to the creditor. This amount should form the base value for determining the tax consequences of debt capitalisation.

Having established the scope and the three requirements for section 24BA to apply, each of the three methods of debt capitalisation can be separately analysed for issues relevant to the particular method of debt capitalisation.

---

\(^{33}\) SARS *supra* n 7 at 140. Section 19 and paragraph 12A of the Eighth Schedule has subsequent to the version of the guide referenced been amended and now refers to the term ‘debt benefit’ instead of ‘reduction amount’. A comparison between the market value of the shares and the face value of the debt, however, remains relevant for the new definition of ‘debt benefit’ depending on the type of ‘concession or compromise’ in respect of that debt.

\(^{34}\) National Treasury *Explanatory Memorandum on the Taxation Laws Amendment Bill (2012)* 31

\(^{35}\) Paragraph 38(2)(e) read with section 24BA(4)(b).
3 Direct settlement

In debt capitalisation by means of direct settlement the debtor company is released from an obligation to pay the debt to the creditor. The creditor accepts, as *quid pro quo* for the debtor’s release from the obligation to perform, shares in the debtor. Debt capitalisation through direct settlement therefore involves only one transaction step, namely the issue of shares by the debtor in exchange for the release from an obligation to pay the debt. The issuing of shares would result in meeting the first requirement for section 24BA to apply.

The second requirement for section 24BA to apply is that an ‘asset’ should be acquired in exchange for shares issued. Given a strict interpretation of the phrases ‘property’ and ‘a right’ to property as part of the definition of ‘asset’, a release from an obligation to pay would not resort under the definition of ‘asset’ as the debtor does not acquire a right enforceable against another party but is rather released from an obligation towards the creditor. An ‘asset’ has also been argued as synonymous with the word ‘property’ as interpreted in the Constitution.\(^ {36}\) The property concept should as result be interpreted wider than in private law, but should be restricted to rights that are vested in the claimant and have patrimonial value.\(^ {37}\) From these conclusions ‘property’ and accordingly an ‘asset’ should be something that the holder thereof can control and exercise use over. During debt capitalisation, when the creditor relieves the debtor from its obligation to pay the debt the creditor elects to no longer exercise a claim against the debtor. In direct settlement as method of debt capitalisation the debtor does not acquire any rights exercisable against the creditor. The debtor merely issued shares as consideration for the settlement of debt and does not acquire an ‘asset’ which results in the second requirement for section 24BA not being met.

Section 24BA would therefore not apply in respect of debt capitalisation through direct issue of shares, however, the debt reduction provisions contained in the Act could still address value shifting. In terms of the debt reduction provisions, in terms of the amended section 19 and paragraph 12A, any difference between the market value of debt and the face value of debt will constitute a ‘debt benefit’ that may result in adverse tax consequences for the debtor company due to the value mismatch.\(^ {38}\)

---

\(^{36}\) Olivier *supra* n 22 at 37.


\(^{38}\) Paragraph (b)(i) of the definition of ‘concession or compromise’ in section 19(1) and paragraph 12A(1) of the Eighth Schedule, read with paragraph (a)(i) of the definition of ‘debt benefit’ in section 19(1) and paragraph 12A(1) of the Eighth Schedule.
4 Set-off

Set-off is recognised as a method in which obligations can be settled or terminated without requiring the exchange of performances. Set-off would occur where two parties are mutually indebted to each other and extinguishes obligations as effectively as if discharged by performance. The appellant in *Ackermans v CSARS* further contended that there is nothing sinister about a contractual arrangement pertaining to set-off and that set-off occurs in overabundance in commercial life. However, set-off has been submitted as one of the most complex areas in the South African law of obligations and SARS notes that set-off may only be applicable in certain circumstances. Although SARS does not elaborate on the specific circumstances, it is submitted that set-off will only be applicable if the legal requirements are met. Based on these legal requirements, considered in section 4.1, the application of section 24BA in the context of set-off is investigated in section 4.2.

4.1 Legal requirements for set-off to occur

The four requirements for set-off to occur are: (i) that both debts must be of the same nature, (ii) both debts be liquidated, (iii) both debts be due and payable and (iv) both debts must be payable by the debtor and the creditor in the same capacity and not to (or by) a third party.

For both debts to be of the same nature requires that the debts must be of the same kind for set-off to occur. Debts of the same nature implies that the debts must be for the delivery of identical kinds of subject matter such as two monetary debts. The debts however do need to be of the same value as debt can also be partially extinguished. Both claims will be regarded as liquidated if for an amount of money which is agreed upon and capable of prompt ascertainment (or ascertainment is a mere matter of calculation). The existence of a liquidated claim can be ascertained without challenge in a timely manner. For both debts to be due and payable such claims should be enforceable and consequently debts subject to time clauses or suspensive conditions cannot be set-off. In the context of debt

40 Van Deventer *supra* n 34 at 1.
42 De Kock *Die uitreik van aandele ten einde verplichtinge na te kom – onkoste werklik aangegaan vir inkomstebelastingdoeleindes of nie* (MAcc dissertation 2012 SU) 54.
43 SARS *supra* n 7 at 140.
44 Van Deventer *supra* n 34 at 37.
45 De Kock *supra* n 7 at 55.
47 *Ibid*.
49 Van Deventer *supra* n 34 at 38.
capitalisation debt not yet due can also by agreement be subjected to debt capitalisation as a contractual liability arises where there is a meeting of the minds and quasi-mutual assent\(^{50}\) and parties can change the payment terms of debts.\(^{51}\)

The final requirement for set-off to occur is that debts must be payable by the debtor and the creditor in the same capacity and not to (or by) a third party. This is a common law requirement, known as the ‘mutuality requirement’, which means that a creditor cannot rely on set-off in a representative capacity but that the debt must be reciprocal between the debtor and creditor.\(^{52}\) Furthermore, for debt capitalisation through set-off to occur regard must be given to the nature of the pre-existing debt as an asset in the hands of the creditor. If the creditor has ceded the debt such debt will not be suitable for set-off as the cessionary succeeds the creditor.\(^{53}\) When a debt has been ceded, the debtor and the creditor no longer owe the respective debts to each other in the same capacity and the subscription loan cannot be set-off against the pre-existing debt. In the absence of any encumbrances on the debt, there is however nothing that prohibits set-off for capitalisation to occur.

Based on the legal requirements for set-off to occur two parties should be indebted to each other which implies that two debts are required. A single obligation cannot be set-off against an obligation that does not exist and set-off in debt capitalisation would consequently require a second debt obligation to be established. Prior to a debt capitalisation transaction being executed only one debt exists, being the pre-existing debt that the debtor company owes to the creditor. Any pre-existing shareholding of the creditor in the debtor company would not represent an enforceable obligation that can be set-off against debt due to the different nature of debt and shares.\(^{54}\) In order to meet the requirement for set-off to occur a second obligation, a subscription loan, is established. Accordingly the creditor subscribes for shares in the debtor and the subscription price is not settled in cash but rather left outstanding as a subscription loan. The subscription loan is an enforceable right which the debtor then has against the creditor and which serves as the second obligation for set-off to occur. The application of section 24BA in this context is considered in the section which follows.

### 4.2 Consideration of section 24BA in context of set-off

The first requirement which has to be met is that a company should issue shares as consideration. In order to create the second obligation required to perform debt capitalisation through set-off the debtor company issues

---

53. Van Deventer supra n 34 at 36.
54. CIR v Datakor Engineering supra n 6 at 9.
shares as consideration for acquiring the subscription loan. The shares issued would satisfy the section 24BA requirement during the first transaction step required for debt capitalisation through set-off.

The second requirement of section 24BA is that an ‘asset’ should be acquired in exchange for shares issued. When a creditor subscribes for shares on loan account, the debtor company acquires an ‘asset’ in the form of the loan which represents an enforceable right against the creditor company to claim payment of the subscription price.\(^{55}\) Accordingly, section 24BA could be applied if there is a mismatch between the value of the shares issued and the value of the subscription loan. In this determination the value at which the subscription loan is recognised is a relevant consideration.

Section 40 of the Companies Act determines that a company must receive ‘adequate’ consideration when shares are issued. SARS indicates that ‘adequate’ consideration does not mean that the subscription price will be equal to the market value of the shares.\(^{56}\) This view is supported and advanced by an argument that even shares issued at a discount could amount to ‘adequate’ consideration in terms of the Companies Act.\(^{57}\) Since the Companies Act does not require consideration to be market related a debtor company can issue shares at a premium or discount to the market value of such shares. Shares issued at a discount, or a premium, based on the market value would necessitate consideration of section 24BA.

In terms of section 24BA(3)(a)(i) a capital gain will result for the debtor company if, immediately after the issue of the shares, those shares have a market value which is less than the subscription loan (notwithstanding the fact that the issue of shares is not a disposal in terms of paragraph 11(2)(b)). The debtor company could potentially also suffer a second capital gain when set-off occurs if the value of the subscription loan differs from the value of the pre-existing debt intended to be capitalised. When the subscription loan is set-off against the pre-existing debt, the extinction of the subscription loan will result in a disposal of the asset in terms of paragraph 11. Section 40CA(a) deems the base cost of the subscription loan that is disposed of to be equal to the market value of the shares issued. The debtor company will therefore dispose of an asset (the subscription loan) of which the base cost is lower than the proceeds (face value) of the debt discharged.\(^{58}\) The creditor who receives the shares must reduce cost actually incurred for those shares with the excess by which the face value of the debt exceeds the market value of the shares. Where the creditor holds the shares as capital assets the base cost should be reduced, whereas for shares held as trading stock the amount taken

55 SARS supra n 7 at 333.
56 SARS supra n 5 at 11.
58 Paragraph 35(1)(a) to the Eighth Schedule to the Act.
into account in respect of those shares in terms of section 11(a) or 22(1) or 22(2) should be reduced.\textsuperscript{59}

In the event that the market value of the shares exceed the face value of the subscription loan, the excess will be deemed to be a dividend \textit{in specie} paid by the debtor company.\textsuperscript{60} Section 40CA in this case vests the base cost for the subscription loan which will result in a capital loss when set-off takes place (due to the base cost being higher than the face value of the debt). This benefit is however offset by the debtor having been deemed to distribute an asset \textit{in specie},\textsuperscript{61} but only to the extent that no exemption or reduction in the rate of tax applicable to dividends \textit{in specie} in terms of section 64FA applies. Section 24BA does not regulate the base cost of the shares acquired by the creditor where the market value of the shares issued is higher than the face value of the debt\textsuperscript{62} and under normal principles, the creditor will be deemed to acquire the shares at the lower face value of the debt.

From the analysis above, section 24BA is submitted as a relevant consideration when debt capitalisation is done through set-off. If established that none of the exclusions to the section are relevant, both the debtor and creditor should consider the tax consequences of section 24BA, as both shares issued at a premium or discount to the value of the subscription loan has tax consequences.

5 Conversion

Apart from direct settlement and set-off debt capitalisation could also occur by means of conversion. Conversion is recognised in the Companies Act, which makes provision for the conversion of debt instruments into shares of a company in Part D of Chapter 2. In terms of section 43(1)(a) of the Companies Act a ‘debt instrument’ includes securities other than the shares of a company. Section 1 of the Companies Act defines ‘securities’ as any shares, debentures or other instruments issued by a company. ‘Convertible securities’ are in turn defined in section 1 of the Companies Act as any securities of a company that may be converted into other securities based on the terms that attach to those securities. Such convertible instruments would include convertible debentures\textsuperscript{63} and contingent convertible capital instruments.\textsuperscript{64} In the context of hybrid debt instruments, National Treasury indicates that a key feature of debt is the ability by the holder of the debt to redeem the capital within a reasonable time\textsuperscript{65}. Debt which

\textsuperscript{59} Section 24BA(3)(a)(ii) of the Act.
\textsuperscript{60} Section 24BA(3)(b) of the Act.
\textsuperscript{61} SARS supra n 7 at 334.
\textsuperscript{62} Ibid.
\textsuperscript{63} SARS Interpretation Note 43: Circumstances in which certain amounts received or accrued from the disposal of shares are deemed to be of a capital nature (2017) 7.
\textsuperscript{64} Liebenberg et al. “Pricing contingent convertible bonds in African Banks” 2016 SAJEMS 369.
does not allow for redemption within a reasonable time would be akin to equity. The period for capital redemption or conversion of convertible debt instruments is regulated through agreement and the terms of discharging the obligation are fixed before the debt instrument is issued. In relation to a ‘debt instrument’, the Companies Act defines a ‘security document’ as a document that embodies the terms and conditions of the debt instrument, although a ‘security document’ is not a prerequisite for the issue of debt instruments and could also occur in a private context. In the case of debentures the redemption or conversion is regulated by an indenture document and bonds are regulated by a convertible bond listing.

The discharge of a debtor’s obligation in terms of a debt instrument can be achieved either through the conversion of the debt instrument to shares or through the redemption thereof in cash. Section 8F(1) of the Act defines ‘redeem’ as the discharge of all liability to pay an amount in terms of the instrument and also acknowledges that taxpayers can ‘convert’ or ‘exchange’ debt instruments for shares. Section 24J contains a similar definition for ‘redemption’ of an instrument, being the discharge of all liability to pay an amount in terms of the instrument. SARS indicates that ‘conversion’ involves a substantive change in the rights that attach to assets.

In the case of redemption in cash the debtor would not issue shares in exchange for the release from the obligation and no debt capitalisation accordingly takes place. The fact that no shares are issued by the debtor would result in the first requirement for section 24BA not being met. Indirectly debt capitalisation would then only occur in cash redemption if the creditor applies the cash proceeds to subsequently subscribes for shares in the debtor at their own discretion.

In the case of conversion of debt instruments the debtor would issue shares in terms of the provisions of the convertible instrument resulting in the first requirement of section 24BA being met. When considering the second requirement, namely if an ‘asset’ has been acquired by the debtor, the contractually regulated provisions of the security document would be decisive. The security document would stipulate the performance required of the debtor and the creditor respectively and the resulting rights and obligations flow as result of conversion. The proposition is that in conversion the debtor and the creditor in essence intend to release a debt obligation through the issue of shares. The

66 Section 43(1)(a)(i) of the Companies Act defines a ‘debt instrument’ to include any securities other than the shares of a company, irrespective of whether or not issued in terms of a security document.
68 SARS supra n 7 at 77.
debtor’s release from a debt obligation in exchange for the issue of shares would in principle be similar to debt capitalisation through direct issue of shares. The interpretation of the phrases ‘property’ and ‘a right’ as part of the definition of ‘asset’ in the Eighth Schedule to the Act discussed in section 3 is consequently submitted as relevant. The debtor does not acquire an enforceable right against the creditor but is rather released from an obligation to perform and as result the debtor does not acquire an ‘asset’. The second requirement for section 24BA is accordingly not met and section 24BA is submitted as not being applicable to conversion as a method of debt capitalisation.

6 Conclusion

The increase in recent BPRs relating to debt capitalisation could be indicative of the concern of taxpayers in respect of the application of the debt reduction provisions to debt capitalisation. In respect of the different methods which can be employed to perform debt capitalisation due consideration of applying section 24BA is also emphasised by findings of this article.

Debt capitalisation through direct issue of shares and conversion of debt instruments to shares would not result in the application of section 24BA. For these two methods no ‘asset’ as defined in the Eighth Schedule is acquired by the debtor company when shares are issued. The debtor company would merely be released from an obligation to perform in a different manner. For debt capitalisation through set-off the debtor would, however, acquire an ‘asset’ in the form of an enforceable subscription loan when shares are issued. In this case of set-off the interaction between the value of the subscription loan and the value of the shares issued would be decisive in the application of section 24BA. If the shares are issued at market value and the subscription loan recognised at the market value of the shares section 24BA is not applicable. If the shares are issued at a discount or premium to the market value of such shares the following would apply:

a. Shares issued at a discount to the value of the subscription loan, section 24BA(3)(a) applies in terms of which the debtor will realise a capital gain;

b. Shares issued at a premium to the value of the subscription loan, section 24BA(3)(b) applies in terms of which the debtor would be deemed to distribute an asset in specie (resulting in consideration of dividends tax).

Despite the potential adverse tax consequences imposed by section 24BA would not apply if the debtor and creditor form part of the same
group of companies, are connected persons (and paragraph 38 applies) or the creditor holds all the shares in the debtor after the shares have been issued. When set-off of the subscription loan against the pre-existing debt is done as a second transaction step in set-off, the debtor will realise either a capital gain or capital loss, depending on the value of the pre-existing debt compared to the base cost of the subscription loan acquired during the first transaction step.

The article has shown that the method of debt capitalisation used by taxpayers would not only be relevant in considering the application of the debt reduction provisions of the Act but also in considering the application of section 24BA. Having considered the impact of section 24BA in respect of set-off as a method of debt capitalisation, it is submitted that selecting set-off as a method of capitalisation requires careful consideration.