DEBT DEFEASANCE: AN INCOME TAX LOOPHOLE OR A POINTLESS PURSUIT

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CHAPTER ONE - INTRODUCTION

The concept of a debt defeasance transaction has recently come under scrutiny in the South African financial market. In the financial arena lower lending rates and efficient tax planning are of paramount consideration to corporate entities seeking to raise finance and to properly structure their affairs. Debt defeasance transactions recognise the time value of money. Companies with long-term borrowings obtain financial advantages if those borrowings can be retired early as the present value of the liability is less than the face value thereof.

The objective of this paper is to present a comparative study of the manner in which debt defeasance transactions have been dealt with in the Australian jurisdiction and how the South African courts would view the income tax consequences of such transactions. The choice of the Australian jurisdiction finds its motivation in the similarity of the income tax regime of that country with the system applied in South Africa. Although the Australian income tax legislation allows for a wider range of income to be recognised as assessable income (hence the frequent references to "income according to ordinary concepts" in the judicial pronouncements in that country) the concept of an accrual of income is recognised and applied in the Australian legislation in a similar manner to that of the South African income tax legislation.

In addition, there have been a number of recent decisions in the Australian courts on debt defeasance transactions that were implemented during the 1980's. Given that the South African courts are mindful of developments in

Australia and will seek guidance from that jurisdiction, the contemporary nature of the Australian decisions referred to below is insightful and useful in a comparative study.

The conclusions reached in this dissertation are that the income tax benefits sought by the parties to the transaction and which are pivotal to the success of the transaction, will not be available in the South African context, just as they are not available in Australia. In certain circumstances the debt defeasance profit, as it is termed in this paper, will be fully taxable in the hands of the taxpayer to whom it accrues, particularly in regard to instantaneous defeasances and where the taxpayer is a financial institution. It is this outcome of the application of the general principles of the South African income tax legislation that leads to the failure of the transaction as a fund raising tool in the structured finance environment.

Thought has been given to whether or not the South African legislation should be amended to cater specifically for the debt defeasance transaction. There are no issues that are created by these transactions, such as mismatches in the timing of accruals and deductions as is the case in the trading of financial instruments, that are not already catered for in the current income tax legislation. The main enquiry in determining the consequences of a debt defeasance transaction is in the application of the gross income definition in section 1 of The Income Tax Act 58 of 1962. The application of the gross income definition is trite law and the judicial pronouncements thereon are adequate guidance and it is submitted that no amendment to the Income Tax Act is required to cater for debt defeasance transactions.

The structure of this paper will be to give an overview of the mechanics of debt defeasance transactions and the consequences thereof. A survey of the Australian examples of debt defeasances is undertaken and the judgements given by the Australian courts in response to such transactions are canvassed. An analysis will finally be undertaken on the income tax consequences of debt defeasances as they have been imported into South Africa.

CHAPTER TWO - DEBT DEFEASANCE EXPLAINED

Debt defeasances may take a number of forms. A <u>legal defeasance</u> is an arrangement whereby the borrower is released from its obligations to the lender when the assumer (a third party) accepts, in return for a consideration, the obligation to pay the lender the principle loan liability on the maturity date of that loan. Typically, the assumer is in a position to invest the consideration paid to it by the borrower and to achieve a rate of return that will place it in a position to pay the principle loan liability on the maturity date. The lender is a party to this arrangement and expressly consents to the release of the debtor. The legal consequence of such an arrangement is that the lender has acquired a right to require the assumer to pay the principal loan liability on the date of maturity. The lender has no further right of action against the borrower and the assumer does not act for or on behalf of the borrower. The release of the borrower is complete on the fulfillment of the assumption contract between it and the assumer. [1] It is submitted that unless the lender has been satisfied as to the ability of the assumption party to perform on the maturity date, the lender will not release the borrower from its obligations.

Alternatively, the defeasance arrangement may involve only the borrower and the assumer. This <u>in substance</u> or <u>de facto</u> <u>defeasance</u> involves the assumer undertaking to fulfil the obligations of the borrower, acting for and on behalf of the borrower, on the maturity date of the loan. The borrower remains

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[1] Debt Defeasance: A Corporate Perspective – Nenna, R.G. & Clough, M.A. – <u>The CCH Journal of Australian Taxation</u> – October/November 1990.

contractually bound to the lender.[2] The release of the borrower from its obligations only occurs upon the assumer repaying the lender in full on the maturity date.

Defeasance arrangements may be entered into in relation to existing debt as a means of allowing the borrower to increase its capital-raising capacity or in relation to a new debt. The latter arrangement is called an instantaneous defeasance. The assumption arrangement may also involve the assumption of the borrower's interest obligations but it frequently does not and in these instances the borrower will remain contractually obligated to the lender to pay the interest on the capital of the loan.

There are a number of benefits that parties to a debt defeasance enjoy. The lender is able to improve the profile of its debtor. This is because the assumption party would typically be an institution with a more stable and improved credit rating than the debtor. The lender will also retain its return on investments. The debtor also strengthens its position because the debt defeasance arrangement results in the reduction of the liabilities reflected on its balance sheet. At the same time the debtor achieves a savings on borrowings

[2] This is because a debt defeasance in its true form is a delegation of the debt from the debtor to a third party. For a valid delegation to take effect the creditor (lender) must give its consent to the transaction. Where there is no such consent the contractual relationship between the debtor and the creditor remains intact. (The Law of South Africa, Vol 3, paragraph 231; see also page 33).

because the loan liability is defeased at the present value thereof.[3]

Analysing the defeasance transactions from the perspective of the tax practitioner, three issues arise for consideration –

1. the nature, for income tax purposes, of the difference between the present value of the loan obligation paid by the borrower to the assumer ("**the assumption payment**") and the face value of the loan obligation in the hands of the borrower ("**the defeasance profit**");

2. the right of the borrower to the continued deductibility in its hands of the interest payments to the lender; and

3. the nature of the assumption payment as being either capital or revenue in the hands of the borrower.

Each of these issues has been raised in the Australian courts and consideration will be given in the following chapter to the manner in which these have been dealt with.

[3] Corporate Finance – Re-visiting Debt Defeasance – Marks, B. – The CCH Journal of Australian Taxation – April/May 1990, 44; see also pg 10.

CHAPTER THREE – THE AUSTRALIAN POSITION

3.1 LEGISLATIVE BACKGROUND

In determining the taxable income of a taxpayer the Income Tax Assessment Act, 1936 uses as its starting point the "total assessable income" of a taxpayer i.e. gross income plus all assessable income derived by the taxpayer during the year of assessment in question. Section 25 of the Income Tax Assessment Act provides:

> *"(1) The assessable income of a taxpayer shall include:*
>
> > *(a) where the taxpayer is a resident: the gross income derived directly or indirectly from all sources whether in or out of Australia; and*
> >
> > *(b) where the taxpayer is a non-resident: the gross income derived directly or indirectly from all sources in Australia;*
>
> *which is not exempt income, an amount to which section 26AC or 26AD applies or an eligible termination payment within the meaning of Subdivision AA.*
>
> *(2) Interest (except interest paid outside Australia to a non-resident on debentures issued outside Australia by a company) upon money secured by mortgage of any property in Australia shall be deemed to be derived from a source in Australia."*[4]

From the total assessable income all allowable deductions are made.

[4] Section 25 of the Income Tax Assessment Act, 1936.

The Income Tax Assessment Act does not contain a definition of the term "income" *per se* and the Australian Courts have failed to assist in defining the concept.[5] Rather, frequent reference is made to "income according to ordinary concepts." In Scott v Commissioner of Taxation [6] Jordan CJ said:

> *"The word income is not a term of art, and what forms receipts are comprehended within it, and what principles are to be applied to ascertain how much of those receipts ought to be treated as income, must be determined in accordance with the ordinary concepts and useages of mankind, except insofar as the statute states or indicates an intention that receipts which are not income in ordinary parlance are to be treated as income, or that special rules are to be applied for arriving at the taxable income of such receipts."* [7] (my underlining)

It should be noted that there are a number of special inclusions into assessable income that could not be regarded as income according to ordinary concepts, for example retiring allowances or balancing charges on disposal of depreciated plant.[8]

The Income Tax Assessment Act deals separately with classes of taxpayer~~,~~s with particular provisions relating to the different classes of taxpayers. In determining the taxable income of corporate taxpayers the

[5] Australian Income Tax Guide, 26th Ed, E.F. Mannix and J.E. Mannix, Butterworths 1981, 17.
[6] (NSW) (1935) 35 SR (NSW) 215.
[7] 219.
[8] Mannix and Mannix, 17.

net profit as per the accounts of the taxpayer is the starting point and various adjustments are to be made thereto. The adjustments involve either the adding back of provisions for which the Income Tax Assessment Act makes no provision to deduct or to allow deductions that the Income Tax Assessment Act allows the taxpayer to deduct.[9]

The tax is levied on income "derived" or deemed to have been derived by the taxpayer. In regard to the income of a business, such income is derived when it is earned and the actual receipt of money in not necessary for the income to be included into assessable income. [10] The system is similar to the concept of the "accrual" of income established by the South African Income Tax Act [11].

The Income Tax Assessment Act is an exceptionally long and voluminous piece of legislation which is currently being rewritten and extensively amended. The basic principles set out above are not amended by the restructuring of the Income Tax Assessment Act. The above is intended merely to provide an overview of the basic principles of the Australian income tax system. Specific sections of the Income Tax Assessment Act are referred to in the case studies conducted below and they are dealt with in that context.

[9] Section 48 of the Income Tax Assessment Act, 1936.
[10] Section 6 of the Income Tax Assessment Act, 1936.
[11] See Commissioner for Inland Revenue v People's Stores (Walvis Bay) (Proprietary) Limited 1990 (2) SA 353 (A) and my discussion thereon at 36.

3.2 CONTEXTUAL BACKGROUND

The instances in which debt defeasances were typically employed in Australia were where the borrower had raised funds by the issue of debentures to the public which debenture issue was usually secured through debenture trust deeds. The trust deed typically imposed borrowing and other financial constraints upon the borrower such as the maintenance of the ratio of assets to liabilities and onerous reporting obligations.

The theoretical possibility of the early redemption of the debentures did not release the borrower from the ratio and reporting obligations. However, the lender would not be adverse to releasing the borrower from its obligation to repay the loan when, as a result of a debt defeasance transaction, a bank or government institution (i.e. a creditworthy institution) stepped into the shoes of the borrower. The benefits were threefold:

i) the borrower enhanced its ability to save on borrowings and at the same time released itself from the restrictive constraints of the trust deed;

ii) the lender retained its return on investment; and

iii) the lender improved the security of its loan capital.[12]

In response to these transactions the Commissioner issued Taxation Ruling IT2495 in September 1988 in which the view of the Commissioner

[12] Nenna & Clough; 17.

regarding debt defeasance transactions was expressed as follows:

1. as a result of the defeasance transaction a profit will in all instances necessarily arise; and
2. such profit will constitute assessable income of the borrowing company pursuant to:
   - Section 25;
   - Division 16E; or
   - Part IIIA

Of the Income Tax Assessment Act.[13]

Section 25 of Income Tax Assessment Act includes into the gross income of a taxpayer gross income derived directly or indirectly from all Australian sources by a taxpayer. The Commissioner seeks to use this section to tax the difference between the assumption payment and the face value of the principal loan liability as being a gain constitution ordinary income. Division 16E provides for the taxation of discounted and deferred interest securities on a daily averaging basis. This section is similar to section 24J of the South African Income Tax Act and is predicated on the argument that the debt defeasance arrangement creates an instrument to which daily averaging (or yield to maturity accounting) could applied for income tax purposes. In relying on the provisions of Part III A of the Income Tax Assessment Act the Commissioner is attempting to bring the defeasance profit within the net

[13] Nenna & Clough, 17.

of the capital gains tax imposes by that Part of the Income Tax Assessment Act.[14] Obviously where section 25 can be applied Part III A will not be capable of being applied simultaneously.

In reaching these conclusions the Commissioner relied very heavily on the Full High Court judgement of The Federal Commissioner of Taxation v The Myer Emporium Limited[15]. In that case the taxpayer was required to raise finance to fund a group company restructure, but its available options were limited by the restrictive borrowing ratios prescribed in the trust deed. The taxpayer accordingly lent to its subsidiary A$80 million at a commercial interest rate over a particular period of time. Within days of entering into the loan agreement the taxpayer assigned its right to receive interest from its subsidiary to a financial institution in return for which the taxpayer received a consideration of A$45 million.

The Commissioner sought to include the A$45 million in the assessable income of the taxpayer under either section 25 (1) or section 26 (a) of the Income Tax Assessment Act by arguing that a gain made as a result of a business deal is income even if that business deal is not concluded in the ordinary course of the business of the taxpayer.[16]

The taxpayer responded with a two-fold argument. Firstly, said the taxpayer, a gain made on a business deal could only constitute income if

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[14] see my comments on 24 below.
[15] 87 ATC 4363.
[16] 4366.

that deal was concluded in the ordinary course of the taxpayer's business and, secondly, the realisation of a capital asset is not income but capital.[17]

The court unanimously held against the taxpayer. As regards the taxpayer's first argument the court said:

> *"the important proposition to be derived from Californian Copper and Ducker is that a receipt may constitute income, if it arises from an isolated business operation or commercial transaction entered into otherwise than in the ordinary course of the carrying on of the taxpayer's business, so long as the taxpayer entered into the transaction with the intention or purpose of making a relevant profit or gain from the transaction."*[18]

That Myer entered into the transaction with the intention of making a profit was clear said the learned judges, particularly because the loan agreement and the assignment of the interest income were interrelated transactions, the one being contingent on the other. It was for this reason as well that the court held that the sale of the interest income was not the mere realisation of a capital asset:

> *"The two transactions were interdependent in the sense that Myer would not have entered into the loan agreement unless it knew that Citicorp would shortly thereafter take an assignment of the moneys due or to become due for a sum approximating the amount*

[17] 4366.
[18] 4366.

> *payable in consideration for the assignment. Indeed, from the viewpoint of Myer the two transactions were essential and integral elements in an overall scheme, that scheme being a profit-making scheme."* [19]

Importantly for the Commissioner the court also confirmed in the Myer case that the basis of accounting in determining profit and losses for the purposes of the Income Tax Assessment Act was historical cost. This means that a taxpayer must account for money lent out by him at the actual (or face value) amount of the capital and not at a discount or a premium in order to take the interest element into account.[20] The consequence of this finding in relation to assumption payments means that the debtor would receive at least an economic gain on the defeasance transaction which, according to the Commissioner in IT2495, is assessable to income under the Income Tax Assessment Act.

In a judgement that came too late to assist the taxpayers in the cases that are canvassed in the next section, the minority of the court in The Commissioner of Taxation v Montgomery[21] qualified the principle established in the Myer case:

> *"Myer decided that singularity was not conclusive, but it did not decide that it was irrelevant. It also decided that, in identifying a*

[19] 4370.
[20] 4370 – 4371.
[21] 1999 HCA 34.

trading purpose of making a profit or gain, the whole transaction, and not merely part of it, is to be considered.'[22]

The case dealt with the nature of a payment made to a lessee in order to induce it to enter into a lease on particular terms and conditions. The majority of the court applied the Myer principle and held that the inducement payment was derived from the utlilsation of the capital structure of the taxpayer and, although the transaction was not in the ordinary course of the business of the taxpayer, the receipt was of a revenue nature.[23]

Whilst Myer was not a case involving a debt defeasance transaction, the success for the Commissioner in this case formed the basis for the attacks which were to be made against the plethora of debt defeasance transactions entered into by the Australian corporate community.

3.3 THE DEBT DEFEASANCE CASES IN AUSTRALIA

In Commissioner of Taxation v Unilever Australia Securities Limited [24] the majority of the Federal Court found in favour of the Commissioner, upholding his main contention that the difference between the assumption payment and the face value of the principle debt was

[22] Internet pg 11.
[23] Internet pg 24.
[24] (1995) 95 ATC 4117 (1995) 30 ATR 134.

assessable to income in the hands of Unilever Australia Securities Limited ("**UAS**").

UAS was the financing arm of the Unilever Australia group of companies and it fulfilled this function until 1986. The principle source of funding of UAS was through the issue by UAS of debenture stock.

In 1987 UAS entered into an in substance defeasance arrangement with the Local Government Finance Authority of South Australia ("**LGFA**") and the trustee of the debenture holders. According to the Liability Assumption Agreement, LGFA agreed to assume the liability of UAS to pay the capital of the debentures on the redemption date in return for the payment of A$6 301 706,00. The total liability was A$7 385 000,00. LGFA only assumed the capital obligation of UAS. The interest obligation of UAS remained vested with it.

The effect of an in substance defeasance is that the relationship of debtor and creditor is not severed[25] and UAS remained liable to the trustee of the debenture holders or the debenture holders themselves.

The Commissioner sought to include in the assessable income of UAS the difference between the assumption payment and the principle obligation as being income derived according to ordinary concepts.

[25] See my explanation on pg 4 above.

The majority was of the view that it could not be disputed that the defeasance arrangement had produced a profit in the hands of UAS. That company, according to the majority had earned the profit in the ordinary course of carrying on its business as a finance company:

> *"Profits or gains made by a finance company in the course of or incidental to the carrying on of its ordinary business of borrowing and lending money and repaying loans will be treated as revenue profits or gains: Avco Financial Services Limited v Commissioner of Taxation (1982) 150 CLR 510 and Coles Myer Finance Limited v Commissioner of Taxation (1993) 176 CLR 640 at 663-4."*[26]

Referring to the principle established in the Myer case that a transaction, although extraordinary having regard to the ordinary course of the business of the taxpayer, may give rise to assessable income when the taxpayer intended to earn a profit, Lockhart J in the majority said:

> *"The defeasance arrangements were unusual, but they nevertheless generated profit or gain to UAS in the course of its business activities which was income according to ordinary concepts."*[27]

Counsel for UAS argued that the finance activities of the company had ceased at the time that the defeasance arrangements had been entered

[26] internet 3.
[27] internet 4.

into; that UAS was in fact going out of business and that a profit or gain made in the ordinary course of going out of business was not a gain on income account.[28] The majority accepted the latter principle but disagreed that UAS was going out of business. Hill J said the following:

> *"The present is not a case where UAS, in the relevant sense, put an end to its business by virtue of the defeasance transaction. Rather, although UAS has resolved not to expand its business but run it down, its business was still continuing ... It continued at least until the moneys borrowed had been repaid and indeed perhaps thereafter, or at least while moneys were owing to it by Unilever related companies."*[29]

Beaumont J in the minority found for UAS on this point holding that a partial release in the form of a debt defeasance to relieve the taxpayer of its liabilities with a view to winding down the business cannot be *"regarded as something ordinarily encountered in that business."*[30] Accordingly the transaction would have to be seen as taking place on capital account.

The majority went on to hold that the profit or gain arose in UAS's hands at the time that LGFA was required to make payment of the principle obligation. The Commissioner argued that the gain arose at the time of

[28] internet 31.
[29] internet 32.
[30] internet 22.

the conclusion of the defeasance arrangement because it was these arrangements that gave rise to the gain in the hands of UAS. The majority did not favour this submission holding that section 25 of the Income Tax Assessment Act included income into assessable income only when it had been derived at a particular point of time. That time, said the majority was the time of the maturity of the debentures when the LGFA fulfilled its obligations under the Liability Assumption Agreement.[31]

The court considered it inappropriate to deal with the Commissioner's alternative argument that the gain made as a result of the defeasance arrangement was a capital gain, it having already held that the gain was assessable to income tax under section 25(1) of the Income Tax Assessment Act.

The case of Federal Commissioner of Taxation v Orica Limited [32] came before the High Court in 1998. The facts of this case proceed from another example of a company under severe borrowing restrictions. ICI Australia Limited ("**ICI**") issued certain debentures redeemable by the holder thereof on selected dates. The debentures were issued under two separate debenture trust deeds but both trust deeds imposed on ICI the obligation to maintain the ratio of liabilities to assets at certain fixed percentages. These restrictions motivated ICI to seek a legal defeasance arrangement between ICI, its trustee and the Melbourne and Metropolitan

[31] internet 30.
[32] 39 ATR 66.

Board of Works ("**MMBW**"). The legal defeasance arrangement contemplated that MMBW would assume ICI's obligations in respect of the capital on the debentures in return for a payment to be made by ICI to MMBW of A$63 million. ICI also entered into an assumption agreement with a financial institution regarding the interest payments on the debentures but this aspect of the transaction did not form part of the appeal and it is not dealt with here.

The Commissioner raised an assessment on ICI during the 1987 tax year in respect of what it considered to be a *"profit made from a debt defeasance transaction"*.[33] Three issues arose for consideration by the High Court:

1. whether the difference between the assumption payment and the amount paid by MMBW to the debenture holders was a profit according to ordinary concepts of income derived in the relevant year;

2. whether that difference was a profit derived by ICI in the course of a profit-making scheme; and

3. whether that difference was a capital gain in the hands of ICI.

The majority of the court found in favour of the taxpayer on the first two issues and in favour of the Commissioner on the third issue.

[33] 73.

The majority was of the view that the difference between the payment made by ICI and the payments made by MMBW did not constitute a receipt[34] in the hands of ICI but rather constituted:

> *"the difference between outlays – one it actually made and one that it would have otherwise had to make. ... That difference is a reduction in expenditure not any inflow or gain to the taxpayer."*[35]

Moreover said the majority, the benefit received was the satisfaction of an obligation of a capital nature:

> *"The benefit obtained by the taxpayer was not the receipt of money into its hands which at its choice was then applied in satisfaction of a capital obligation. It was a benefit constituted by the discharging of that capital obligation."*[36]

Whilst the transaction may have given rise to an accounting difference in the hands of ICI, the effect of the transaction said the majority was the acquisition of a right by one party to require another party to pay or defease existing capital obligations of the first party some time in the future. This does not give rise to a profit or gain in the hands of the taxpayer and the accounting difference is not income according to

[34] The possibility of the amount having accrued in terms of the provisions of section 25 of Income Tax Assessment Act was not canvassed by the court in Orica. However, see the argument of the minority set out on 23 below.
[35] 88 – 89.
[36] 89.

ordinary concepts.[37]

Following the same line of reasoning the majority held that the accounting difference did not constitute income from a scheme of profit-making:

> *"Standing alone, the Principal Assumption Agreement reveals no profit for the taxpayer, only an accounting difference between the face value of the debentures and the amount paid by the taxpayer to have MMBW pay amounts satisfying the principal sums due. For the same reasons that this difference does not constitute income according to ordinary concepts, it is not profit arising from a profit-making scheme."*[38]

The majority distinguished the Myer case on the basis that in that case the taxpayer had acquired an asset (i.e. the right to receive interest) and utilised that asset in such a way so as to realise a profit. These were not the facts *in casu* where the view of the majority was that the taxpayer had simply sought to defease liabilities of a capital nature.

All that the taxpayer received was a promise by MMBW to perform in the future. That promise said the court is not income.[39]

[37] 90.
[38] 91.
[39] 87.

Interestingly, the findings of the majority of the court echo the arguments of Nenna and Clough raised for the first time in 1990 in the CCH Journal of Australian Taxation. In that article the authors pursue the argument that all that the debtor receives in return for the assumption payment is a promise by the assumer to pay a future liability.[40] The authors advance the argument and say that if a money value has to be allocated to that promise it would be nominal in the hands of the debtor either because the damages for breach of promise would be nominal or, if the debtor is suing the assumer at the instance of the lender, payable to the lender. In any event, argue Nenna and Clough, the value of the promise can never exceed the present value of the loan paid by the borrower to the assumer in which case there is no gain or profit in the hands of the borrower.[41]

The majority in the Orica case preferred not to attempt to value the "promise" preferring rather to hold that the promise was to defease the capital obligations of the borrower and that that promise was not income.

Brennan CJ in the minority had no trouble in finding that the difference between the face value of the principle debt and the assumption payment was income in the hands of ICI.

[40] Nenna and Clough at 18.
[41] Nenna and Clough at 18.

"Although section 25 (1) does not define the term "gross income derived ...from all sources", it brings into the assessable income of a taxpayer pecuniary benefits of an income nature. "It is not open to question that income can be in the form of money's worth", as Sir Wilfred Greene said in Cross v London and Provincial Trust Limited. ICI received no money into its own hands, but it obtained the benefit of payments in discharge of its debts. It is immaterial that the money that redeemed the debentures was not paid first to ICI but was paid directly by MMBW to the Trustee or to the debenture holders. The money was applied to discharge ICI's pecuniary liability and the benefit which ICI received was "that to which can be turned to pecuniary account" to adopt Lord Watson's phrase in Tennant v Smith. Here MMBW's obligation was "turned to pecuniary account" by payment of ICI's debts."[42]

Brennan CJ valued the "benefit" received by ICI on the basis of the argument in the Myer case that historical cost is the accounting basis to be used when accounting for profit and losses. Accordingly, if the capital obligation is reflected in ICI's books at historical cost (or full face value) then any increment on that value has to be income and not capital or, in the words of Brennan CJ :

"The "tree" is always of the same size, unlike other assets, it cannot grow in value. If there be no other factor to indicate that a receipt is other than an increment upon the capital money paid out

[42] 75.

... the increment wears the aspect of the "fruit" of the tree and has the character of income."[43]

Although the majority accepted the finding in Myer that profits and losses should be accounted for on the basis of historical cost no further reference was made to it or its effect in the majority judgement. It is submitted that this is as a result of the majority's position that the "accounting difference" was in fact not income in ICI's hands.

The Commissioner argued in the alternative that the right acquired by ICI to require the assumer to make payment of ICI's capital obligations was an asset which gave rise to a capital gain in the hands of ICI when MMBW discharged its obligations. The majority of the court, including Brennan CJ found in favour of the Commissioner on this alternative argument.

The Income Tax Assessment Act levies a capital gains tax in accordance with provisions of Part IIIA of the Income Tax Assessment Act. Two requirements must be complied with before capital gains tax will be imposed: there must be an asset as defined in section 160A and there must be a disposal of that asset in accordance with the provisions of section 160M. The majority was of the view that the rights acquired by ICI under the Principle Assumption Agreement constituted an asset for the purposes of section 160A. The disposal of that asset, said the

[43] 79.

court, took place on the performance by MMBW of its obligations under the agreement as that performance gave rise to the disposal of the rights of ICI against MMBW.[44]

Pane and Chin submit that a capital gain can only arise in relation to an in substance defeasance where no formal release has been given by the lender to the debtor.[45] A legal defeasance will result in the immediate release of the debtor at the time that the defeasance payment is made and the debtor will no longer be entitled to enforce the obligations of the assumer to pay the principle debt on maturity. The lender now has the right of action against the borrower.

The combined effect of the Orica and Unilever decisions are that a defeasance profit will be assessable to income where it is derived in the ordinary course of the business of the taxpayer (or where that transaction meets the test in the Myer case) and where it is of a capital nature the defeasance profit will constitute a capital gain, subject always to the provisions of Part IIIA of the Income Tax Assessment Act being fulfilled.

In Consolidated Press Holdings Limited & Another v Commissioner of Taxation[46] Hill J upheld the decision in Unilever on facts that were very

[44] 91-92.
[45] Debt Defeasance: Some Additional Observations – Pane, T. and Chin, A. – The CCH Journal of Australian Taxation – April/May 1992.
[46] (1998) 1277 FCA.

similar in nature. The facts of Consolidated Holdings were that Consolidated Press International Finance ("**CPIF**") had entered into two public bond issues on the Swiss bond market during 1984 and 1985. By 1989 the bonds were trading at a substantial discount and CPIF had suffered severe exchange rate losses. After redeeming a portion of each of the bond issues CPIF entered into an in substance defeasance arrangement with EFS European Finance and Securities Limited ("**EFS**") in terms of which EFS, in return for the assumption payment, undertook to pay the interest, agency fees and principle debt when the same became due. Naturally the Commissioner sought to include in the assessable income of CPIF the amount of the "defeasance profit".

Counsel for CPIF argued that the defeasance profit was not made in the ordinary course of business of CPIF but rather in the ordinary course of going out of business. The submission found little favour with Hill J who, having already found that CPIF was a finance company and conducted business as such, found that CPIF continued to conduct business as it remained liable to repay interest and the principle debt on the bonds (the result of an in substance defeasance arrangement).[47]

CPIF however was a controlled foreign corporation and for the Commissioner to successfully include the defeasance profit in the income of CPIF, the Commissioner had to prove that the income was a "tainted asset" for the purposes of the Income Tax Assessment Act. In

[47] 19.

holding that it was not tainted income, Hill J held that the defeasance arrangement did not involve the disposal of any asset. All that happened was that in return for a consideration the taxpayer obtained the benefit of an obligation on the part of the assumer to fulfil the obligations of the taxpayer.[48]

None of the cases canvassed above dealt with the issue of where the taxpayer remains liable for the interest obligations of the principle debt, whether that taxpayer would be allowed to continue to deduct the interest expenditure incurred after having concluded the defeasance arrangement.

Pane and Chin[49] agree with Nenna and Clough[50] that:

> *"it is strongly arguable on the authorities that the continuing periodic payments, legally required to be made by the borrower to the lender, continue to be 'interest' payments by definition, in that they continue to represent compensation contractually owed by the borrower to the lender in consideration for the lender continuing to be deprived of its principal…'*[51]

The test for the deductibility of an "outgoing" is set out in section 51 of the Income Tax Assessment Act. Sub-section (1) sets out the basic test and provides:

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[48] 20 – 22.
[49] Pane and Chin, 33.
[50] Nenna and Clough,24.
[51] Nenna and Clough, 24.

> *"(1) All losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income, or are necessarily incurred in carrying on a business for the purpose of gaining or producing such income shall be allowable deductions to the extent to which they are losses or outgoings of capital, or of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income."*[52]

In assessing the scope and ambit of the positive requirements of section 51(1) the High Court in Ronipibon Tin N.L. and Tongkah Compound N.L. v Federal Commissioner of Taxation[53] said that :

> *"[F]or expenditure to form an allowable deduction as an outgoing incurred in gaining or producing the assessable income it must be incidental and relevant to that end. The words "incurred in gaining or producing the assessable income" mean in the course of gaining or producing such income. ... In brief substance, to come within the initial part of the sub-section it is both sufficient and necessary that the occasion of the loss or outgoing should be found in whatever is productive of the assessable income or, if none be produced, would be expected to produce assessable income."*[54]

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[52] section 51(1) of the Income Tax Assessment Act 1936.
[53] 1949 78 CLR 47.
[54] 56 – 57.

Accordingly, even if it could be argued that the payments continued to be made by the borrower were not interest *per se* and provided that funds originally raised in the borrowing continue to be used in the production of income, then such amounts will be deductible as being incidental and relevant to gaining or producing income.

3.4 CONCLUSION

From the analysis conducted above, it seems clear that the Australian courts will hold the defeasance profit to be assessable to income tax when it arises in the ordinary course of business or trading of the taxpayer. A defeasance profit derived in the course of defeasing a capital obligation will not be income in the hands of the taxpayer, subject however to the application of the capital gains provisions of the Income Tax Assessment Act.

The interest obligations of the debtor arising from the loan of the capital would continue to be a deductible or "outgoing"[55] to the extent to which it can be shown that the interest continues to represent compensation contractually owed to the lender in consideration for the lender continuing to be deprived of his funds.

An issue that has not been canvassed in any of the decisions analysed above is the nature of the payment made by the taxpayer to the assumer. That payment will be categorised as an expenditure of either a capital or revenue nature. I will

[55] Section 51(1) of the Income Tax Assessment Act.

analyse the nature of this payment in the next section relating to the position in the South African law, but it would seem to me that the Australian courts would hold that payment to be of a capital nature in the hands of the taxpayer where the taxpayer is seeking to defease a capital obligation and thus non-deductible. The payment would be of a revenue nature and therefore deductible if the obligation sought to be defeased was on revenue account.

CHAPTER FOUR - SOUTH AFRICA

FN - N1/4ea1

4.1 INTRODUCTION

The South African Income Tax Act taxes an artificial concept of income the starting point of which is gross income as defined in the Income Tax Act.

According to the definition, gross income is:

> *"the total amount, in cash or otherwise, received by or accrued to or in favour of such person during such year or period of assessment from a source within or deemed to be within the Republic, but excluding receipts or accruals of a capital nature..."*[56]

The general rule is that liability for the tax on income cannot arise unless there is a receipt or an accrual in the hands of the taxpayer that meets the requirements of the definition. An analysis of the nature of the defeasance profit in the hands of a taxpayer must therefore begin with a determination of whether or not the taxpayer has received gross income in his hands or whether there has been an accrual to the taxpayer of an amount taxable in terms of the Income Tax Act.

[56] The Income Tax Act 56 of 1962, section 1 sv "gross income".

4.2 ANALYSIS OF THE TRANSACTION

A useful tool of analysis is a consideration of the accounting treatment of the debt defeasance transaction. The loan to the debtor will be shown as a liability on the balance sheet of the debtor. If the debtor then enters into an in substance defeasance arrangement the loan liability of the debtor becomes contingent upon the performance of the assumption party and the debtor will now reflect the liability as a contingent liability in its balance sheet. The result of a legal defeasance is that the debtor would no longer have to reflect the loan as a liability.

The debtor now makes the assumption payment. For the purposes of accounting for the transaction, the debtor will reflect an increase in its income either in the year in which the assumption payment is made (in a legal assumption) or in the year in which the assumer performs under the assumption agreement. For accounting purposes then the debtor has made a profit. For income tax purposes though, the accounting profit must comply with the definition of gross income before it will be considered to be a profit that is subject to the income tax.[57]

In determining the incidence of tax the true nature of the contractual arrangements to which a taxpayer is a party will determine the tax consequences of those arrangements. The true legal nature of a debt defeasance transaction is the novation of the debt by the debtor to a third party. Strictly speaking the debt, an obligation of the debtor, is delegated

[57] Pyott Limited v Commissioner for Inland Revenue 13 South African Tax Cases 121, 126.

to the third party. Delegation is a species of novation. Corbett AJA (as he then was) describes the consequences of such a delegation:[58]

> *"There is no doubt that, generally speaking, a contractual obligation cannot effectively be transferred from the debtor to a third person by agreement unless the creditor consents thereto and agrees to accept the third person as his debtor in substitution for the original debtor (see Voet, 46.2.11 and 12; Brenner v Hart, 1913 TPD 607; Van Achterberg v Walters, 1950 (3) SA 734 (T) at pg 745). Such a transfer, therefore, involves the concurrence of the three parties concerned and is properly termed a "delegation" which is a species of novation. ... It has further been held that even where the creditor has agreed to accept discharge of the debt by a third person, this does not constitute proper delegation unless it is clear that, in so agreeing, the parties intended that the obligation of the original debtor be discharged and the obligation of the third person be substituted in its place. In the absence of proof of such an intention, both the original debtor and the third person are regarded as being contractually bound in solidum to the creditor, who thus acquires a supplementary right of action against the third person (see also Brenner v Hart supra; Williams v Kirk 1932 CPD 159)."*

In law then, our courts will have no difficulty in identifying and categorising the nature and legal consequences of the transaction. It is

[58] Froman v Robertson 1971 (1) SA 115 (A) at 122 E-H.

submitted that the characterisation of the parties to the transaction and the nature of the business that they conduct will influence the taxation consequences of the transaction.

4.3 INCOME TAX CONSEQUENCES OF THE DEBT DEFEASANCE TRANSACTION

4.3.1 "RECEIPT OR ACCRUAL"

In a legal defeasance arrangement the defeasance profit results from an accounting difference that arises in the hands of the debtor on entering into the assumption agreement and making the assumption payment. There is no actual amount of money that is received by the taxpayer in his hands, for his own benefit and for and on his own behalf.[59] This is as a result of the fact that having already received the loan principal at some time in the past, the taxpayer does not receive a further amount upon the making of the assumption payment. Accordingly, there is no receipt in the hands of the taxpayer for the purposes of gross income.

Before there can be an accrual for the purposes of gross income, there must be an amount capable of determination that can be said to accrue to the taxpayer. According to Watermeyer J in Lategan v Commissioner for Inland Revenue [60] income is what a person earns as a result of work or the employment of capital. That income, according to Watermeyer J can

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[59] Geldenhuys v Commissioner for Inland Revenue 1947 (3) SA 256 (CPD).
[60] 1926 CPD 203, 2 SATC 16.

take the form of cash, corporeal property or even a right of action [61] and provided that an ascertainable money value can be attached to the right or the property, such right or property will be income for the purposes of the gross income definition if it accrues to the taxpayer.[62] The *quantum* of the defeasance profit is easily capable of determination, it being the difference between the face value of the loan and the assumption payment.

Watermeyer J, in the Lategan case, held that if income could be property or rights of action in addition to mere cash then the word "accrued" must mean that to which the taxpayer "has become entitled".[63] Watermeyer J later refined that test in a judgement given in Ochberg v Commissioner for Inland Revenue [64] holding that the entitlement of the taxpayer had to be unconditional.[65] Thus if the right or entitlement of the taxpayer is conditional or contingent in any way there will be no accrual to the taxpayer of the money value of that right or entitlement until it becomes unconditional.

The test laid down by Watermeyer J was confirmed by the then Appellate Division for the first time in the case of Commissioner for Inland Revenue v People's Stores (Walvis Bay) (Proprietary) Limited [66] in a unanimous judgement given by Hefer J. In upholding the tests laid down by

[61] 19.
[62] Commissioner for Inland Revenue v Butcher Brothers (Proprietary) Limited 1945 AD 301.
[63] 20.
[64] 1933 CPD 256.
[65] 259.
[66] 1990 (2) SA 353 (A).

Watermeyer J in the Lategan and Ochberg cases (now known as the Lategan Principle) Hefer J said that the interpretation of accrual as meaning "entitled to" is merely a practical application of the principle that income can be in the form of money or money's worth including rights of action.[67] If one accepts that a right of action having an ascertainable money value is gross income then "accrue" must include the taxpayer's entitlement to enforce that right of action.

Hefer JA was of the view that the valuation of the accrual amount would be affected by the fact that the right or entitlement was enforceable only at a point in the future.[68] The debate was silenced by the introduction of the first proviso to the gross income definition shortly after the decision in the People's Stores case. Prior to the People's Stores case the South African Revenue Services applied the principle of entitlement but did not allow any deduction to be made from an amount in order to discount the future face value of an accrual to its present value.[69] When Hefer J upheld the Lategan approach and confirmed the need to discount an accrual to its present value the legislature stepped in and introduced the first proviso to the definition of gross income in the Income Tax Act. The effect of the first proviso is to give the practice adopted by the Revenue legislative legitimacy by denying the taxpayer the right to discount an accrual to its present value.

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[67] 365.
[68] 367.
[69] Silke on South African Income Tax, Vol 1, paragraph 2.9, 2-16.

There are two very early decisions of the Income Tax Special Court which consider the position of a debtor released from his indebtedness to a creditor. In ITC 214[70] the taxpayer entered into a compromise with his creditors and in so doing he was relieved of liabilities to the extent of £1 600,00. The Commissioner treated this amount as an accrual of income and included it in the taxpayer's taxable income.

In a very short judgement the President of the special court held in favour of the taxpayer:

> *"When he entered into the compromise of 10s. in the £, it seems to me that he was not receiving an amount of 10s. in the £, he was not enriched to any extent thereby. It seems to me this cannot be looked upon in his hands as a trade receipt, and it is only if it were a trade receipt, having regard to the nature of the taxpayer's business, that we can regard it as a taxable sum."*[71]

The President went on to say

> *"If the appellant is not wealthier then there is no increase in his income for the year under consideration."*[72]

In ITC 455 [73] the appellants were three subsidiaries of a company to which they had become indebted in the course of trading. The parent

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[70] 6 SATC 67.
[71] 68.
[72] 68.
[73] 11 SATC 168.

company forgave a substantial portion of the debts of all three appellants. The Commissioner sought to include the amount of the debts forgiven in the taxable income of the appellants.

The Commissioner argued that the release was made in the ordinary course of trading and therefore constituted receipts of a revenue nature.[74] In reaching its conclusion the special court relied on the English case of British Mexican Petroleum Company Limited v Jackson [75]. In that case it was held that the release from a liability did not form a receipt of income in the year in which it was granted. The President of the special court quoted extensively from the judgement of Rowlatt J in the British Mexican case. It is worth quoting a short extract of what is set out in the case:

> *"What is chargeable to Income Tax under either the First or Second Case of Schedule D, I forget which it is – the trading case – is the profit which is made by comparing the amount which you receive from selling goods or rendering services, or whatever it is, with the amount which you pay out in putting yourself in a position to do that by buying goods and equipping yourself, funding the expenses for rendering the services or whatever it is – with the necessary adjustments in the account to allow for the stock which is carried over from year to year in the way Mr Hills drew my attention to – that is what it is, the difference which you enjoy between what you receive and what you have to pay out in the*

[74] 169.
[75] 16 TC 570.

year's trading. How on earth the forgiveness in that year of a past indebtedness can add to those profits I cannot understand." [76]

Deciding that the British Mexican case and the case before it were identical on the facts and applying the judgement in the British Mexican case as confirmed on appeal to the House of Lords, the special court held in favour of the appellants.

Neither ITC 214 nor ITC 455 considered the question of whether or not an amount had accrued to the taxpayer for gross income purposes. The tests to determine whether there had been an accrual in the hands of the taxpayers in either case were not applied as they have been set out above. It is clear that the concepts of "enrichment" or "increased wealth" in the estates of the taxpayer are not the tests to be applied.

In ITC 1634[77] Wunsh J considered whether certain amounts transferred by the Appellant to its accounting profit through the income statement were amounts that had been received by or accrued to the Appellant for the purposes of the gross income definition and if not, and in the alternative, whether such amounts could be said to be capable of recoupment in terms of section 8(4)(a)[78] of the Income Tax Act.

[76] 170.
[77] 60 SATC 235.
[78] Section 8(4)(a) of the Income Tax Act is what is colloquially known as a "claw-back" provision. Where a taxpayer recovers or recoups expenditure in respect of which it was entitled to a deduction, such amount will be included in the taxable income of the taxpayer.

The facts of ITC 1634 were that the Appellant carried on business as shipping, clearing and forwarding agents. In the course of conducting its business the Appellant incurred certain expenditure which, according to the terms of its trade with its suppliers, the Appellant was not required to pay unless it had been provided with an invoice. In the event that a supplier did not render an invoice within two years of the transaction date, the Appellant transferred the credit from its "credits in suspense" account to profit through the income statement. There were also instances where the Appellant's suppliers would invoice the Appellant for amounts less than the actual indebtedness and after the Appellant had already recovered the full amount of its disbursement from its customer.

The Appellant excluded these amounts so transferred to profit from its taxable income. The Commissioner for Inland Revenue disputed this treatment of the accounting profit.

The Appellant argued that the "amounts" identified by the Commissioner were in fact liabilities previously claimed by the appellant and which, at least until the liability became prescribed, the Appellant treated as no longer being payable. If one accepted this proposition then the unpaid liabilities were not something of money's worth and even if they were, the creditor's failure to take action to recover such amounts did not mean that such amounts had either been received by or accrued to the Appellant or been recouped by the Appellant. Furthermore, argued the Appellant, the transferal of the "credits in suspense" to the profit of the Appellant were mere accounting entries and could not per se lead to a receipt or an accrual in the hands of the Appellant.[79]

According to Wunsh J the crucial issue was whether an event which occurs in a later tax year subsequent to the initial incurral of an expense can have a fiscal effect in the year in which it happens. According to Wunsh J:

> *"[I]t is accepted in Australia, as in this country, that if the amount of an expense deducted in a year of assessment is varied or extinguished in a later year or if an activity in a year of assessment produces an accrual in a subsequent year, the income or expenditure in the year of assessment in which the expense was deducted or the activity took place is not open to adjustment."*[80]

Acknowledging that the question was left open in Caltex Oil (SA) Limited v Secretary for Inland Revenue [81] and that Commissioner for Inland Revenue v Felix Schuh (SA) (Proprietary) Limited[82] did not assist in the present case Wunsh J turned to the Australian case law preferring the approach he found there as being the "sensible and realistic approach of looking at a business enterprise conducted for profit as having a continuing existence and function".[83] Analysing Australian case law that

[79] 241.
[80] 247-247.
[81] 1975 (1) SA 665 (A).
[82] 1994 (2) SA 801 (A).
[83] 248.

dealt mostly with foreign exchange gains and losses the following passage in International Nickel Australia Limited v Federal Commissioner of Taxation [84] found great favour with Wunsh J:

"Gibbs J said:

> *'However the proposition upon which the appellant founded its argument is unsound. It is not correct to say, in the case of a trader who carries on a continuing business, that there can be no income unless there has been a receipt. On the contrary, the income derived by such a trader from his business will almost necessarily be determined upon an earnings or accruals basis. (I underline). Such a method will be adopted in assessing the income derived from trading if, as will generally be the case, it is calculated to give a substantially correct reflex of the taxpayer's true income.'*[85]

In adopting this approach of the Australian law Wunsh J referred to a number of Australian cases before reaching the conclusion that the *de facto* recognition by the appellant of the disputed amounts as profit resulted in the Appellant treating these amounts as having accrued to it or having been recognised by it. This conduct said Wunsh J justified the

[84] 7 ATR 739.
[85] 252.

recognition of the amounts transferred to profit as being income.[86]

The approach of Wunsh J may have been the result of a desire to reach an equitable decision given the favour with which the learned judge viewed the Australian concept of a continuing enterprise, but it is submitted that the learned judge did not consider whether or not the amounts so transferred by the Appellant constituted an accrual or a receipt for the purposes of gross income as that concept is applied in South Africa. The conduct of the taxpayer and the manner in which it elects to treat the transaction for accounting purposes is certainly not the test, nor is the fact that the business of the taxpayer can be categorised as a continuing enterprise. It is also submitted that Wunsh J incorrectly, with respect, relied on the approach of the Australian courts in the foreign exchange gains or losses cases. A taxpayer is not released from a debt where a variation of the debt has occurred as a result of foreign exchange fluctuations; there is merely a variation in the *quantum* of the debt and the only issue to be determined is the timing of the accrual or the deduction, as the case may be, which may result from the exchange rate fluctuation. The release of a debt that results in a saving to the taxpayer raises different enquiries and it is submitted is not analogous to the effects of an exchange rate gain or loss on particular taxpayers.

[86] 257.

The appellant also argued that the reduction of a debt did not result in an accrual to the taxpayer for if it did, the provisions of section 20(1)(a)(ii) in the Income Tax Act would be redundant.[87] Section 20(1)(a)(ii) of the Income Tax Act provides that the assessed loss of a taxpayer shall be reduced by the value of any benefit received by or accruing to a person by reason of a concession or compromise with that person's debtors. In the decision of the lower court in Commissioner for Inland Revenue v Louis Zinn Organisation (Proprietary) Limited [88] the President of the court was of the view that the need for the special inclusion of the sub-section into section 20 implied that ordinarily such amounts i.e. concessions or compromises of debts would not be income and therefore the need for the special provision.

Wunsh J was unconvinced by this argument. The learned judge, besides being of the view that the provision was tautologous, determined that the meaning of the words "received by or accrued to" having been introduced into the Income Tax Act in 1914 could not be influenced by the set-off provisions which were only introduced into the Income Tax Act in 1941. Moreover, Wunsh J said that regard should be had to the fact that the recoupment provision only applied where a taxpayer had previously claimed the expenditure as a deduction and that this was not a requirement of section 20. There was doubt according to Wunsh J that section 20, section 8(4)(a) and the definition of gross income covered the

[87] 244.
[88] 1958 (4) SA 477 (A).

same ground.[89] For these reasons the learned judge disposed of the argument.

The Appellate Division in the Louis Zinn case did not decide the matter and it remained a controversial argument whether a release from a debt was a mere saving or a recovery or a recoupment that would form part of the taxable income of the taxpayer. The legislature has remedied the controversy in favour of the *fiscus* with the introduction of section 8(4)(m) into the Income Tax Act in 1997.[90] That section now provides that where a taxpayer has been relieved wholly or partly from the obligation to make payment of certain expenditure, where such expenditure has not actually been paid and a deduction had previously been allowed in respect of such expenditure then the taxpayer will be deemed to have recouped an amount equal to the amount of the expenditure from which the taxpayer was relieved.

The years of assessment under review in ITC 1634 were 1987, 1988, 1989 and 1990 and Wunsh J did not have the benefit of the provisions of section 8(4)(m). Instead the learned judge embarked on a lengthly attempt to establish an accrual where one had not occurred for the purposes of the gross income definition. In the absence of the applicability of section 8(4)(m) a mere saving cannot result in an accrual.

[89] 247.
[90] Sub-paragraph (m) of section 8 was introduced by section 6(1)(b) of Act 28 of 1997 with effect from 4 July 1997.

It is submitted that in a legal defeasance arrangement (where the creditor is a party to the novation) there can be no accrual to the taxpayer of the difference between the face value of the debt and the assumption payment. The debtor is fully discharged from its obligations to the creditor and the assumption party is substituted for the debtor. The debtor has no right of action against the assumer; that rests with the creditor who has consented to the arrangement. The debtor has no entitlement and as the court in Orica said a promise, which is all the assumer makes or gives to the debtor, is not income. The benefit takes the form of a release from indebtedness which, it was argued in the Louis Zinn case[91], is a benefit of a purely negative character and which results in nothing more than a mere saving to the taxpayer.[92]

There can also be no accrual in an in substance defeasance initially because the defeasance profit is contingent upon performance by the assumer and, upon such performance, because the debtor has now been released from its obligations to the creditor in the same way as in a legal defeasance arrangement. The debtor is only entitled to sue the assumer to perform under the assumption agreement and that entitlement does not result in an accrual of the defeasance profit.

The gross income enquiry ceases with the conclusion that there is no

[91] 1958 (4) SA 477 (A) at 480 A-D.

[92] The Appellate Division did not decide this argument and it was left open until the introduction of section 8(4)(m). It should be noted that section 8(4)(m) will only apply to expenditure incurred in the production of income and not to capital expenditure such as loan capital repayments.

accrual of the defeasance profit to the debtor and that section 8(4)(m) does not operate to recoup the defeasance profit in the taxpayer's hands.[93] An enquiry into the capital or revenue nature of the defeasance profit or the source thereof becomes irrelevant.

Accrual pre requisite for application of s 8(4)(

A debate which will arise in the future is whether the entering into of the assumption agreement by the debtor results in the acquisition by him of a capital asset which will be subject to the new capital gains tax introduced by the Minister of Finance in his budget speech during February 2000 and which is effective from 1 January 2001. The position paper issued by the South African Revenue Services on 23 February 2000 advises that affected capital assets will include intangible assets[94] (one assumes this includes rights of action), but does not give sufficient guidance as to what will constitute a capital gains tax event. If one has regard to the findings of the court in the Orica case[95] it could certainly be within the contemplation of the South African legislature to intend that the performance of the assumption party under the assumption agreement will result in a disposal of the rights of the debtor and therefore result in a capital gains tax event.

It is submitted that the position may be different in the event of an instantaneous defeasance. The taxpayer receives the loan principal and

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[93] This is so because one of the pre-requisites for the application of section 8(4)(m) is that the expenditure incurred by the taxpayer (assumption payment) was previously allowed as a deduction. It is submitted at 46 *et seq* that the assumption payment is not a deductible item of expenditure.

[94] South African Revenue Services, Guide to Capital Gains Tax, 18.

[95] 19 - 23 above.

immediately pays a portion thereof away to the assumer in the form of the assumption payment. The taxpayer is left with the difference between what he received and what he paid in his hands being an identifiable sum of money that was received by the taxpayer for and on its own behalf. There is no doubt that this constitutes a receipt for gross income purposes.

In order for the receipt to qualify as taxable income, it must not be of a capital nature in the hands of the taxpayer.

4.3.2 RECEIPTS OR ACCRUALS OF A CAPITAL NATURE

Income is what is produced by the application of capital but there is some difficulty in applying that principle without having reference to other factors. Our courts have said that in determining the capital or revenue nature of a receipt or an accrual regard must be had to all the circumstances of each case as they are presented to the court and what the analysis of those circumstances reveals.[96]

The enquiry is centered around whether the transaction entered into by the taxpayer constitutes the realisation of a capital asset, in which case the receipt would be of a capital nature, or whether the transaction constitutes the sale of an asset in the course of a scheme of profit-

[96] Natal Estates v SIR 1975 (4) 177 (A) 22.

making, in which event the receipt would be of a revenue nature. In making this assessment the intention of the taxpayer is an important factor, both at the time of the acquisition of the asset and at the time of its disposal. Intention however, must be looked at in the context of the other factors related to the transaction.[97]

It is submitted that tax paying entities such as banks and money-lenders would be hard-pressed to justify the receipt of the defeasance profit as being capital in nature where the structure of the defeasance transaction is of the instantaneous kind. The lending of money, both for its own purposes and for the benefit of its clients, is an integral part of the ordinary business of a financial institution. Money forms the stock-in-trade of a financial institution and these institutions trade in it in order to make a profit. For these reasons alone the receipt of the defeasance profit should be considered to be of a revenue nature in the hands of a bank or a money-lender.

If one analyses the commercial rationale for a financial institution to enter into a transaction such as this, it is evident that funds are raised at a lower cost by the bank or money-lender which in turn can pass the cost of lower lending rates on to its clients. This transaction is solely in the pursuit of raising business for the financial institution and achieving a profit. These factors are all of a revenue nature and will result in the defeasance profit being considered to be of a revenue nature.

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[97] Elandsheuwel Farming (Edms) Bpk v SBI 1978 (1) SA 101 (A) 180 – 182.

Pick-n-Pay Share Employee

Corporates that are not money lenders would be required to show that an instantaneous defeasance is not a transaction in pursuit of a profit-making intention. Lack of continuity or frequency of entering into such transactions does not assist a corporate taxpayer[98] which would have to show that its sole intention in entering into the transaction was to retire long-term liabilities or to restructure such liabilities. These are reasons giving rise to the inference of a capital intention. It is submitted that it would be particularly difficult for a corporate taxpayer to make this argument in relation to an instantaneous defeasance and that the approach of the court in Myer would find favour with any court hearing these facts. It is true that a corporate taxpayer could argue that such a transaction is not within the ordinary course of its business but it is submitted that such a transaction is also not within the ordinary course of the taxpayer raising long-term capital. The motive to make a profit will weigh heavily against the taxpayer and it is reiterated that the onus will be particularly difficult to discharge.

Having determined the circumstances in which the defeasance profit will or will not be received or accrued by a taxpayer, it is necessary to assess the deductibility of the assumption payment having regard to these circumstances and the tests laid down for making the determination of the deductibility of expenditure incurred by a taxpayer.

[98] CIR v Leydenberg Platinum 1929 AD 137, 4 SATC 8, 16.

4.3.3 **DEDUCTIBILITY OF THE ASSUMPTION PAYMENT**

The consequence of there being no receipt or accrual of the defeasance profit is that it necessitates an enquiry into the deductibility of the assumption payment for the purposes of section 11(a) as read with section 23 of the Income Tax Act.

Where the receiving of a loan as a deposit is within the ordinary course of the taxpayer's business the provisions of the general deduction formula must be applied to determine the deductibility or otherwise of the assumption payment.

The general deduction formula is prescribed by the provisions of section 11(a) of the Income Tax Act and must be read in accordance with section 23 of the Income Tax Act, the negative counterpart to the provisions of section 11(a). Section 11(a) provides:

> *"11 For the purpose of determining the taxable income derived by any person from carrying on any trade within the Republic, there shall be allowed as deductions from the income of such person so derived-*
>
> *(a) expenditure and losses actually incurred in the Republic in the production of the income, provided such expenditure and losses are not of a capital nature;"*

The first element of the test is that the taxpayer must be carrying on a trade. "Trade" is a term widely defined in section 1 of the Income Tax Act and it has been held that effect must be given to the wide definition.[99] There is no doubt that a money-lender or financial institution would be acting within the ordinary course of its business, and thus trading, if it recognised the time value of money and made the assumption payment in order to reduce its liabilities to an acceptable level. It is submitted that seen in isolation this transaction would not be unusual.

The expenditure constituting the assumption payment must be actually incurred. The taxpayer must have an unconditional obligation to incur the expenditure either immediately or in a future tax year, but as soon as the legal liability to pay is unconditionally established the expenditure is deductible in that year of assessment regardless of when it is actually paid.[100] Typically the assumption agreement is entered into between the taxpayer and the assumer and the assumption payment made simultaneously. The expenditure is actually incurred for the purposes of section 11(a).

The assumption payment must be incurred "in the production of income". The meaning of the phrase was considered in Port Elizabeth Electric Tramway Co. Limited v The Commissioner for Inland Revenue [101] by

[99] Burgess v Commissioner for Inland Revenue 1993 (4) SA 161 (A) 181.
[100] Commissioner for Inland Revenue v Golden Dumps (Proprietary) Limited 1993 (4) SA 110 (A). But see 52 below for comments on the proposals in the February 2000 budget speech.
[101] 1936 CPD 241.

Watermeyer AJP and the tests emerging from this case have remained the reference point for the South African courts ever since. The facts of the case involved the PE Electric Tramway company having to pay damages to the family of a train driver who was killed in the course of his employment. The company resisted the damages claim and incurred legal fees in doing so. The company sought to deduct the damages that it was ordered to pay and the legal fees it incurred. Watermeyer AJP said that income was not earned from the making of expenditure but rather by means of labour or the employment of capital. In the process of working or trading expenditure is incurred. In order for that expenditure to be deductible it had to be so closely connected to the act of trading that it could be regarded as being part of the cost of performing the act of trading.[102] The payment of damages in compensation was accordingly held to be a deductible expense, the court being of the view that the employment of train drivers carried with it the potential that they will suffer harm which will have the necessary consequence that compensation must be paid. The legal costs were disallowed because they were expended to avoid having to pay the compensation and not to earn income.

The court in Commissioner for Inland Revenue v Genn & Co. (Proprietary) Limited [103] paraphrased the test in the following way:

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[102] 245.

[103] 1955 (3) SA 293 (A).

> *"If I am right in understanding the words "they may be regarded" as connoting that it would be proper, natural or reasonable to regard the expenses as part of the cost of performing the operation this passage seems to state the approach to such questions correctly. Whether the closeness of the connection would properly, naturally or reasonably lead to such treatment of the expenses must remain dependent on the Court's view of the circumstances of the case before it."* [104]

and later

> *"In deciding how the expenditure should properly be regarded the court has to assess the closeness of the connection between the expenditure and the income-earning operations, having regard both to the purpose of the expenditure and to what it actually effects."* [105]

"The income" referred to in section 11(a) means income as defined i.e. gross income less exemptions. Thus section 23(f) expressly prohibits the deduction of expenditure that is incurred to earn amounts that do not constitute income. These include exempt income as defined in section 10 of the Income Tax Act and income earned from a non-South African source. It will also include amounts that cannot be said to have been received by or accrued to the taxpayer.

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[104] 299.
[105] 299.

A particular item of expenditure need not be capable of being matched to a particular item of income. In Sub-Nigel Limited v Commissioner for Inland Revenue[106] Centlivres CJ said:

> *"It seems to me clear on the authorities that the court is not concerned whether a particular item of expenditure produced any part of the income: what it is concerned with is whether that item of expenditure was incurred for the purposes of earning income."*[107]

In Commissioner for Inland Revenue v Allied Building Society [108] the majority was of the view that:

> *"... the court is not concerned with whether a particular item of expenditure produced any part of the income, but with whether that item of expenditure was incurred for the purpose of earning income."* [109]

Whilst these cases are authority for the fact that expenditure will be deductible even though it cannot be matched to a particular item of income and that it will be deductible even though income is not earned in the same year of assessment or is only earned later, the intention of the expenditure must still be to produce income. The assumption payment

[106] 1948 (4) SA 580 (A).
[107] 592.
[108] 1963 (4) SA 1 (A).
[109] 14D.

can be matched to the defeasance profit. This will always be the result whether the defeasance profit is realised in the same or a future year of assessment. The purpose of the expenditure which is the assumption payment is to reduce the liabilities of the taxpayer and increase its bottom-line profitability. However, it does not result in the receipt or accrual of income for income tax purposes. Accordingly, if one has regard to the test laid down in Commissioner for Inland Revenue v Nemojim (Proprietary) Limited [110] that the purpose of the expenditure and what it actually effects must be looked to, then it is submitted that the assumption payment cannot be deductible in accordance with the provisions of section 11(a) of the Income Tax Act. In his budget speech Which are? the Minister of Finance addressed the tax erosion caused by the mismatch in the timing between receipts and accruals and expenditure. Effectively, a taxpayer can incur expenditure in terms of the principle laid down in the Port Elizabeth Electric Tramways case but only accrue the income produced thereby in a later year, thus postponing the tax liability. On the arguments raised, the mismatch in timing will not be relevant because the deduction will not be allowed as the expenditure was not in the production of income.

It is submitted that the debate does not arise where the taxpayer has entered into the transaction for purposes of retiring or rescheduling its long-term debt and is utilising the time value of money to do so. In these circumstances the taxpayer is defeasing a capital obligation and the

[110] 1983 (4) SA 935 (A) 947.

assumption payment will be of a capital nature and not deductible in the hands of the taxpayer.[111] These transactions are typically not instantaneous in nature and there would in any event have been no accrual or receipt to the taxpayer of the defeasance profit.

The position, again, will be different where the taxpayer, as a result of being involved in an instantaneous defeasance, suffers a receipt of the defeasance profit. On the arguments raised above the taxpayer would be entitled to claim the deduction as being expenditure incurred in the production of its income as the expenditure resulted in the receipt of income for the purposes of section 11(a). In this instance there is also no mismatch of income and expenditure as the income is received immediately and the expenditure incurred simultaneously.

4.3.4 CONTINUED DEDUCTIBILITY OF INTEREST PAYMENTS

A typical defeasance arrangement in the Australian example consists of the taxpayer entering into a defeasance arrangement in respect of the capital obligation only.[112] The taxpayer retains the obligation to make the interest payments to the creditor. Interest has been defined as being compensation paid for the use of another's money[113] or in the manner of Lord Wright in Riches v Westminster Bank Limited [114]

[111] New State Areas Limited v Commissioner of Inland Revenue 1946 AD 610.
[112] see my comments at 4 above.
[113] The Deduction of Interest Payments for Income Tax Purposes – Louise Tager – 1976 The South African Law Journal 12.
[114] [1947] 1 All ER 469.

"... the essence of interest is that it is a payment which becomes due because the creditor has not had his money at the due date. It may be regarded either as representing the profit he might have made if he had the use of the money, or, conversely, the loss he suffered because he had not that use. The general idea is that he is entitled to compensation for that deprivation." [115]

The taxpayer however, as a result of the defeasance arrangement has been released, either conditionally or fully, from the obligation to repay the capital. In these circumstances the issue that arises for consideration is whether the taxpayer would remain entitled to deduct the interest expenditure as having been incurred in the production of income.

In determining the deductibility of interest expenditure regard must again be had to the provisions of section 11(a) of the Income Tax Act as read with section 23 and the manner in which these provisions have been applied by the South African courts with particular reference to interest.

In <u>Financier v Commissioner of Taxation</u> [116] Tredgold J said:

"1. Where a taxpayer borrows a specific sum of money and applies that sum to a purpose unproductive of income, and not directly connected with the income-earning part of his business,

[115] 472.
[116] 17 SATC 34.

then the interest paid on the borrowed money cannot be deducted as expenditure incurred in the production of income.

2. Where a taxpayer has for good and sufficient reasons borrowed money for use in the business producing his income, despite the fact that he subsequently, in pursuit of a legitimate business purpose, invested such money in an investment which does not produce taxable income, the interest is still deductible for income tax purposes." [117]

The approach to determining the deductibility of interest as outlined by Tredgold J has become a well-established and accepted test. More specifically the court in Standard Bank of South Africa Limited v Commissioner for Inland Revenue [118] produced well formulated and clear guidelines for the deductibility of interest in the following often quoted passage:

"(1) Generally, in deciding whether moneys outlaid by a taxpayer constitute expenditure incurred in the production of the income (in terms of the general deduction formula) important and sometimes overriding factors are the purpose of the expenditure and what the expenditure actually effects; and in this regard the closeness of the connection between the expenditure and the income-earning

[117] 36.
[118] 1985 (4) SA 485 (A).

operations must be assessed. The same general test applies to the provisions of section 23(f) of the Act.

(2) More specifically, in determining whether interest (or other like expenditure) incurred by a taxpayer in respect of moneys borrowed for use in his business is deductible in terms of the general deduction formula and its negative counterparts in the Act, a distinction may in certain instances have to be drawn between the case where the taxpayer borrows a specific sum of money and applied to it an identifiable purpose, and the case where, as in the instance of the Society in the Allied Building Society case and the Bank in the present case, the taxpayer borrows money generally and upon a large scale in order to raise floating capital for use in his (or its) business.

Too long a Quote

(3) In the former type of case both the purpose of the expenditure (in the form of interest) and what it actually effects can readily be determined and identified: a clear and close causal connection can be traced. Both these factors are, therefore, important considerations in determining the deductibility of the expenditure.

(4) In the latter type of case, however, and more particularly in the case of institutions like the Society and the Bank, there are certain factors which prevent the identification of such a causal connection and one cannot say that the expenditure was incurred in order to achieve a particular effect. All that one can say is that in a general sense the expenditure is incurred in order to provide

the institution with the capital with which to run its business; but it is not possible to link particular expenditure with the various ways in which the capital is in turn utilised." [119]

It is submitted that regardless of whether it is a legal or an in substance defeasance the interest will remain an expense which the taxpayer would be entitled to deduct. In the case of a bank in the position of the debtor which makes the assumption payment, the acceptance of deposits (as loans or otherwise) is in the ordinary course of such an institutions' business. The funds are allocated to a central pool to be utilised by the bank in carrying on its income-earning operations of borrowing and lending money. Upon entering into a defeasance arrangement some years later the link between a particular deposit and the manner in which it has been applied can never be established, the loan which the bank is seeking to defease having lost its identity in the circulating capital of the bank. Similarly an individual or company taxpayer which borrowed the funds to finance working capital requirements would be entitled to the continued deduction of the interest expenditure provided that the purpose of the taxpayer at the time that the borrowing was made is one that renders the expenditure sufficiently closely connected to the income-earning operations so as to be deductible in accordance with section 11(a).

[119] 500H – 500F.

CHAPTER FIVE - INSTANTANEOUS DEFEASANCE: A DONATION?

Instantaneous defeasances give rise to a particular problem in South African jurisprudence that questions the efficiency of this particular transaction in the South African context. The instantaneous defeasance occurs where the loan and the defeasance are entered into simultaneously.[120] In effect, the lender undertakes to lend to the debtor the capital on the basis that the debtor pays the present value of the face value of the loan to a third party and not to repay the loan directly to the creditor. The agreement may be couched in the form of a loan but the parties thereto never intend that the borrower should repay the capital of the debt.

In Western Bank Limited v Registrar of Financial Institutions & Another [121] Boshoff J gives a clear exposition of the common law principles of a loan:

> *"At common law the contract known as "verbruiklening", mutuum or loan for consumption, is classified as a contract founded on a thing (re) and is not completed without delivery. It is a contract whereby one person delivers some fungible thing to another person who is bound subsequently to return to the former a thing of the same kind, quality and quantity; Grotius,3.10.1; Voet, 12.1.1; Van Leeuwen, R.H.R, 4.10.1; Van der Linden, 1.15.4. A loan of money is therefore basically a contract whereby money is delivered to another who undertakes to repay an equal sum at some future time; Moser v Meiring 1931 O.P.D 74 at p.77."* [122]

And again at page 44:

[120] See my comments at 4 above.
[121] 1975 (4) SA 37 (TPD).
[122] 43.

"There can thus be no loan of money, not even substantially, unless there is a contract to pay money to another who undertakes to repay an equal sum. The words "whatever its form may be" do no more than emphasise the well-known doctrine that the law, where substance and form differ, regards substance rather than form." [123]

The substance of the agreement is therefore not a loan because the borrower, although giving an undertaking to repay, in fact has no intention of repaying the debt and the obligation to repay never arises. There cannot therefore be a novation of the debt to an assumer because the borrower did not incur the obligation to repay in the first instance.

It is submitted that the transaction between the lender and the borrower may be a donation. Certainly where it is intended that the third party is to repay both the capital and interest obligations there has been a gratuitous disposal of the difference between the present value and the face value of the loan to the debtor. [124] Momentarily the debtor and the creditor enter into a loan agreement with all the requisite terms that such a relationship require, but in the next second the debtor is released from his obligations. The creditor has waived the right to receive payment. Concluded simultaneously, it is submitted that these agreements give rise to a donation for the purposes of the Income Tax Act. When dealing with a tax case the South African courts have consistently viewed a particular transaction in the context of the series of transactions of which it is a

[123] 44.
[124] section 55(1) of the Income Tax Act defines a donation as being a *"gratuitous disposal of property including any gratuitous waiver or renunciation of a right."*

part in order to determine if the substance of the transaction is true to its form.[125] The principle is that the law will regard the substance rather than the form of a transaction[126] and consideration will be given to the facts of each particular case to determine if there is an intention which manifests itself differently form the intention encapsulated in the transaction documents.[127] Thus viewed, it is submitted there can be no doubt that the relationship between the debtor and the creditor is not one of a loan but rather a donation of the amount of the defeasance profit. This analysis will give rise to donations tax payable by the donor (in this case the creditor) at the rate of 25% of the amount so donated.[128]

If the analysis above is correct and the relationship of a loan is not created between the creditor and the debtor, an instantaneous defeasance that involves only the assumption of the capital of the "loan" almost defies analysis. Interest paid is incurred for the right of use of funds of which the creditor would otherwise have had the use and the creditor's entitlement to such interest is conditional upon his willingness to make the capital available to the debtor for the period. However, as no loan obligation is created between the parties the commercial rationale for paying interest does not arise and it is submitted that the taxpayer would be hard pressed to substantiate the continued payments of interest in circumstances such as an instantaneous defeasance. This view would add to the difficulties of the taxpayer in not being able to avail himself of the deduction of the interest payments in terms of section 11(a) of the Income Tax Act as set out above.

[125] Erf 3183/1 Ladysmith (Pty) Ltd and Another v Commissioner for Inland Revenue 1996 (3) SA 942 (A).
[126] Dadoo Ltd & Others v Krugersdorp Municipal Council 1920 AD 530, 547.
[127] Zandberg v Van Zyl 1910 AD 302, 309.
[128] S54 of The Income Tax Act 58 of 1962.

CHAPTER SIX - CONCLUSION

The analysis of the South African income tax regime conducted above concludes that there can be no receipt or accrual of the defeasance profit except in the circumstances of an instantaneous defeasance. Subject to the content of the new capital gains tax legislation and having regard to the Australian position, the defeasance profit may be subject to the new capital gains tax regime. Where the defeasance profit is received as a result of an instantaneous defeasance the receipt, in the hands of money-lending institutions will be of a revenue nature and it is submitted that the same consequence will result for corporate taxpayers that are not money-lenders.

The assumption payment is not deductible because it does not produce income in defeasance arrangements that are not instantaneous. The assumption payment will be deductible pursuant to an instantaneous defeasance as the debtor receives income as a result of the expenditure.

The interest expenditure will continue to be deductible in accordance with the provisions of the Income Tax Act in all instance of defeasance arrangements, provided that the purpose for which the borrowing is made is one that renders the expenditure sufficiently clearly connected to the income-earning operations.

Defeasance arrangements have not been successful in Australia and it is submitted that they will not be successful in South Africa. The income tax consequences of the defeasance arrangements are unattractive and the arguments to be made in favour of those tax consequences that are to be had are difficult and complex. It is submitted that a taxpayer (even one given to aggressive tax structuring) would deem it prudent not to become involved in a debate of any kind with the South African Revenue Services on the merits or otherwise of this particular fund-raising mechanism.

Good understanding of difficult issues.

70%

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