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The CGT consequences of reduction or cancellation of a debt

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Capital gains tax

Prior to the introduction of Capital Gains Tax it was common practice in the estate planning environment to bequeath outstanding debts to the relevant debtors on the death of a planner or to write off a portion of the debt (normally the portion allowed as an annual exemption for Donations Tax) by way of journal entries without cash actually flowing in the process.

Example

A planner sold an asset to a trust or an heir and the purchase price remains owing to the planner on loan account. The idea is that the trust or the heir will eventually not be required to repay the loan account. During his lifetime the planner will make an annual Donations Tax-free donation to the trust or the heir by writing off R100 000 of the loan account by way of a journal entry.

In his will the planner will bequeath whatever balance is owing on the loan account to the trust or heir in order to ensure that, after his death, the loan account will no longer exist.

With the introduction of Paragraph 12 (5) of the Eighth Schedule this was no longer possible without incurring Capital Gains Tax on the amount of the reduction of the loan.

Effective from 1 March 2013, Paragraph 12 (5) of the Eighth Schedule has been repealed and any reference to Paragraph 12 (5) in Paragraphs 38(1) and 40 (2) has been deleted. A new Paragraph 12A has been inserted to deal with the reduction or cancellation of debts. For purposes of this discussion Paragraph 12A (6) (a) and (b) are of importance.

In terms of Paragraph 12A(6)(a), Paragraph 12A does not apply to any debt owed by a person that is an heir or legatee of a deceased estate to the extent that:

1. The debt is owed to the deceased estate;
2. The debt is reduced by the deceased estate; and
3. The amount by which the debt is reduced by the deceased estate forms part of the property of the deceased estate for purposes of the Estate Duty Act, 1955.

The basic rebate for Estate Duty purposes amounts to R3.5 million at this stage.

The question can be asked whether the exemption will still apply if the total estate amounts to less than R3.5 million. We believe the answer is in the affirmative.

Section 3 of the Estate Duty Act defines as property for Estate Duty purposes all property of a person as at date of his death and all property which in accordance with the Act is deemed to be property of that person at that date.

Section 3 (2) defines property as any right to property, movable or immovable, corporeal or incorporeal ……"

The fact that the estate might not be subject to Estate Duty owing to the rebate of R3.5 million does not take away from the fact that any loan account owing to the deceased by any person constitutes property for Estate Duty purposes, as defined.

Paragraph 12A(6)(b) also provides that Paragraph 12A does not apply to any debt owed by a person to the extent that;

1. The debt is reduced by way of a donation as defined in Section 55 (1); or
2. Any transaction to which Section 58 applies.

On the same basis as reasoned above the fact that the donation might be less or equal to the annual exemption will have no bearing on the fact that such donation by which a debt is reduced will not be subject to Capital Gains Tax.

The Explanatory Memorandum on the Taxation Laws Amendment Bill, 2012 (Page 45) seems to indicate that the reason for this change is the fact that in the case of a bequest in an estate the debt will be subject to Estate Duty and in the case of a donation, to Donations Tax.

The end result is that the bequest of an outstanding loan to the particular creditor or the reduction of a loan by way of donation during the lifetime of the debtor will no longer be subject to Capital Gains Tax.

Section 19 of the Income Tax Act must be borne in mind regarding the possible Income Tax consequences where the reduction or cancellation of a debt under certain circumstances is concerned.

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