



Distressed capital markets

Addressing key considerations of debt restructuring solutions

Taxpayers, susceptible to cash flow pressure and debt management issues, may be required to restructure debt, equity, financing instruments and possibly even their financing models.

In doing so, taxpayers should be aware of the key considerations when dealing with distressed debt and capital restructuring. These considerations include, but are not limited to, cash flow risk and liquidity headroom, robust forecasting to predict any risk scenarios, domestic and cross border tax implications as well as support from shareholders.



Setting the scene

In the uncertain world we live in today, Deloitte has developed a respond, recover and thrive approach to a crisis, which has been adopted by many businesses across the globe. This three-phased approach helps guide businesses through the impact of current challenges in order to emerge more resilient once the crisis fades.

The respond phase focuses on cash optimisation and legal considerations such as applications for government support programs and looking for opportunities for mergers and acquisitions. The recover and thrive phases, on the other hand, focus on asset disposals and simplifying legal entity structures to align with the business post COVID operating models.

If taxpayers are not aware of the tax consequences of the decrease in profits and capital due to COVID-19, and therefore do not take any action, they could be faced with adverse tax implications such as non deductibility of interest due to transfer pricing adjustments and application of other interest cap rules in companies that are considered to be thinly capitalised as well as being liable to account for withholding tax on debt that is irrecoverable.



Tax implications of distressed debt

Transfer pricing

- Consideration will need to be given to debt funding with respect to local operations and the thin capitalisation implications thereof. This assessment should not only include the considerations around the arm's length nature of the debt pricing (i.e. interest rate), but also the entity's debt carrying capacity in order to demonstrate that they are able to service the debt. In the event that the borrower is financially distressed, it may be more appropriate for the shareholders to inject additional equity into the business as opposed to debt.
- With respect to outbound debt, it is important to consider the credit profile of the borrower, noting that the credit rating of the borrower may have deteriorated due to the impact of COVID-19. In cases where interest free loans are provided, it is important to note that certain countries within Africa (e.g. Botswana, Kenya, Malawi, Tanzania and Zambia) have deeming interest provisions.
- The current economic environment may also increase the need for parental guarantees or loan covenants, which must be priced at arm's length.
- Multinational enterprises (MNEs) should also consider restructuring the debt financing within the group (e.g. by renegotiating the repayment terms and interest rates), due to central bank interventions that have resulted in decreased interest rates in a number of jurisdictions, which may have an impact when determining arm's length terms and conditions of existing loans.
- Intragroup loans with no repayment terms are at risk of being recharacterised to equity by the revenue authorities.

New and existing interest limitation rules

- In South Africa, section 23M of the Income Tax Act limits the deduction of interest on debt owed to a person that is not subject to tax in South Africa where the creditor is in a controlling relationship with the debtor or where the creditor is not in a controlling relationship with that debtor, but the creditor obtained the debt funding advanced to the debtor from a person that is in a controlling relationship with the debtor.
- National Treasury is proposing to replace section 23M with new interest limitation rules applying to all companies forming part of a MNE group of companies, all debt (third party and related) as well as local-to-local and cross border debt.
- Under the new rules, net interest expense will be limited to 30% of earnings before interest, taxes, depreciation and amortization (EBITDA) and any disallowed interest expense will be allowed to be carried forward for five years. A decrease in EBITDA will, therefore, result in higher amount of interest being disallowed in an inbound loan.
- For outbound loans, it should also be considered whether the borrower's country of residence has similar rules or thin capitalisation rules which could also limit the amount of interest allowed.

Withholding tax considerations

- In South Africa, a withholding tax is charged at a rate of 15% (subject to treaty relief) on interest paid by any person (borrower) to or for the benefit of a foreign person (foreign lender) from a source within South Africa.
- The liability for withholding tax on interest arises either when interest is paid or becomes due and payable. Therefore, where a South African borrower does not review its debt arrangements, there is a risk that they may be liable to account for withholding tax on interest that may not be recoverable due to COVID-19 on the business.



Debt restructuring in the market place

As mentioned above, taxpayers may consider restructuring its debt and financing models under any of the above-mentioned phases and, therefore, must be aware of the tax consequences that may follow.

Below are four debt restructuring options that we are seeing in the market.

- Amending and restating debt terms;
- Consensual re-financing such as debt and debt-for-equity swaps;
- Enforcement and change of control such as, establishing new holding structures and incentivising management; and
- Insolvency and mergers and acquisitions (M&A) (e.g. appointment of insolvency practitioners to realise assets and repay outstanding creditors)

The remainder of this article focuses on consensual re-financing tax considerations as we expect the majority of taxpayers will be considering transactions within this option.



Consensual re-financing options: tax considerations

South African income tax

Generally, a debt waiver or debt-to-equity swap may result in adverse income (or capital gains) tax implications in the hands of the debtor. In South Africa, the tax treatment of these type of transactions is in terms of the provisions of section 19 of the Income Tax Act (the Act) and paragraph 12A of the Eighth Schedule to the Act.

The provisions of section 19 and paragraph 12A will apply where the debt waiver or debt to equity swap results in a 'tax benefit' for the debtor. In the case of a debt waiver, a 'debt benefit' is the amount of debt waived for no consideration. However, in the case of a debt-to-equity swap, a 'debt benefit is, generally speaking, the amount by which the face value of the debt exceeds the increase in the market value of the shares held by the creditor as a result of the debt-to-equity swap.

Where a debt waiver or debt-to-equity swap results in a 'debt benefit', the tax treatment for the debtor will depend on what the loan funds were used for. Below is a summary of possible tax consequences under various scenarios:

- If the borrower used the debt to fund trading stock, the cost or tax value of trading stock still on hand must be reduced by the amount of the debt benefit. Should the debt benefit be more than the value of trading stock, the excess debt benefit will be treated as a recoupment included in the taxable income of the borrower.



Consensual re-financing options: tax considerations

South African income tax

- If the borrower used the debt to fund tax deductible expenditure, such as operational costs, the debt benefit must be treated as a recoupment and included in the taxable income of the borrower.
- If the borrower used the debt to fund a tax allowance asset that is still held, the debt benefit-must first reduce the remaining base cost of the allowance asset per paragraph 12A of the Eighth Schedule. The excess debt benefit (if any) must be treated as a recoupment and included in the taxable income of the borrower.
- Where the debt was used to fund an allowance asset that was disposed of in prior years and the recoupment determined at the time of the disposal of the asset is less than the amount that would have been determined if the debt benefit had been taken into account in the year of disposal, the difference is treated as a recoupment included in the taxable income of the borrower in the year in which the debt benefit arises.
- Where the debt was used to fund a non-allowance asset that is still held at the time the debt benefit arises, the base cost of the non-allowance asset must reduced by the amount of the debt benefit.
- Where the debt was used to fund a non-allowance asset that was disposed of in prior years and the capital gain or loss or different to what it would have been if the asset was disposed of in the year the debt benefit arises, the difference is treated as a capital gain in the year in which the debt benefit arises.

Section 19 and paragraph 12A contain exemptions which will apply if certain requirements are met, for example, when lender and the borrower form part of the same group of companies and the borrower is dormant.

If an offshore borrower entity is a controlled foreign company (CFC), the abovementioned rules must be taken into account when calculating its net income for the purposes of the CFC rules contained in section 9D(2A) of the Act. However, to the extent that the CFC qualifies for one of the exemptions contained in section 9D, the attribution of its net income will not be required.

Donations tax

Where debt is reduced for no consideration or inadequate consideration, the lender, if a South African resident, must consider whether such debt is reduced by way of a donation and, if so, whether donations tax is payable by the lender.



Reportable arrangements

Steps taken to restructure debt financing may result in the participants having a reportable arrangement. Participants to a reportable arrangement is obliged to disclose information pertaining to such arrangement to SARS within 45 business days. The information includes a detailed description of all steps, key features, assumed tax benefits, names registration numbers, registered addresses of all participants as well as a list of all agreements.

Other

In addition to the above where a debt waiver or debt-to-equity swap involves a non-resident lender or borrower, the foreign tax consequences as well as exchange control requirements must also be considered.



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