South African Institute of Tax Professionals

15 May 2020

The South African Revenue Service

Lehae La SARS,

299 Bronkhorst Street

PRETORIA

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BY EMAIL: policycomments@sars.gov.za

RE: Comments on the Draft Interpretation Note Concerning Doubtful Debts (Section 11(j))

We write to comment on the draft interpretation note addressing doubtful debts (section 11(j)).

A. General Support

There is general support for the views stated in the draft interpretation note based on our interaction with tax practitioners. The ruling provides considerable clarity on a key recurring consideration for most businesses. More importantly, this draft interpretation note comes at a timely moment in South African economic history when businesses are under distress and the repayment of debts has in many instances become questionable.

The purpose of this submission is to raise a few issues not answered by the draft interpretation note and to raise a few anomalies. One small anomaly appears to the reference point for the interpretation note. The interpretation appears to be relying on a prior version of section (11)(j) without taking into account certain recent changes that have occurred (i.e. from 2019). For instance:

- Section 11(j)(i)(aa)(B) has been amended substantially; and
- Section 11(j)(ii) now refers to "if IFRS 9 is not applied to debt"; whereas the section quoted in the draft interpretation note states "if IFRS is not applied to that debt" (i.e. the revised legislation makes it clear that section11(j)(ii) will apply where IFRS for small and medium businesses is applied by the taxpayer at issue).

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B. Coverage

One issue for consideration is coverage. While we understand that draft interpretation notes are typically directed toward a single section of a tax act, section 11(j) is best seen as an integrated whole with other related provisions dealing losses incurred by creditors. In particular, clarification is required about how "bad debts" under section 11(i) can be claimed and how doubtful debt allowances shift to full on "bad debt". Secondly, a comparable interpretation note is required for doubtful debts of covered persons (e.g. banks) so that the terms and concepts of sections 11(j) and 11(jA) are working in parallel.

Without going into too many details, here are some quick points to consider (which may require a change in legislation via a tax amendment as opposed to a modified interpretation):

- Section 11(i) refers to "bad debts". Recent changes in section 11(j) and (jA) have a dual focus. There is now an IFRS focus as well as a residual common law focus in determining a "doubtful debt". The language of section 11(i) solely refers solely to "bad debt" presumably under old common law without direct reference to IFRS. Moreover, how do the IFRS doubtful debt rules apply when those same debts are no longer recoverable (i.e. "bad") under section 11(i)?

- The draft interpretation note rightly demarcates section 11(j) from section 11(jA) as if there is no choice between the two sections. Section 11(jA) is limited to covered persons, but section 11(j) appears more open-ended. For instance, can covered persons listed under section 11(jA) instead choose to apply section 11(j)? The draft interpretation note seems to suggest that section 11(jA) covered persons are excluded, but where is the authority for this exclusion? It seems like section 11(jA) covered persons indeed have the option to choose section 11(j) if one looks at the literal words.

A third issue relates to the VAT rules of irrecoverable debts, which allow for the reversal of prior VAT outputs. These VAT rules talk of amounts "written off so much of the said consideration as has become irrecoverable" (section 22(1)(c)) and provides a ratio for obtaining VAT inputs (i.e. reversals of VAT outputs) based on a ratio "so written off as irrecoverable" (bottom paragraph under section 22(1)). The question is how the terms "written off" for VAT compare to those terms of income tax.

C. Potential Application of IFRS

Section 11(j) and the overall doubtful debt regime divides the construct between IFRS and non-IFRS 9 application. The question is what is the meaning of IFRS 9 being "applied" or "not applied" to a debt.

Does this rule apply on an "all-or-nothing" basis for the taxpayer in full or only on a debt—by-debt basis. At an instrument level, one would assume that IFRS 9 must apply to the debt at issue in its entirety as opposed to only a portion. Is this correct?

Another issue is implied optionality. A taxpayer choosing to report in terms of IFRS may not fall within the ambit of IFRS 9. Alternatively, a specific debt may fall outside of the provisions of IFRS 9, but the taxpayer will still apply IFRS. Lastly, taxpayers may in fact be applying IFRS or “IFRS for SMME's” and not apply IFRS 9 to their debt.

These questions may be resolvable by interpretation or may require legislative amendment.

D. Incongruity between IFRS 9 and Section 24J Interest

The tax rules for determining includible interest under section 24J have a slightly different starting point than the interest revenue calculation based on IFRS 9. These differences mean that the two systems do not blend properly. In short, section 24J requires a full inclusion of interest income, followed by a doubtful debt (or bad debt) write-off deduction. IFRS 9, however, initially recognises a net figure.

More specifically, IFRS 9 requires a three-stage recognition process. The incongruity is caused by the third stage of recognition. In stage 3,

> ***“if the credit risk of a financial asset increases to the point that it is considered credit-impaired, interest revenue is calculated based on the amortised cost (i.e. the gross carrying amount less the loss allowance). Financial assets in this stage will generally be assessed individually. Lifetime expected credit losses are recognised on these financial assets.”*** (Emphasis added)”

The key is IFRS 9 recognition at “amortised cost” (i.e. on the net reduced amount). Stated differently, IFRS 9 requires that interest revenue is calculated using a ‘net method’ of applying the effective interest rate to the net amortised cost balance (i.e. including the loss allowance as a credit adjusted). The tax rules require a full inclusion of section 24J interest as gross income, followed by a doubtful (or bad) debt allowance as an offset against this full inclusion.

The concern is that the confusion of the two systems can potentially result in a double offset for the same potential doubtful loss in respect of interest.

This issue also seemingly arises in terms of section 11(jA). It is our understanding that some of the major banks have obtained IFRS 9 opinions that these banks can disclose the full interest income on stage 3 debts (despite the above questions to the contrary) and that they can then create a loss allowance against this income. This restatement is done solely with the purpose of receiving a section 11(jA) tax allowance on the interest component without triggering a double loss.

All that the draft interpretation note (paragraph 3.4) states in this regard is that *“The stage of default also determines how interest revenue is accounted for in the financial statements.”* The draft interpretation needs to specifically address this point to eliminate the confused integration of IFRS and section 24J. Alternatively, a change in law may be required.

E. Debt Security

1. Non-IFRS taxpayers

The draft interpretation note deals with doubtful debts backed by security. However, we note that Annexure C of the 2020 Budget Review specifically raises the concept of debt-backed securities as an item that must be revisited for revised legislation. For instance, the Budget Review specifically states that doubtful deductions "do not account for the taxpayer's debt security. It is proposed that the determination of deductions in respect of secured debt arrears owed to non-bank taxpayers not applying IFRS 9 should be reviewed." Hence, this draft interpretation note may be premature in this regard and should await final legislation.
Under the current version of the draft interpretation, the question of security for non-covered persons (i.e. parties other than banks and authorised users) only matters where the taxpayer requests the doubtful debt allowance be increased to 85%. Clearly, the question of security should impact the analysis in all cases where the taxpayer is claiming a doubtful debt deduction at any level (outside the IFRS system).
We also note that the mere existence of security should not per se prevent a claim for doubtful debt. The question that has to be asked is the value of that security. A good example is debt backed by real estate. The value of that real estate (industrial, commercial or residential) may not fully compensate for failure to recover debt, especially after the impact of COVID-19 is taken into account.

2. IFRS taxpayers

The draft interpretation note does not appear to directly deal with security-based debts in terms of IFRS taxpayers claiming doubtful debt allowances. The existence of such security presumably falls within the IFRS calculation. The impact of viable securities should be stated within the draft interpretation note to make this point explicit, along with an example to see how the impact of securities should be applied for IFRS taxpayers.

F. Recording age analysis

According to our practitioners, private-sector accounting systems are not set up to record when a debt is due (i.e. the date when the arears begin to arise). These systems only record the age of the debt that is calculated from the date that the debt is recorded. If debt is due on presentation of invoice, the debtor's age analysis will assist in this calculation. However, the date of the invoice and the date payment is due are often not the same (for instance, the due date may be within 10, 15 or 30 days from the date of invoice).

Further difficulties may be experienced if the taxpayer has different due dates for different clients with numerous invoices. Specific problems may be experienced in the professional services industry (in particular engineers and architects) where due dates of invoices for various projects may differ. It may further have an impact on accounting and audit firms where clients often negotiate invoices payable after 30, 60 or 90 days despite the norm being "payable on presentation".

The ruling should perhaps provide some simplifying rule in this regard. Simplifications are especially warranted when large numbers of potential debt transactions are involved.

G. Lease receivables

The definition of lease receivables under section 11(j) is unclear. The exclusion of lease receivables remains a key issue. We understand that National Treasury seemingly believes that affected taxpayers would be claiming capital allowances on the underlying leased assets and should not be able to claim again on the lease receivable. Setting aside the overall reasoning, it should be noted that REITs generally lack most capital allowances.

We note that this issue remains open for legislation. Annexure C of the Budget Review indicates further changes. This issue may have to be reserved at this stage.

H. Miscellaneous

Provided below are a series of smaller issues:

3.2 Lifetime Expected Losses (LECL's)	The draft interpretation note provides guidance on the treatment of LECL's. However, it does not seem to address the following: · If a taxpayer chooses to apply the simplified approach, does this simplified approach still fall within the ambit of IFRS 9 and therefore section 11(j)(i)? · If the implementation of IFRS 9 has been delayed (by insurers for example), can the parties apply the provisions of s11(j)(ii) on the basis that IFRS 9 is not applied to their debt, even though they report in terms of IFRS (also refer comments above in this regard)?
3.4 Impairment – definition of default	Is it necessary for taxpayers to have their definition of default available to SARS where claiming a 40% allowance in respect of Stage 3, or only when applying for a directive?
3.4.3 Stage 3: Lifetime Expected losses And 5.6.5 Bad debt	It is stated that IFRS 9 requires an entity to write off non-performing debt only where there is no reasonable expectation of further material recoveries. This criteria is the same as that listed in 5.6.5. Apart from partial write-off, can it be concluded that this definition of bad debt in IFRS is in line with the requirements for tax purposes?

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	As stated above, more guidance is required when debt is considered bad from a tax perspective and why it would different to the accounting “no reasonable prospect of recovery”.
3.6 Forward looking information	Is the economic impact of COVID-19 expected to have any specific tax implications, other than being considered as an external factor outside of the model?
5.3 Unused facilities	The section is calculated with reference to the ECL allowance. This may include unused facilities, and these may have an impact on the ECL calculated in respect of facilities used. This cannot always be separated?

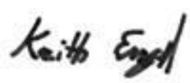
I. <u>Requests for further clarifications</u>

The draft interpretation note indicates that directive applications can be sought for “such other considerations as the Commissioner may deem relevant” and reiterates that this information will be requested on a case-by-case basis. Given the factual complexities in this area, the draft interpretation note should provide more information about the information required and process associated with these directives.

* * * *

In closing, we realise that this is a complex subject, and we appreciate the overall effort to clarify these matters at this most difficult economic juncture. You are welcome to contact me (082 455 5597 or kengel@thesait.org.za) should you have any comments or questions.

Yours faithfully,



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