

A critical evaluation of the doubtful debt income tax treatment in South Africa

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APPROACH OF STUDY

As determined by the North-West University, with reference to the General Academic Rules, a dissertation may be presented in either the “traditional book format” or the “article format”. Given that the author of the study is of the view that the research would be of practical value to the reader thereof, the latter format has been selected.

The mini-dissertation consists of Chapter 1, which sets forth the introduction, Chapter 2, which embodies the article and Chapter 3, which outlines the summary and conclusion of the study. It is worth noting that in an attempt to present the mini-dissertation in a logical, structured manner, it was inevitable that certain information contained within Chapters 1 and 3 would be replicated in Chapter 2.

It must be emphasised that this mini-dissertation was submitted in partial fulfilment of the requirements for this Masters’ Degree. Since the scope of the study is limited, the principle objective to submit a single article is justified.

ABSTRACT

The objective of section 11(j) of the Income Tax Act 58 of 1962 (“the Act”) is to afford relief to taxpayers who doubt the recoverability of debt that is due to them. The Taxation Laws Amendment Act 23 of 2018, issued on 17 January 2019, established an amendment to the doubtful debt allowance to promote certainty. This amendment was succeeded by another amendment to section 11(j), included in the Taxation Laws Amendment Act 34 of 2019, to align the South African Revenue Service’s (“SARS”) intention with the current wording of the legislation.

The main concern facing SARS is that it has failed to provide certainty to taxpayers through the amendments to section 11(j). Apart from that, there is a possibility that the income tax treatment resulting from the 2019 amendment is not consistent with the fundamental principles of taxation. This inconsistency may be attributable to the distinction made in section 11(j) between taxpayers applying IFRS 9 and taxpayers not applying IFRS 9.

Pursuing this matter further, the purpose of this study is to critically evaluate current legislation regarding section 11(j) against the fundamental principles of taxation to determine compliance thereof. The study reveals that the principles of neutrality, certainty and simplicity, and effectiveness and fairness might be in contravention because of variations in the income tax treatment of doubtful debts for the different types of taxpayers identified by current legislation. Ultimately, the study points towards the possibility that section 11(j) is not in conformance with the fundamental principles of taxation.

KEYWORDS

- Doubtful debt allowance
- IFRS
- IFRS 9 Financial Instruments
- Loss allowance
- Expected credit losses
- Fundamental principles of taxation

LIST OF ABBREVIATIONS

Abbreviation	Description
AICPA	American Institute of Certified Public Accountants
Carter Report	Report of the Royal Commission on Taxation
CIPFA	Chartered Institute of Public Finance and Accounting
Covid-19	Coronavirus
GDP	Gross Domestic Product
Henry Review	The report to the Commonwealth Treasurer on Australia's Future Tax System
IAS 39	IAS 39 <i>Financial Instruments: Recognition and Measurement</i>
IASB	International Accounting Standards Board
ICAEW	Institute of Chartered Accountants in England and Wales
IFRS	International Financial Reporting Standards
IFRS 9	International Financial Reporting Standard 9 <i>Financial Instruments</i>
IFRS for SMEs	IFRS for Small and Medium-sized Entities
IFRS 15	IFRS 15 <i>Revenue from Contracts with Customers</i>
IFS	Institute of Fiscal Studies
Mirrlees Review	Tax by Design: The Mirrlees Review
OECD	Organisation for Economic Co-operation and Development
PD	Probability of default
SAIT	South African Institute of Tax Professionals
SARB	South African Reserve Bank
SARS	South African Revenue Service

Section 11(j)	Section 11(j) of the Income Tax Act 58 of 1962
Stats SA	Department of Statistics South Africa
The Act	Income Tax Act 58 of 1962
The Committee	Davis Tax Committee

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CHAPTER 1 INTRODUCTION

1.1 Introduction

1.1.1 Background

The South African economy has been under pressure for a considerable time. This situation is attributable to several reasons, in particular regime uncertainty, corruption, South Africa's education crisis, the national energy crisis, emerging market sentiment, the inefficacy of infrastructure, and the intricate regulatory environment. Taking the current poor economic climate of South Africa into account, it is inevitable that taxpayers, such as creditors, will be burdened with the uncertainty of securing payments from debtors (Brink, 2019).

The emergence of the 2019 novel coronavirus ("Covid-19") has affected economic and financial markets (Deloitte, 2020:1). On this account, all industries and sectors are confronted with the economic challenges resulting from the measures (e.g. regulatory and organisational mandates) that have been implemented to address the pandemic, for example, school closures and social distancing. Entities are subjected to the adverse effects of an economic contraction as the pandemic advances, which could have a detrimental effect on their financial results (Deloitte, 2020:1). An economic crisis can result in "financial market volatility and erosion, deteriorating credit, liquidity concerns, further increases in government intervention, increasing unemployment, broad declines in consumer discretionary spending, increasing inventory levels, reductions in production because of decreased demand, layoffs and furloughs, and other restructuring activities" (Deloitte, 2020:1). Likewise, Covid-19 has had dire consequences on debtors' ability to meet their contractual obligations, which has compelled entities to closely examine the measurement of their impairment losses (Deloitte, 2020:2).

The term 'gross income' is defined in section 1 of the Income Tax Act 58 of 1962 ("the Act") as "the total amount, in cash or otherwise, received by or accrued to or in favour of such resident". Consequently, a taxpayer must include in gross income amounts that have been received or accrued to him or her. The principle laid down in the case of *Secretary for Inland Revenue v Silverglan Investments (Pty) Ltd* (1969) is that the legislation's wording requires amounts to be included in gross income whenever the amounts fall within the ambit of the definition of gross income for the first time. In the *Mooi v Secretary for Inland Revenue* (1972) case, it was evident that accrual supervenes when a taxpayer becomes unconditionally entitled to an amount.

In the event that a taxpayer provides goods or services on credit, the entire amount from the sale of the goods or services will be included in the taxpayer's gross income upon provision of the goods or services. In essence, the taxpayer becomes unconditionally entitled to this amount. If, however, the consumer only makes payment in the following year of assessment, the taxpayer will, as a result, shoulder the burden of

taxation in advance. This problem is intensified if the consumer eventually repudiates payment of his or her debt (Hartley, 2018:1).

Hartley (2018:11;24) states that the term ‘bad debt’ is not defined in the Act. He concludes that a bad debt is a debt that is uncertain enough to be classified as such. According to Hartley (2018:23), the Act contains neither a definition for the word ‘doubtful’ nor a definition for the term ‘doubtful debt’. On the basis thereof, Hartley (2018:24) defines the concept of a ‘doubtful debt’ as “a debt of which there is more uncertainty of recovery than a bad debt”. This reflects the fact that there is a larger extent of uncertainty as to whether a doubtful debt will be recovered – in fact, it is more likely than not that a bad debt will not be recovered.

A certain extent of relief is provided to taxpayers who are uncertain about the recovery of their debt through the application of section 11(j) of the Income Tax Act 58 of 1962 (“section 11(j)”), which provides an allowance for doubtful debts. A taxpayer can deduct this allowance every year in respect of the debt that is deemed to be doubtful, providing that the allowance is added back to the taxpayer’s income in the following year of assessment (Steenkamp, 1998:91). Hartley (2018:25) states that the purpose of the section 11(j) deduction is to prevent inequity where it is found that a taxpayer bears the responsibility of taxation on an amount that the taxpayer is hardly likely to recover from a debtor.

1.1.2 Literature review

Section 11(j) is examined by observing the language, the purpose and the context of the section, in conjunction with the amendments made to section 11(j) over the years. The predecessor of section 11(j), namely section 11(2)(g) of the Income Tax Act 40 of 1925, allowed a doubtful debt allowance of which the amount was determined at the Commissioner’s discretion. In *Income Tax Case 93* (1927), it was held that the amount of the allowance should not be determined arbitrarily – there must be an application of mind as to what should be the proper amount of the allowance. Consequently, the Commissioner should use a sensible and logical method to determine the allowance. This principle was further supported by the ruling in *Income Tax Case 273* (1933) where it was established that the Commissioner must ‘apply his mind’ when he determines the amount of the doubtful debt allowance.

In 2012, the Taxation Laws Amendment Act 22 of 2012 replaced the term ‘debts’ in section 11(j) with ‘debt’. The reason for the change was to avoid the generation of unwarranted or dubious interpretations (National Treasury, 2012:31). The Taxation Laws Amendment Act 25 of 2015, published on 8 January 2016, amended the Act to allow a doubtful debt allowance of an amount that the Commissioner considered to be doubtful, as stated by the criteria set out in a public notice issued by the Commissioner. This amendment occasioned the removal of the Commissioner’s previous discretion (National Treasury, 2015:70).

However, as is indicated in the Draft Explanatory Memorandum on the Taxation Laws Amendment Bill, which was released on 26 July 2018, the effective date for the removal of the Commissioner's discretion in section 11(j), as aimed by the Taxation Laws Amendment Act 25 of 2015, has not yet been announced (National Treasury, 2018b:27). This stems from the fact that Commissioner has yet to formulate the criteria to claim the allowance for doubtful debts. It was noted that the amendment in 2015 sought to promote the income tax self-assessment system (National Treasury, 2018a:25). Previously, a detailed list of doubtful debts had to be compiled and submitted to the Commissioner to which the Commissioner would apply a rate, not exceeding 25%, to the debt considered to be doubtful (De Koker & Williams, 2019).

It is important to note that section 11(j) does not clearly indicate how the doubtful debt allowance should be calculated (PricewaterhouseCoopers, 2018). It has, however, become the Commissioner's practice to grant an allowance equivalent to 25% in respect of doubtful debts. This practice has been reinforced by the statement made by the South African Revenue Service ("SARS") in the Draft Interpretation Note on Doubtful Debts. The statement indicates that SARS, in practice, generally allowed 25% of a taxpayer's listed doubtful debts as a doubtful debt allowance (SARS, 2020:2). In the event that it was unfeasible for a taxpayer to compile a detailed list of doubtful debts (for example, a taxpayer with a large client base), SARS allowed a special formula to calculate the amount of the allowance (De Koker & Williams, 2019).

The Explanatory Memorandum on the Taxation Laws Amendment Bill, 2018, proposes specified criteria to determine the amount allowed as a doubtful debt allowance with the intention of affording certainty (National Treasury, 2018a:25).

On 17 January 2019, the Government Gazette published the Taxation Laws Amendment Act 23 of 2018. This Amendment included amendments to the tax treatment of doubtful debts to provide certainty. The amendments came into operation on 1 January 2019 and apply in respect of years of assessment commencing on or after that date. The Government Gazette published the most recent Taxation Laws Amendment Act 34 of 2019 on 15 January 2020. This consists of an amendment to paragraph (j)(i)(aa) for subitem (B), which is essential to align legislation with SARS's intention (National Treasury, 2019:54).

The latest tax treatment of the Act regarding doubtful debt allowances distinguishes between taxpayers applying International Financial Reporting Standard 9 *Financial Instruments* ("IFRS 9") and taxpayers not applying IFRS 9. The present wording of section 11(j)(i)(aa) of the Act allows 40% of the IFRS 9 loss allowance, measured at an amount equal to the lifetime expected credit losses as contemplated in IFRS 9, other than debts in respect of lease receivables as defined in IFRS 9, if IFRS 9 is applied by taxpayers. It also includes 40% on amounts of bad debts for accounting purposes that did not meet the requirements of section 11(a) or (i). Furthermore, if IFRS 9 is applied, section 11(j)(i)(bb) allows a 25% loss allowance related to the impairment, as contemplated in IFRS 9, other than debts in respect of lease receivables as defined in IFRS 9 or debt taken into account under item (aa). In other words, it entails the difference

between the IFRS 9 loss allowance for accounting purposes and the 40% allowance allowed for tax purposes (National Treasury, 2018a:26).

Conversely, section 11(j)(ii)(aa) of the Act allows a loss allowance of 40% of the face value of so much of any debt, due to the taxpayer, if that debt is 120 days or more in arrears if IFRS 9 is not applied by the taxpayer. Additionally, section 11(j)(ii)(bb) allows a loss allowance of 25% of the face value of so much of any debt, due to the taxpayer, if that debt is 60 days or more in arrears if IFRS 9 is not applied by the taxpayer, excluding debts that are 120 days or more in arrears.

Section 11(j) allows taxpayers to apply to SARS for a higher percentage. The 40% allowance can be increased to a percentage not exceeding 85% if the Commissioner issues a directive to the taxpayer which indicates that the percentage may be increased. This provision enables non-bank taxpayers to receive a similar deduction to what banks are allowed under section 11(jA) for amounts comparable in the wider sense (National Treasury, 2018a:26). The following criteria, as specified by section 11(j), will be taken into account:

- the history of the debt owed to that taxpayer, including the number of repayments not met, and the duration of the debt;
- the steps taken to enforce repayment of the debt;
- the likelihood of the debt being recovered;
- any security available in respect of that debt;
- the criteria applied by the taxpayer in classifying the debt as bad; and
- such other considerations as the Commissioner may deem relevant.

Adam Smith (1776, 2009 printing) observed that by virtue of the fairness and practicality of four maxims regarding taxation (namely equality or ability, certainty, convenience, and economy), most nations made efforts to generate their taxes in an equal manner to ensure certainty, to afford convenience to the taxpayer with respect to the time and the method of payment alike, and to render taxes in relation to the revenue contributed by the taxpayer. According to Stamp (1921:12-14), Smith's four canons as set out in his seminal work, *An inquiry into the nature and causes of the wealth of nations*, helped shape the four fundamental principles of taxation. These canons are still recognised to this day (Alley & Bentley, 2005:586). Smith's work established the principles of equity, certainty, the convenience of payment, and economy in collection, which consists of fairness, government revenue, and efficiency (Du Preez, 2016:68-74).

In 1998, the Organisation for Economic Co-operation and Development ("OECD") published a report on the widely accepted taxation principles. This was considered to be a continuation of the development of taxation principles and the OECD consequently recognised the conditions for a taxation framework (Du Preez & Stiglingh, 2018:145). The report embraced the principles of neutrality, efficiency, certainty and

simplicity, effectiveness and fairness, and flexibility (OECD, 1998:4). These principles can be summarised as follows:

- The neutrality principle suggests that for taxation to be neutral, taxpayers in resembling situations performing comparable transactions should be subject to the same degree of taxation (OECD, 1998:4).
- The efficiency principle generally minimises the compliance cost for taxpayers and the administrative costs for the tax authorities as far as is practicable (OECD, 1998:4).
- The certainty-and-simplicity principle was defined as clear and straightforward tax rules (OECD, 1998:4).
- The effectiveness-and-fairness principle attempts to reduce tax evasion and avoidance to a minimum (OECD, 1998:4).
- The flexibility principle implies that a taxation system should be amendable and ever-changing (OECD, 1998:4).

Recognising that section 11(j) differentiates between taxpayers who apply IFRS 9 and taxpayers who do not apply IFRS 9, the complexity of the calculation of the IFRS 9 loss allowance as prescribed by IFRS 9 and the limited availability of the interpretation of the criteria to apply for an increased percentage, it is possible that the amended section 11(j) does not conform with the fundamental principles of taxation.

The amendment will briefly be evaluated against the abovementioned principles to establish which of the fundamental principles of taxation appear to be in contention.

1.1.2.1 Neutrality

The latest tax treatment of section 11(j) regarding doubtful debt allowances distinguishes between taxpayers applying IFRS 9 and taxpayers not applying IFRS 9. This distinction could lead to inconsistencies in the calculation of the amount allowed as a deduction for the different types of taxpayers. Consequently, this situation can potentially result in non-conformity with the principle of neutrality.

The measurement of expected credit losses of a financial instrument should demonstrate an unbiased and probability-weighted amount, which is determined by evaluating a range of possible outcomes. It should also incorporate the effects of the time value of money (Deloitte, 2018b:3). As a result, the entity should apply a certain percentage to the amount of expected credit losses to determine the impairment to be recognised. A doubtful debt allowance can be awarded to taxpayers who apply IFRS 9, which is calculated as a percentage of a loss allowance that already takes probability into account. Taxpayers who do not apply IFRS 9 are awarded an allowance, which is calculated as a percentage of the face value of the doubtful debt.

Consequently, taxpayers not applying IFRS 9 will be allowed a larger allowance. This potentially does not reflect similar levels of taxation for taxpayers who are in similar situations and who carry out similar transactions.

It follows that taxpayers applying IFRS 9 are allowed a doubtful debt allowance at the present value of the expected credit losses. Discounting will reduce the present value of cash flows to a value below that of corresponding future cash flows (Schmidt, 2020). Having said that, taxpayers not applying IFRS 9 are allowed a doubtful debt allowance at the undiscounted value of doubtful debts. This is yet another example of possible failure to conform to the neutrality principle as it could lead to a larger allowance for taxpayers not applying IFRS 9.

1.1.2.2 Efficiency

The application of IFRS results in a significant and directly observable cost to adopt IFRS to prepare financial statements in accordance with IFRS and fees paid as a result of statutory audits (De George *et al.*, 2013:457). As a result, the compliance cost might be high for taxpayers to apply IFRS 9 and for them to be allowed the section 11(j) allowance. However, the latest tax treatment of the Act regarding doubtful debt allowances distinguishes between taxpayers applying IFRS 9 and taxpayers not applying IFRS 9. As a result, a taxpayer need not apply IFRS 9 to be allowed an allowance at all. Hence, the efficiency principle does not appear to experience conflict.

1.1.2.3 Certainty and simplicity

The latest tax treatment regarding doubtful debt allowances differentiates between taxpayers applying IFRS 9 and taxpayers not applying IFRS 9. Irrespective of this distinction, the legislation does not refer to taxpayers applying IFRS for Small and Medium-sized Entities (“IFRS for SMEs”). As a result, it may be uncertain under which of the two categories these taxpayers fall.

Moreover, the provision to section 11(j) allows taxpayers to apply for a percentage not exceeding 85% of their amount of doubtful debts to be allowed as a deduction, which is contingent on the satisfaction of certain criteria as set out in section 11(j). At this particular time, no court case ruling has been made that is relevant to the interpretation of the criteria, neither has a public notice nor binding general ruling been issued by the Commissioner. Nonetheless, the Draft Interpretation Note on Doubtful Debts has set out guiding factors that the Commissioner considers when issuing a directive for an increased percentage allowance (SARS, 2020:15). However, as stated by the South African Institute of Tax Professionals (“SAIT”), the Draft Interpretation Note on Doubtful Debts should provide further clarification on the

prescribed information, as well as the procedures followed, to apply for a directive (SAIT, 2020:6). Considering this situation, the current guiding factors are regarded as being limited. Consequently, these new criteria might bring the certainty-and-simplicity principle into contention once again, seeing as that the interpretation thereof might be dubious.

1.1.2.4 Effectiveness and fairness

It is debatable whether it is appropriate for SARS to incorporate IFRS within the legislature. According to Rezaee (2002:18), cases of fraudulent financial statements have increased considerably during the past number of years, which had adverse consequences for investors and creditors. Financial-statement fraud pertains to the intentional misrepresentation of an entity's financial statements to deceive users of the financial statements (Rezaee, 2002:18). The possibility of manipulation of accounting figures should be examined as accounting records, prepared in accordance with IFRS, will now be used to calculate the allowance for doubtful debts granted by the Act for taxpayers applying IFRS 9. This could lead to larger deductions of allowances and the potential for tax evasion may increase. As a result, this situation might not be consistent with the effectiveness-and-fairness principle as maintained by the OECD.

Another factor to consider is the tax treatment of doubtful debt allowances for taxpayers not applying IFRS 9, where an allowance is granted if the debt is either 60 or 120 days in arrears. Based on the current wording of section 11(j), which only considers the days a debt is in arrears to grant a doubtful debt allowance, it follows that no consideration has been made to the type of industry in which the debt came into existence. It also does not consider what would be regarded as a normal and customary period of default before a debt is viewed as doubtful. This could lead to a deduction of an allowance for doubtful debt when the debt is, in fact, not yet doubtful. Consequently, this situation might be deemed to be non-compliance with the effectiveness-and-fairness principle as it does not produce the right amount of tax at the right time.

1.1.2.5 Flexibility

The Taxation Laws Amendment Act 34 of 2019, published on 15 January 2020 by the Government Gazette, is proof that the taxation system, specifically relating to the section 11(j) allowance, is amendable and ever-changing. For this reason, there seems to be no non-compliance with the flexibility principle.

1.1.3 Motivation

It comes as no surprise that South Africa currently experiences an economic crisis and that doubtful debts are a reality most taxpayers face (Brink, 2019). On 3 March 2020, the Department of Statistics South Africa (“Stats SA”) announced that the South African economy dived into its third recession since 1994 after the economy contracted with 1.4% in the fourth quarter of 2019 (Stats SA, 2020a). This is further supported by the report released by Stats SA (2020b) on 30 June 2020, which indicated that the South African economy plunged drastically as a result of the fact that the real Gross Domestic Product (“GDP”) growth rate declined with 2% in the first quarter. Additionally, on 24 June 2020, Stats SA released the Quarterly Labour Force Survey for the first quarter of 2020. It indicated in the report that the number of people employed in the South African economy declined (Stats SA, 2020c). South Africa was also downgraded to junk status on 27 March 2020 by rating agency Moody’s Investors Service as a result of a deceleration in economic growth and the heightened debt levels of the country (Wallace, 2020). On 26 March 2020, the South African Reserve Bank (“SARB”) emphasised the dire consequences of the Covid-19 pandemic. It stated that “the onset of Covid-19 and the devastating impact it has on financial markets and the global economy will invariably impact expected credit loss provisioning, both as a result of changes in credit quality and macroeconomic information taken into account in determining provision level” (SARB, 2020:1).

The effect on a taxpayer might be viewed as negligible when it is considered that the doubtful debt allowance claimed in one year of assessment will be added back in the following year of assessment. Having said that, for certain taxpayers (such as large retailers who have a significant number of debtors) the aggregate value of doubtful debts may be considerable. Presumably, this situation might have a profound effect on the taxpayer’s cash flow activities, as taxpayers will be required to settle the tax payable in year one. The funds that are no longer available to invest, along with future business prospects being foregone, embody the economic cost of the funds used to settle their tax debt (Hartley, 2018:2).

The purpose of the amendment in 2018 was to increase the level of certainty when calculating the amount allowed as a doubtful debt allowance (National Treasury, 2018a:25). The objective of the 2019 amendment, in turn, was made to exclusively align legislation with the policy intent (National Treasury, 2019:54). Despite National Treasury’s stated purpose, it is quite clear from the discussion in par. 1.1.2 that it could be concluded that the latest amendment is not in accordance with the fundamental principles of taxation. As a result, a critical evaluation of the amendment is considered to be relevant.

This study aims to critically evaluate the amendments to the doubtful debt allowance in the Taxation Laws Amendment Act 34 of 2019 by determining whether the amendments are in fact in compliance with the fundamental principles of taxation. Based on the brief comparison of the amendment to the fundamental principles of taxation in par. 1.1.2, the study will critically evaluate the compliance of section 11(j)

following the principles of neutrality, certainty and simplicity, effectiveness and fairness, and other related principles, since these principles appear to be more susceptible to non-conformity.

1.2 Problem statement and research question

SARS is faced with the possibility that it has not have managed to deal with the concerns that the 2018 amendment to section 11(j) sought to address. By the same token, the 2019 amendment has distinguished between taxpayers applying IFRS 9 and taxpayers not applying IFRS 9. Considering the fundamental principles of taxation, this distinction may have established further challenges associated with the income tax treatment of the doubtful debt allowance. By virtue of the problem statement, the research question is as follows:

Are the most recent amendments to the income tax treatment of doubtful debts in conformance with the fundamental principles of taxation?

1.3 Limitation of scope

This study will only focus on section 11(j) for doubtful debts. Consequently, no consideration will be made to section 11(i) applicable to bad debts or section 11(jA) applied to a holding company as defined in the Banks Act 94 of 1990. Furthermore, the study will not consider the tax treatment of doubtful debts in accordance with the Value-Added Tax Act 81 of 1991 or any other tax act other than the Act, nor will it consider the tax treatment of doubtful debts in foreign jurisdictions. While the study considers the current amendments of 2019, there is a possibility that SARS will introduce future amendments that could have a profound impact on this study.

1.4 Objectives

1.4.1 Primary research objective

The primary research objective is to critically evaluate whether the most recent amendment to the income tax treatment of doubtful debts in the Taxation Laws Amendment Act 34 of 2019 is in accordance with the fundamental principles of taxation.

1.4.2 Secondary research objectives

The primary research objective will be achieved through the following secondary research objectives:

- i. a historical overview will be carried out to determine how the fundamental principles of taxation have developed over time (addressed in Chapter 2.2: Historical overview of the fundamental principles of taxation);
- ii. a comprehensive review of current legislation concerning the section 11(j) doubtful debt allowance as incited by the Taxation Laws Amendment Act 34 of 2019 will be carried out. This review will include an in-depth examination of the calculation of the IFRS 9 loss allowance (addressed in Chapter 2.3: A comprehensive review of current legislation);
- iii. the amended doubtful debt allowance will be compared to the fundamental principles of taxation to determine whether the current legislation is in line with these principles (addressed in Chapter 2.4: A critical evaluation of current legislation in view of the fundamental principles of taxation); and
- iv. it will be concluded whether the most recent amendment to the income tax treatment of doubtful debts in the Taxation Laws Amendment Act 34 of 2019 is in accordance with the fundamental principles of taxation (addressed in Chapter 2.5: Conclusion and Chapter 3: Conclusion).

1.5 Research design and methodology

1.5.1 Literature review

A literature review aims to provide insight into available research and to enhance the knowledge of the researcher (Western Sydney University, 2017:1). This study will entail a detailed literature review of the current legislation, amendment bills published by the Government Gazette, views expressed by SARS in the explanatory memorandum and academic literature relating to this study. This study will also consist of a literature review of the IFRS 9 *Financial Instruments*, and will focus specifically on the accounting treatment of impairment losses and the *Basis for Conclusion* paragraphs accompanying IFRS 9.

1.5.2 Paradigmatic assumptions and perspectives

As stated by McKerchar (2008:5), taxation is not a discipline of its own accord – it is a societal phenomenon that can be interpreted using several disciplines, inter alia law, accounting, economics, political science, psychology and philosophy. McKerchar (2008:6) further maintains that taxation is an intricate field and

that it is vital for a researcher to fully grasp the philosophical research paradigms and strategies of inquiry, the theory and the fundamental principles of research to prevent unsound interpretations.

1.5.2.1 Ontological assumptions

The term ‘ontology’ can be described as the convictions about the nature of reality and humankind (Tuli, 2010:99). Ontology is construed as how the researcher perceives his or her surroundings. Two primary paradigms guide researchers, namely positivism and interpretivism (McKerchar, 2008:6). A positivist approach can be observed in the case where the researcher experiences the world independently from his or her understanding of it, and it is commonly founded on realism (McKerchar, 2008:7). The positivist research paradigm entails the testing of a hypothesis and implies that the researcher needs to be indifferent or removed (Tuli, 2010:102). Conversely, interpretivism is grounded on the assumption that the researcher and the research subject are coherent, and that the research is subject to the researcher’s interpretation thereof (McKerchar, 2008:7). The research is influenced by the researcher’s own experiences, observations and perceptions (Tuli, 2010:102).

The study will be based on a critical evaluation of the amendments to the income tax treatment of doubtful debts in light of the fundamental principles of taxation. The evaluation will be achieved through a comprehensive review of current legislation. The very fact that legislation can be amended is taken as evidence that legislation can be evaluated, influenced or changed. It is also apparent that the legislation will be interpreted in a variety of ways by different researchers. An interpretivist approach will be assumed since the conclusion reached will be from the researcher’s point of view.

1.5.2.2 Epistemological assumptions

The term ‘epistemology’ refers to how knowledge was established (McKerchar, 2008:6). It can also be rendered as the nature of this knowledge (Tuli, 2010:99).

The main objective of this study is to critically evaluate the amendment to the income tax treatment of doubtful debts pursuant to the fundamental principles of taxation. This objective will be realised by reviewing current legislation, amendment bills, explanatory memoranda, and other theoretical resources, which will be followed by a subjective interpretation of the knowledge gained. Inherently, this study will entail a comprehensive investigation on the accounting treatment of impairment losses recognised in accordance with IFRS 9. This aim will be accomplished by conducting a literature review of IFRS 9 *Financial Instruments* standard, along with the *Basis for Conclusion* paragraphs concerning IFRS 9. This

study will also consist of an extensive analysis of the fundamental principles of taxation that have been developed over the course of history.

1.5.2.3 Methodological assumptions

The term ‘methodology’ pertains to how knowledge will be obtained (Tuli, 2010:99). It can be perceived as how the research will be performed. The methodology is the strategy used to transform the ontological and epistemological principles into academic research (Tuli, 2010:105).

Quantitative methodology involves endeavours that measure social phenomena, that gathers numerical data and which identifies a relationship between the two. Conversely, qualitative methodology is more preoccupied with the connotation of the social phenomena and pays attention to several attributes (Tuli, 2010:106).

It appears that a positivist approach generally takes on a quantitative methodology and that quantitative research relies heavily upon logic. It should also be noted that quantitative research is inherently empirical. An interpretivist approach, on the other hand, is ordinarily accompanied by a qualitative methodology and is rather based on reasoning or the researcher’s convictions (McKerchar, 2008:7).

From this perspective, a qualitative research will be conducted as personal views will be expressed as to whether the most recent amendment is in accordance with the fundamental principles of taxation, rather than the research being independent from the knowledge thereof. It should be stressed that this study will not contain numerical data and, for this reason, a quantitative approach will not be followed. Given that a qualitative approach will be followed, empirical research will not be applicable to this study.

Grounded theory is one of the many theoretical frameworks used to conduct qualitative research (McKerchar, 2008:14). A grounded theory can be described as a researcher’s endeavour to distil a general, abstract theory of a process (McKerchar, 2008:15). This study will entail a grounded theory as it will include a historical overview on how the fundamental principles of taxation have been developed throughout history.

It should be noted that legal research depends to a large extent on technical processes and involves obtaining expertise, which consists of the identification of case law and statute law relevant to the research, instead of the methodology the researcher will use to meet the objectives. Furthermore, legal doctrinal research is commonly referred to as the ‘black letter law’ approach and is characterised by the manner in which statutes, judicial decisions and commentary is selected and how it is examined (McKerchar, 2008:18-19).

This study will set forth a comprehensive review of current legislation concerning section 11(j). It will be conducted in accordance with a legal doctrinal approach to determine the income tax treatment of the doubtful debt allowance after the most recent amendment in 2019. The study will be accompanied by an extensive review of the accounting treatment of impairment losses recognised in accordance with IFRS 9 *Financial Instruments* standard. This review will be accomplished as part of the legal doctrinal approach since section 11(j) specifically refers to IFRS 9. Owing to the technicality of an IFRS 9 impairment loss calculation, this study can be considered as descriptive research.

After gaining an understanding of the theoretical application of section 11(j), current legislation will be thoroughly compared to the fundamental principles of taxation in order to determine the compliance thereof. This process is referred to as comparative research and, proceeding from this, a conclusion will be reached.

1.6 Chapter overview

Chapter 1: Introduction

This chapter sets forth the relevance of doubtful debts when considering the current economic climate. It also includes an abstract review of the most recent amended section 11(j) doubtful debt allowance in accordance with the fundamental principles of taxation. On that premise, the problem statement, research question, research objectives and the limitation of scope was established. In the final instance, the research design and methodology were devised to outline the way in which the study will be conducted.

Chapter 2 (Research Article): A critical evaluation of the doubtful debt income tax treatment in South Africa

Chapter 2.1: Introduction

This part will introduce the background and motivation for the research article. Additionally, it will set out the problem statement, the research question, the objectives of the study, and the research design and methodology followed to conduct the study.

Chapter 2.2: Historical overview of the fundamental principles of taxation

This part will consist of an extensive analysis of the fundamental principles of taxation that have developed over time in order to address the secondary objective as identified in par. 1.4.2(i).

Chapter 2.3: A comprehensive review of current legislation

To achieve the secondary objective specified in par. 1.4.2(ii), this part sets forth a comprehensive review of current legislation concerning the section 11(j) doubtful debt allowance for taxpayers applying IFRS 9 and for taxpayers not applying IFRS 9.

Furthermore, this part will entail a comprehensive investigation of the accounting treatment of impairment losses recognised in accordance with IFRS 9. This will be accomplished by conducting a literature review of the IFRS 9 *Financial Instruments* standard, along with the *Basis for Conclusion* paragraphs concerning IFRS 9.

Chapter 2.4: A critical evaluation of current legislation in light of the fundamental principles of taxation

Ultimately, in response to the secondary objective stated in par. 1.4.2(iii), this part will compare the tax treatment of section 11(j) to the fundamental principles of taxation to determine which of these principles have not been adhered to.

Chapter 2.5: Conclusion

A conclusion will be arrived as to whether the most recent amendment to the income tax treatment of doubtful debts is in accordance with the fundamental principles of taxation in order to address the secondary objective indicated in par. 1.4.2(iv).

Chapter 3: Conclusion

This chapter will consist of an explanatory summary of the outcome arrived at in *Chapter 2*. Proceeding from this discussion, a conclusion will be reached as to whether SARS has reached its intention to increase certainty with the amendment. In addition to this, reference will be made to any new concerns raised by the study, considering the fundamental principles of taxation, as a result of the 2019 amendment to section 11(j).

**CHAPTER 2 RESEARCH ARTICLE: A CRITICAL EVALUATION OF
THE DOUBTFUL DEBT INCOME TAX TREATMENT IN SOUTH
AFRICA**

ABSTRACT

A certain degree of relief is provided to taxpayers who are burdened with doubt regarding their ability to recover their debts through the application of section 11(j) of the Income Tax Act 58 of 1962 (“the Act”). On 17 January 2019, the Government Gazette issued the Taxation Laws Amendment Act 23 of 2018, which consists of an amendment to section 11(j), in an effort to extend certainty towards taxpayers. This was followed by the Taxation Laws Amendment Act 34 of 2019, which incorporated yet another amendment to section 11(j); this time with the objective to bring the wording of section 11(j) in line with its intended purpose as viewed by the South African Revenue Service (“SARS”).

The key issue that arises is whether SARS’s intention of amending section 11(j) to afford certainty to taxpayers has indeed been attained. Another matter of concern brought to light by the amendment is the possibility that the income tax treatment is not in accordance with the fundamental principles of taxation. The distinction made between taxpayers applying IFRS 9 and taxpayers not applying IFRS 9 could be the contributing factor.

In response to this, the study seeks to establish whether the current income tax treatment of the doubtful debt allowance is in conformance with the fundamental principles of taxation by performing a critical evaluation of section 11(j). The evaluation demonstrates that several principles are potentially in contravention, namely, the principles of neutrality, certainty and simplicity, and effectiveness and fairness. This contravention may be due to the inconsistencies identified in the application of section 11(j), which distinguishes between the different types of taxpayers recognised by SARS. Finally, the outcome of the study indicates the possibility that section 11(j) is in breach of these three fundamental principles of taxation.

KEYWORDS

- Doubtful debt allowance
- IFRS
- IFRS 9 Financial Instruments
- Loss allowance
- Expected credit losses
- Fundamental principles of taxation

LIST OF ABBREVIATIONS

Abbreviation	Description
AICPA	American Institute of Certified Public Accountants
Carter Report	Report of the Royal Commission on Taxation
CIPFA	Chartered Institute of Public Finance and Accounting
Covid-19	Coronavirus
Henry Review	The report to the Commonwealth Treasurer on Australia's Future Tax System
IAS 39	IAS 39 <i>Financial Instruments: Recognition and Measurement</i>
IASB	International Accounting Standards Board
ICAEW	Institute of Chartered Accountants in England and Wales
IFRS	International Financial Reporting Standards
IFRS 9	International Financial Reporting Standard 9 <i>Financial Instruments</i>
IFRS for SMEs	IFRS for Small and Medium-sized Entities
IFRS 15	IFRS 15 <i>Revenue from Contracts with Customers</i>
IFS	Institute of Fiscal Studies
Mirrlees Review	Tax by Design: The Mirrlees Review
OECD	Organisation for Economic Co-operation and Development
PD	Probability of default
SAIT	South African Institute of Tax Professionals
SARS	South African Revenue Service
Section 11(j)	Section 11(j) of the Income Tax Act 58 of 1962
The Act	Income Tax Act 58 of 1962

The Committee

Davis Tax Committee

2.1 Introduction

2.1.1 Background and motivation

The coronavirus (“Covid-19”) pandemic and the efforts taken to curb the spread of the coronavirus (for example, limiting the movement of people, suspending travel and temporarily closing business institutions) may result in a global economic slowdown (EY, 2020:7). The novel coronavirus has affected the supply of goods and services, and certain industries, such as the transport, retail and tourism industry (EY, 2020:7). Likewise, the Covid-19 outbreak may cause cashflow constraints that could have adverse consequences, including a decrease in debtors’ ability to settle their payments in accordance with their contractual arrangements and a subsequent increase in the risk of default of the debtor (EY, 2020:7).

The Income Tax Act 58 of 1962 (“the Act”) grants taxpayers a measure of relief against doubtful debts. This is achieved through the utilisation of the allowance awarded under section 11(j) of the Income Tax Act 58 of 1962 (“section 11(j)”). The Taxation Laws Amendment Act 23 of 2018 was published in the Government Gazette on 17 January 2019. It contained an amendment to the tax treatment of the section 11(j) doubtful debt allowance with the intention to advance certainty (National Treasury, 2018a:25). This was followed by another amendment to section 11(j) included in the Taxation Laws Amendment Act 34 of 2019, which was published in the Government Gazette on 15 January 2020, in an effort to bring the wording of section 11(j) in line with intention of the South African Revenue Service (“SARS”) (National Treasury, 2019:54).

It is worth noting that the most recent amendment concerning doubtful debt allowance distinguishes between taxpayers applying IFRS 9 and taxpayers not applying IFRS 9. It sets forth different approaches to compute the doubtful debt allowance for the different types of taxpayers. Section 11(j) has established requirements in pursuance of calculating the doubtful debt allowance for taxpayers applying International Financial Reporting Standard 9 *Financial Instruments* (“IFRS 9”) and refers to the accounting treatment of doubtful debts in terms of International Financial Reporting Standards (“IFRS”) (Brink, 2019). Similarly, section 11(j) lays down certain criteria for taxpayers not applying IFRS 9 (for example, the number of days that the debt is past due) in the interest of determining the doubtful debt allowance (Brink, 2019).

As a result of this distinction, the possibility exists that the latest amendment is not in line with the fundamental principles of taxation. This study intends to critically evaluate whether the most recent amendment to the income tax treatment of the doubtful debt allowance conforms to the fundamental principles of taxation.

2.1.2 Problem statement and research question

The concerns arising from the most recent amendment to section 11(j) is that SARS has not achieved its intention of providing certainty. Furthermore, the distinction between taxpayers applying IFRS 9 and taxpayers not applying IFRS 9 may have placed the fundamental principles of taxation under contention. Proceeding from these considerations, the research question concerns whether the most recent amendment to the income tax treatment of doubtful debts is in agreement with the fundamental principles of taxation.

2.1.3 Objectives

2.1.3.1 Primary research objective

The main objective of the study is to critically evaluate the income tax treatment of the most recent amended doubtful debt allowance, as is introduced by the Taxation Laws Amendment Act 34 of 2019, against the fundamental principles of taxation.

2.1.3.2 Secondary research objectives

The following secondary research objectives stem from the primary research objective:

- i. a review of how the fundamental principles of taxation came into existence (addressed in Part 2.2: Historical overview of the fundamental principles of taxation);
- ii. an extensive analysis of the income tax treatment of section 11(j) as put forward by the Taxation Laws Amendment Act 34 of 2019, along with a detailed consideration of how the IFRS 9 loss allowance is determined (addressed in Part 2.3: A comprehensive review of current legislation);
- iii. an evaluation of the amended doubtful debt allowance against the fundamental principles of taxation to identify whether the amended section 11(j) complies with the identified principles (addressed in Part 2.4: A critical evaluation of current legislation in view of the fundamental principles of taxation); and
- iv. a conclusion as to whether the income tax treatment of doubtful debt allowance, as set forth by the Taxation Laws Amendment Act 34 of 2019, is aligned with the fundamental principles of taxation (addressed in Part 2.5: Conclusion).

2.1.4 Research design and methodology

In order to achieve the specified objectives, the study necessitates a literature review of current legislation as amended by the Taxation Laws Amendment Act 34 of 2019, as well as a literature review of IFRS 9 *Financial Instruments*. Emphasis will be placed on the accounting treatment of impairment losses and the *Basis for Conclusion* paragraphs accompanying IFRS 9 will be consulted. A legal doctrinal approach will be adopted to review section 11(j) and IFRS 9.

This study will entail an interpretivist approach, considering that the legislation being examined has been amended. This is further supported by the fact that the conclusion arrived at will depend on the researcher's comprehension and experience (Tuli, 2010:102). In response to this, qualitative research will be set forth since the outcome of the study is based on the researcher's personal convictions (McKerchar, 2008:7).

Additionally, this study will make use of grounded theory since a detailed analysis will be conducted regarding the development of the fundamental principles of taxation over time. Following this step, comparative research will be performed to establish whether the most recent amendment to section 11(j) is in accordance with the fundamental principles of taxation.

2.2 Historical overview of the fundamental principles of taxation

This part of the study will consist of a historical overview of the fundamental principles of taxation that have evolved over time to regulate taxation.

2.2.1 The history of the principles of taxation

Alley and Bentley (2005:582) state that "[t]he interpretation and content of the principles underlying the system are embedded within the perceived purpose of taxation". Following Du Preez and Stiglingh (2018:140), the concept of the 'fundamental principle' in the context of taxation can be defined as "a general truth – constructed through a chain of reasoning – that forms the most important part of the foundation of a unique field of study, from which theories and applied practices can be derived and verified in accordance with the current knowledge available to humanity".

As claimed by Du Preez (2016:73), several individuals and groups have endeavoured to construct the guiding principles of taxation over the course of history, which has yielded numerous viewpoints and inclinations as to the context of the principles. The development of these guiding principles by multiple

stakeholders throughout history is outlined below. Having said that, it should be noted that even though this list is extensive, it is not all-encompassing.

In 1776, Adam Smith elucidated the foundation of a good tax structure by establishing the four maxims, which were founded on his personal experience (Du Preez, 2016:76). These are equity, certainty, the convenience of payment and economy in collection (Du Preez, 2016:76). Smith (1776, 2009 printing) argued that the subjects of every state ought to contribute toward the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue that they respectively enjoy under the protection of the state. The equity principle ascertained by Smith was that members of the public should furnish the government with support in relation to their individual ability to make such a contribution from the revenue earned by the respective individual (Smith, 1776, 2009 printing). Smith (1776, 2009 printing) pointed out that the tax liable for payment by every individual, particularly concerning the time and manner of payment, along with the quantity to be paid, should be certain and not arbitrary. Smith (1776, 2009 printing) further expressed that the time and manner in which tax is levied should be convenient for the individual responsible for payment. Lastly, he suggested that individuals should be taxed as little as possible, giving rise to the principle of economy (Smith, 1776, 2009 printing).

Stamp (1921:13) highlighted that Adam Smith's four maxims had to be reconsidered, even though modern teaching was essentially grounded on these maxims, as "it can hardly be affirmed that we can find enshrined in those four sentences the whole duty of man and the State amid our modern perplexities". Considering the many citations of Adam Smith's four maxims, it is evident that these maxims still play a significant role in the current tax environment (Alley & Bentley, 2005:586). Alley and Bentley (2005:586) state that in order for tax legislation to adhere to the established purpose of the tax system, the development of tax policy should be mindful of the principles ascertained by Adam Smith.

In 1966, Canada released the Report of the Royal Commission on Taxation, which is widely known as the "Carter Report". The report created further principles (namely equity, neutrality, transparency and accountability, certainty, simplicity and flexibility) to achieve economic and social objectives (Alley & Bentley, 2005:586). The Asprey Review, released by the Taxation Review Committee in 1975 in Australia, adopted the principles of fairness, simplicity, efficiency, flexibility and stability (Asprey & Parsons, 1975:11-17). It was recommended in the Asprey Review that different methods should be investigated to evaluate income from a tax perspective (cited by Du Preez, 2016:77). It was furthermore proposed that economic well-being should be measured on consumption, instead of income (cited by Du Preez, 2016:77).

Towards the end of the 1970s, the Meade Committee in the United Kingdom published a report on the structure and reform of direct taxation, which is known as the "Meade Report". In an attempt to make the tax structure simpler, more effective and fairer, the most suitable characteristics of a good tax structure were considered (Meade, 1978:7). As stated by Du Preez (2016:77), Adam Smith's four maxims were

revised in the Meade Report to create an expansive list. It was noted in particular that “[t]ax should be just, efficient, effective, redistributing wealth, equitable, coherent, simple and easy, straightforward, flexible, stable and compatible with the country’s international position” (Du Preez, 2016:77).

The Green Paper report published by Her Majesty’s Stationery Office in the United Kingdom in 1981 set out the principles of practicality, fairness, accountability, cost of administration, fiscal dimensions and financial control (Alley & Bentley, 2005:587).

Reports that were grounded on principles established in the past included the O’Brien Report released in 1982 in Ireland, the Institute of Fiscal Studies (“IFS”) Report issued by Ridge and Smith in 1991, as well as the 1994 Chartered Institute of Public Finance and Accounting (“CIPFA”) Report published by Jackson (cited by Du Preez, 2016:78). Following this, James and Nobes reconvened the principle of equity and efficiency in 1997 (cited by Du Preez, 2016:78).

In pursuit of re-evaluating tax principles, the Organisation for Economic Co-operation and Development (“OECD”) published the OECD Report in 1998 and it adopted the principles of neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility (OECD, 1998:4). Alley and Bentley (2005:579) advocated the adoption of the neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility as principles to govern tax design on account of recent commercial practices.

According to Du Preez (2016:78), the Institute of Chartered Accountants in England and Wales (“ICAEW”) assisted in the creation of a “better tax system” by advancing ideas to increase the focus on tax revenue, as well as the notion of continuous consultation. This objective could be achieved by revising tax legislation periodically and by considering the legislation’s competitive capability.

In 2001, the American Institute of Certified Public Accountants (“AICPA”) published the *Guiding principles of good tax policy: A framework for evaluating tax proposals*. This framework concentrated on “economic growth, minimizing the gap and collecting appropriate government revenues” (Du Preez, 2016:78). Subsequently, the president of the United States’ Advisory Panel, together with the President’s Economic Recovery Advisory Board reaffirmed the principle of simplicity in 2005 and 2010 respectively (Du Preez, 2016:78).

The report to the Commonwealth Treasurer on Australia’s Future Tax System (“Henry Review”) was delivered in December 2009. The Henry Review, being the successor of the Asprey Review, revised the tax system by leveraging the enhanced comprehension of an individual’s behaviour in response to tax, as well as the economy (Henry *et al.*, 2009:16). The principles adopted in this report included fairness, efficiency, simplicity, sustainability and policy consistency (Henry *et al.*, 2009:15-16), of which the latter two were inaugurated by this report. The sustainability principle indicates that the government should be

able to raise revenue to support government needs while policy consistency implies that tax policy should not consist of contradictory rules (Henry *et al.*, 2009:17).

The *Tax by Design: The Mirrlees Review* (“Mirrlees Review”), delivered in 2011 in the United Kingdom, set forth the principles that ought to form the cornerstone of a 21st-century tax system by following the example that was laid out in the Meade Report (Mirrlees, 2011:1). The Mirrlees Review used Adam Smith’s four canons as a point of departure to evaluate a good tax system; however, it noted that the guidance provided was not extensive enough to resolve complex matters (Mirrlees, 2011:22). The Mirrlees Review underlined several vital factors to take into account. It noted that a tax system should reduce adverse consequences on welfare and economic efficiency, reduce administration and compliance costs, advocate fairness with regards to procedures and expectations, and promote transparency (Mirrlees, 2011:22). According to Mirrlees *et al.* (2012:1), the Mirrlees Review “proposes a move to a more neutral tax system”.

The most recent local development took place in 2016. The Davis Tax Committee (2016:13) highlighted several vital principles to assess the performance of a tax system and to guide the revision of the tax system because of the constitutional, socio-economic, political and policy context that South Africa faces. In the course of developing a tax policy to meet the general objectives of a tax system, the Davis Tax Committee (2016:13-14) outlined the principles of efficiency, equity, simplicity, transparency and certainty, and tax buoyancy.

As is evidenced by the historical review above, numerous viewpoints exist on the fundamental principles of taxation. This study will next investigate the most essential principles of taxation, which will form the basis against which the most recent amendment to section 11(j) will be evaluated.

2.2.2 Essential principles

The fundamental principles of taxation established over the years have been identified by examining the history of its development above. Based on this overview, there are universally recognised principles that can be used in the development of a tax system (Alley & Bentley, 2005:582). Nevertheless, it is crucial to recognise that these universal principles may not necessarily be coherent and that they can be contradictory at times (Alley & Bentley, 2005:582). The interpretation of the principle that will have a greater influence is dependent on the judgement of the person who implements that principle (Alley & Bentley, 2005:582).

In relation to the OECD principles, Alley and Bentley (2005:582) stated that these principles “are particularly important given that they represent the agreed position of the most powerful economies of the developed countries in the world”. For this reason, the principles established by the OECD in 1998 will be

relied on to perform the critical evaluation of section 11(j), which includes the principles of neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility (OECD, 1998:4).

Conversely, as stated by Smulders (2014:14) the Davis Tax Committee's ("the Committee") objective is to "assess South Africa's tax policy framework and its role in supporting the objectives of inclusive growth, employment, development and fiscal sustainability". Considering the prominent role of the Committee in South Africa, as well as the fact that the Committee is supported by representatives of National Treasury and SARS, the principles adopted by the Davis Tax Committee in the *Final Report on Macro Analysis of the Tax System and Inclusive Growth in South Africa* issued during April 2016 is of considerable significance to evaluate section 11(j).

On this account, the fundamental principles of taxation established by the OECD during 1998 and the Committee during 2016 will constitute the foundation on which the evaluation of the section 11(j) amendment will be conducted. A more comprehensive analysis of these principles is presented below.

2.2.2.1 Neutrality

Haig *et al.* (1921:7) define 'income' as the money-value of the net increment to a person's economic position over a period of time. From a common law point of view, the Haig-Simons theory proposes that income should be subject to tax (cited by Alley & Bentley, 2005:592). According to Alley and Bentley (2005:592), the Haig-Simons theory is founded on the principle of neutrality and implies that the tax base should be applied consistently and in a holistic manner.

According to the OECD (1998:4), the concept of 'neutrality' indicates that: "Taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation."

In response to this definition, neutrality refers to a tax system that is impartial, fair and just towards all taxpayers in order to promote sound economic decision-making, and which is considered independently from the potential tax consequences.

2.2.2.2 Efficiency and tax buoyancy

Revenue collection, which is the primary purpose of tax authorities, is enhanced by reducing the compliance costs for taxpayers and simplifying the compliance process (Alley & Bentley, 2005:596). As claimed by the OECD (1998:4), the concept of ‘efficiency’ suggests that “[c]ompliance costs for taxpayers and administrative costs for the tax authorities should be minimised as far as possible”. Similarly, the concept of ‘efficiency’ adopted by the Davis Tax Committee (2016:14) means that “[t]he tax system must produce sufficient income for the state, with minimum distortions to the economy (i.e. it must be neutral)”. The efficiency principle is enhanced by the principle of tax buoyancy as established by the Davis Tax Committee (2016:14), which indicates that “[t]he tax system should raise sufficient revenue during all phases of the business cycle, while simultaneously embodying scope for a counter-cyclical fiscal framework”.

On this account, the efficiency principle can be construed as a tax system that facilitates revenue collection by the tax authorities through reduced compliance costs. As such, it acts as an incentive for taxpayers to pay their taxes. It also decreases tax administrative costs that have a counteractive outcome on revenue collection and places strain on the economy. Tax buoyancy can be interpreted as a tax system that seizes revenue collection opportunities during the various stages of the trading cycle.

2.2.2.3 Certainty and simplicity

The certainty principle set forth by Smith (1776, 2009 printing) was adopted in the Asprey Review (1975), the Meade Report (1978), the Henry Review (2010) and the Mirrlees Review (2011) – all of which highlight its significance (Du Preez, 2016:95). According to Alley and Bentley (2005:597), the principle of certainty and simplicity is the most supported principle of taxation, even though it is the most unattainable attribute of a tax system. As maintained by the OECD (1998:4), the concept of ‘certainty and simplicity’ can be interpreted to mean that “tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted”.

The simplicity principle set forth by the Davis Tax Committee (2016:13-14) suggests that: “As far as possible, taxes should be simple to understand and should be collected in a timely and convenient manner. Compliance costs are thereby minimised.” On the other hand, the principle of transparency and certainty reinforced by the Davis Tax Committee (2016:14) assumes that: “The manner in which taxes are collected and the calculation of tax liabilities should be certain. Moreover Tax rules and procedures should be transparent and applied consistently.”

Considering the points discussed, the concept of ‘certainty and simplicity’ pertains to a tax system that is characterised by certitude, transparency and straightforwardness. In addition, it aims to uphold a tax system that is applied coherently and allows taxpayers to predict the potential tax consequences of a transaction in advance.

2.2.2.4 Effectiveness and fairness

In line with the OECD (1998:4), the concept of ‘effectiveness and fairness’ indicates that: “Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimised while keeping counter-acting measures proportionate to the risks involved.” This definition is from the viewpoint of the tax authorities; however, the reference to the “right amount of tax at the right time” implies fairness from the taxpayer’s standpoint (Alley & Bentley, 2005:600). The final section of the definition states that counter-acting measures should be proportionate to the risks involved. According to Alley and Bentley (2005:600), this indicates that resources should be effectively distributed in relation to the level of taxation or avoidance involved, rather than referring to the measures employed against a taxpayer engaged in tax evasion or avoidance.

The principle of equity accepted by the Davis Tax Committee (2016:14) implies that: “All residents must contribute to the fiscus in proportion to their ability to do so. Both horizontal and vertical equity are important. Where appropriate, tax equity should also consider the benefits of the public good received in relation to the tax burden imposed.”

Against this background, effectiveness and fairness can be outlined as a tax regime that advocates integrity and appropriateness, while taking taxpayers’ ability to contribute towards the fiscus into consideration when formulating legislation.

2.2.2.5 Flexibility

It is essential for a tax system to maintain its stability, while remaining flexible to change, considering that the economic and political setting is ever-evolving (Du Preez, 2016:96). This idea is addressed by the concept of ‘flexibility’, which proposes that “[t]he systems for the taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments” (OECD, 1998:4). Hence, in order to be flexible, a tax system must remain receptive to changes in the economic environment and it should continue to adapt in response to those changes.

2.2.3 Concluding remarks

For this study, the interpretation of the most significant principles presented above will be contingent on the definitions provided by the OECD and the Committee, respectively. Following this consideration, section 11(j) will be critically evaluated in accordance with the aforementioned interpretations.

2.3 A comprehensive review of current legislation

This section provides a comprehensive review of current legislation concerning the section 11(j) doubtful debt allowance for taxpayers applying IFRS 9 and for taxpayers not applying IFRS 9. Additionally, this chapter sets out a comprehensive investigation on the accounting treatment of impairment losses recognised in accordance with IFRS 9 *Financial Instruments*, as well as the *Basis for Conclusion* paragraphs accompanying IFRS 9.

In order to critically evaluate the amended section 11(j) against the fundamental principles of taxation, a comprehensive understanding of both current legislation and the accounting treatment of impairment losses must be established prior to the evaluation. This understanding will ensure that a coherent conclusion is reached on completion of the study.

2.3.1 A comprehensive review of section 11(j)

Current legislation regarding section 11(j) will be reviewed comprehensively by observing the language, context, purpose and background of the provision to determine the income tax treatment of the doubtful debt allowance after the most recent amendment in 2019. It is important to note that the term ‘doubtful debt allowance’ refers to the allowance calculated under section 11(j) of the Act (SARS, 2020:2). Moreover, in the interest of performing a comprehensive review of current legislation, it is imperative to investigate the principles of interpretation set out in par. 2.3.1.1.

2.3.1.1 The principles of interpretation

It is essential to consider the judgement laid out in *Natal Joint Municipal Pension Fund v Endumeni Municipality* (2012) when interpreting a statutory provision, for instance section 11(j). In this ruling, Wallis JA submitted that there have been significant developments in the law that relate to the interpretation of documents, both in this country and in others that follow similar rules to our own, over the last century.

Wallis JA held that the present state of the law can be expressed as follows:

[18] ... **Interpretation is the process of attributing meaning to the words** used in a document, be it legislation, some other statutory instrument, or contract, having regard to the context provided by reading the particular provision or provisions in the light of the document as a whole and the circumstances attendant upon its coming into existence.
...

The ‘inevitable point of departure is the language of the provision itself’, read in context and having regard to the purpose of the provision and the background to the preparation and production of the document.

[19] ...It clearly adopts as the proper approach to the interpretation of documents the second of the two possible approaches mentioned by Schreiner JA in *Jaga v Dönges NO and another*, namely that **from the outset one considers the context and the language together, with neither predominating over the other**. (Emphasis added.)

As a result, the language, context, purpose and background of section 11(j) will be interpreted objectively by considering the context and the language together, with neither predominating. This view is further supported by the principle laid down in *Bato Star Fishing (Pty) Ltd v Minister of Environmental Affairs and Tourism and Others* (2004) where it was held that: “[90] The emerging trend in statutory construction is **to have regard to the context in which the words occur, even where the words to be construed are clear and unambiguous**.” (Emphasis added.)

Consequently, in order to perform a comprehensive review of section 11(j), the context in which the words occur will be taken into consideration.

2.3.1.2 The language of section 11(j)

Since the “inevitable point of departure is the language of the provision itself”, as Wallis JA highlights in *Natal Joint Municipal Pension Fund v Endumeni Municipality* (2012), the language of section 11(j) will be examined from the outset.

The current legislation of section 11(j) to the Act states the following:

11. General deductions allowed in determination of taxable income.—For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived—

(j) an allowance in respect of any debt due to the taxpayer, if that debt would have been allowed as a deduction under any other provision of this Part had that debt become bad, of an amount equal to—

(i) if **IFRS 9 is applied** to that debt by that person for financial reporting purposes, the sum of—

(aa) **40 per cent** of the aggregate of—

(A) the **loss allowance** relating to impairment that is measured at an amount equal to **the lifetime expected credit loss**, as contemplated in IFRS 9, in respect of debt other than in respect of lease receivables as defined in IFRS 9; **and**

(B) the amounts of **debts included in the income** of the taxpayer in the **current or any previous year** of assessment that are **disclosed as bad debt written** off for financial reporting purposes and that have not been allowed as a deduction under section 11 (a) or (i) for the current or any previous year of assessment; **and**

(bb) **25 per cent** of the **loss allowance** relating to impairment, as contemplated in IFRS 9, in respect of debt other than in respect of lease receivables as defined in IFRS 9 or debt taken into account under item (aa); or

(ii) if **IFRS 9 is not applied** to that debt by that person for financial reporting purposes, the sum of—

(aa) **40 per cent** of so much of any debt, other than a debt contemplated in subparagraph (i), due to the taxpayer, if that debt is **120 days or more in arrears**; and

(bb) **25 per cent** of so much of any debt, other than a debt contemplated in subparagraph (i) or item (aa), due to the taxpayer, if that debt is **60 days or more in arrears**;

Provided that an allowance under this paragraph must be **included in the income of the taxpayer in the following year of assessment**: **Provided further that** the Commissioner may, on application by a taxpayer, **issue a directive** that the **percentage** contemplated in subparagraph (i) (aa) or (ii) (aa) **may be increased**, to a percentage **not exceeding 85 per cent** after taking into account—

(a) the **history** of a debt owed to that taxpayer, including the number of repayments not met, and the duration of the debt;

- (b) steps taken to **enforce repayment** of the debt;
 - (c) the **likelihood** of the debt being **recovered**;
 - (d) any **security** available in respect of that debt;
 - (e) the **criteria** applied by the taxpayer in **classifying debt as bad**; and
 - (f) such **other considerations** as the Commissioner may deem relevant;
- (Emphasis added.)

In the case of *Ex Parte the Minister of Justice In Re Rex v Jacobson & Levy* (1931), it was held that:

Whether a statute deals with civil matters only or with criminal matters, the same rule applies that **if the language of the statute is not clear and would be nugatory if taken literally, but the object and the intention are clear**, then the statute must not be reduced to a nullity merely because the language used is somewhat obscure. (Emphasis added.)

To interpret section 11(j), the purposive approach will be adopted. Consideration will be given to the intention of the legislature by referring to the Draft Interpretation Note on Doubtful Debts issued by SARS on 18 February 2020 to serve as a guideline to calculate the section 11(j) doubtful debt allowance (SARS, 2020:2). Moreover, SARS issued accompanying documents, which provide guidance on the application process for a directive, requests for information and excel-based Loss Allowance Models.

Coinciding with the Draft Interpretation Note on Doubtful Debts, the provision of the doubtful debt allowance under section 11(j) applies to taxpayers other than taxpayers who qualify for the section 11(jA) allowance (SARS, 2020:7). This is based on the fact that section 11(jA) applies to certain taxpayers included in the definition of ‘covered persons’ as noted in section 24JB(1) to the Act. To claim a deduction under section 11(j), the taxpayer should have been able to qualify for a deduction under another section of the Act in the case where the debt has become bad. Section 11(i), in this regard, allows a deduction of the amount of any debt due to the taxpayer that has become bad during the year of assessment.

According to the first proviso to section 11(j), the doubtful debt allowance granted under this section in the current year of assessment should be included in the income of the taxpayer in the following year of assessment. The wording of the current legislation regarding doubtful debt allowances differentiates between persons applying IFRS 9 to the debt due to the taxpayer for financial reporting purposes under subparagraph (i) and persons not applying IFRS 9 to the debt due to the taxpayer for financial reporting purposes under subparagraph (ii).

2.3.1.2.1 The term ‘debt due’

The term ‘debt due’ is not defined in the Act. Consequently, the principles of case law require consideration.

In the *Commissioner for Inland Revenue v People’s Stores* (1990) case Judge Heffer JA stated that:

Counsel for the taxpayer, albeit in a different manner, also relied on the provisions of the Act relating to bad or doubtful debts. Section 11(i) and (j) respectively provided for a deduction in respect of bad and doubtful 'debts due to the taxpayer'. If the *Lategan* principle were to be applied, so the argument went, the anomalous result would be that debts due to the taxpayer would be subject to the deduction for bad or doubtful debts, whereas debts owing to him but not due would have to be included in his 'gross income' without the benefit of such a deduction. The problem that I have with this submission is that it presupposes that the word 'due' in s 11(i) and (j) means 'due and payable', which is by no means clear. **Admittedly, 'due' often means 'due and payable'** when it is said e g that a debt is due or when one speaks of the due date of a debt. But I am not convinced that the word was used in that sense here. 'Due and payable' is actually used at least twice in the Act (in ss 7(1) and 91(3)) and in s 7A(2) mention is even made of a salary or pension which 'has become payable'. Taking account also of the Afrikaans version of s 11(i) and (j) ('skulde aan die belastingpligtige verskuldig') **it appears to me rather that 'due' was intended to mean 'owing' and no more.** (Emphasis added.)

Based on the above, Judge Heffer JA stressed that even though the term ‘due’ often means “due and payable”, in the context of section 11(j) it only refers to “owing”. As a result, bearing the context and language of legislation in mind as determined in *Natal Joint Municipal Pension Fund v Endumeni Municipality* (2012), the debt must be owed to the taxpayer to qualify for a section 11(j) allowance.

2.3.1.2.2 Taxpayers applying IFRS 9

The current wording of section 11(j)(i)(aa) of the Act permits an allowance of 40% of the sum total of the loss allowance relating to impairment. This is measured at an amount equal to the lifetime expected credit loss, as contemplated in IFRS 9, in respect of debt as defined in IFRS 9. It occurs along with debts that are disclosed as a bad debt written off for financial reporting purposes and which have not been allowed as a deduction under section 11(a) or (i) for the current or any previous year of assessment. In this case, the amounts of debts must have been included in the income of the taxpayer in the current or any previous year of assessment.

Since section 11(j)(i)(aa)(A) specifically refers to “the lifetime expected credit loss, as contemplated in IFRS 9”, only debts generally referred to as stage 2 and stage 3 debts in terms of IFRS 9 will fall within the ambit of section 11(j)(i)(aa)(A) (KPMG, 2018:2). It should be noted that section 11(j)(i)(aa)(A) does not

apply to the loss allowance relating to the impairment recognised in respect of lease receivables that fall within the scope of IFRS 9 (KPMG, 2018:1).

In addition, section 11(j)(i)(bb) of the Act permits an allowance of 25% of the loss allowance relating to impairment, as contemplated in IFRS 9, in respect of debt other than a debt taken into account under section 11(j)(i)(aa). As a result of the wording of section 11(j)(i)(bb), debts generally referred to as stage 1 debts in terms of IFRS 9 will fall within the ambit of section 11(j) (BDO, 2017). Similar to section 11(j)(i)(aa)(A), section 11(j)(i)(bb) does not apply to the loss allowance relating to the impairment recognised in respect of lease receivables that fall within the scope of IFRS 9 (KPMG, 2018:2).

2.3.1.2.3 Taxpayers not applying IFRS 9

The current wording of section 11(j)(ii) of the Act provides an allowance of the sum total of 40% of so much of any debt due to the taxpayer, if that debt is 120 days or more in arrears, as permitted by section 11(j)(ii)(aa). It also provides 25% of so much of any debt, other than a debt contemplated in subparagraph (i) or item (aa), due to the taxpayer, if that debt is 60 days or more in arrears, as permitted by section 11(j)(ii)(bb).

It should be noted that according to the language of section 11(j), neither section 11(j)(ii)(aa) nor (bb) applies to a debt contemplated in subparagraph (i) of section 11(j). In addition, 11(j)(ii)(bb) does not apply to a debt taken into account under section 11(j)(ii)(aa).

According to the comments made by the South African Institute of Tax Professionals (“SAIT”) on the Draft Interpretation Note concerning Doubtful Debts, the revised legislation, which refers to “if IFRS 9 is not applied to that debt”, clearly indicates that section 11(j)(ii) will apply to taxpayers who apply IFRS for Small and Medium-sized Entities (“IFRS for SMEs”) for financial reporting purposes (SAIT, 2020:1).

2.3.1.2.4 Increased allowance rate

The second proviso to section 11(j) permits taxpayers to obtain a directive from SARS to allow an increased percentage not exceeding 85% for the deduction of such debt. The Request for Information documents and the excel-based templates accompanying the Draft Interpretation Note specify the format in which the information needs to be submitted to SARS to apply for an increased allowance (SARS, 2020:9). Based on the limitations of this proviso, only debts due that qualify for the allowance equal to 40% of the loss allowance measured in accordance with IFRS 9 or 40% of the debt due will be allowed to apply for such a directive.

SARS will consider the following criteria to determine whether a directive should be issued to enable the taxpayer to claim a doubtful debt allowance of up to 85% of the debt due:

- the history of the debt owed to that taxpayer, including the number of repayments not met, and the duration of the debt;
- the steps taken to enforce repayment of the debt;
- the likelihood of the debt being recovered;
- any security available in respect of that debt;
- the criteria applied by the taxpayer in classifying the debt as bad; and
- such other considerations as the Commissioner may deem relevant.

It should be noted that paragraph 5.6 of the Draft Interpretation Note on Doubtful Debts provides guidance on the factors that SARS (2020:15-17) takes into account in issuing a directive for an increased allowance under section 11(j)(i) and (ii). For the purposes of this study, these factors will not be examined in detail.

It should be emphasised that the calculation of the doubtful debt allowance under section 11(j) is an annual event and, for this reason, the taxpayer must apply annually for a directive from SARS for an increased percentage to be used in the calculation of the doubtful debt allowance (SARS, 2020:17).

2.3.1.3 The purpose and background of section 11(j)

The purpose of section 11(j) is to provide relief to taxpayers by granting an allowance in respect of doubtful debts (PricewaterhouseCoopers, 2018:1). Previously, the section 11(j) allowance was reliant on SARS's discretion as to whether a debt was regarded as doubtful. Nevertheless, it was SARS's practice to provide an allowance at 25% of the face value of the debt viewed to be doubtful.

The section 11(j) amendment inaugurated in 2018 was attributable to the uncertainty that arose as a result of SARS's broad discretionary power (Brink, 2019). Additionally, as claimed by SARS (2020:2) in the Draft Interpretation Note on Doubtful Debts, section 11(j) was amended during 2018 in connection with the fact that the final version of IFRS 9 *Financial Instruments* was published by the International Accounting Standards Board ("IASB") in July 2014 to replace IAS 39 *Financial Instruments: Recognition and Measurement* ("IAS 39"). The amendment introduced in 2019 aimed to align the language of section 11(j) with SARS's objective of the allowance (National Treasury, 2019:54). In addition, the Draft Interpretation Note, issued on 18 February 2020, was released at the most opportune time, considering the financial distress that businesses face and the uncertainty of whether debtors will be able to settle their debt (SAIT, 2020:1).

2.3.2 A comprehensive review of IFRS 9

Considering that section 11(j)(i) refers to taxpayers who apply IFRS 9 to the debt due to that person for financial reporting purposes to determine the doubtful debt allowance, it is essential to consider the accounting treatment of the doubtful debt allowance in accordance with IFRS 9.

The comprehensive review of IFRS 9 is developed further in the Draft Interpretation Note on Doubtful Debts. SARS (2020:3) states that since the language of section 11(j)(i) consists of nomenclature derived directly from IFRS, the legislation cannot be interpreted independently from IFRS.

2.3.2.1 An introduction to IFRS 9

The final IFRS 9 standard was issued in July 2014 and it does not apply to a specific industry. Furthermore, the standard is effective for annual periods beginning on or after 1 January 2018, with earlier adoption permitted (IASB, 2014b:46). Before IFRS 9, the provision of the doubtful debt allowance for financial reporting purposes was based on IAS 39. The impairment models included in IAS 39 made use of past observations and were conditional on the estimation of future recoveries (SARS, 2020:3). In order to address the problems that came into existence as a result of the global financial crisis in October 2008, the IASB set forth to rectify the weaknesses in IAS 39 (IASB, 2014a:6). These weaknesses included the delayed recognition of credit losses on loans and other financial instruments (IASB, 2014a:6).

It is worth noting that the impairment methodology of IFRS 9 does not necessitate a default event to have taken place before a credit loss is recognised. This was the case in IAS 39, however, where an incurred loss model was applied and valid information on impairment was a prerequisite before a credit loss could be recognised (Deloitte, 2018b:1-2). The recognition of lifetime expected credit losses will give rise to the financial reporting of expected credit losses in a timelier and more forward-looking manner compared with IAS 39 (IASB, 2014a:122). It will simultaneously resolve the deferred recognition of credit losses associated with the incurred loss approach (IASB, 2014a:122).

Regarding IFRS 9, an entity should always account for expected credit losses. In conjunction with this consideration, the entity will adjust the amount of expected credit losses at each reporting date to demonstrate the effect of any changes in credit risk from the date of initial recognition of the financial instrument. This results in the timely delivery of information regarding the expected credit losses (IASB, 2014b:6).

Paragraph 1.1 of IFRS 9 notes that “[t]he objective of this Standard is to establish principles for the financial reporting of *financial assets* and *financial liabilities* that will present relevant and useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of an entity’s

future cash flows” (IASB, 2014b:9, original emphasis). The objective of IFRS 9 is reinforced by the IASB’s (2014a:108) view, outlined in paragraph BC5.86, concerning the objectives for depicting expected credit losses:

However, to be consistent with the *Conceptual Framework*, faithful representation of expected credit losses implies that the depiction of those credit losses is neutral and free from bias. The depiction of expected credit losses in an unbiased way informs the decisions of a broad range of users of financial statements, including regulators and investors and creditors. (Original emphasis.)

According to Volarević and Varović (2018:269), the principal objective of IFRS 9 was to establish an impairment model for financial instruments, which is measured in accordance with expected credit losses and the credit risk model of a company.

2.3.2.2 Approaches to impairment

According to IFRS 9 5.5.1, an entity is required to recognise a loss allowance for expected credit losses on a financial asset measured at amortised cost, a financial asset measured at fair value through other comprehensive income, a lease receivable, a contract asset or a loan commitment, as well as a financial guarantee contract that is subject to the impairment requirements as detailed in paragraphs 2.1(g), 4.2.1(c) or 4.2.1(d) (IASB, 2014b:26).

The term ‘expected loss’ is adopted from statistics (Hartley, 2018:61). It is defined as the “estimated loss frequency multiplied by estimated loss severity, summed for all exposures” (International Risk Management Institute, 2020). Proceeding from this definition, the concept of a ‘loss allowance’ is defined by the IASB (2014b:56) as “[t]he allowance for expected credit losses on financial assets measured in accordance with paragraph 4.1.2, lease receivables and contract assets, the accumulated impairment amount for financial assets measured in accordance with paragraph 4.1.2A and the provision for expected credit losses on loan commitments and financial guarantee contracts”. It is worth noting that the loss allowance referred to under section 11(j) signifies the loss allowance as defined in terms of IFRS 9. Additionally, ‘expected credit losses’ is defined by the IASB (2014b:55) as “[t]he weighted average of credit losses with the respective risks of a default occurring as the weights”.

It is important to point out that IFRS 9 sets out the following three approaches to recognise impairment. These are the general approach, the simplified approach, and the purchased or originated credit-impaired approach. These respective approaches are discussed in further detail below.

2.3.2.2.1 General approach

The general approach has two separate conditions under which the expected credit losses can be measured, namely 12-month expected credit losses and lifetime expected credit losses (Deloitte, 2018a). The term ‘12-month expected credit losses’ is defined by the IASB (2014b:53) as “[t]he portion of lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date”. The concept of ‘lifetime expected credit losses’ can be distinguished from 12-month expected credit losses in that it refers to “[t]he expected credit losses that result from all possible default events over the expected life of a financial instrument” (IASB, 2014b:56).

The term ‘default’ is not defined in IFRS 9 and, for this reason, an entity needs to develop its own policy as to what a default will entail (Deloitte, 2018a). The default definition established by the entity for IFRS 9 should be coherent with the definition used by the entity for internal credit risk management purposes in relation to that particular financial instrument (IASB, 2014b:120). It should also take suitable qualitative factors into account (IASB, 2014b:120). Hence, an entity could have several different definitions for the term ‘default’, depending on the type of financial instrument (SARS, 2020:4). It should be borne in mind that the IASB (2014a:145) included a rebuttable presumption that, in the absence of reasonable and supportable information to promote a delayed default criterion, default does not come to pass later than when a debt is 90 days past due. Consequently, if a financial asset is 90 days past due, it is considered to be a default event to determine either the 12-month or lifetime expected credit losses.

As the Draft Interpretation Note on Doubtful Debts points out, there are several stages under which the expected credit losses can be recognised in accordance with IFRS 9. This recognition is contingent on the level of risk at the inception of the financial instrument as opposed to the level of risk associated with the repayment of the financial instrument at the reporting date (SARS, 2020:4). Apart from that, the recognition of interest income on the financial instrument is also conditional on the stage of default (SARS, 2020:4). However, the accounting treatment of the interest income will not be examined for this study. The three different stages of default will be discussed below.

Following IFRS 9 5.5.5, an entity is required to measure the loss allowance of a financial instrument at an amount equivalent to 12-month expected credit losses if, at the reporting date, the credit risk relating to that financial instrument has not increased significantly from the date of initial recognition (IASB, 2014b:26). This requirement is more commonly referred to as ‘stage 1’ (BDO, 2017).

The 12-month expected credit loss is calculated as the expected credit losses that arise from default events, which could occur within 12 months after the reporting date, weighted by the probability of default (“PD”) occurring (SARS, 2020:4). The term ‘probability of default’ was defined as the “[p]robability of a

counterparty not making full and timely repayment of credit obligations over a specific time horizon” (Standard Bank, 2008:35).

Pursuant to IFRS 9 5.5.3, an entity is required to measure the loss allowance of a financial instrument at an amount equivalent to the lifetime expected credit losses if, at the reporting date, the credit risk associated with that financial instrument has increased significantly from the date of initial recognition (IASB, 2014b:26). This requirement is ordinarily referred to as ‘stage 2’ (KPMG, 2018:2). As is stated in IFRS 9 5.5.4, the purpose of the impairment requirements set out above is to recognise lifetime expected credit losses on all financial instruments that have been subjected to a significant increase in credit risk from the date of initial recognition, while taking all reasonable and supportable information, including forward-looking information, into account (IASB, 2014b:26).

To assess whether the credit risk on a financial instrument has increased significantly since initial recognition, the entity should bear in mind all reasonable and supportable information, which is accessible without unmerited cost or effort at each reporting date (IASB, 2014b:27). In order to evaluate whether the credit risk has increased significantly, an entity should consider the risk of a default materialising throughout the expected life of the financial instrument as opposed to the difference in the amount of expected credit losses (IASB, 2014b:27).

The IASB (2014a:128) did not define the concept of a ‘significant increase in credit risk’ since entities administer their financial instruments and the associated credit risk using different modes with varying levels of complexity. However, it is submitted that the credit risk on a financial instrument will increase significantly before the financial instrument is rendered as credit-impaired or an actual default takes place (IASB, 2014b:112). It should be recognised that, in concordance with IFRS 9 5.5.11, there is a rebuttable presumption that the credit risk on a financial asset has increased significantly from the date of initial recognition in the event that the contractual payments associated with the financial instrument are more than 30 days past due (IASB, 2014b:27). A financial asset is considered to be past due in circumstances where a counterparty has been unable to make a payment although the payment was contractually due (IASB, 2014b:57). According to Hartley (2018: 62-63), even though IFRS 9 contains guidelines on how to determine whether the credit risk on a financial asset has increased significantly, entities will still need to exercise a considerable amount of judgement.

It can be noted that what is commonly referred to as ‘stage 3’ applies to credit-impaired financial assets and is comparable to the incurred loss event as described under IAS 39 (BDO, 2017). Similar to a stage 2 financial asset, an entity should measure the loss allowance for a financial instrument at an amount equal to the lifetime expected credit losses.

According to the definition of a ‘credit-impaired financial asset’, a financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred (IASB, 2014b:53). These events are ascribable as default events (SARS, 2020:3). The term ‘default events’ is not defined in IFRS 9; however, the definition of a credit-impaired financial asset indicates when a financial asset will be considered to be credit-impaired (i.e. what would constitute a default event). This includes recognisable data about the substantial financial difficulty of the issuer or the borrower of the financial instrument or a violation of contract, for instance, a default event or a past due event (IASB, 2014b:53). It should be stressed that it is not always feasible to identify an exclusive default event. As an alternative, a financial asset may be credit-impaired when considering the collective impact of multiple default events (IASB, 2014b:53).

Consequently, a financial asset classified under stage 3 is deemed to be irrecoverable in substance; however, the financial asset has not yet been written off (SARS, 2020:5). This situation is attributable to the fact that an entity will only write off a financial asset when the entity has no plausible expectations of recovering the financial asset in totality or a part thereof (IASB, 2014b:26). It should be noted that a financial asset that has been partially written off for financial reporting purposes will not be considered as bad for tax purposes. For this reason, the asset will not be allowed as a deduction under section 11(i).

A summary of the three stages under the general approach is provided in Table 2-1 below.

Table 2-1: Summary of stages under the general approach

	Stage 1	Stage 2	Stage 3
Indicator	Initial recognition	Significant increase in credit risk	Credit-impaired
Recognition of expected credit losses	12-month expected credit losses	Lifetime expected credit losses	Lifetime expected credit losses

Source: Author’s compilation of information provided above

2.3.2.2.2 Simplified approach

In certain instances, the general approach is too cumbersome and, for this reason, the simplified approach was introduced (Deloitte, 2018a). The simplified approach enables an entity, in accordance with IFRS 9 5.5.15, to always measure the loss allowance at an amount equivalent to the lifetime expected credit

losses (IASB, 2014b:28). Consequently, an entity that follows the simplified approach is not required to estimate the amount equal to the 12-month expected credit losses. The simplified approach enables entities to recognise lifetime expected losses on trade receivables, contract assets and lease receivables without the requirement to determine significant increases in credit risk (Deloitte, 2018a).

An entity must use the simplified approach for trade receivables or contract assets that result from transactions that are within the scope of IFRS 15 *Revenue from Contracts with Customers* (“IFRS 15”) and which do not contain a significant financing component (IASB, 2014b:28). IFRS 15 paragraph 62 provides a list of factors for cases where a contract with a customer would not have a significant financing component. Conversely, IFRS 15 paragraph 63 includes a practical expedient that it is needless for an entity to account for the effects of a significant financing component. The practical expedient will apply if, at the commencement of the contract, the entity anticipates that the period will be one year or less between when a promised good or service is conveyed to a customer and when the customer makes payment for that good or service (IASB, 2014c:A680). If the abovementioned requirements are met, an entity must always apply the simplified approach and does not have a choice to apply the general approach (Deloitte, 2018b:4).

On the contrary, it is essential for an entity that an accounting policy choice is made for trade receivables or contract assets that result from transactions that are within the scope of IFRS 15 and which contain a significant financing component in accordance with IFRS 15 (Deloitte, 2018b:4). In accordance with IFRS 15 paragraph 60, a significant financing component will be present if the payment deadlines agreed to by the contractual parties, either explicitly or implicitly, represent a significant benefit of financing the transfer of goods or services on behalf of the customer. In this instance, the entity should elect to measure the loss allowance at an amount equal to lifetime expected credit losses as per its accounting policy (IASB, 2014c:A679). It should be emphasised that the accounting policy should inevitably be applied to all such trade receivables or contract assets; however, the entity is permitted to apply the accounting policy separately to trade receivables and contract assets (IASB, 2014b:28). This consideration is intensified by IFRS 9 5.5.16, which states that an entity may select its accounting policy for trade receivables, lease receivables and contract assets on an individual basis (IASB, 2014b:29).

Considering that section 11(j)(i)(aa) and (bb) specifically relate to debt other than in respect of lease receivables, the simplified approach for lease receivables will not be examined.

2.3.2.2.3 Purchased or originated credit-impaired approach

The purchased or originated credit-impaired approach is suitable to apply in the case where an entity purchases or originates a financial asset that is credit impaired on initial recognition, for example, when an entity purchases an asset at a deep discount (PricewaterhouseCoopers, 2017:34). Under the purchased or

originated credit-impaired approach, an entity is required to only recognise the aggregate variations in lifetime expected credit losses from the date of initial recognition as a loss allowance at the reporting date (IASB, 2014b:28).

2.3.2.2.4 Conclusion

Today, almost every entity holds a financial instrument. More specifically, most entities have trade and other receivables for which they need to account in their financial statements (Deloitte, 2018b:2). Taking this into consideration, the broader scope of entities will most likely adopt the simplified approach. However, any of the approaches discussed above could be used in conjunction with section 11(j).

2.3.2.3 Measurement of expected credit losses

An expected credit loss is a probability-weighted assessment of the credit losses throughout the expected life of the financial instrument. In essence, an expected credit loss is the present value of all cash shortfalls, being the difference between the contractual cash flows that fall due as specified in the contract and the cash flows that the entity anticipates to collect (IASB, 2014b:118).

The measurement requirements of expected credit losses are dictated by IFRS 9 paragraph 5.5.17 (IASB, 2014b:29):

5.5.17 An entity shall measure expected credit losses of a financial instrument in a way that reflects:

- (a) an **unbiased and probability-weighted** amount that is determined by evaluating a range of possible outcomes;
- (b) the **time value of money**; and
- (c) **reasonable and supportable information** that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions. (Emphasis added.)

It is worth noting that an entity should examine the risk or probability of a credit loss occurring by deliberating the likelihood of a credit loss transpiring against the likelihood of a credit loss not transpiring, regardless of whether the likelihood is very limited (IASB, 2014b:29). For this reason, the concept of an ‘unbiased and probability-weighted amount’ suggests that an estimate of expected credit losses should always reflect the possibility of a credit loss taking place. It also points to the possibility that no credit loss will take place regardless of whether the most probable outcome is that there will be no credit loss (IASB,

2014b:121). Consequently, the purpose of estimating expected credit losses is neither to predict worst-case scenarios nor best-case scenarios (IASB, 2014b:121). The intricacy of the expected credit losses measurement is not stipulated in the standard (Hartley, 2018:63). As a result, both unsophisticated models and refined models are embraced (Hartley, 2018:63).

Considering that the time value of money should be taken into account when measuring expected credit losses, the expected credit losses need to be discounted to the reporting date using the effective interest rate assessed at initial recognition date or at a rate that approximates the aforementioned rate (IASB, 2014b:122). It is worth noting that the concept of an ‘effective interest rate’ is defined as “the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortised cost of a financial liability” (IASB, 2014b:55). In order to calculate the effective interest rate, an entity has to determine the expected cash flows by taking all the cash flows as specified in the terms of the contract applicable to the financial instrument into account (IASB, 2014b:55).

In relation to IFRS 9, the concept of ‘reasonable and supportable information’ refers to information that is relatively accessible at the reporting date without unwarranted cost or effort. It also entails information relating to past developments, existing circumstances and future projections of the economic climate (IASB, 2014b:122). This enables entities to record expected credit losses that have not yet been observed without increasing the operational load of identifying information that is not reasonably available (Hartley, 2018:62). The requirement to integrate forward-looking information into the calculation of expected credit losses suggests that significant judgement will have to be applied when determining expected credit losses (EY, 2020:4).

2.3.2.3.1 Practical expedient to the measurement of expected credit losses

As maintained by IFRS 9 B5.5.35, an entity that applies the simplified approach may use a practical expedient when measuring expected credit losses if the principles are coherent with those mentioned in paragraph 5.5.17 (IASB, 2014b:119). This enables the entity, for example, to calculate the expected credit losses on trade receivables by applying a provision matrix and incorporating its historical credit loss experience. A provision matrix can be employed by applying a default rate to the appropriate groupings of trade receivable balances, based on the customer’s default patterns (Deloitte, 2018b:3). The historical credit loss experience employed by the entity for trade receivables to estimate the 12-month expected credit losses or the lifetime expected credit losses on the financial assets, as relevant, should be appropriately adjusted in accordance with paragraphs B5.5.51–B5.5.52 (IASB, 2014b:119).

Pursuant to IFRS 9 B5.5.51, it is appropriate for an entity to consider all reasonable and supportable information, in conjunction with circumstances that particularly relate to the borrower, as well as the broader economic climate (IASB, 2014b:122-123). The entity should evaluate both the present and future direction of conditions at the reporting date, in the event that the information is relatively accessible without unwarranted cost or effort. Additionally, in line with IFRS 9 B5.5.52, an entity should amend historical data on the grounds of existing observable data to demonstrate the effects of the present circumstances as well as predictions of future conditions that did not have an impact on the period from where the historical data originated (IASB, 2014b:123). Moreover, an entity should eliminate the effect of events that are related to the historical period if the information does not apply to future contractual cash flows (IASB, 2014b:123). An example of a provision matrix is set out in Table 2-2 below.

Table 2-2: Example – Provision matrix

Trade receivables ageing	Current (0 days past due)	1 to 30 days past due	31 to 60 days past due	61 to 90 days past due	More than 90 days past due	Total
Trade receivables balance at the reporting date	R102,000	R43,000	R31,000	R18,500	R4,500	R199,000
Default rate	3%	5%	8%	11%	15%	
Expected credit losses [Balance * Default rate]	R3,060	R2,150	R2,480	R2,035	R675	R10,400

Source: Author's compilation of information provided above

2.4 A critical evaluation of current legislation in light of the fundamental principles of taxation

This part sets forth the critical evaluation of the tax treatment of the amended section 11(j) against the fundamental principles of taxation, based on the interpretation established in Part 2.2. It aims to ascertain which of the essential principles have not been complied with by examining each principle individually.

2.4.1 Neutrality

As discussed in par. 2.2.2.1, the neutrality principle describes a tax system that is unbiased and equitable towards all taxpayers. The possibility that the amended section 11(j) is in contravention with the neutrality principle stems from the distinction between taxpayers applying IFRS 9 and taxpayers not applying IFRS 9. Given this distinction, emphasis will be placed on the most significant differences in how the doubtful debt allowance is calculated for the different types of taxpayers. Furthermore, the dire consequences of the exclusion of lease receivables from the doubtful debt allowance on taxpayers operating in the property industry will be examined below as this could bring the neutrality principle into contention.

2.4.1.1 Allowance as opposed to debt

Considering that the latest tax treatment of section 11(j) of the Act regarding doubtful debt allowances has distinguished between taxpayers applying IFRS 9 and taxpayers not applying IFRS 9, a lack of cohesion could arise between the calculation of the amount allowed as a deduction for the different types of taxpayers.

Section 11(j)(i)(aa)(A) grants an allowance equal to 40% of the amount equal to the lifetime expected credit loss, as contemplated in IFRS 9, which represents a stage 2 and stage 3 debt in terms of IFRS 9 if the general approach is followed (KPMG, 2018:2). As previously discussed in par. 2.3.2.2.1, for a stage 2 debt an entity should measure the loss allowance for a financial instrument at an amount equal to the lifetime expected credit losses if, at the reporting date, the credit risk on that financial instrument has increased significantly since initial recognition (IASB, 2014b:26). Similar to a stage 2 financial asset, an entity should measure the loss allowance for a financial instrument at an amount equal to the lifetime expected credit losses if the asset is classified under stage 3 (refer to par. 2.3.2.2.1). Otherwise, if the simplified approach is applied, the entity will always measure the loss allowance at an amount equal to the lifetime expected credit losses (Deloitte, 2018b:4).

In addition to this, section 11(j)(i)(bb) of the Act permits an allowance of 25% of the loss allowance relating to impairment, as contemplated in IFRS 9, in respect of debt other than a debt taken into account under section 11(j)(i)(aa), which refers to a stage 1 debt in terms of IFRS 9 (refer to par. 2.3.1.2.2). For a stage 1 debt, an entity should measure the loss allowance for a financial instrument at an amount equal to 12-month expected credit losses if, at the reporting date, the credit risk of a financial instrument has not increased significantly since initial recognition (BDO, 2017).

The measurement requirements of expected credit losses dictated by IFRS 9 paragraph 5.5.17 will apply to allowances addressed by section 11(j)(i)(aa)(A) and section 11(j)(i)(bb). According to the measurement

requirements, an entity should measure the expected credit losses of a financial instrument in a way that reflects an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes (Deloitte, 2018b:3).

An entity should estimate the risk of a default occurring on the financial instrument during its expected life for lifetime expected credit losses, whereas 12-month expected credit losses represent a portion of the lifetime expected credit losses. In other words, it embodies the lifetime cash shortfalls that result if a default occurs in the 12 months after the reporting date. If the expected life of a financial instrument is less than 12 months, it can represent a shorter period. Both lifetime expected credit losses and 12-month expected credit losses should be weighted by the probability of that default occurring (IASB, 2014b:121).

For example, entity A has a trade receivable to the value of R1 million at the reporting date. Using reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions, entity A estimates that the risk of a default occurring on the financial instrument during its expected life is 30%. Furthermore, the entity estimates that the risk of a default occurring in the 12 months after the reporting date is 5%. At the reporting date, the lifetime expected credit losses will be R300,000, calculated as R1,000,000 multiplied by 30%. On the other hand, the 12-month expected credit losses will be R15,000, calculated as R1,000,000 multiplied by 30% multiplied by 5%.

As the example illustrates, by applying the measurement requirements of IFRS 9, the loss allowance as contemplated in IFRS 9 already takes the probability of default occurring into account. Since legislation grants an allowance equal to 40% or 25% of the loss allowance relating to impairment, as contemplated in IFRS 9, the probability of default occurring on the financial instrument is considered in the specified base.

Conversely, for taxpayers not applying IFRS 9, section 11(j)(ii) of the Act provides an allowance of the sum total of 40% of so much of any debt due to the taxpayer, if that debt is 120 days or more in arrears, as permitted by section 11(j)(ii)(aa). It also makes an allowance of 25% of so much of any debt, other than a debt contemplated in subparagraph (i) or item (aa), due to the taxpayer, if that debt is 60 days or more in arrears, as permitted by section 11(j)(ii)(bb) (KPMG, 2018:2). Given that the allowance of 40% or 25% is applied to the debt of the taxpayer, and not the loss allowance of the taxpayer, the probability of a default is not taken into account in the specified base.

In terms of the information above, it can be observed that if entity A from the example applied IFRS 9 earlier, entity A would be granted an allowance of 40% of R300,000 under section 11(j)(i)(aa)(A) or an allowance of 25% of R15,000 under section 11(j)(i)(bb), whichever is relevant to the circumstances of entity A. This would result in a section 11(j) allowance of R120,000 and R3,750, respectively. If entity A did not apply IFRS 9, entity A would be granted an allowance of 40% of R1,000,000 (i.e. the debt) as

permitted by section 11(j)(ii)(aa) or 25% of R1,000,000 (i.e. the debt) as permitted by section 11(j)(ii)(bb), giving rise to an allowance of R400,00 or R250,000, respectively. When compared with the allowance granted to taxpayers applying IFRS 9, it is evident that taxpayers not applying IFRS 9 enjoy preference over the principles established by section 11(j). The aforementioned figures are presented in Table 2-3 below.

Table 2-3: Example – Allowance as opposed to debt

	Allowance of 40% (R)	Allowance of 25% (R)
Taxpayers applying IFRS 9	R120,000	R3,750
Taxpayers not applying IFRS 9	R400,000	R250,000

Source: Author's compilation of information provided above

Based on the example above, there is a lack of similar taxation levels for taxpayers in similar situations carrying out similar transactions. Considering that the allowance claimed by both types of taxpayers in the current year of assessment is added back to the taxpayers' income in the following year of assessment (Steenkamp, 1998:91), there will be a more significant effect in the first year that taxpayers adopt the amended section 11(j). In conclusion, the neutrality principle is potentially not being adhered to.

Subsequent to this discussion, the time value of money will be addressed since there are dissimilarities in how the different types of taxpayers account for the time value of money.

2.4.1.2 The time value of money

The non-conformity resulting from the distinction between taxpayers applying IFRS 9 and taxpayers not applying IFRS 9 is further emphasised in the calculation of the amount allowed as a deduction for the different types of taxpayers.

As previously emphasised in par. 2.4.1.1, the measurement requirements of expected credit losses dictated by IFRS 9 paragraph 5.5.17 will apply to allowances addressed by section 11(j)(i)(aa)(A) and section 11(j)(i)(bb). According to the measurement requirements, an entity should measure expected credit losses of a financial instrument by considering the effects of the time value of money (Deloitte, 2018b:3). Hence, the entity should discount the expected credit losses using an effective interest rate determined on initial recognition of the financial instrument to determine the present value of the loss allowance (IASB, 2014b:122). Subsequently, the allowance permitted by section 11(j) equal to 40% and 25% of the loss

allowance relating to impairment, as contemplated in IFRS 9, will be applied to the present value of the loss allowance. In comparison with this, for taxpayers not applying IFRS 9, the allowance of 40% and 25% granted under section 11(j)(ii)(aa) and section 11(j)(ii)(bb) is applied to the undiscounted face value of the debt of the taxpayer, and not the present value of loss allowance of the taxpayer.

To further elaborate on the example discussed in par. 2.4.1.1, it can be supposed that the trade receivable to the value of R1,000,000 at the reporting date is payable in two years' time. The effective interest rate determined on initial recognition of the trade receivable is 10% per annum. If entity A applied IFRS 9, the present value of the loss allowance will be measured by discounting the future loss allowance of R120,000 and R3,750 respectively, using the effective interest rate of 10% per annum over a discounting period of 2 years. This results in a present value of R99,174 and R3,099 for the lifetime expected credit losses and 12-month expected credit losses respectively. In the case where entity A does not apply IFRS 9, the lifetime expected credit losses and 12-month expected credit losses will remain R400,000 and R250,000, respectively, since the time value of money is not taken into account under section 11(j)(ii). Table 2-4 below sets out the foregoing figures to better illustrate the possible effect of the time value of money.

Table 2-4: Example – The time value of money

	Allowance of 40% (R)	Allowance of 25% (R)
Taxpayers applying IFRS 9	R99,174	R3,099
Taxpayers not applying IFRS 9	R400,000	R250,000

Source: Author's compilation of information provided above

From this perspective, it can be observed that the amended section 11(j) serves the interest of taxpayers not applying IFRS 9 since these taxpayers are awarded a greater allowance when applying the provisions of section 11(j) compared with taxpayers applying IFRS 9. This does not represent similar levels of taxation for taxpayers in similar situations carrying out similar transactions. From these facts, one can conclude that the neutrality principle is possibly not being complied with.

2.4.1.3 Lease receivables

It is noteworthy that current legislation regarding section 11(j) specifically prevents a doubtful debt allowance to be deducted for a loss allowance that relates to lease receivables in respect of taxpayers applying IFRS 9.

In the 2020 budget review released on 26 February 2020, National Treasury recognised that the consequences of the exclusion on leasing businesses were unintentional (National Treasury, 2020a:134). As set out in the Explanatory Memorandum on the Draft Taxation Laws Amendment Bill, 2020, the reason for the exclusion is that the lease receivables determined in accordance with IFRS 9 not only include lease receivables that have already accrued to the entity (which had not yet been paid) but also include all future lease receivables that have not yet been received or accrued and, hence, not yet included in the taxpayer's taxable income (National Treasury, 2020b:2). Considering this, granting a doubtful debt allowance on future lease receivables as described above would be unfitting (National Treasury, 2020b:22).

It follows that taxpayers applying IFRS 9 are unable to deduct a doubtful debt allowance on the lease receivables relating to either finance leases or operating leases as set out in IFRS 16 *Leases*, since the impairment requirements of IFRS 9 relates to all types of lease receivables (KPMG, 2020b:1). Because of the present economic situation, as well as the devastating consequences that Covid-19 has caused for the property industry, not being able to deduct an allowance for doubtful debts attributable to taxpayers' principal source of income, namely rental income, has had serious repercussions on these taxpayers (KPMG, 2020b:2).

This concern is further emphasised by the knowledge that taxpayers not applying IFRS 9 are able to deduct a doubtful debt allowance on outstanding lease payments, which is dependent on how long the lease payment has been outstanding (National Treasury, 2020b:22). National Treasury has proposed to remedy this issue by only excluding lease receivables that have not yet been received or accrued to determine the doubtful debt allowance for taxpayers applying IFRS 9 (National Treasury, 2020a:134).

It should be noted that the 2020 Draft Taxation Laws Amendment Bill issued on 31 July 2020 included an amendment to the words preceding item (aa) of section 11(j)(i) that the exclusion of lease receivables for taxpayers who apply IFRS 9 only applies in respect of lease receivables that have not been included in the taxpayer's income (National Treasury, 2020c:15). As a result, taxpayers in the property industry will be able to deduct a doubtful debt allowance on lease receivables that have accrued but remain outstanding. The proposed amendment will only become effective on 1 January 2021 and will apply to the years of assessment commencing on or after 1 January 2021 (National Treasury, 2020b:22). The matter of concern is that these taxpayers will not be able to deduct a doubtful debt allowance for the period between 1 January 2019 and 1 January 2021, when the proposed amendment comes into operation (KPMG, 2020b:2).

Given the above information, the dissimilarities of the doubtful debt allowance granted to taxpayers applying IFRS 9 and the taxpayers who do not apply IFRS 9 in respect of lease receivables may place the neutrality principle into contention even though the proposed amendment has been announced.

2.4.2 Efficiency

Pursuant to par. 2.2.2.2, it was determined that the efficiency principle can be interpreted as a tax system that encourages taxpayers to pay their taxes by implementing reduced compliance costs. For the purpose of this study, it is deemed to be relevant to investigate the potential compliance costs associated with the application of the amended section 11(j).

2.4.2.1 IFRS compliance costs

Considering that the latest tax treatment of the Act regarding doubtful debt allowances has referred to taxpayers applying IFRS 9, it is necessary to evaluate the cost of IFRS compliance and enforcement.

In Pawsey's (2017:116) study, which was conducted in 2017 about the transitional and ongoing costs on the adoption of IFRS, it was emphasised that firms incurred considerable costs to adopt IFRS initially. They also incurred these costs with the enforcement of IFRS henceforward – particularly in the development of an accounting information system, the education of personnel and the adjustment of financial statements that have to be prepared in accordance with the requirements of IFRS. In addition to this, the survey indicated a consensus in that firms noticed an estimated 20% annual progressive increase in the compliance cost of the accounting standard (Pawsey, 2017:116).

As is revealed by Hitz and Müller-Bloch (2016:1-6), the significant costs associated with the compliance of IFRS took precedence over the transparency benefits accompanying the application of IFRS. This subsequently caused firms to downlist (i.e. transfer to an unregulated or open market). The decision to downlist was motivated by an economic justification, namely that firms were convinced that the cost-benefit trade-off would give rise to a more favourable position to the firm. In essence, abandoning the high compliance costs associated with the regulated market would surrender cost savings and promote an enhanced firm value (Hitz & Müller-Bloch, 2016:23-24). Ultimately, Hitz and Müller-Bloch (2016:32) called into question whether the cost to implement IFRS, owing to its complexity and the comprehensive disclosure requirements, was excessive.

It can be deduced that the compliance cost related to the adoption and implementation of IFRS is high. For this reason, the compliance cost to qualify for a section 11(j) allowance, specifically for taxpayers applying IFRS 9, can be regarded as being considerable. Taking into consideration the definition of efficiency as adopted by the OECD and the Davis Tax Committee, it appears that the latest amendment to section 11(j) does not minimise the compliance cost for taxpayers as far as is practicable. Furthermore, the significant compliance costs relating to IFRS can be perceived as a distortion to the economy, which is supported by the decisions of firms to downlist to an open market.

Nevertheless, bearing in mind that the latest tax treatment distinguishes between both taxpayers applying IFRS 9 and taxpayers not applying IFRS 9, one may conclude that legislation does not solely permit a doubtful debt allowance to taxpayers applying IFRS 9. Consequently, section 11(j) does not necessitate a taxpayer to apply IFRS in order to benefit from the doubtful debt allowance. Because of this, the latest tax treatment of the Act regarding doubtful debt allowances could be seen as being consistent with the principle of efficiency.

2.4.3 Certainty and simplicity

On the authority of par. 2.2.2.3, the certainty-and-simplicity principle necessitates a tax system that uses clear, concise and unambiguous language to enable taxpayers to predict tax consequences. The measurement uncertainty affiliated with the determination of the IFRS 9 loss allowance, the fact that current legislation does not make reference to taxpayers applying IFRS for SMEs, and the incertitude accompanying the criteria to apply for an increased rate could call the certainty principle into question. It thus warrants further consideration. Additionally, views expressed by other parties regarding the uncertainties related to current legislation are detailed in par. 2.4.3.4.

2.4.3.1 Measurement uncertainty

According to Alley and Bentley (2015:598), the objective of drafting rules is to advance certainty by ensuring that language use is unambiguous and straightforward. However, despite using clear language, the rules will only prove to be certain over time. In the initial phase of adopting new or amended legislation, the rules will undoubtedly be perceived as complicated since the preliminary interpretation and application will be diverse. Following this, it is inevitable that the initial application of the amended section 11(j) will give rise to uncertainties. Nonetheless, these uncertainties should be clarified over time as the rules are applied by taxpayers.

Even so, the loss allowance as contemplated by IFRS 9, which is used as the starting point for the doubtful debt allowance for taxpayers applying IFRS 9, is subject to measurement uncertainty. This is supported by the statement in IFRS 9 BC5.85 regarding the use of the expected credit loss framework to recognise an impairment (IASB, 2014a:108). The statement indicates that “because expected credit losses are not directly observable, their measurement is inherently based on judgement and any model that attempts to depict expected credit losses will be subject to measurement uncertainty” (IASB, 2014a:108).

Moreover, the unpredictability of the impact of the Covid-19 outbreak has made the consideration of reasonable and supportable forward-looking information in the assessment of expected credit losses more perplexing (Deloitte, 2020:8). Likewise, Hartley (2018:67) affirms that the uncertainty of the calculation of the doubtful debt allowance can be enhanced by compelling taxpayers to estimate the expected credit losses of a financial asset in the absence of a loss event.

Considering that the IFRS 9 loss allowance is exposed to measurement uncertainty, quintessentially, the certainty principle is a source of contention. Taxpayers will be unable to accurately anticipate the tax consequences in advance of a transaction since the calculation of the IFRS 9 loss allowance is open to judgement. On the other hand, taxpayers can control the amount determined as a loss allowance by manipulating the outcome of the increase in the credit risk of the financial instrument, or by misrepresenting the effective interest rate elected as the discount rate. The possibility of manipulation is examined further in par. 2.4.4.1.

2.4.3.2 IFRS for SMEs

It should be noted that the amendment to the doubtful debt allowance, inaugurated by the Taxation Laws Amendment Act 23 of 2018, merely distinguishes between taxpayers applying IFRS 9 and taxpayers not applying IFRS. In view of the fact that IFRS for SMEs does not refer to IFRS 9 or lifetime expected credit loss, it was assumed that taxpayers applying IFRS for SMEs would be subjected to the tax treatment applicable to taxpayers not applying IFRS. Despite this assumption, the legislation can be viewed as vague and ambiguous since the tax rules can be perceived as unclear and difficult to understand. Consequently, the 2018 amendment to section 11(j) might be in breach of the certainty-and-simplicity principle as set out by the OECD.

Be that as it may, recognising that the latest tax treatment of section 11(j) has distinguished between taxpayers applying IFRS 9 and taxpayers not applying IFRS 9, the potential breach of the certainty-and-simplicity principle has been resolved. This resolution is further supported by the statement made by SAIT (2020:1) that the revised legislation, which refers to taxpayers not applying IFRS 9, clearly demonstrates that taxpayers who apply IFRS for SMEs for financial reporting purposes would be subjected to the tax treatment applicable to taxpayers not applying IFRS 9 under section 11(j)(ii). Consequently, the concern relating to the certainty-and-simplicity principle has been resolved by the 2019 amendment.

Proceeding from this, it can be concluded that the latest tax treatment of section 11(j) does not place the certainty-and-simplicity principle into contention because it does not refer to taxpayers applying IFRS for SMEs.

2.4.3.3 Criteria to apply for increased rate

For this study, it is relevant to evaluate the guiding factors that the Commissioner considers when issuing a directive for an increased percentage allowance, not exceeding 85%, as set out in the Draft Interpretation Note on Doubtful Debts.

According to SARS (2020:15), the Request for Information and excel-based templates attempted to address all of the criteria outlined in the second proviso to section 11(j); however, the guidance provided is not all-encompassing. Consequently, the onus is on the taxpayer to remain attentive to the relevant factors that should be considered when applying for an increased percentage and should provide this information to the Commissioner (SARS, 2020:15).

One of the criteria that SARS will consider in determining whether a directive should be issued is the likelihood of the debt being recovered. The likelihood of the debt being recovered, indicated as a percentage value, will alternate between borrowers and is contingent upon the borrowers' credit profile (SARS, 2020:18). The determination of this percentage value is subject to the judgement of the taxpayer, which can cause uncertainty.

However, as discussed in par. 2.4.3.1, when adopting new or amended legislation, it is undeniable that the rules will initially be viewed as complicated and, as a result, uncertain (Alley & Bentley, 2015:598). This is true for the criteria that SARS will use to determine whether a directive should be issued. In light of the situation, it is deemed that these initial challenges are not adequate to conclude that the certainty principle is in contention.

2.4.3.4 Other views expressed

Although SARS's attempt to clarify and simplify the calculation of the doubtful debt allowance for tax purposes, by removing the Commissioner's discretion and bringing it in line with the accounting treatment, is noted with satisfaction, evidence suggests that the intention has not succeeded (KPMG, 2020a:1). In reality, the calculation of the doubtful debt allowance is potentially more difficult than ever before, which is highlighted by the possibility of inconsistencies in the language of section 11(j), coupled with SARS's interpretation of legislation (KPMG, 2020a:1). Another problem concerns how the allowance will be determined in practical and commercial terms (KPMG, 2020a:1).

Considering that legislation only refers to taxpayers who apply IFRS 9 and taxpayers who do not apply IFRS 9, the following uncertainties have emerged:

- It is unclear under which category insurers will fall who have been excused from applying IFRS 9 on an interim basis and, as a consequence, how these taxpayers should determine the doubtful debt allowance (KPMG, 2020a:2).
- At present, it is uncertain how the doubtful debt allowance will be influenced from a tax perspective if the taxpayer elects to apply the simplified approach under IFRS 9 to account for the loss allowance (KPMG, 2020a:2).
- It is unclear whether a taxpayer who applies IFRS for SMEs will be adversely affected (KPMG, 2020a:2).
- The ability of a taxpayer who applies section 11(jA) to make use of section 11(j) is yet to be confirmed in cases where it is found that a particular debt is not within the scope of IFRS 9 (KPMG, 2020a:2).

Apart from these uncertainties, the Draft Interpretation Note on Doubtful Debts issued by SARS on 18 February 2020 raised further concerns, including:

- For a financial asset that consists of both used and unused facilities, the entity may take facilities that are unused, yet available, into consideration when determining the expected credit losses. In response to the Draft Interpretation Note stating that section 11(j) will not apply to unused facilities, it might be complicated to remove the unused facility from the used portion when determining the doubtful debt allowance (KPMG, 2020a:2).
- The Draft Interpretation Note once again highlighted the uncertainty regarding the given moment that a debt becomes bad for tax purposes, as well as the uncertainty as to how this aligns with the accounting treatment (KPMG, 2020a:2).

On 15 May 2020, SAIT published its comments on the Draft Interpretation Note Concerning Doubtful Debts submitted to SARS to raise concerns relating to matters that are not addressed by the Draft Interpretation Note and to draw attention to some of its deficiencies. A number of the observations made by SAIT highlights uncertainties associated with the latest amendment to the income tax treatment of the doubtful debt allowance, including the following:

- Based on the current wording of section 11(j), it is unclear whether covered persons, as described under section 11(jA), can elect to apply section 11(j) instead of applying section 11(jA) (SAIT, 2020:2). According to SAIT (2020:2), the possibility exists that this incertitude can exclusively be resolved by amending legislation in contrast with revising the interpretation.
- Concerning the application of IFRS within legislation, the reference to “if IFRS 9 is applied to that debt” raises the question as to what it precisely entails. For instance, does it entail that IFRS 9 should be applied to all the taxpayer’s debt? Or does it mean the taxpayer can apply IFRS 9 on a debt-by-debt basis depending on whether the debt falls within the ambit of IFRS 9? Furthermore,

there is a chance that a taxpayer can apply IFRS, but the taxpayer does not apply IFRS 9 to that particular debt. These ambiguities can be addressed either by amending legislation or by updating the interpretation thereof (SAIT, 2020:2-3).

- A factor that the Commissioner considers when issuing a directive for an increased allowance in accordance with the second proviso to section 11(j), is that the Commissioner can request the taxpayer to provide information that the Commissioner may deem relevant when deciding to issue a directive (SARS, 2020:15). According to SAIT (2020:6), the Draft Interpretation Note should elaborate on the type of information that may be requested from the taxpayer and the process that is followed when issuing a directive, given the sophisticated nature of the doubtful debt allowance.

The examples discussed above demonstrate that the latest amendment to the doubtful debt allowance still consists of uncertainties. Hence, the certainty-and-simplicity principle is potentially in breach.

2.4.4 Effectiveness and fairness

As is highlighted in par. 2.2.2.4, the principle of effectiveness and fairness can be described as a tax system that generates the appropriate amount of tax at a suitable time. Given the reference to IFRS 9 in current legislation, the potential manipulation of financial statements, which is used as a starting point for the calculation of the doubtful debt allowance for income tax purposes, may result in the levying of an inappropriate amount of tax. Likewise, the tax outcome devised by granting an allowance when a debt is arbitrarily 60 or 120 days past due may be inappropriate. Lastly, the inconsistent consideration given to debt-backed securities for different taxpayers may be unfitting. These potential concerns relating to effectiveness and fairness will be further explored below.

2.4.4.1 Incorporating IFRS within legislation

Prior to the amendment of the section 11(j) allowance in the 2018 Amendment Bill, Hartley (2018:68) stated that the adoption of IFRS 9 as a starting point for the doubtful debt allowance calculation would be inappropriate. This is because it would not be in line with case law, which advocates that the adoption of an accounting standard does not demonstrate the exertion of the Commissioner's discretion. However, the Taxation Laws Amendment Act 23 of 2018 eradicated the Commissioner's prior discretion to determine the doubtful debt allowance. The amendment did so by replacing the amount that the Commissioner considered to be doubtful with a doubtful debt allowance of 40% or 25% of the loss allowance as contemplated in IFRS 9 or the debt due to a taxpayer, whichever is relevant. On this basis, it is not inappropriate for SARS to incorporate IFRS within the legislation. Nevertheless, it is relevant to investigate

the potential manipulation of the financial statements that will now be used as a point of departure for the calculation of the doubtful debt allowance for taxpayers applying IFRS 9.

According to Drábková and Pech (2019:41-42), the existence of fraud in financial statements is a source of grave concern for the regulators. It is further maintained that the essential aim of manipulation of financial statements is to achieve tax evasion or money laundering. This inherent risk of financial statements is often affiliated with the terms ‘creative accounting’ and ‘fraud’. The term ‘creative accounting’ is defined as “a process during which economic transactions are realized directly in order to achieve favourable accounting results or, more often, this term concerns a purpose-directed manipulation of data” (Drábková & Pech, 2019:41-42). The outcome is that users of financial statements are incapable of obtaining assurance regarding the faithful representation of the financial situation as depicted by the financial statements (Drábková & Pech, 2019:41-42).

As affirmed by Hartley (2018:27-28), it is required since 1969 for the doubtful debt allowance to be included in the taxpayer’s income in the following year. Hartley (2018:27-28) alleges that this method has profoundly alleviated the possible abuse that SARS might face. Even though this may reduce the risk that SARS may encounter, it is unlikely that it will eliminate this risk. Consequently, the potential existence of fraud in financial statements can result in the right amount of tax not being produced at the right time. Subsequently, the incorporation of IFRS 9 into section 11(j) does not minimise the potential for tax evasion and avoidance. For this reason, the effectiveness-and-fairness principle could prove to be in contention.

2.4.4.2 Days past due

The latest amendment to the doubtful debt allowance has arbitrarily granted taxpayers not applying IFRS 9 an allowance of 25% or 40% of the taxpayers’ debt if such debt is respectively 60 or 120 days in arrears, as noted in par. 2.3.1.2.3. Consequently, an age analysis is applied in order to determine whether a 25% or 40% doubtful debt allowance is applicable to the taxpayer not applying IFRS 9 (National Treasury, 2020a:134). This is referred to as an age-based allowance (National Treasury, 2020b:20). From this perspective, it is clear that the age of debt is the only factor used to determine whether a doubtful debt allowance should be granted to a taxpayer not applying IFRS 9.

In accordance with IFRS 9 5.5.11, there is a rebuttable presumption that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due (IASB, 2014b:27). According to the responses received from field participants who took part in the 2013 Impairment Exposure Draft, the majority of the participants noted an interrelatedness between financial instruments that were more than 30 days past due and the significant increase in the credit risk on that financial instrument since initial recognition (IASB, 2014a:132). Nevertheless, some respondents

reckoned that past-due information provides a delayed indication of when the credit risk of a financial instrument has increased significantly (IASB, 2014a:132). Even though these responses were observed by the IASB in pursuit of refining IFRS 9, these findings can equally be applied to taxpayers not applying IFRS 9.

In addition, the IASB (2014a:145) highlighted that defining the term ‘default’ could contribute towards the implementation of an impairment model in a manner that does not provide valuable and relevant information concerning the actual credit risk of a financial instrument. Similarly, by arbitrarily granting taxpayers not applying IFRS 9 an allowance of 25% or 40% of the debt of the taxpayer if such debt is respectively 60 or 120 days in arrears contributes to the right amount of tax not being produced at the right time. This is because past-due information does not necessarily depict a debt that is considered to be doubtful, especially when considering the different types of products, jurisdictions and industries in which taxpayers operate.

Moreover, there is a concern that the accounting systems of entities operating within the private sector are not developed to calculate the days that a debt is in arrears and instead calculate the age of the debt since the debt has been recognised (SAIT, 2020:4). As a result, these accounting systems will only be appropriate if the debt is due on presentation of the invoice; however, this is not normally the case (SAIT, 2020:4). The problem is further intensified if the taxpayer has different due dates for different clients. For instance, in the engineering architecture industry, different due dates may be applied to the invoices issued. Moreover, accounting and auditing firms may encounter difficulties in determining the days a debt is in arrears since it is customary for these firms to renegotiate the invoice payable at a later date even though these invoices are generally payable on presentation (SAIT, 2020:4). These limitations faced by taxpayers in the private sector could lead to the right amount of tax not being produced at the right time.

In conclusion, the effectiveness-and-fairness principle could be in dispute since the tax rules do not consider the unique situation of the taxpayer and the constraints relating to the accounting system used by the taxpayer.

2.4.4.3 Debt-backed securities

As is highlighted in par. 2.3.1.2.4, in the event that a taxpayer not applying IFRS 9 submits a request under the second proviso to section 11(j) to apply for an increased doubtful debt allowance not exceeding 85%, the Commissioner takes into account whether the taxpayer holds the security for the respective debt. This poses the problem that the security available for a debt is only considered when the taxpayer applies for an increased allowance. Consequently, section 11(j)(ii) of the Act, which provides an allowance of 40% or 25%, does not consider the security held in respect of the debt. As evidenced by SAIT (2020:4), the

consideration of the security should not only be limited to the existence thereof but should also take into consideration the value of the security held in relation to the debt.

It is presumed that the security available for debt held by taxpayers applying IFRS 9 is incorporated within the provisions of IFRS 9 when determining the loss allowance (SAIT, 2020:4). Nevertheless, it is advised that the Draft Interpretation Note should provide a detailed list of securities that the Commissioner would deem feasible to take into consideration, explicitly stating the impact of such security accompanied by an example to illustrate the impact (SAIT, 2020:4).

Based on the current wording of section 11(j), there is an inconsistency between the calculation of the doubtful debt allowance on trade receivables for taxpayers who apply IFRS 9 and taxpayers who do not apply IFRS 9 (KPMG, 2020c:1). This discrepancy stems from the fact that taxpayers who apply IFRS 9 take the security held in respect of the debt into account when determining the loss allowance for accounting purposes while taxpayers who do not apply IFRS 9 solely take the debt due into account without any reference to the security held in relation to such debt (KPMG, 2020c:1). To rectify the concern noted, SARS issued the 2020 Draft Taxation Laws Amendment Bill on 31 July, which included the suggested amendment to items (aa) and (bb) of section 11(j)(ii) that taxpayers who do not apply IFRS 9 should consider any security held in respect of the debt (National Treasury, 2020c:15).

In conclusion, the failure to incorporate the security held in respect of debt when applying section 11(j)(ii) for taxpayers not applying IFRS 9 could lead to the right amount of tax not being produced at the right time. As a result, the effectiveness-and-fairness principle is potentially in contention if the proposed amendment to section 11(j)(ii) in the 2020 Draft Taxation Laws Amendment Bill is not upheld.

2.4.5 Flexibility

As pointed out in par. 2.2.2.5, a tax system should constantly develop to keep up with the economic and political climate. Proceeding from this point, it is vital to consider the section 11(j) amendments inaugurated by SARS.

2.4.5.1 Amendments to tax law

Legislation surrounding the doubtful debt allowance has undergone numerous amendments over the past few years, the most significant of which was introduced during 2018 when SARS incorporated IFRS within the section 11(j) legislation. The Taxation Laws Amendment Act 23 of 2018 established the amendment to the doubtful debt allowance in an effort to give certainty over the tax rules.

Subsequently, the Taxation Laws Amendment Act 34 of 2019 contained another amendment to section 11(j) to align the wording of the legislation with SARS's intention (National Treasury, 2019:54). The most recent amendment to section 11(j) relates to the Draft Taxation Laws Amendment Bill 2020. It aims to ensure equality between taxpayers who apply IFRS 9 and taxpayers who do not apply IFRS 9 with respect to debt-backed securities and lease receivables (National Treasury, 2020b:20-22).

The very fact that the doubtful debt allowance is continuously amended is evidence that the taxation system is flexible and dynamic. Against this backdrop, it can be affirmed that the latest amendment to the doubtful debt allowance does not appear to bring the flexibility principle into discord.

2.5 Conclusion

In its entirety, this article consisted of an analysis of the fundamental principles of taxation that were established throughout history, a comprehensive review of the section 11(j) doubtful debt allowance, an investigation of the accounting treatment of impairment losses recognised in accordance with IFRS 9, and a critical evaluation of section 11(j) against the fundamental principles of taxation.

The objective of this article is to conclude whether the income tax treatment of the doubtful debt allowance is in accordance with the fundamental principles of taxation. From the findings of the evaluation in Part 2.4, it is evident that the latest amendment to the doubtful debt allowance could be in breach of the majority of the fundamental principles of taxation. A summary of the principles that may be in breach is outlined below.

The neutrality principle is possibly not being adhered to since taxpayers applying IFRS 9 are awarded a doubtful debt allowance, which is calculated as a percentage of a loss allowance that already takes probability into account, whereas taxpayers not applying IFRS 9 are awarded an allowance calculated as a percentage of the face value of the doubtful debt. This finding is further supported by the fact that the percentage of the allowance is applied to the undiscounted face value of the debt of the taxpayer not applying IFRS 9, in comparison with the present value of loss allowance of the taxpayer applying IFRS 9. Lastly, the variations in the tax treatment relating to lease receivables for taxpayers applying IFRS 9 and those not applying IFRS 9 may cause the neutrality principle to be in breach.

Additionally, the income tax treatment of the doubtful debt allowance relating to taxpayers applying IFRS 9 is potentially in contravention of the certainty-and-simplicity principle since the IFRS 9 loss allowance is subject to the measurement of uncertainty by its very nature. Over and above that, the views expressed by other parties, for instance, accounting firms and SAIT, demonstrated that the certainty-and-simplicity principle is not being complied with.

As a latter point, the effectiveness-and-fairness principle may be in violation, given that the incorporation of IFRS 9 within section 11(j) could lead to tax evasion and avoidance since fraudulent financial statements can be used as a starting point for the calculation of the doubtful debt allowance. Moreover, arbitrarily granting taxpayers not applying IFRS 9 a doubtful debt allowance only if the debt is 60 or 120 days in arrears, and the failure to consider securities held by taxpayers not applying IFRS 9, contributes to the effectiveness-and-fairness principle presumably being in breach.

Considering the information discussed, it can be concluded that the most recent amendment to the income tax treatment of doubtful debts is arguably not in accordance with the fundamental principles of taxation – in particular the principles of neutrality, certainty and simplicity, and effectiveness and fairness.

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CHAPTER 3 CONCLUSION

3.1 Introduction

This study aimed to answer the research question as to whether the most recent amendment to the income tax treatment of doubtful debts is in conformance with the fundamental principles of taxation by reviewing current legislation, amendment bills, explanatory memoranda and other theoretical resources, accompanied by a subjective interpretation of the insights acquired.

3.2 Research findings

In order to achieve the primary research objective of critically evaluating whether section 11(j) complies with the fundamental principles of taxation, a review was carried out in *Chapter 2.2* of the development of the fundamental principles of taxation over the course of history. A thorough examination of current legislation, as amended by Taxation Laws Amendment Act 34 of 2019, and a review of the calculation of the IFRS 9 loss allowance was performed in *Chapter 2.3*. The discussion was followed by a critical evaluation of the amended section 11(j) against the fundamental principles of taxation in *Chapter 2.4*. Lastly, a conclusion was drawn as to whether the income tax treatment of the doubtful debt allowance complied with the fundamental principles of taxation in *Chapter 2.5*. A summary of the key findings of the study with reference to the research objectives established in par. 1.4.2 are set out below.

3.2.1 Research objective 1

On the basis of the historical review performed of the fundamental principles of taxation in *Chapter 2.2*, the most essential principles were identified, which provided the foundation against which the amended section 11(j) was evaluated. It was found that the most essential principles consisted of neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility. The outcome of this research objective was to rely on the interpretation of the most essential principles as set forth by the OECD and the Davis Tax Committee.

3.2.2 Research objective 2

The comprehensive review performed in *Chapter 2.3* on section 11(j), as amended by Taxation Laws Amendment Act 34 of 2019, highlighted the context, purpose and income tax treatment of the doubtful debt

allowance. It was established that legislation makes a distinction between taxpayers applying IFRS 9 and taxpayers not applying IFRS 9. As a result of this distinction, the legislation sets out different methods to calculate the doubtful debt allowance of the respective taxpayers. In addition to this, it was pointed out that taxpayers can obtain a directive from SARS to increase the allowance by a rate not exceeding 85%.

In conducting the in-depth analysis of the calculation of the IFRS 9 loss allowance in *Chapter 2.3*, it was noted that three different approaches exist to recognise an impairment loss. These are the general approach, the simplified approach and the purchased or originated credit-impaired approach. Moreover, it was determined that the measurement requirements of expected credit losses incorporate probability, the time value of money, and reasonable and supportable information.

3.2.3 Research objective 3

On the grounds of the comparison carried out in *Chapter 2.4* between section 11(j) and the fundamental principles of taxation, a brief summary below sets out the principles that are possibly in breach.

The neutrality principle is possibly not being adhered to given that taxpayers applying IFRS 9 can only claim a doubtful debt allowance after applying the percentage as set out in section 11(j) to the loss allowance calculated in accordance with IFRS 9. This is coupled with the fact that taxpayers applying IFRS 9 take the time value of money into account when determining the loss allowance used as the basis of the doubtful debt allowance. On the contrary, taxpayers not applying IFRS 9 can claim a doubtful debt allowance calculated as a percentage as set out in section 11(j) to the face value of the debt, without discounting the debt to its present value. In addition to this, the inconsistency between taxpayers applying IFRS 9 and taxpayers not applying IFRS 9, resulting from the exclusion of lease receivables from the doubtful debt allowance granted to taxpayers applying IFRS 9, may cause a violation of the neutrality principle.

By virtue of the fact that the calculation of the IFRS 9 loss allowance, which is used as the foundation of the doubtful debt allowance calculation, is susceptible to measurement uncertainty, the possibility exists that the amended section 11(j) is not in line with the certainty-and-simplicity principle. In conjunction with this, the possibility that the certainty-and-simplicity principle is in contention is highlighted by the views expressed by other parties, particularly accounting firms and SAIT.

Furthermore, section 11(j) may be in breach of the effectiveness-and-fairness principle since the integration of IFRS 9 within the income tax legislation could give rise to tax evasion or tax avoidance, resulting in the right amount of tax not being collected at the right time. This is attributable to the possibility that fraudulent financial statements, from where the IFRS 9 loss allowance will be derived, can be used as the point of departure to calculate the section 11(j) doubtful debt allowance. Besides that, in light of the fact that

taxpayers not applying IFRS 9 are awarded a doubtful debt allowance if the debt is either 60 or 120 days in arrears, without considering the industry in which the taxpayer operates, the effectiveness-and-fairness principle may be in contention. As a latter point, the inconsistent consideration of debt-backed securities between taxpayers applying IFRS 9 and taxpayers not applying IFRS 9 may result in the effectiveness-and-fairness principle being in breach.

3.2.4 Research objective 4

Based on the critical evaluation of the doubtful debts income tax treatment performed in *Chapter 2.4*, it was concluded in *Chapter 2.5* that section 11(j) is possibly not in agreement with the majority of the fundamental principles of taxation.

3.3 Conclusion

In *Chapter 1* it was presumed that the intention of the 2018 amendment to section 11(j) to provide certainty would not be attained. Considering the conclusion reached in *Chapter 2.5* that the certainty-and-simplicity principle is potentially in contravention, it is the author's view that SARS has not achieved its intention to afford certainty to taxpayers applying section 11(j) by amending legislation.

Likewise, it was suspected that the distinction between taxpayers applying IFRS 9 and taxpayers not applying IFRS 9 may have led to further challenges associated with the income tax treatment of the doubtful debt allowance. For instance, it was presumed that the latest tax treatment of the doubtful debt allowance as amended by the Taxation Laws Amendment Act 34 of 2019 would fail to comply with other fundamental principles of taxation. As evidenced by the critical evaluation performed in *Chapter 2*, the amendment to section 11(j) potentially gave rise to the neutrality, certainty and simplicity, and effectiveness and fairness principles being brought into contention.

In the final instance it can be concluded that the most recent amendment to the income tax treatment of doubtful debts is possibly not in conformance with the majority of the fundamental principles of taxation.

3.4 Further research

Taking into consideration the conclusion reached in *Chapter 3.3* above, a suggested field of study is to make recommendations on how SARS can amend section 11(j) to align the income tax treatment of the doubtful debt allowance with the fundamental principles of taxation.

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