

# **ASSESSED LOSSES**

**An investigation into the restrictions imposed on a taxpayer, prohibiting  
the utilisation of the relief from taxation arising from an assessed loss**

*by*

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**Submitted in partial fulfilment of the requirements for the degree of  
Masters in Commerce (Taxation)**

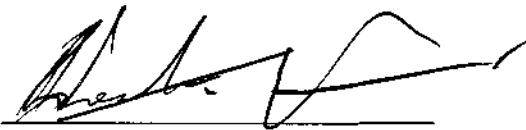
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## Declaration

This research has not been previously accepted for any degree and is not being currently submitted in candidature for any degree.

Signed:  \_\_\_\_\_

Date: 31<sup>st</sup> October 2004

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## **Abstract**

Section 20 of the Income Tax Act, No 58 of 1962 allows a taxpayer that has sustained an assessed loss to carry forward the balance of assessed loss and be set off against income earned in the future years. In addition, the loss sustained from one source may be set off the income from another.

The assessed loss may be carried forward indefinitely, provided the taxpayer does not fall foul to a provision that restricts the continued use of the assessed loss. The taxpayer's right to retain, carry forward and utilise the assessed loss will be lost if:

- The taxpayer's debt(s) are reduced or extinguished, without it being settled.
- When a company cease trading.
- Also in the case of a company, when income is channelled into it solely for the utilisation of the assessed loss.

A recent amendment prevents certain individuals from setting off the assessed loss sustained in certain activities against the income of another.

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## **CHAPTER ONE INTRODUCTION**

### **1.1 Relief from taxation on income**

A layman once asked; 'last year I made a profit (meaning that he had taxable income) so I paid the Receiver, this year I made a loss (i.e. he incurred an assessed loss), will the Receiver pay me? The reply was; 'you will only be repaid what you have paid for the year'. However, in certain instances an assessed loss does provide an inflow of much needed cash.

From this it is gathered that, in the year, when a taxpayer incurs an assessed loss he is relieved of the burden of taxation. In South Africa (RSA), this relief extends beyond the year in which the assessed loss is incurred. The taxpayer is not only allowed to set off the loss of one trade against, but is also allowed to carry forward the loss and have it set off against income earned in future years, until utilised.

### **1.2 Carry back and carry forward of assessed loss in the USA**

The treatment of and the benefits provided by an assessed loss differ from county to country. The Zimbabwean cases reported in RSA infer that the principles of carrying forward of assessed losses in Zimbabwe are very similar to RSA.

According to Gitman (1994:59), in the United States of America (USA), the assessed loss can be carried back three years and carried forward fifteen years. Note that the term 'tax loss' is used. This difference from the RSA approach is demonstrated by an example:

Table 1.1 details the income/(losses) accrued to or incurred by Z Ltd:

**Table 1.1 – Income(losses) accrued to or incurred by Z Ltd**

<b>Year</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>	<b>8</b>	<b>9</b>	<b>10</b>	<b>11</b>
<b>R '000</b>	25	25	25	25	(550)	25	25	25	25	25	25
<b>Year</b>	<b>12</b>	<b>13</b>	<b>14</b>	<b>15</b>	<b>16</b>	<b>17</b>	<b>18</b>	<b>19</b>	<b>20</b>	<b>21</b>	<b>22</b>
<b>R '000</b>	25	25	25	25	25	25	25	25	25	25	25

Determination of taxable income or assessed loss in RSA.

**Table 1.2 – The determination of taxable income or assessed loss in RSA**

<b>Year</b>	<b>Income (loss)</b>	<b>Assessed loss brought forward</b>	<b>Taxable income/ assessed loss</b>	<b>Assessed loss carried forward</b>
1	25 000	0	25 000	0
2	25 000	0	25 000	0
3	25 000	0	25 000	0
4	25 000	0	25 000	0
5	(550 000)	0	(550 000)	(550 000)
6	25 000	(550 000)	(525 000)	(525 000)
7	25 000	(525 000)	(500 000)	(500 000)
8	25 000	(500 000)	(475 000)	(475 000)

The assessed loss would continue, indefinitely, to be set off against income earned in the future years, until the loss has been fully utilised.

## Determination of taxable income or assessed loss in USA.

**Table 1.3 – The determination of taxable income or assessed loss in USA**

Year	Income (loss)	Assessed loss brought forward/back	Taxable income/assessed loss	Assessed loss carried forward
1	25 000			
2	25 000	from yr 5 (550 000)	(525 000)	(525 000)
3	25 000	(525 000)	(500 000)	(500 000)
4	25 000	(500 000)	(475 000)	(475 000)
5	(550 000)			
6	25 000	(475 000)	(450 000)	(450 000)
7	25 000	(450 000)	(425 000)	(425 000)
8	25 000	(425 000)	(400 000)	(400 000)

A continuation of the table and calculation would result in a balance of assessed loss of R 100 000 at the end of year 20. As year 20 would be the fifteenth year of carrying forward the loss incurred in year 5, the balance of R 100 000 is forfeited. No balance of the assessed loss is carried to year 21.

This example clearly illustrates that:

- In RSA, an assessed loss has no effect on any prior years' taxable income, while in the USA it does.
- In USA, after carrying forward and utilising the assessed loss for fifteen years, any balance, thereafter, cannot be carried forward any further. The benefits of which are forfeited. The assessed loss in RSA is carried for indefinitely.

### **1.3 Circumstances/events that prevent a taxpayer from the utilisation of an assessed loss**

Certain provisions of the Income Tax Act, 58 of 1962 (the Act) may prevent the taxpayer from claiming the relief provided by the utilisation of an assessed loss. This report focuses on those provisions. These provisions can broadly be classified in two categories:

- Those that seek to deprive the taxpayer of the assessed loss as he/it is no longer entitled to the assessed, and
- Those that are anti-avoidance measures.

The continuity in the carrying on of a trade is a key requirement that entitles a taxpayer to carry forward and set off the assessed loss from the previous year. It then stands to reason that, when a taxpayer ceases trading it is no longer entitled to the assessed loss.

Another instance that gives rise to an adverse effect to the balance of an assessed loss is the perceived recoupment of the expenses/allowances that have given rise to the assessed loss. This situation arises when a taxpayer is released from an obligation to settle a debt.

Trusts and companies are taxed as separate legal entities. The channelling of income into entities in an attempt to utilise its assessed loss and avoidance of taxation is curtailed by the anti-avoidance provisions specifically enacted for that purpose.

Recently the Act was amended to prevent certain individuals from setting off the income from one trade against the assessed loss of another. This amendment arose as avoidance to what was perceived to be an abuse. Non-trade activities (e.g. hobbies and retirement investments) operating at a loss were disguised to be trade activities

so that the losses incurred may be used to reduce the tax liability due on the income earned from the true trade activity.

#### **1.4 General overview of assessed losses**

Before the above provisions are reviewed, the next chapter presents a broad overview of assessed losses.

## CHAPTER TWO

### ASSESSED LOSSES IN GENERAL

#### 1.1 Introduction

The focus of this report remains on events and non-events that may jeopardise the utilisation of an assessed loss incurred by a taxpayer. However, it is necessary to review certain other salient aspects of assessed losses.

#### 1.2 Definition

The definition per section 20(2) of the Income Tax Act, 58 of 1962 (here in after referred to as 'the Act'):

'For the purposes of this section "assessed loss" means any amount by which the deductions admissible under sections 11 to 19, inclusive, exceeded the income in respect of which they are so admissible.'

This definition is also used by other section in the Act, in which case specific reference is made to the definition of an assessed loss defined in section 20.

#### 1.3 Determination and calculation

The above definition is illustrated by an example.

**Table 2.1 – Information relating to ABC (Pty)Ltd**

Assessed loss at the end of 2003	100 000
For 2004 year:	
Net income fore special and capital allowances	240 000
Section 12C and 13 capital allowance	251 000
Section 24 debtors allowance	30 000



**Table 2.2 – The calculation of the assessed loss at the end of 2004**

Net income fore special and capital allowances	240 000
Section 12C and 13 capital allowance	- 251 000
	- 11 000
Section 24 debtors allowance	0
	- 11 000
Assessed loss at the end of 2003	- 100 000
Assessed loss carried to 2005	-111 000

Note that the debtors allowance was not taken into account because it falls outside of sections 11 to section 19. It is generally said the debtors and other allowances that fall outside section 11 to section 19 'cannot create or increase an assessed loss'.

#### 1.4 **Set-off of assessed losses**

Section 20(1)(a) of the Act allows the set off of 'any balance of assessed loss incurred by the taxpayer in any previous year which has been carried forward from the preceding year of assessment'. However this is subject to provisos (i) and (ii). Proviso (ii) is the focus of chapter 5 of this report.

Proviso (i) deals with an individual whose estate has been sequestrated. It dictates that a person's whose estate has been sequestrated is not entitled to carry forward any assessed loss incurred prior to sequestration. However, where the order of sequestration is set aside, the individual will be allowed to carry forward the assessed loss less any amount of the assessed loss utilised in the insolvent estate.

## **1.5 Aggregating of income and losses of different trades**

Section 20(1)(b) of the Act allows the set off of the assessed loss of one trade against the income of the other trades conducted by the same taxpayer.

However, the taxpayer has to have conducted the trade in his own right (i.e. not via a company). Where the taxpayer participated in a partnership only his share of the net income or assessed loss must be taken into account.

## **1.6 Set-offs not allowed**

The assessed loss may not be set off against the income from certain sources.

### **1.6.1 Fund surplus**

Paragraph (eB) of the gross income definition of section 1 of the Act specifically includes any amount received by or accrued to by an employer by way of a distribution by a pension or provident fund (other than that is recovered in terms of section 37D of the Pension Funds Act).

Proviso (a) of section 20(1) of the Act prohibits the set-off of this distribution against the assessed loss incurred during the year or carried forward from the previous year.

### **1.6.2 Residence based taxation**

Residence based tax requires all local and foreign income of a person to be taxed in the Republic. Further, section 20(1)(b) of the Act permits the loss incurred in one trade to be set off the income of another that is carried on by the same taxpayer.

However, proviso (b) of section 20(1) of the Act prohibits the set-off of the assessed loss incurred by a taxpayer in a trade carried on outside the republic, against the income of a trade carried on in the Republic.

## **1.7 Exceptions applicable to individuals**

It is a common occurrence were an individual after a number of years of poor trading and accumulating assessed losses cease trading, without going into sequestration. Section 20(2A) of the Act permits him to carry forward his assessed loss beyond the years in which he had neither income nor any trading activities.

### **1.7.1 Trading**

For a person to carry forward and set of an assessed loss, section 20(1) of the Act requires the person to be carrying on a trade. However, section 20(2A)(a) of the Act permits an individual who has not carried on a trade to determine his taxable income in terms of section 20(1) of the Act even though he has not carried out trade.

'The carrying on of a trade' is the focus of chapter 4 of this report.

### **1.7.2 Not earning any income**

Section 20(2A)(b) of the Act provides that:

'[t]he said taxpayer shall.... not be prevented from carrying forward a balance of assessed loss merely by reason of the fact that he has not derived any income during any year of assessment.'

## CHAPTER THREE

### TRAFFICKING IN COMPANIES WITH ASSESSED LOSSES

#### SECTION 103(2)

##### 3.1 Introduction

As discussed in chapter 2, where a taxpayer carries out more than one trade the taxable income and assessed loss of all trades must be aggregated to determine the tax liability of the taxpayer. This allows for a scheme to reduce the tax on income, by channelling the said income via an entity that has an assessed loss to offer. However, section 103(2) of the Act empowers the Commissioner to 'disallow the setting-off of an assessed loss or balance of an assessed loss against the company's 'tainted' income.' (Williams, 1995:559).

Section 103(2) of the Act reads:

'Whenever the Commissioner is satisfied that—

- (a) any agreement affecting any company or trust; or
- (b) any change in—
  - (i) the shareholding in any company; or
  - (ii) the members' interests in any company which is a close corporation; or
  - (iii) the trustees or beneficiaries of any trust,

as a direct or indirect result of which—

- (A) income has been received by or has accrued to that company or trust during any year of assessment; or
- (B) any proceeds received by or accrued to or deemed to have been received by or to have accrued to that company or trust in consequence of the disposal of any asset, as contemplated in the Eighth Schedule, result in a capital gain during any year of assessment,

has at any time been entered into or effected by any person solely or mainly for the purpose of utilizing any assessed loss, any balance of assessed loss, any capital loss or any assessed capital loss, as the case may be, incurred by the company or trust, in order to avoid liability on the part of that company or trust or any other person for the payment of any tax, duty or levy on income, or to reduce the amount thereof—

(aa) the set-off of any such assessed loss or balance of assessed loss against any such income shall be disallowed;

(bb) the set-off of any such assessed loss or balance of assessed loss against any taxable capital gain, to the extent that such taxable capital gain takes into account such capital gain, shall be disallowed; or

(cc) the set off of such capital loss or assessed capital loss against such capital gain shall be disallowed.'

Like most other tax legislation the courts were called upon on various occasions to assist with its interpretation and applicability of particular situations. Some of the disputed issues that required the courts decisions were:

- The interpretation of the phrase 'any agreement affecting any company'.
- Whether, for the successful application of section 103(2) of the Act, the entering of the agreement and the accrual/receipt of the resultant income need to occur in the same tax year.
- Whether the application of section 103(2) of the Act limited to income that has been diverted into a company with an assessed loss.

### **3.2 Any agreement affecting any company**

The case of CIR vs Ocean Manufacturing Ltd 1990 AD concerned two agreements – a merger agreement, and a transfer agreement. The court had to decide on the relevance of each agreement to the application of section 103(2) of the Act.

Brick and Potteries Company Limited ('B&P') was a public company listed on the Johannesburg Stock Exchange (JSE). It had via a number of subsidiaries manufactured of bricks, tiles, pipes and earthenware. In 1974 B&P acquired all the issued shares in Model Homes and Property Development Corporation Limited ('Model Homes') – the taxpayer. In 1978 the B & P group encountered serious financial problems and was in danger of liquidation. A scheme of arrangement was reached, whereby B&P retained the 'shell' companies with minimal assets and no liabilities. The JSE listing of B&P's shares was suspended, on condition that appropriate action be taken.

After the scheme of arrangement and by exercising its options, Finansbank Limited ('Finansbank') took control of B&P.

Ocean Manufacturing (Proprietary) Limited ('Ocean') manufactured and distributed domestic refrigerators and freezers. The company also imported and distributed electrical appliances. Due to the large costs and the company's Zimbabwean background there were difficulties in obtaining a listing of its shares on the JSE.

Finansbank was anxious to revitalise the B&P group so as to recoup its losses, found the solution to all. A 'back-door listing' of Ocean was to be facilitated by a reverse take over of B&P. In the negotiations Ocean was also advised that certain companies in the B&P group had assessed losses, with specific reference being made to the assessed loss of R775 304 accumulated by Model Homes.

Negotiations led to the conclusion of the merger agreement, which led to: (a) the shareholders of Ocean acquiring 75% interest in B&P; (b) B&P acquired 100% interest in Ocean; (c) B&P's existing shareholders received 25% of the new shares in B&P; and (d) B&P received R637 500 from the rights issue.

The merger agreement required the Ocean to sell its business as a going concern to Model Homes & Property Development Corporation Limited. However, due to many factors the transfer of the business was delayed by six months. Thereafter Model Homes & Property Development Corporation Limited changed its name to Ocean Manufacturing Ltd.

The CIR, in terms of section 103(2) of the Act, disallowed the loss brought forward into 1982.

The court was required to decide whether the transfer (of the business) agreement is an agreement which fell within the ambit of section 103(2) of the Act. Nicholas AJA, in the Appellate Divisions, found that the contract had all the required set out in this provision:

- (i) It is an 'agreement affecting any company' (i.e. Model Homes – the taxpayer).
- (ii) As a direct result of the arrangement income was received by that company.
- (iii) Presumptively it was entered into solely or mainly for the purpose of utilising that company's assessed loss.

However, it was argued on behalf of the taxpayer that while the merger agreement and transfer agreement were in the legal form two separate agreements, the transfer agreement formed an integral part of the merger agreement.

The courts below found in favour of the taxpayer – finding that the critical agreement to be considered was the merger agreement and not the transfer agreement.

Nicholas AJA disagreed with the courts *a quo* for the following reasons:

- The transfer of Ocean's business was not a component of the merger agreement.
- Model Homes was not a party to the merger agreement. The agreement had no effect on it. Nor did it cause any income to accrue to Model Homes.
- The transfer of the business was an internal re-arrangement of assets between the subsidiaries of B&P.
- While the transfer of the business would not have taken place if it was not for the merger, the merger agreement was discrete from the business transfer agreements.

In the alternate it was argued on behalf of the taxpayer that the expression 'any agreement affecting any company' in section 103(2) 'is restricted to an agreement which affects the control of the company or one which affects any person's right to participate in the profits or dividends of the company'.

Nicholas AJA disagreed:

'In my opinion there is nothing to warrant that interpretation. *Any* is 'a word of wide and unqualified generality. It may be restricted by the subject-matter or the context, but *prima facie* it is unlimited.' (Per Innes CJ in *R v Hugo* 1926 AD 268 at 271.) 'In its natural and ordinary sense, any – unless restricted by the context – is an indefinite term which includes all of the things to which it relates.' (Per Innes JA in *Hayne & Co v Kaffrarian Steam Mill Co Ltd* 1914 AD 363 at 371.)

In regard to the subject-matter there is nothing in s 103(2) to suggest that the word *any* was used in a limited sense.'



### 3.3 Delaying the accrual of the 'tainted' income

In *Conshu (Pty)Ltd vs CIR 1994 AD* the taxpayer was formerly known as National Tyre Co (Pty) Ltd, and had had 30 June financial year end.

During 1984 financial year the company was in the business a tyre retreader and dealer. At the end of 1984 it had an accumulated assessed loss of R5 856 947. The same business continued during 1985, recording poorer results.

Drastic steps were required. Hence, towards the end of the 1985 financial year, the taxpayer:

- Changed its name to Conshu Holdings(Pty) Ltd.
- Effected a change in its shareholding – the change being part of a reorganisation of the Calan group of companies of which taxpayer had been a member.
- Had acquired all the trading assets and liabilities of United-Fram. This had been alleged that this took place on 30 June – the last day of the financial year and a Sunday.
- Disposed of the bulk of its business.

As a result of the above, the 1985 return of income described the taxpayer's business as that of retreader and distributor of pneumatic and solid tyres, manufacturers of rubber footwear, other footwear and related products. The return also disclosed the disposal of the old business and the purchase of the trading assets and liabilities of United-Fram.

The CIR was satisfied that the assets of 'various footwear companies' had been transferred to taxpayer 'solely or mainly for the purposes of the postponement of the liability for the payment of income tax'. He,

accordingly did not allow the assessed loss brought forward to be set off against the 1986 income.

It was contended on behalf of the taxpayer that:

'The Commissioner should have applied the provisions of s 103(2) of the Act in the assessment that he raised for the year in which the agreement was entered into and in which it took effect, namely the year ended 30 June 1985. Once the Commissioner had failed to apply the provisions of s 103(2) in respect of the 1985 year of assessment, it was not competent for him to endeavour to apply the provisions of the subsection for the first time in respect of the 1986 year, as he purported to do in the revised assessment.'

The question for decision was whether the CIR, after failing to apply section 103(2) to the tax year in which an agreement of the kind referred to in this section was entered, is entitled to apply it in respect of an ensuing tax year.

The majority judgement lead by Harms JA found that it was correct for the CIR to apply section 103(2) in the ensuing years:

'[i]t empowers the Commissioner to disallow the attempted set-off against 'any such income', i.e. 'income (that) has been received by or has accrued to that company during any year of assessment'. It permits him no more. It does not allow him to issue a declaratory order. He has to await an attempted set-off by the taxpayer in terms of s 20. I have shown that the appellant did not claim the benefit of s 20 in 1985. He did so for the first time in 1986. There was consequently no occasion for the Commissioner to disallow the set-off of any assessed loss or balance of assessed loss during the former year. In addition, the appellant had no otherwise taxable income during 1985 against

which the assessed loss could have been set off. To hold that, because the Commissioner could not have applied s 103(2) to the 1985 year entails that he could also not have done it in relation to 1986 would be destructive of the purpose of the provision. It would also allow for the evasion of the provision. It must, from a commercial point of view, be simple to structure a deal in such a manner that the change in shareholding is effected in year 1, and to have the company receive income as a result of it in year 2 or 3 whilst the assessed loss is kept alive by some or other insignificant untainted trade.' (My underlining)

The majority judgement also explained the mechanics of the set off in terms of section 20. Coetzee H 1998:

'The majority in the case in point reached a far-reaching conclusion: The word income, as used in the introductory part of Section 20(1), is not used in its defined sense but rather as the income taxable but for the set off. It simply means that a set off, in terms of Section 20, can only arise if there would otherwise have been taxable income, that is, pre-tax profit.'

This would imply that the assessed loss brought forward cannot be accumulated if in the current year a loss was incurred. The loss incurred in the current year is to be carried forward into the next with the loss brought forward from the prior year being unutilised and lost.

At the request of Coetzee (1998), SARS has issued a statement expressing its view on the judgement:

'At present the approach of SARS is to determine the taxable income (assessed loss) of every company for a particular tax year not having regard to the Conshu judgement. We fully agree with your views that the judgement handed down in that case with regard to the majority judgement, should it be applied as

found, would have a draconic effect on the manner in which the carry forward of losses is concerned.'

SARS, therefore, permits the accumulation of assessed losses to be carried forward.

#### **3.4 Tainted income is not limited to the income that is diverted into the company**

In ITC 1123 1968 T the taxpayer company had originally engaged in manufacture with its products marketed largely in East and Central Africa. The boycott of South African products adversely affected the company's business and financial position. It therefore went into liquidation.

After realising the assets the liquidators was left the immovable property, which proved difficult to sell. Eventually one R, a director of companies and an experienced business man, made an offer of R 45 000 for the property, which was acceptable to the liquidators.

However the liquidators convinced R that purchasing the shares in the company was better in that property transfer costs and duties would be avoided. The cost of incorporating another company would also be avoided. R's offer of R 45 000 was acceptable to all. After making the offer but before it was accepted, R was approached by K & K. R took them as co-shareholders to prevent K & K making a higher offer on the property.

Initially R's purpose in acquiring the shares was to get control over the immovable property with the intention of letting it. Later, but before he made the offer to purchase he had conceived further ideas about using the company. By the time R had made the offer, his purpose in

acquiring the shares was not only to get the immovable property but also to activate the company into doing some business.

R or one of his companies was a creditor of the taxpayer company and therefore he was aware of its financial position from the documents that the liquidators had furnished to creditors and in particular, he knew of its assessed loss.

It was impossible for R to work with K & K. K & K bought the property for R 45 000. R then became the sole shareholder of the taxpayer, that had no assets or liabilities but an accumulated assessed loss. R immediately arranged for an overdraft facility of R80 000, which he guaranteed, and the company commenced to carry on business. He did not however resuscitate any manufacturing process although machinery was acquired for the purpose of manufacturing certain articles but was later sold. The trading activities of the company produced net incomes of R10 220 in the 1964 tax year and R11 372 in the 1965 tax year, comprising category (a) transactions with connected companies under the control of R – commission, interest, administration fees and profit on the sales of certain articles produced by such companies; and category (b) transactions with independent parties – profits from the buying and selling of machinery and equipment, the lending of money at interest and the discounting of bills.

The Secretary for Inland Revenue, applying the provisions of section 103(2) of the Income Tax Act, refused to allow the set-off of the assessed loss against the incomes of R 10 220 and R 11 372 for the years of assessment ended 28 February, 1964, and 1965 respectively and assessed the said amounts of income to tax.

At the outset Trollip J set the requirements of section 103(2):

'Section 103(2) provides that the set-off of a previous assessed loss must be disallowed whenever the Secretary is satisfied about three essentials; (1) that a change of shareholding in the company has taken place; (2) that as a direct or indirect result thereof income has been received by or has accrued to that company during the year of assessment: and (3) that the change in shareholding was effected solely or mainly for the purpose of utilizing the company's assessed loss in order to avoid liability on the part of the company or any other person for tax on such income.' (My underling)

It was conceded on behalf of the company that the income diverted into the taxpayer from related companies (i.e. category (a)) is subject to section 103(2), and that the SIR was correct in disallowing its set off against the assessed loss. However, it was contended that the income earned by activities with third parties (i.e. category (b)) must be set off against the assessed loss. In this regard counsel for the taxpayer relied on para 1620 of Meyerowitz and Spiro's Taxpayer's Permanent Volume on Income Tax in South Africa and South West Africa where the authors expressed their own view about the meaning of section 103(2) as follows:

'It is considered that the section is only applicable where there has been a diversion of income because of an agreement or change of shareholding, since it is only in this circumstance that there can be an avoidance of liability for tax by any person . . . But where there has been no diversion and the company earns income because, for example, the new shareholders are able to and do conduct the business more efficiently, or because the company enters into a new field of business or undertakes a new enterprise, the section, it is considered, does not apply. Without a diversion of income there can in the circumstances be

no avoidance of liability for tax and therefore no purpose to do so.'

Trollip J disagreed with this contention and said:

'That the section was intended to apply where income was diverted from another person to a company in order to avoid liability for tax on the part of that person is clear from its very language. But its wording is wide and there is no warrant for limiting its application to such cases. It refers in the first place to 'income. . . received by or. . . accrued to that company during any year of assessment. . .

That is wide enough to include income produced by its own activities in contradistinction to income diverted to it. Secondly, the section speaks of avoiding liability for tax 'on the part of that company' in addition to and in contradistinction to avoiding liability for tax 'on the part of. . . any other person'; that shows that not only diverted income but income produced by the company's own activities can fall within the ambit of the section if its other requirements are fulfilled. Otherwise, to take a clear example, the income from a new and unrelated type of business started by the new shareholders of the company, they having acquired the shares solely or mainly for tax avoidance, would escape liability for tax on such income by its being set off against the assessed loss produced by the old and discontinued business of the company under its erstwhile shareholders. The section seems to have been designed... to prevent that very thing from happening. Consequently the views expressed by the authors .... cannot, with respect, be accepted as correct.' (My underlining)

### **3.5 Section 103(2) and section 20(1)(a)(ii)**

In the case of *New Urban Properties Ltd VS SIR 1966 AD* the taxpayer was a land dealing company that was registered in 1945. As a result of sustaining large losses, by the end of its financial year ending on 30 June 1958 it was hopelessly insolvent with an assessed loss of £ 767 709 having brought forward an assessed loss of £ 268 000 from the preceding year.

Between 1 July 1958 to 31 December 1958 the company was dormant. However, on 1 January 1959, its controlling interest was acquired by five parties who were interested in other land-dealing companies, who intended to divert income from their other companies to the taxpayer company in order to make use of the accumulated loss.

The taxpayer's trading between 1 January to 30 June 1959 (i.e. after the change in shareholding) yielded income of approximately £ 5 640. For the year of assessment ended on 30 June 1959 the company disclosed this income and claimed to set off against it the accumulated loss brought forward from 1958.

The CIR was of the opinion that the income had been received as the direct result of a change in the shareholding in the company effected solely or mainly for the purpose of utilizing the assessed loss. Accordingly in terms of section 90(1)(b) of the Income Tax Act, No 31 of 1941 (section 103(2) of the current Act), disallowed the set-off claimed.

It was conceded on behalf of the taxpayer that the income had been received as a result of arrangements effected for the purpose of utilising the assessed loss to avoid liability for tax on that income, but it was claimed that while the balance of assessed loss could not be



utilised as a set-off against the income in question, the assessment should show that balance as available for set-off against future income.

After reviewing the SA Bazaars and the Louis Zinn cases, Beyers JA:

'According to both decisions subsection (3) envisages a continuity in setting off an assessed loss in every year succeeding the year in which it was originally incurred, so that in each succeeding year a balance can be struck to the satisfaction of the Secretary which can then be carried forward from year to year until it is exhausted; if, for any reason, the assessed loss cannot be so set off and balanced in any particular year, there is then no 'balance of assessed loss' for that year which (viewed from that year of assessment) can be carried forward to the succeeding year, or (viewed from the succeeding year of assessment) there is no 'balance of assessed loss which has been carried forward from the preceding year of assessment;' in other words, the essential continuity has been fatally interrupted. In the S.A. Bazaars case, supra, that interruption occurred through the taxpayer's ceasing to trade in a particular year. In the present case it has occurred through the operation of section 90(1)(b) which prohibited the balance of assessed loss from being set off against the only income received by the appellant, in respect of the only trading activities conducted by it, as will appear later. In other words, although the respective causes of interruption were different, the result under section 11(3) was the same in each case.'

Beyers JA, therefore, held the opinion that the balance of assessed loss failed to survive the 1959 tax year, and was correctly regarded by the SIR as not being available for set-off in future years.

### 3.6 The taxpayer *ipse dixit* with regard to the change in shareholding

Section 103(4) of the Act presumes that, until the taxpayer proves the contrary, the sole or main purpose for the change in shareholding was the utilisation of the assessed loss. Section 103(4) reads:

'Any decision of the Commissioner under subsection (1), (2) or (3) shall be subject to objection and appeal, and whenever in proceedings relating thereto it is proved that the transaction, operation, scheme, agreement or change in shareholding or members' interests or trustees or beneficiaries of the trust in question would result in the avoidance or the postponement of liability for payment of any tax, duty or levy imposed by this Act or any previous Income Tax Act or any other law administered by the Commissioner, or in the reduction of the amount thereof, it shall be presumed, until the contrary is proved—

- (a) ...
- (b) in the case of any such agreement or change in shareholding or members' interests or trustees or beneficiaries of such trust, that it has been entered into or effected solely or mainly for the purpose of utilizing the assessed loss, balance of assessed loss, capital loss or assessed capital loss in question in order to avoid or postpone such liability or to reduce the amount thereof.' (My underlining)

Ordinarily the facts, events and circumstances will indicate to the court whether or not the change in shareholding was solely or mainly motivated by the utilisation of the assessed loss. In other cases the testimony of the parties, if they can be relied upon, present the facts, events and circumstances.

In the Rhodesian case of ITC 1209 1974 R the court found that the sole shareholder was a reliable witness and relied on her evidence in handing down judgement. In this case the taxpayer company that carried on the business of farming. With the result of losses incurred, the company had ceased trading and had become dormant. At this point it had accumulated a substantial assessed loss. The returns of the company for income tax purposes were prepared by a trust company whose secretary was the public officer of the taxpayer.

During the year 1969 the public officer was approached by the owner of a hairdressing business (Miss N) who wished to transfer her business to a company and asked him to arrange for a company to be formed for that purpose.

The public officer advised that the purchase of the shares of a dormant company would be less expensive than the formation of a new company and the applicant, on being advised that her liability in respect of the company would be limited to the amount to be paid for the shares, purchased those of the taxpayer company.

The name of this company was then changed and on 1 April 1970 it commenced to trade as a hairdressing salon.

The taxpayer company's income tax returns for the year of assessment ended 31 March 1971 was prepared by the assistant manager of the same trust company. In the course of preparing them he advised Miss N that the company had an assessed loss which could be claimed as a set-off against the profits of that year.

The deduction of the assessed loss was accordingly claimed, but the claim was disallowed by the Commissioner of Taxes on the grounds that the shares in the company had been acquired solely or mainly for the purpose of taking advantage of the assessed loss for taxation purposes.

Mr Anderson, representing the COT, submitted that Miss N's evidence was unacceptable for a number of reasons. He urged that it was highly improbable that she, as an experienced and astute business woman, would not have known at the time of the purchase of the shares that the company had an assessed loss. He pointed also to the suspicious coincidence of the shares in the dormant company being available at the precise time that Miss N had expressed a wish to transfer her business to a company and he further criticized her for her inability to state precisely what sum the appellant company stood to gain as a result of the successful outcome of this appeal.

To this EJ Whitaker QC said:

'I have given consideration to these criticisms but, these notwithstanding, I am satisfied that Miss N was completely frank with the court. I base this conclusion upon her manner in giving evidence and also upon the corroborative evidence of the assistant manager, who said that her immediate response on being told of the assessed loss was to inquire whether she would be held responsible for it. I cannot find, as I was invited to do, that this response was simulated.'

While the public officer's evidence was riddled with inconsistencies EJ Whitaker QC said:

'Despite these criticisms, however, I accept this witness's evidence as to his knowledge and motives. His demeanour was good and I can think of no reason why he should, without any prospect of gain to himself or his firm and without the knowledge of Miss N, have devised the scheme. Nor can I think of any sound reason why he should now give false evidence.'

I am satisfied that the change in shareholding was not effected solely or mainly in pursuance of or in connection with a scheme for taking advantage of the assessed loss. The appeal is accordingly allowed and the appellant's assessment for the year ended 31 March 1971 must be altered accordingly.'

### 3.7 Conclusion

De Koker (2002:§19.17) submits that CSARS need not always rely on section 103(2) to attack a scheme of tax avoidance involving the use of the assessed loss of a company. In appropriate circumstances the CSARS may resort to section 103(1).

Broomberg and Kruger (1998:258) render the following advice in tax planning:

'[w]hen a planner is negotiating a contract that involves a change in shareholding in a company with an assessed loss, or an agreement concerning an assessed-loss company, an effort should be made to leave the target company in possession of some of its own assets which are capable of generating "untainted" income. This is an insurance policy: Because even if a successful attack under section 103(2) prevents the set-off of "new" income against the assessed loss, the assessed loss will be preserved by reason of the continued flow of untainted income; and this position can be maintained until the problems of section 103(2) are overcome; perhaps by the establishment of a brand new business, or in any other manner which does not involve a diversion of income to the company.'

## CHAPTER FOUR

### COMPANIES NOT TRADING

#### 4.1 Introduction

Section 20(1)(a) of the Act allows a person, in determining its taxable income, to set off any assessed loss carried forward from the preceding year of assessment. The opening lines of section 20(1) of the Act, specifically, direct that:

- the concession is available to persons 'carrying on a trade', and
- the assessed loss carried forward must be set off the 'income so derived'.

Section 20(1)(a) of the Act reads:

'For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall, subject to section 20A, be set off against the income so derived by such person—

- (a) any balance of assessed loss incurred by the taxpayer in any previous year which has been carried forward from the preceding year of assessment'.

From the above it can be gathered that a company after many years of poor trading and accumulating an assessed loss will lose its rights to carry forward and utilise of the benefits of the assessed loss, as soon as it ceases trading or suspends trading for the year.

## 4.2 Carrying on trade/trading

The term 'trade' is defined in section 1 of the Act:

"trade" includes every profession, trade, business, employment, calling, occupation or venture, including the letting of property and the use of or grant of permission to use any patent ... or any trade mark ... or any copyright ... or any other property which is of a similar nature'.

However, the courts were called upon, on a number of occasions, to decide whether a company has been 'trading' or 'carrying on a trade' during the year. Some of the more relevant issues before the courts were:

- To differentiate between a company maintaining its existence and trading
- Whether an unsuccessful effort in trading is trading
- Whether disposals by liquidators equate trading
- Whether the collection of outstanding debts is the carrying of a trade
- Whether the planning of a business venture is considered to be a trading activity

## 4.3 Company maintaining its existence

The case of *SA Bazaars (Pty)Ltd v CIR 1952 AD*, was amongst the pioneering cases on the issue, and it concerned section 11(3) of the Income Tax Act, No 31 of 1941 – a predecessor of section 20(1)(a) of the Act.

*SA Bazaars (Pty)Ltd* (the appellant company) traded as a general dealer. After a number of years of poor trading and accumulating a

loss of £ 7 623, on 16 November 1941, it closed down its business. Thereafter and up until the year ended 30 June, 1947, the company maintained its existence, continued its banking account, obtained a transfer of its trading licences to other premises and renewed them annually, paid its company tax and licence duty and complied with all the requirements of the Income Tax and Companies Acts. However, it did not carry on any ordinary trading operations.

For the years ending on 30 June 1944 and 1945, respectively, the Receiver of Revenue (Durban), permitted the company to carry forward the assessed loss by issuing assessments that reflected 'Loss brought forward £ 7 623.' No assessments were issue for 1946 and 1947.

During the year ended 30 June 1948 the company resumed active business operations and, in addition, acted as agent to insurance companies, earning a profit. The CIR, in determining the company's taxable income, did not allow the balance of assessed loss to be set off against the 1948 income of £ 280 10s. 11d. The CIR proceeded and withdrew the 1944 and 1945 assessments, and issued nil assessments for the 1944 to 1947 years of assessments.

An objection was lodged on the grounds 'that there should, in every year, have been carried forward from the preceding year of assessment the balance of assessed loss incurred by the appellant company in previous years, i.e. in the tax year ended 30 June, 1944, there should have been allowed the deduction of £ 7,623 and that a similar process should have been followed in the tax years ended 30 June, 1945 to 1947, inclusive'.

Centlivres CJ, in delivering judgement, deemed it fit to first, decided whether the company was entitled to carry forward the assessed of £ 7 623 into the year ending on 30 June 1944. This was so because;



if the company was not entitled to carry the loss into the 1944 it would not be entitled to the loss in the subsequent years.

The judge said that the mere fact that the company kept itself alive it did not mean that the company was carrying on a trade during those periods. The facts of the case clearly showed that it closed down its business. As long as it kept its business closed it cannot be said to have been carrying on a trade, even though it may have held the intention to resume its trading activities at a future date.

The judge found that, during the 1944 year, the appellant did not carry on any trade, and therefore not entitled to carry the 1943 assessed loss into the 1944 year. The company was therefore not entitled to carry the loss into the subsequent years, and could not to be set off against the 1948 income.

Following the decision of the SA Bazaar case the Act was amended to allow persons other companies to carry the loss forward even though no trade was carried out.

#### **4.4 Unsuccessful efforts in trading**

In ITC 777 1953 T the company (the appellant) was registered in 1941. During the years ended 30 June 1942 and 1943 it carried on a manufacturing business. As the business was not successful, during the 1944 tax year the manufacturing business was discontinued, after incurring losses. The name of the company was changed, and certain fixed properties and shares were acquired as income-producing investments.

For the year-ended 30 June 1947, the company had incurred an assessed loss, determined by CIR of £ 1 616. During the year-ended 30 June 1948, the company earned dividends. In addition certain of its shareholdings were sold, yielding a profit on the total. Also, during

the 1948 year, the company held fixed property from which no rentals were derived although endeavours to let the property were made.

In assessing the company for the 30 June 1948 year of assessment the CIR did not allow the assessed loss of 1947 to be carried forward and set off against the 1948 income. The CIR held the opinion that the company had not carried on trade during that year of assessment.

Nesser J considered the following to arrive at his decision:

- If a person did not carry on a trade during the year it was not entitled to set off in its income tax return for that year the balance of assessed loss incurred by it in any previous year – SA Bazaars case.
- While the company sold shares during the year, it was not a dealer in shares. Therefore this could not be construed as carrying on a trade.
- The mere investing of money is not carrying on a trade.
- A mere intention to let out property would not amount to the carrying on of a trade. But there need not be an actual letting for there to constitute a carrying on a trade. The company did endeavour to let the property via associated companies.
- "Because in the middle of a great career a company, or still more an individual professional man, might have a year when he was holding himself out for business, or the company was holding itself out for business, but nothing came, yet that would not effect a break in the life of the company for income tax purposes."
- 'The extent of the effort or the amount of money expended cannot, however, be the test whether a company or person was trying to

get business. It is sufficient if there was some attempt, even if no money was expended.'

Considering the above Nesser J found that the company had endeavoured to let out the property and was of the opinion that it did carry on a trade during 1948.

As it was not an issue of contention that the appellant would have been entitled to set off that balance merely because it earned no income. Nesser J therefore found it not necessary to decide in this regard.

#### **4.5 Disposals by Liquidators**

In the case of Robin Consolidated Industries Ltd vs CIR1997 AD, the court was called upon to decide whether two sales transaction held during the year constituted the carrying on of a trade. The court was, further, asked to review the validity of precedent set by the SA Bazaars case *supra*. The overturning of this decision would allow Robin to carry forward its assessed loss to later years even though it neither traded nor earned an income from trade during the 1988 year.

The appellant (Robin) was a manufacturer, wholesaler and retailer of stationery and associated products operating shops throughout the country through subsidiary companies.

As it was running at a loss and had become insolvent, on 16 September 1986 Robin placed in provisional liquidation. The liquidators powers included that of carrying on business in so far as it might be necessary for beneficial winding up in terms of s 386(4)(f) of the Companies Act 61 of 1973.

The creditors considered it most beneficial to sell the business as a going concern. Therefore, the liquidators continued to trade as before

from the date of liquidation, 16 September 1986 to 30 September 1986 (1987 tax year) which was the day before the effective date of the sale of the business. This trading realised sales of R168 897,95 and they were later reflected in the liquidation accounts as 'trading income' under the main heading 'Realisations'.

The sale of the going concern included all assets except stock in transit and in bonded warehouse. The creditors did not wish appellant to continue trading after the sale of the business on 3 October 1986 because of the losses anticipated on the continued trading.

Between 1 October 1986 and 15 March 1988, the remaining bonded stock was sold in bulk to two companies. The buyers had to pay all imposts and charges necessary to have the goods cleared from bond. The proceeds of the sales of R6 000 and R3 000 were described, in the liquidation account these amounts, as 'sale of shipments' under the main heading 'Realisations'.

The sales of these stock, the appellant contended, constituted 'trading' during the 1988 year of assessment as it was 'in the normal course of trading for a liquidator' to sell off stock in bulk.

The CIR contended that appellant had not carried on trade during the 1988 year of assessment and, therefore, not be able to set-off assessed losses accumulated prior to the 1988 year of assessment against the income of succeeding years.

It was contended on behalf of Robin that the sales in question were effected in the course of their trading activities.

It was further contended that the Appellate Division in all of its prior decisions that, per section 20(1), if there is no income or loss from trading in a given year the machinery for setting off an assessed loss

cannot operate, with the result that the assessed loss disappears, was wrong and should not be followed.

In answering the question of 'Did Robin carry on trade in the 1988 year?', Schutz JA accepted the wideness of the definition of the word 'trade' in s 1 of the Act and the consequent recognition by the courts. He also accepted that it is possible for even a single transaction to constitute trade, and further yet, it is possible in special circumstances for sales at a loss to constitute trading.

In considering the circumstances of the case Schutz JA said:

'The creditors had decided to bring an end to trading as soon as this could be advantageously done. They accepted an offer to purchase from which was excluded the stock in bond, which would cost money to reduce into possession. Thereafter no new trading venture was commenced – certainly no trading venture in any ordinary sense. A decision was taken by the creditors' representatives, the liquidators, not to incur any expense in order to take delivery of the stock in bond. There was a reason for that. It might lead to a loss. There was no venture into trading in the ordinary way – by the acquisition and holding of stock in the hope of reselling it at a profit – whilst accepting the risk of loss. On the contrary, the stock in bond was kept at a distance, and the opportunity was offered to others to make a profit and risk a loss... positive steps were taken to see that Robin did not receive stocks already destined for it... The disposal of the stock in bond was, it seems to me, designed to allow others to trade in that stock and release Robin from the risks entailed in doing so itself.'

Evidence was given that 'it is in the normal course of trading for a liquidator to sell off assets in bulk.' Schutz JA disagreed and said that this would be 'equating trade and realisation, which are normally viewed as different, sometimes even opposed concepts.'

He therefore concluded that the court *a quo* was correct, that the two sales transactions did not constitute the carrying on of trade.

#### **4.6 Collection of outstanding debts**

Whether the collection of outstanding debtors constitute the carrying on of trade cannot be answered by a 'yes or no'. The collection of debts by a collection agency or similar business can with very little argument be classified as 'carrying on a trade'. This is not so clear in the case of a person, who is not in the debt collection of business. The facts of the case and taxpayers activities were found to be the deciding factors:

##### **4.6.1 Timberfellers (Pty) Ltd vs CIR 1994 NP**

Here, the appellant (the taxpayer) was, at the relevant time, a wholly-owned subsidiary of Sharon Air (Pty) Ltd, all the shares in which were owned by Mr MB McCarthy.

The taxpayer had traded for many years in the supply of specialised equipment to harvest timber which it then sold in terms of franchise agreements with the overseas manufacturers. It also sold certain specialised sugar milling equipment under franchise.

During 1982 the taxpayer ran into financial difficulties. On 20 September 1982 it was placed in provisional liquidation which was then made final. On 5 October 1983 an offer of compromise in terms of s 311 of the Companies Act 61 of 1973, made by Mr McCarthy through a company which had been utilised as a vehicle for that purpose, was sanctioned and taxpayer was discharged from liquidation.

In the process the taxpayer had lost all its franchises and was left with very little stock and equipment. It also retained no staff.

The significant items on the balance sheet were the pre-liquidation debtors (asset) and a loan account with Sharon Air (liability).

Since the liquidation and up until its sale the company was involved in the collection of the outstanding debts. The proceeds of which were used to settle the loan with Sharon Air.

The taxpayer claimed a set off, of the 1983 assessed loss carried forward of R2 336 568, against the income of the 1984 year of assessment. This was disallowed by the CIR, as he did not consider the company to have traded.

The Special Court found that the collection of debts in the case of the taxpayer did not constitute 'carrying on a trade'

Counsel for the taxpayer submitted that the court *a quo* had erred in attaching any significance to the fact that such collection had been carried out, not by an employee of the appellant itself, but through the agency of a firm of attorneys and through its accountants. He further contended that the evidence revealed that McCarthy himself had collected some of the debts.

Mr McCarthy made vague allegation of activities during the period that could amount to trading. These activities included the attempt to obtain a new franchise and the servicing of equipment previously sold. However no satisfactory proof of this was presented. Page JA:

'In my view, the contention that a party may carry on trade within the meaning of the section through the agency of another is well-founded. There is nothing in the section to warrant a limitation of its ambit to trade carried on by the taxpayer personally or to exclude the operation of the ordinary rule that *qui facit per alium facit per se*. If the collection of debts which took place through the agency of others does amount to carrying

on a trade, I am of the view that their actions should be regarded as those of the appellant for purposes of the section.

The crucial question is whether those actions constitute carrying on a trade.'

Referring to *Merchant vs COT 1945 SR*, where it was stressed that this enquiry was one of fact and depended on the circumstances of each case, Page JA:

"Tredgold J said: .... 'The collection of outstanding debts may be, but is not necessarily, an operation in the carrying on of a trade. It is not difficult to envisage circumstances which would establish beyond doubt that the collection of outstanding debts was related to a defunct business and was simply the making available as capital of monies earned prior to the cessation of the business.'"

Page JA concluded that the taxpayer had not carried out trade during the period in question.

'The collection of the outstanding debts of the appellant was undertaken with one purpose and one purpose only: to enable Mr McCarthy to recover insofar as he could the amounts to which he was entitled through the loan account of Sharon Air(Pty) Ltd. Whilst Mr McLean had advised Mr McCarthy of the necessity for continuing to trade to keep the assessed loss alive, he was admittedly under the mistaken impression that the collection of debts in itself constituted trading, no matter for what purpose it was undertaken, and this advice clearly dictated McCarthy's approach. Not one cent of the money collected was utilised or made available for any trading activity on the part of the applicant, and its collection was clearly not intended to further any such activity. It was, to use the words employed in



the Merchant case, *supra*, simply the making available as capital of the monies earned prior to the placing of the company in liquidation, before disposing of it to a third party.'

#### 4.6.2 ITC 1751 2002 C

In this case the taxpayer was a company in liquidation. Prior to liquidation it conducted the business of business investment, trust management and property development but the essence of its trade was as a moneylender, by borrowing and lending to persons engaged in speculative ventures. From this, interest income was earned.

When the liquidators assumed control they did not obtain any further loans of money, nor did they make fresh advances of money (save in exceptional circumstances) but collected money from borrowers and repaid the lenders

The CSARS disallowed the pre-liquidation assessed loss of R16 435 111 to be carried forward into the liquidation and distribution accounts prepared by the liquidators.

CSARS contended that the taxpayer had not carried on trading post liquidation as required by s 20(1)(a) and consequently the assessed loss could not be carried forward. The CSARS held the view that:

- The taxpayer had ceased trading on the day which the last property had been sold by the liquidators, i.e. October 1994.
- From the 1996 year of assessment, the taxpayer did not carry on trade but merely earned interest.

Taxpayer contended that:

- In its hands money was its stock-in-trade in that it was a moneylender and that the money was its stock-in-trade or circulating capital no less after liquidation than it had been before liquidation.
- What the liquidators did by way of collecting money owed to taxpayer, a moneylender, constituted the carrying on of a trade as contemplated in s 20(1)(a), and was, therefore, entitled to set off its balance of assessed loss against its post-liquidation income.

It was decided that the collection of outstanding debts, the advancing of loans, and repayment of loans, in the case of a moneylender, does constitute trade. Davis J:

'It had employed capital to make loans and thus its capital was of a circulating nature; that is trading-stock. For almost a decade after liquidation it had continued to employ its circulating capital accordingly. The liquidators were required to allow the circulating capital to be used accordingly and as the management of the appellant had done previously, namely, manage the process by way of collecting the repayment of interest and return of capital.

In my view, appellant was in a similar position to a trader who decides to close his business at a particular point, not acquire further stock but trade until its existing stock was sold. In these circumstances the appellant had for a decade continued to trade as it continued to conduct its business.'

#### 4.7 The planning of a business venture

The case of CSARS vs Contour Engineering (Pty)Ltd 1999 ECD required the court to decide on whether the laying of plans for business and the incurring of auditors remuneration, telephone and travel expenses constituted the carrying of a trade.

Here the taxpayer company had conducted business as a steel construction company. After running into serious financial difficulty and accumulating an assessed loss of some R813 364, the company was placed into provisional liquidation on 2 September 1987 and then final liquidation on 19 November 1987.

After the provisional liquidation the business was acquired, as a going concern, by Contour Engineering (SA) (Pty)Ltd. All of the taxpayer's business assets and premises were sold. The transaction was facilitated by a Venter and Engele.

After further negotiation Venter and Cohen acquired all shares in the taxpayer and, in terms of s 311 of the Companies Act 61 of 1973, made a compromise offer to its creditors. This discharged the liquidation order on 14 December 1988.

The taxpayer claimed an assessed loss of R818 434, in its tax return for the year ending 31 December 1988. The CSARS disallowed the assessed loss brought forward from 1987 had been disallowed, relying on sections 20(1), 103(1) and 103(2).

Cohen, being the only witness at the hearing, testified that after the taxpayer had been discharged from liquidation it had started to collect from its outstanding debtors and this required certain attention to maintenance work and structural faults in contracts which had previously been performed by the taxpayer.

He claimed that since being discharged from liquidation, the taxpayer sold engineering equipment for commission. Cohen claimed that Venter had attended to this side of the business and had gone out and concluded some deals on behalf of the taxpayer even before 14 December 1988 and that he had continued with such sales after 14 December.

The Special Court, on the basis of Cohen's evidence, was of the view that Venter's activities constituted trading and that Venter had actually earned commission on behalf of the taxpayer.

'Even prior to 14 December 1988, Cohen and Venter had laid plans for the company's venture. Venter before that date in fact commenced canvassing potential clients. The final papers reflect that during the period in question the company incurred expenses in regard to Venter's activities, as well as general expenses relating to the servicing of the company's overdraft and the payment of auditor's fees. In my view, these activities constituted trading as contemplated in the proposition accepted by the learned judge of appeal *supra*.

What is more, Venter actually earned commission on behalf of the appellant. This was admittedly a single transaction. The question whether it amounted to trading must be viewed in the context of appellant's activities, as well as its plans and prospects at that stage. The commission it seems was earned as part of the ongoing business activity of the appellant, which – on the evidence – continued profitably into the subsequent years. The earning of the commission was therefore not a single isolated act, but part of appellant's commercial venture amounting to trading.'

In deciding on whether the taxpayer's activities did constitute the carrying on of a trade Eksteen JA said:

'It is clearly correct that a venture must be viewed as a whole and that it may straddle more than one tax year. There is, however, a vast difference between the mere laying of plans for the respondent's future, on the one hand, and the commencement of preparatory activities for a future venture, on the other, as was contemplated in the afore going passage from Robin's case. At least some activity is required. In my view the mere laying of plans cannot constitute the carrying on of a trade as envisaged in s 1 of the Act in the absence of some positive act aimed at promoting the said plans.'

He proceeded to the incurring of auditors remuneration and found that it is not indicative of trading, as the mere existence of a company, whether trading or dormant, requires an audit to be carried out each year.

The interest paid was found to be attributable to the overdraft that had arisen during the liquidation process, and not incurred in the pursuance of any trading activities.

#### **4.8 The recommencement of trade and the assessed loss**

In the alternate, it was argued in the Robin case (*supra*), that Robin was entitled to carry forward its assessed loss to later years even though it neither traded nor earned an income from trade during the 1988 year.

Schutz JA said 'This argument entails a frontal assault' on the rule in SA Bazaars ruling. Referring to Beyers JA in *New Urban Properties Ltd v SIR* 1966(1) SA 217(A):

'the section 'envisages a continuity in setting off an assessed loss in every year succeeding the year in which it was originally incurred, so that in each succeeding year a balance can be struck to the satisfaction of the secretary which can then be carried forward from year to year until it is exhausted; if, for any reason, the assessed loss cannot be so set off and balanced in any particular year, there is then no 'balance of assessed loss' for that year which (viewed from that year of assessment) can be carried forward to the succeeding year, or (viewed from the succeeding year of assessment) there is no 'balance of assessed loss which has been carried forward from the preceding year of assessment'; in other words, the essential continuity has been fatally interrupted.'

Beyers JA makes it clear from the above that a balance can be carried forward from any year only if a balance has been struck in that year, which clearly means only if an assessment has been issued for that year reflecting the balance of assessed loss at the end of it.

Schutz JA did not agree With Robin's argument that there is nothing in the language which suggests that a new balance has to be struck every year and there is no exclusion of the same balance simply being carried forward from year to year.

He sharply differentiated between the generality of the words 'incurred by the taxpayer in any previous year' (phrase one) from the phrase 'which has been carried forward from the preceding year of assessment' (phrase two). He added that phrase one refers to all previous years, while phrase two is limited to a particular year, and that year is the preceding one, which clearly means the one immediately preceding.

Schutz JA:

'For any balance to have been brought forward from that year it must have been assessed for that year, as only assessed losses can be carried forward. Accordingly it seems indeed to be necessary to the operation of s 20(1) that a new balance be struck in that year.'

#### 4.9 **The business of an investment company**

In ITC 770 1953 T Dowling J referring to the definition (at the time) of trade said:

'A business of investment in shares in companies is a well-established occupation in the business world and in my opinion it falls under if not some of the words 'trade', 'business', 'occupation' or 'venture' used in the definition of 'trade', which is obviously intended to embrace every profitable activity and which I think should be given the widest possible interpretation.'

However, in the recent case of CSARS v MEGS Investments (Pty) Ltd and Another 2004 SCA, the court was required to determine whether the taxpayers continued to trade as investment companies, by earning interest on investments.

Both taxpayers were affiliated to the same group. They conducted business from the same premises with the same staff. The only difference was that one concentrated its business on retail outlets while the other on wholesale outlets. This business involved the arrangement and management of discounts for a chain of retail and wholesale grocery outlets trading as "Sentra Stores", "Megasave", "Value Stores", "Till Late", "Pop 2000" and "Retail Management Group".

The discount was obtained by the use of the combined buying power of the taxpayers members. The taxpayers did not handle any stock. Their members ordered directly from suppliers, and these stocks were directly delivered to the respective members. However, the taxpayers, on behalf of their members, settle the accounts with the suppliers. These payments were then recovered from the members.

The taxpayers' income/profit was the difference between the discounts secured from the suppliers and the discounts passed on to their members.

On January 1996 both taxpayers sold their entire business as a going concern to Shoprite Checkers (Pty)Ltd for the price of R 21 000 000. The contract of sale required the taxpayers, during the transition period, to make payments to the suppliers and collect payments from members on behalf of Shoprite Checkers. However, during 1996 the taxpayers did not carry on their normal trading activity of recovering portion of the discount on their own account.

The taxpayers did, however, receive, during 1966, interest on the selling price of R 21 000 000 while it was being held in trust. They also received interest on the investment of a portion of the selling price (R 6 000 000) placed with ABSA.

R 6 000 000 was distributed as a dividend.

R 9 000 000 was invested interest free in three Namibian companies. This investment was made with the view to the possible development of a similar chain store organisation in Angola and other countries to the north. Both taxpayers carried out various activities during the year which were directed at exploring this objective.

While considerable time, money and effort were expended by the directors, no contracts were concluded, no organisation was



established, no trading activity carried out, and no income was earned.

While the taxpayers earned profits during 1995, it had accumulated a large assessed loss from the previous years. There remained a balance of assessed loss which they sought to carry forward and set off against their interest income earned in 1996.

The CSARS disallowed this set off; as he contended that the taxpayers did not carry out a trade nor earned any income from it. He further contended that the taxpayers failed to prove that they had carried out a trading activity, and that their activities amounted to nothing more than acts in preparation for trading at some time in the future.

The Special Court found that the taxpayers' endeavours to set up a business in Angola along the lines of the business previously carried out by them in the Republic did amount to carrying on a trade within the meaning of the wide definition of trade given in the Act.

One of two requirements laid out, by the Robin Consolidated and the SA Bazaars cases (*supra*), for the setting off a balance of assessed loss is that the company must have traded during the year in question.

Counsel of the taxpayers did not attempt to relate the taxpayers' activities aimed at developing the new business to the interest income. He did, however, argue that the necessary connection between income and carrying on at traded is present when regard is had to the wide definition given to the term 'trade' in the Act. It was submitted on behalf of the taxpayers that they had carried out the trade of an investment company by investing the proceeds on the sale of businesses and deriving interest there from.

Jones AJA: 'This argument cannot be sustained'. He could not accept that the taxpayers had conducted the trade of an investment company for the following reasons:

- The taxpayers earned investment income in the past years, and that they did so during the year in question does not, without more, show that they carried on the business of an investment company.
- It is settled that under ordinary circumstances income in the form of interest on an investment is not income derived from carrying on a trade within the meaning of the Act.
- It was not the taxpayers' case that they conducted the trade of an investment company. On the contrary, evidence was led that they intended to carry on a similar trade as they previously did.
- They made interest free investments, of R 9 000 000, in the Namibian companies. This is very unlike an investment company.
- The investment of the R 6 000 000 in ABSA was at a lower rate than would otherwise be achieved by an investment company. The funds were placed with ABSA to permit easy access when needed for the development of the new business.
- No sound reason was advanced for the taxpayers for the taxpayers using the proceeds on the sale of a going concern to carry out a trade of an investment company.

Jones AJA, therefore, found that the taxpayers have not shown that section 20(1) permits the set off of their assessed loss brought forward from the previous year.

#### 4.10 Onus of proof

Section 82 places, on the taxpayer, the burden of proving that trading activities did take place during the relevant period. Section 82 reads:

'The burden of proof that any amount is–

(a) ....

(b) Subject to any ... set-off ...

(c) ....

shall be upon such person claiming such .... or set-off, or ....and upon the hearing of any appeal from any decision of the Commissioner, the decision shall not be reversed or altered unless it is shown by the appellant that the decision is wrong.'

The more important issue to be taken from the Contour case is the courts decision of whether the taxpayer had adequately proven its claim – that it did trade during the year.

Regarding the evidence supporting the taxpayer's claim that it did trade during the year, Eksteen JA, in the Supreme Court of Appeal, found Cohen's testimony was riddled with contradictions:

- The first supporting document purported to be a resolution, passed on 15 December 1988, by the members of SA Pneumatic) (Cape) CC, appointing the taxpayer as a sales agent. While Venter was a member of the CC Cohen was not. There was no evidence of the authenticity of the resolution.
- The second document purported to be an invoice to SA Pneumatic for commission earned by the taxpayer. This document too was not authenticated. The amount per the invoice of R17 291 was the entire turnover per the taxpayer's financial statements.

- This cast doubt on the previous evidence of Cohen. This contradicted Cohen's previous testimony that the taxpayer sold on behalf of various suppliers.
- The resolution was taken on 15 December 1988. This contradicted Cohen's evidence that that some deals were in fact concluded before 14 December 1988.
- These considerations coupled with Cohen's inability to identify any purchasers of equipment render the reliability of Cohen's evidence to be questionable.
- The third document alleged to be a working paper of the auditors of the taxpayer. This too was not authenticated.
- Finally, the Cohen's evidence regarding the incurring of travel and telephone expenses was vague and speculative.

Eksteen JA in holding that the taxpayer had not proved the presence of business activities and the earning of commission, said that Venter, was available to testify, and would have assisted in clarifying the inconsistencies as he was involved in the sales. He, further, had knowledge of SA Pneumatics and would be able to verify the payment of commission and authenticate the resolution passed.

#### 4.11 **Conclusion**

According to Silke (1997:84) the critical lessons to be learnt from the above is that the liquidators, creditors and others must be careful to continue trading in order to keep the assessed loss alive. The realisation of assets (including stock), by the liquidators do not constitute the carrying on a trade. In addition the collection of debts,

simply to make available capital earned before being placed into liquidation, also do not constitute trading.

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## CHAPTER FIVE

### ASSESSED LOSSES AND THE WAIVER OF A DEBT

#### 5.1 Introduction

Companies with assessed losses more often have these losses to their credit because of poor trading and rather than from special tax allowances granted to them. After a number of years of poor trading, accumulating losses and accumulating assessed losses the company may find it self unable to settle its creditors in full. The creditors may find it more attractive to accept an arrangement whereby an amount less than their claims is received instead of placing the company in liquidation.

Where a company's debts are forgiven, in terms of section 20(1)(a)(ii) the accumulated assessed loss must accordingly be reduced. Section 8(4)(m) may, also, may be invoked in transactions of this type. However, section 8(4)(m) is not the focus of the report, and little else would be discussed on this section.

Section 20(1)(a)(ii) of the Act:

'the balance of assessed loss shall be reduced by the amount or value of any benefit received by or accruing to a person resulting from a concession granted by or a compromise made with his creditors whereby his liabilities to them have been reduced or extinguished, provided such liabilities arose in the ordinary course of trade'

In essence, this provision requires, where a taxpayer is released from liability without settling the liability must have a corresponding reduction in its assessed loss. In practice this simplistic explanation is not anywhere near sufficient.

The courts were called upon, on a number of occasions, to answer:

- Which balance must be reduced?
- Has any benefit been received or accrued?
- The basis of valuation of the benefit?
- Which creditors?
- What constitutes a concession or compromise?

## 5.2 Which balance of assessed loss must be reduced

Is it the opening or closing balance of the assessed loss that must be reduced? In some cases it makes no difference while in others it may have a significant impact. The example below illustrates this.

**Table 5.1 – Z (Pty)Ltd has the following:**

	R(m)
Assessed loss at 31/12/2002	75
Income (taxable) for the 2003 year	90
Compromise with creditors during 2003	35

What is the taxable income for 2003 or assessed loss to be carried to 2004?

Approach A – reduces the opening balance of the assessed loss:

**Table 5.2 - Opening balance of the assessed loss is reduced**

	R(m)	R(m)
Income for the 2003 year		90
Assessed loss b/f	- 75	
Compromise with creditors during 2003	35	- 40
Taxable income for the year – 2003		50

Approach B – reduces the closing balance of the assessed loss:

**Table 5.3 – Closing balance of the assessed loss is reduced**

	R(m)	R(m)
Income for the 2003 year		90
Assessed loss b/f		- 75
		15
Compromise with creditors during 2003		0
Taxable income for the year – 2003		15

In Approach B there is no assessed loss to reduce. Note that the effect of section 8(4)(m) was not taken into account in this example.

So, which is the correct approach?

This question was answered in CIR v Louis Zinn Organisation (Pty)Ltd 1958 AD.

During the year ended 30 June 1954 the taxpayer made trading loss of £ 105 401. Its liabilities from trading at the end of the year amounted to £ 133 936 (inclusive of balances from prior years). Due to financial difficulties a compromise agreement was reached with the creditors. This reduced the liabilities by £ 93 755, and was disclosed in the balance sheet as:

'Gain on compromise with creditors - £ 93 755'

In the assessment for 1954 the CIR reduced the company's assessed loss of £ 105 401 by £ 93 755 to £ 11 646. The CIR relied on section 11(3)(a), the equivalent of today's section 20(1)(a). In the alternate the CIR relied on section 11(4)(a)(5), the equivalent of today's section 8(4)(a), as he claimed it to be a recoupment deductions previously allowed.



The taxpayer contended:

'[t]hat as the loss incurred of £105 401 was not a balance of assessed loss carried forward from a previous year of assessment the provisions of section 11(3)(a)(ii) of the Income Tax Act had no application inasmuch as they did not provide for a reduction of a loss in the current year of assessment in respect of a benefit by compromise accruing in that year of assessment'.

In dismissing the taxpayer's contention Schreiner ACJ:

'Whenever there has been a trading loss in the tax year, or where there has been a balance of assessed loss brought loss forward from the previous year, there has to be a determination of the balance of assessed loss to be carried forward into the next year. There may have been a profit in the tax year but not large enough to obliterate the balance of assessed loss carried over from the previous year. Then the new balance of assessed loss will be smaller than the previous one. If there has been a working loss in the tax year the balance of assessed loss to go forward will be increased. If there has been no previous balance the assessed loss in the tax year will be the balance of assessed loss carried forward. The point to keep in mind is that, although at the stage where it is to be used, i.e. when it is to be set off against a profit, a balance of assessed loss looks back to the past, at the stage where it is being determined, i.e. when the amount is being calculated, it looks forward to the future when it will be used. ...

If there was a profit in that year large enough to wipe out the whole £ 105 401, the whole £ 93 755 would, so for as section 11(3)(a)(ii) is concerned, disappear from the calculations, since it would not be needed; there would be no balance to be carried forward into the year ending 30<sup>th</sup> June 1956, for it to reduce.

But if there were an assessed loss in the year ending 30<sup>th</sup> June 1955, or a profit of not less than £ 105 401, the £ 93 755 would operate to reduce or extinguish the balance of assessed loss to be carried forward into the year ending 30<sup>th</sup> June 1956.'

De Koker (2002:§8.129) summaries:

'The court held that the value of a compromise benefit received in one year must go to reduce any balance of assessed loss incurred at the end of that year. It must not reduce the balance of loss incurred at the end of the preceding year that is carried forward to the year in which the compromise benefit is enjoyed.'

### **5.3 A compromise for equity in the company**

Where the creditors waive their claims, and in lieu accept something else these question may not quite easily be established if the provisions of section 20(1)(a) are applicable.

In CIR v Datakor Engineering (Pty)Ltd 1998 AD, the facts of the case were very unlike the simplistic norm. In terms of a scheme of arrangement, per section 311 of the Companies Act 61 of 1973, the taxpayer was discharged from liquidation. Further, in terms of the arrangement, taxpayer company had capitalised its debt by issuing its creditors with redeemable preference shares with a par value of 1c at a premium of 99c, in lieu of the creditors claims of R 18 997 499. This gave rise to Share Premium of R 18 807 524, with debts to the amount of R 18 997 499 being extinguished.

The court was asked to decide whether:

- Any benefit been received by or accrued the taxpayer?
- If so, was it the result of a concession granted by or a compromise made by the creditors?
- Has the amount or value of the benefit been established?

### 5.3.1 **Has any benefit been received or accrued to**

Wunsh P, in the court *a quo* (i.e. ITC 1613 1996 T), held that in a scheme whereby a debtor company is protected from the rights of its creditors as to allow its continued existence, whether by means of a subordination agreement or capitalisation of debts, is a benefit to the debtor company. This has the effect of saving the company from liquidation, as its creditor is replaced with a shareholder, and the holder of redeemable preference shares cannot claim for repayment when payment falls due.

The views of Wunsh P were found to be similar to that of *RDJ Schemes of Arrangements – A New Development* (1989) 28 *Income Tax Reporter*, who argued that the effect of a scheme is to rid a company of its creditors, and the fact that the ownership of the company has changed does not detract from the fact that the creditors claims do not exist in any form.

Wunsh P, referring to Prof Blackman in 4(1) *LAWSA* paragraph 103 (reissue):

'There is nothing .... which obliges the company to redeem, or which prohibits an agreement not to exercise the right of redemption, unless, possibly, where the effect of the agreement is to deprive the shares concerned of their character of

redeemable preference shares, example by providing that they are under no circumstances to be redeemed.'

Harms JA agreed with the court *a quo*, that a benefit was received:

- 'The Act is not concerned with the benefit received by the creditor, but with benefit received by the debtor.'
- The words 'any benefit' has a 'wide and indeterminate' meaning.
- The benefit mentioned in the Act is to be found in the reduction or extinction of the company's debts
- The company had received a benefit when its creditors accepted nebulous 'right' of redemption of redeemable preference shares, in exchange for the waiver of their exigible claims.

### **5.3.2 Did the benefit arise from a concession granted by or a compromise made with its creditor**

The court *a quo* found that the benefit did arise from a concession, if not a compromise. Its finding was based on the fact that the creditors had surrendered their rights to the proposer (Datakor Ltd) for no consideration, had in effect received something less than the face value of their claims.

Harms JA, pointed out the error in this reasoning. He said that the section is not concerned with the relationship between the creditor and a third party. The relationship with a third party is irrelevant. The concession granted to the taxpayer by the creditors needs to be established. He, however, accepted that there was a concession.

Harms JA

'The mere substitution of a creditor's claim with a share even a redeemable preference share, amounts to a concession. An enforceable obligation is replaced with something of a

completely different nature. In this case of debts, all assets of the company are available to satisfy the claims of the creditors whereas,

in the case of redeemable preference shares, only profits available for dividends or the proceeds of a fresh issue of shares may be used to redeem the shares (s 98(1) of the Companies Act 61 of 1973). The right to redeem vests in the company and the creditor cannot enforce a 'right' to redemption.'

### 5.3.3 Can the value or amount of the benefit be quantified

In the case of a creditor forgoing a claim the amount abandoned is the amount of the benefit, to the debtor. But where the creditor accepts equity in the debtor instead, the value of the benefit to the debtor is not immediately apparent. For the application of section 20(1)(a)(ii) the benefit received must have a value or amount. To be an amount the benefit must have an ascertainable money value (CIR v Butcher Bros (Pty)Ltd 1945 AD).

Harms JA found that the taxpayer's financial statements reflected the share premium arising from the issue of the preference shares, which was used to extinguish the liabilities. Harms JA, therefore, said that the amount was fixed and ascertained.

Wunsh P, in the court *a quo*:

'A benefit has worth in money to the extent that it compensates the recipient or save it from expenditure or can be realised for money. The problem in the present case is that there is no way in which one can quantify the benefit received by the appellant on these principles. *Silke on South African Income Tax*, relying on the *Butcher* case at p319,6(6) correctly, in my opinion, says in regard to gross income that the *onus* of proving that a ascertainable money value exists rests on the Commissioner ....

I consider that the same apply to the benefit or amount .... of s20(a)(ii).'

There are provisions in the Act, like paragraphs (e) and (i) of the *gross income* definition in section 1, section 8A(3) of the Act, that prescribe the formula in determining the amount of certain abstract benefits. But no such provisions that to determine that amount of the benefit of section 20(a)(ii) of the Act.

Wunsh P, in the court *a quo*, could not place a value on the benefit:

'It was a benefit not derived without cost, since the preference shares carry a dividend and have to be redeemed. I find it impossible, on what has been submitted to us, to quantify the benefits in monetary terms, the value of the benefit is not the face value or amount of the previously existing claims, having regard to the nature of redeemable preference share capital and other factors which require examination. In my opinion, without a prescribed formula or deeming provision in the Income Tax Act, it is not possible to ascribe a monetary value to the benefit'.

Failing to place a value on the benefit Wunsh P, in the Special Court, up held the appeal of the taxpayer.

In the Supreme Court of Appeal, Harms JA, pointed out that the objector 'shall be limited to the grounds stated in his notice of objection'. He further pointed out that the issue of the quantification of the amount of the value or benefit was never raised by the taxpayer. It was incorrect for Wunsh P to raise the issue himself. Harms JA, therefore, deemed it pointless to fully address this. As this was not an issue of the objection SARS's appeal was upheld.

#### 5.4 Which creditors

Do the word creditors mean the “whole body of creditors” or to “any portion of creditors”? This was originally asked in the Rhodesian case of *Blue Moon Investments v COT* 1966 RAD. It must be noted that the Rhodesian Act uses the words ‘any of his creditors’. The court found that the compromises made with a substantial portion of creditors constituted an arrangement with creditors.

In ITC 8533 1988 T, as discussed in *The Taxpayer* (1999:138-140), the taxpayer imported, from a group company, stock to the value of R 1 679 213. In order to improve the financial structure of the company, a group company (creditor) released the taxpayer from the indebtedness. The Commissioner reduced the taxpayers assessed loss by R 1 679 213. This adjustment was made in terms of section 8(4)(m), and in the alternate section 20(1)(a)(ii) of the Act.

The taxpayer contended that the provisions of section 20(1)(a)(ii) could not apply to a concession granted by a single creditor.

Melament J looked to section 6(b) of the Interpretation Act 33 of 1957 which provides, *inter alia*:

‘In every law unless the contrary appears word in the singular number include plural, and words in the plural number include singular.’

Melament J, then said that there was nothing in section 20(1)(a)(ii) of the Act to indicate that the plural used should not include singular. He found it contrary and illogical to allow a taxpayer with an assessed loss to retain the full benefit of the allowance after he has received a benefit conferred by a concession granted a single large creditor, but disallow the benefit should the same benefit emanate from the general body of creditors.

He went on to say if the Act meant the body of creditors reference to the Companies Act would have been made.

He, therefore, found that the concession granted by a single creditor fell within the ambit of s 20(1)(a)(ii).

Meyerowitz (2002:§12.141) disagrees with this decision, and contends that:

'The section refers to creditors and liabilities in the plural and while the Interpretation Act states that plural imports singular, it is always subject to the context. It is suggested that in the context of the section the plural does not include the singular. It is suggested that in the context of the section the plural does not include the singular and what the provision deals with is a general compromise or concession by creditors and not an arrangement with an individual creditor for release or reduction of a liability.'

## **5.5 Liabilities that arose in the ordinary course of trade**

For the application of the provision the liabilities in question must have arisen in the ordinary course of trade. Therefore 'ordinary course of trade' needs to be defined.

De Koker (2002:§8.129) submits that liabilities that arise in the ordinary course of trade are those that are incurred on the income or revenue account (e.g. purchase of merchandise), while those incurred on a capital account (e.g. the purchase of a plant and equipment) would not arise in the ordinary course of trade.



In the Rhodesian case of *A v COT*, 31 SATC 66 the taxpayer carried on the business of manufacturer of fruit juice and mineral waters borrowed a sum of £ 498 765 from a liquor company.

The funds were used to finance working capital. The creditor company later reduced the appellants liability by waiving the right to recover an amount of £ 387 804. The court was asked to decide if the liabilities arose in the ordinary course of trade or not.

The taxpayer contended that the liabilities did not arise in the ordinary course of trade as the loans were advanced because of the special relationship between the two companies.

Goldin J held the view that a liability incurred for the purpose of financing the usual income-producing activities of the taxpayer's trade arises in the ordinary course of trade. He further stated that each case will depend on its own facts and that the rigid application of the distinction between capital and revenue expenditure is not justified.

The judge found that the borrowing of the money and the purpose there of arose in the ordinary course of the appellants trade, and that the fact that the creditor was not in the business of money lending was irrelevant.

## **5.6 Subordination agreement**

Companies in financial distress have an alternative means to ameliorate its financial position. The creditors could be persuaded to enter into a subordination agreement, whereby they subordinate their claims in favour of future creditors until such time that the company's assets exceeds its liabilities, excluding those liabilities that were subordinated.

The effect of entering into a subordination agreement on a company's assessed loss has not been determined by the courts as yet. Some conflicting opinions have arisen.

#### 5.6.1 ***The Taxpayer***

*The Taxpayer* (1999:107) reflected the view that section 20(1)(a)(ii) cannot be invoked when a company enters into a subordination agreement – preserving the assessed loss. This view stemmed from following:

- That the nature of the claims and the quantum of their face value is not altered by the subordination; and
- That no quantifiable amount or benefit is received by or accrued to the company.

#### 5.6.2 **The views of a practising advocate**

After an analysis of the legal consequences of a subordination agreement Burt (2004), a practising advocate, holds the opinion that section 20(1)(a)(ii) can be invoked when a subordination agreement is entered into. His analysis:

##### 5.6.2.1 **Legal effect of a subordination agreement**

Burt K refers to *Ex parte De Villiers and Another NNO: In re Carbon Developments (Pty) Ltd (in liquidation) 1993 (1) SA 493*, where Goldstone JA outlined the legal effect of a subordination agreement:

'Save possibly in exceptional cases, the terms of a subordination agreement will have the following legal effect: the debt ... continues to exist ... but its enforceability is made subject to the fulfilment of a condition. Usually the condition is that the debt may be enforced by the creditor only if and when the value of

the debtor's assets exceeds his liabilities, excluding the subordinated debt ...

In the event of the insolvency of the debtor, [liquidation] would normally mean that the condition upon which the enforceability of the debt depends will have become incapable of fulfilment. The legal result of this would be that the debt dies a natural death ... The result would be that the erstwhile creditor would have no claim which could be proved in insolvency ... The debt would not normally survive [liquidation]' (My underling).

Notwithstanding the above dictum, Burt K submits that, a subordination agreement, save possibly in exceptional cases, is not an agreement in terms of which a person agrees not to enforce a right of action until the occurrence of an uncertain future event. That is, it is not *conditional pactum de non petendo*. He submits that a subordination agreement consists of three separate agreements:

- an obligatory agreement whereby the company's creditors and the company undertake to extinguish existing obligations by the substitution therefore of later (new) obligations (*novatio in specie*);
- an agreement setting forth the terms of the later (new) obligatory relationship; and
- a novating (or dispositive) agreement which actually effects the novation.

Burt, therefore, contends that a subordination agreement goes beyond merely modifying the terms of the obligation relationship existing between each of the company's creditors and the company. The existing obligations are, in terms of the subordination agreement, extinguished by the substitution of later (new) obligations.

In the event of the liquidation of the company, the creditors of the company, who have subordinated their claims in favour of future creditors, will have no claim against the company and will not be entitled to fall back upon the earlier obligations.

Accordingly, Burt goes on to disagree with the contention that:

- '[a] subordination of claims involves no change in the nature of the claims'. (Meyerowitz, Emslie and Davis (eds) *The Taxpayer* (1999) 48 at 107.)
- 'If the liability in respect of the expenditure [which has been incurred and which has resulted in an assessed loss in any previous tax year] remains intact, as in the case of subordination [of creditors' claims against the company], it would be ... illogical to disallow the carry forward and deductibility thereof.' (Getz and Jooste 'Section 311 of the Companies Act: Preserving the Assessed Loss' *Acta Juridica*, 1995, 56 at 71.)
- 'If the parties intended that the earlier obligations be superseded by later, conditional obligations, the earlier obligations will be extinguished regardless of the subsequent fulfilment or failure of the condition.' (My underlining)

#### 5.6.2.2 Subordination agreement - 'concession' or 'compromise'?

The words 'concession' and 'compromise' are not defined for the purposes of s 20(1). Burt reviewed the ordinary and grammatical meaning of the words:

- 'concession' means *inter alia* a 'thing that is conceded [that is surrendered or yielded]'. (The Concise English Dictionary, Oxford: OUP, 1999, sv 'concession'.)

- 'compromise' means *inter alia* an 'agreement reached by each side making concessions'. (The Concise English Dictionary (above), sv 'compromise'.)

Burt K referring to *Cachalia v Harberer & Co 1905 TS 458 at 462*:

'The ordinary and grammatical meaning of the word 'compromise' accords substantially with its meaning at law, namely an agreement whereby each party 'abated some of his previous demands [and] receded to some extent from the position formerly taken up". (My underlining)

In a subordination agreement only one party (the creditor) abates some of his previous demands. Therefore no compromise could have taken place. But by the surrendering or yielding of their immediate rights, the creditors do grant a concession.

#### 5.6.2.3 Extinction of existing claims against the company

Burt proceeds, on the assumption that, on entering into a subordination agreement, those creditors, who have subordinated their claims in favour of future creditors, would be regarded as having granted a 'concession' to the company, it follows that the proviso will find application only if those creditors' claims are either 'reduced' or 'extinguished' thereby.

He therefore holds the opinion that:

'the effect of entering into a subordination agreement will not be to reduce the creditors' (existing) claims, but rather to extinguish them by substituting them for later, conditional claims against the company, which bear the same face value as the erstwhile claims.'

#### 5.6.2.4 Application s20(1)(a)(ii)

Should Burt K be correct in his analysis, s20(1)(a)(ii) will be applicable to subordination agreements. It then follows that the balance of the company's assessed loss will be reduced by the 'benefit' which accrues to the company by virtue of the extinction of such creditors' (existing) unconditional claims by the substitution of (later) conditional claims against the company.

The question of whether the benefit to the company should be valued with reference to the later, conditional claims against the company has not been the subject of an authoritative pronouncement by the courts. Harms JA in CIR v Datakor Engineering (Pty) Ltd (*supra*), choose not to answer this question. However, Burt submits that the total amount of the claims extinguished is the quantum of the benefit.

#### 5.7 Section 20(1)(a)(ii) v section 8(4)(m)

While it been stated above that this report does not deal with section 8(4)(m), it is necessary, in concluding, to differentiate be it from section 20(1)(a)(ii).

Section 8(4)(m) was recently introduced in 1997, and answers an unanswered question raised in Louis Zinn Organisation case (*supra*). Section 8(4)(m) reads:

'Subject to the provisions of section 20, where –

- (i) as a result of the cancellation, termination or variation of an agreement or due to prescription, waiver or release of a claim for payment, any person was during any year of assessment relieved or partially relieved from the obligation to make payment of any expenditure actually incurred;

- (ii) such expenditure was at the date on which such person was so relieved or partially relieved not paid; and
- (iii) such expenditure or any allowance in relation to such expenditure was in the current or any previous year of assessment allowed as a deduction from such person's income

such person shall for the purpose of paragraph (a) be deemed to have recovered or recouped an amount equal to the amount of the obligation from which the person was so relieved or partially relieved during the year of assessment in which the person was so relieved or partially relieved.'

It is submitted that in the case of a concession or compromise leading to the reduction or extinguishment of a debt, section 8(4)(m) will only take effect if the liability stems from an expenditure that was allowed as a deduction or an allowance. The question of the taxpayer having an assessed loss or not is irrelevant.

The application of section 20(1)(a)(ii) differs in that it is applicable whether or not the liability arose from an expenditure that permitted the taxpayer a deduction or an allowance. The second and obvious difference is that the taxpayer has to have an assessed loss to be reduced. That implies the adjustment in terms of section 20(1)(a)(ii) is limited to the balance of assessed loss, were as section 8(4)(m) has no such limitation.

## CHAPTER SIX

### INDIVIDUALS: RING-FENCING OF ASSESSED LOSS – SECTION 20A

#### 6.1 Introduction

One often hears that a person has incurred an expense or loss to obtain a tax deduction. This is quite nonsensical. For every R 40.00 (in the case of an individual whose income is taxed at the maximum marginal tax rate) and R 30.00 (in the case of a company) of tax savings R 100.00 has to be expended. It then stands to reason that on the net the person has lost R 60.00 (in the case of the individual) R 70.00 in the case of the company.

So why incur the loss? The fact of the matter is, that the taxpayer incurs these losses in his hobby (and other non trade activities) that do not meet the requirements of s11(a) and s23(g), but then disguise them so that a reduction of taxes is obtained. This has often been attacked by SARS and the courts have applied a number of tests to determine the deductibility of these loss. Now the legislature has assisted with the enactment of section 20A, which came into operation on 1 March 2004 and will apply to any year of assessment commencing on or after that date.

The Explanatory Memorandum (at 24-25) presents the following background to the enactment of section 20A of the Act:

- **Current law**

‘Section 11 of the Income Tax Act currently lays down the general requirements for deducting expenditure and losses to the extent that a person derives income from the carrying on any trade. Section 11 must be read in conjunction with section 23, the latter containing criteria for denying deductions for various items, for example, domestic and private consumption.’



- **Reasons for change**

'Not every activity is a trade, even if intended or labelled by the taxpayer as such. Whether or not an activity is a trade is a question of law that depends on the "facts and circumstances" of each case. These "facts and circumstances" are deliberately left open to accommodate the wide range of trade activities existing in a modern economy.

While this "facts and circumstances" test is generally appropriate, special concerns exist when a taxpayer disguises private consumption. More often than not, private consumption can be masqueraded as a trade (for a hobby) so that an individual can set-off these expenditures and losses against other income (usually salary or professional income). This attempt to deduct hobby-like expenses undermines the ability to pay principle of the income tax system because a wealthier individual has more means to disguise hobby expenses as a trade. Hence, a more stringent "facts and circumstances" test will be introduced as a means to uncover these artificially-labelled trades.

In a recent court case the court had regard to the intention of the taxpayer which is a subjective test. Unfortunately, as was noted in an earlier judgment, this places SARS in a difficult position. In the words of Smalberger J in ITC 1319 ((1980) 42 SATC 263 at 264); "Insofar as the test propounded by Silke purports to be an entirely subjective one, I do not agree with it. It seems to me that before a person can be said to be carrying on farming operations there must be a genuine intention to farm, coupled with a reasonable prospect that an ultimate profit will be derived, thereby incorporating an objective element into the test. To hold otherwise would make it well-nigh impossible for the Commissioner to determine whether or not to allow farming

losses as a deduction from other income, for he must needs adopt an objective approach when doing so.”

This chapter focuses on the interpretation, mechanics and application of section 20A of the Act.

## 6.2 The new law

According to Mitchell and Mitchell (2004:21) section 20A(1) provides, notwithstanding the provisions of 20(1)(b) (discussed in chapter 2) that the assessed loss incurred by a natural person in the carrying on of certain trades may not be set off against the income from his other sources. The said assessed loss may only be set off against the income derived from the same trade. However, this only applies when the when it is evident that the circumstances detailed in section 20A(2) are present. In addition, section 20A(3) provides certain exemptions from the application of section 20A(1).

The Explanatory Memorandum explains, simply, that:

- Section 20A aims to improve the integrity of the tax system by preventing expenditures and losses normally associated with suspect activities (for example, a disguised hobby) from being deducted to reduce taxable income.
- Section 20A(1) lays down the general rule and seeks to ring-fence assessed losses from suspect trades (as described in s 20A(2)) to prevent a taxpayer from deducting them from other income that he derives.
- However, the person may set of that loss from a suspect trade against other income from that suspect trade.
- Loss may be wholly disallowed if it stems from an activity that fails to qualify as a trade on the application of the general ‘facts and circumstances’ test.

- This limitation applies only to natural persons and not companies or trusts.

### 6.3 The Conditions for the application of section 20A

Section 20A applies to persons carrying on a suspect trade and whose income would otherwise be taxed at the maximum marginal tax rate.

#### 6.3.1 Maximum marginal tax rate

The opening lines of section 20A(2) reads:

‘Subsection (1) applies where the taxable income of a person for a year of assessment (before taking into account the set-off of any assessed losses incurred in carrying on any trade during that year and the balance of assessed loss carried forward from the preceding year) equals or exceeds the amount at which the maximum marginal rate of tax chargeable in respect of the taxable income of individuals becomes applicable, and where...’

The Explanatory Memorandum (at 25) explains:

‘Section 20A ring-fencing applies only to natural persons whose taxable income equals or exceeds the amount at which the maximum marginal tax rate becomes applicable (currently 40% imposed on taxable income exceeding R255 000). This part of the threshold is determined before set-offs of any assessed (that is, net) losses incurred from any trade (not just from suspect trades described in paragraphs (a) and (b) of section 20A(2)) that arise during the year of assessment at issue or any loss carryover from a prior year. This aspect of the threshold ensures that section 20A ring-fencing is targeted solely at higher-income

individuals who have the means for disguising hobbies as trades.' (My underlining)

Note that the memorandum was drafted during the 2004 tax year. Currently, that is the 2005 tax year, the maximum marginal rate of tax, of 40%, becomes applicable when an individual's income exceeds R 270 000.

The determination of the threshold can be illustrated by the following example:

*Facts*

The taxpayer is a medical practitioner and a dealer in collectible cars. He also owns a clothing store (which the Commissioner believes is a genuine business). For the 2005 year of assessment he has following profit (taxable) and incurred assessed losses:

	<b>R</b>
Medical practice	400 000
Clothing store	- 135 000
	<hr/>
	265 000
Dealing in collectables	- 65 000
	<hr/>
Net income	200 000
	<hr/>

*Result*

In determining the maximum marginal rate threshold only the income from medical practise of R 400 000 can be taken into account. The taxpayer's incomes from the medical practice, current and prior losses from his collectible car-dealing activities are ignored.

Current and prior losses from his clothing store and collectible car-dealing activities must be ignored. The loss from the clothing must, also, not be taken into account, notwithstanding the fact that is not to be ring fenced.

Section 20A would apply, since the R400 000 from the medical practice exceeds the maximum marginal tax rate threshold for a natural person in 2005 – of R 270 000.

### 6.3.2 **Suspect trade**

For the application of section 20A(1) both critical requirements of section 20A(2) must be present. The first being the person's income must exceed the 'maximum marginal tax rate threshold'. The second requires that the trade which sustained the loss be a suspect trade. The Explanatory Memorandum (at 26) states:

'Only losses from suspect trades are subject to potential ring-fencing. This aspect of the threshold represents an "either or" test. Under this "either or" test, the taxpayer has a suspect trade if the trade fails the "three out of five year" loss rule or has been explicitly listed as a suspect trade.' (My underlining)

#### 6.3.2.1 **The *three out of five year* rule**

Section 20A(2)(a) broadly classify a trade that has during the past five years sustained losses during any three of the five years. Section 20A(2)(a) reads:

'[d]uring the five year period ending on the last day of that year of assessment, incurred an assessed loss in at least three years of assessment in carrying on the trade contemplated in subsection (1) (before taking into account any balance of assessed loss carried forward)'

On this issue, the Explanatory Memorandum (at 26) states the following:

'Under this aspect of the threshold, a loss activity is treated as a suspect trade if assessed losses arise during three out of the last five years, including the current year of assessment. Loss years are determined without regard to a loss brought forward. Sustained losses of this kind are frequently an indicator of a suspect trade because natural persons would rarely continue with a trade generating losses on a long-term scale as it does not make sense from an economic perspective unless tax motives are present.'

The examples below illustrate the application of the three out of five year rule.

Example 1: The following income is earned by a taxpayer:

	R
2005	-12 000
2006	-15 000
2007	-20 000
2008	-6 000
2009	-3 000

His trade is a suspect from 2007, as the trade has incurred losses in the passed 3 years.

Example 2: The following income is earned by a taxpayer:

	R
2005	-12 000
2006	4 000
2007	2 000
2008	-20 000
2009	-3 000

His trade is suspect from 2009. The income earned in 2006 and 2007 assist in delaying the treated of a suspect trade. The unused portion of the 20000 i.e. R 6 000 (R 12 000 – R 4 000 – R 2 000) with the R 20 000 and R 3000 is carried forward into 2010.

However, take note of 6.3.2.2 (below).

#### 6.3.2.2 Specified suspect trades

The alternate to the three out of five year rule are specifically listed suspect trades. In terms of section 20A(2)(b) the specifically identified trades would be a suspect trade whenever it sustains a loss. The following trades are specified in section 20A(2)(b):

- (i) any sport practised by that person or any relative;
- (ii) any dealing in collectibles by that person or any relative;
- (iii) the rental of residential accommodation, unless at least 80 per cent of the residential accommodation is used by persons who are not relatives of that person for at least half of the year of assessment;
- (iv) the rental of vehicles, aircraft or boats as defined in the Eighth Schedule, unless at least 80 per cent of the vehicles, aircraft or boats are used by persons who are not relatives of that person for at least half of the year of assessment;
- (v) animal showing by that person or any relative;

- (vi) farming or animal breeding, unless that person carries on farming, animal breeding or activities of a similar nature on a full-time basis;
- (vii) any form of performing or creative arts practised by that person or any relative; or
- (viii) any form of gambling or betting practised by that person or any relative.

According to the Explanatory Memorandum (at 27), the selection of these activities have been based on past experience in terms of revenue enforcement and in terms of international comparative administrative approaches. It has been found that taxpayers use activities of this nature to generate little gross income as compared to their expenses because taxpayers are actually seeking to disguise private consumption.

This list of suspect activities generally contains qualifiers so as to ensure that the list is not overly punitive. For instance, many of the activities described will be suspect only if practiced by the taxpayer or a relative. This focus is important, because suspect activities practiced by the taxpayer (or relative) suggest a hobby element; while a mere passive investment in which the taxpayer has no active operational involvement, does not.

The Explanatory Memorandum (at 27) illustrates some examples:

- (i) Sporting activities practiced by the taxpayer (or relative) include, for example, any form of sport, hunting, yachting or boat racing, water-skiing and scuba diving.
- (ii) Dealing in collectibles by the taxpayer (or relative) includes, for example, cars, stamps, coins, antiques, militaria, art and wine.



- (iii) The rental of residential accommodation is included, unless at least 80% of residential accommodation is used by persons who are not relatives of the taxpayer for at least half of the year of assessment. Residential accommodation within this category is intended to include the rental of holiday homes, bed-and-breakfast establishments, guesthouses and dwelling houses. For instance, the bed-and-breakfast letting of a few rooms within the taxpayer's main home would fall under the suspect list. Holiday homes used by the taxpayer and not used by persons who are not relatives for at least half of the year of assessment would be similarly suspect.
- (iv) The rental of vehicles, aircraft or boats by a taxpayer constitutes a suspect activity, unless at least 80% of the assets are used by persons who are not his relatives for at least half of the year of assessment.
- (v) The showing of animals in competitions by the taxpayer (or relative) is suspect and includes, for example, the showing of horses, dogs and cats.
- (vi) Farming or animal breeding by the taxpayer, other than on a full-time basis, is suspect, for example, weekend or casual farming. One notable activity within this suspect class would be game farming.
- (vii) Performing or creative arts practiced by the taxpayer (or relative) scores as a suspect activity and includes, for example, acting, singing, film making, photography, writing, pottery and carpentry. As stated above, mere passive investment in these activities would not generally fall within the suspect class. For instance, an investment in commercial film making would not be suspect if the taxpayer (or relative) has no real involvement with the making of the film, while the making of home movies may suggest a hobby-like element.
- (viii) Gambling or betting by the taxpayer (or relative) includes trying one's luck at a casino on a regular basis, card playing, lottery purchases and sports betting.

As the dealing in collectables is specifically identified as a suspect trade, in applying the provisions of section 20A(2)(b) to the examples 1 and 2 in 4.3.2.1 (above), the dealing in collectable cars will be a suspect trade from the 2005 year.

Horse racing has deliberately been excluded from the specified list of suspect trade. The Explanatory Memorandum (at 28) sheds some light on this exclusion:

'Following deliberations before the Portfolio Committee on Finance, ownership of racehorses has not been specifically included in the list of suspect trades. From the evidence submitted to the Committee it appears that owners of racehorses represent a pillar of the racing industry as a whole and further consultation is required before a decision is made on the specific inclusion of this activity on the list. Owners of racehorses will, however, still be subject to the three out of five year rule just like any other trade.'

#### **6.4 Exemption from ring-fencing**

Section 20A(3) is referred to the escape hatch and provides an escape route that allows the taxpayer to prevent the ring fencing of the assessed loss incurred by a legitimate trade. Section 20A(3):

'The provisions of subsection (1) do not apply in respect of an assessed loss incurred by a person during any year of assessment from carrying on any trade contemplated in subsection (2) (a) or (b), where that trade constitutes a business in respect of which there is a reasonable prospect of deriving taxable income (other than taxable capital gain) within a reasonable period....'

To escape the tainting by section 20A(2), the activity must constitute a 'business' (as opposed to a hobby or a mere venture). The explanatory Memorandum (at 28) continues:

'More importantly, this business must have a reasonable prospect of generating taxable income within a reasonable period (which is determined pursuant to an objective standard rather than mere subjective taxpayer intent). This determination is based on the 'facts and circumstances', which the taxpayer has the onus of proving (in terms of s 82 of the Act). This 'facts and circumstances' test must have 'special regard' to the 'facts and circumstances' outlined in paras (a) to (f) of s 20A(3) – detailed below. Other 'facts and circumstances' may also be considered, should unique circumstances arise.'

#### **6.4.1 Proportion of losses to income**

Section 20A(3)(a) states that regard must be had to the:

'the proportion of the gross income derived from that trade in that year of assessment in relation to the amount of the allowable deductions incurred in carrying on that trade during that year'

This factor focuses on the proportion of gross income the taxpayer derives from that activity in relation to the deductions arising for it. If a taxpayer has relatively small amounts of gross income and claims disproportionately large deductions, it highlights a risk to the fiscus. But should the taxpayer be generating large amounts of gross income in relation to deductions, this will be a factor favourable to the taxpayer.

#### 6.4.2 Advertising and selling

Section 20A(3)(b) states that regard must be had to the:

'level of activities carried on by that person or the amount of expenses incurred by him on advertising, promoting or selling in carrying on that trade'.

The Explanatory Memorandum (at 28) points out that:

'[t]ypically, trading requires regular selling and marketing initiatives in terms of time and expense (including advertisements). More often than not, hobby activities tend to involve large amounts of expenses or losses, while the level of selling activities is minimal. The taxpayer must demonstrate selling or advertising efforts in terms of activities performed or expenses incurred.'

#### 6.4.3 The commercial manner in which the trade is carried out

Section 20A(3)(b) states that regard must be had to

'[w]hether that trade is carried on in a commercial manner, taking into account—

- (i) the number of full-time employees appointed for purposes of that trade (other than persons partly or wholly employed to provide services of a domestic or private nature);
- (ii) the commercial setting of the premises where the trade is carried on;
- (iii) the extent of the equipment used exclusively for purposes of carrying on that trade; and
- (iv) the time that the person spends at the premises conducting that business'.

The question here is, whether the activity is carried on in a business-like manner? A hallmark of a trade is the business-like system or method employed in conducting the activities. The Explanatory Memorandum (at 28) details the indicators:

- (i) The number of full-time employees employed in the activity (as opposed to part-time help (distinguishable from employees limited to the high season) that may include relatives). Employees providing services of a domestic or private nature are excluded for this purpose (for example, domestic servants and residential gardeners, regardless of whether or not they are also involved in the trade).
- (ii) The commercial setting where the activity is situated (for example, the business is located in a commercial district and the business-like nature of its appearance).
- (iii) The amount and value of the equipment used exclusively for the business (hence, mixed-use property, for example, yachts, will be excluded from qualifying as a favourable factor).
- (iv) The amount of time a taxpayer spends at the premises conducting the activity.

#### **6.4.4 The period of losses in the duration of the activities**

Section 20A(3)(d) states that regard must be given to

*'the number of years of assessment during which assessed losses were incurred in carrying on that trade in relation to the period from the date when that person commenced carrying on that trade and taking into account—*

- (i) any unexpected events giving rise to any of those assessed losses; and
- (ii) the nature of the business involved'.

Consideration must be given to the number of years in which a loss is incurred in the activity in proportion to the total number of years that the taxpayer has been engaged in that activity. Consideration must be given to:

- (i) any unexpected or unforeseen events that may give rise to losses (for example, heavy rains or droughts would provide grounds for mitigating sustained losses for farmers); and
- (ii) the nature of the activity (for instance, does the activity typically have a long start-up period, for example, olive farming).

#### **6.4.5 Business plans**

Section 20A(3)(e) states that regard must be given to

'[t]he business plans of that person and any changes thereto to ensure that taxable income is derived in future from carrying on that trade'.

Where it is shown that business plans and steps put in place by the taxpayer to prevent or limit further losses. Also, favourable consideration will be given where it is proven that the taxpayer has strategically intervened to ensure the activity will ultimately be profitable.

#### **6.4.6 Trade vs Recreation**

Section 20A(3)( f ) states that regard must be given to

'the extent to which any asset attributable to that trade is used, or is available for use, by that person or any relative of that person for recreational purposes or personal consumption.'

This is what section 20A is all about. However, it is often the most difficult to prove or disprove. Here the taxpayer will have to prove that the asset was generally unavailable or not actually used by him (or a relative) for recreational use or personal enjoyment. For example, where a taxpayer has a holiday home, the taxpayer will have to prove that the property was not readily available for personal use with details of periods when persons other than the taxpayer (or a relative) occupied the home during the year of assessment.

#### 6.5 **The *six out of ten year rule***

Section 20A(4) closes the net on a suspect trade that has passed the escape hatch and sets out the 'six out of ten year rule'. The subsection reads:

'Subsection (3) does not apply in respect of a trade contemplated in subsection (2) (b) (other than farming) carried on by a person during any year of assessment where that person has, during the ten year period ending on the last day of that year of the assessment, incurred an assessed loss in at least six years of assessment in carrying on that trade (before taking into account any balance of assessed loss carried forward).'

The Explanatory Memorandum (at 27) adds the following:

'The "facts and circumstances" escape route provided by section 20A(3) does not apply if the taxpayer has incurred six years of losses during the last ten years of assessment (including the current year of assessment). This test is applied in the same manner as the "three out of five" year threshold in section 20A(2)(a).

This automatic ring-fencing of losses incurred from the year of assessment the taxpayer's trade generated losses for six out of ten years is premised on the notion that a person from an economic perspective could not afford a legitimate trade indefinitely if continuous losses are sustained (unless motives other than profit were present). Hobbies, on the other hand, frequently generate sustained losses for indefinite periods. Farming was excluded from the six-out-of-ten-year prohibition because many forms of legitimate farming entail long-term losses before the expectation of profit can be realised.

Losses incurred in any year of assessment ending on or before 29 February 2004 will not count against a taxpayer.'

#### **6.6 Permanent ring-fencing**

Section 20A(5) prevents the loss from being set off against the income from other sources that are earned in the future years, and reads:

'Notwithstanding section 20 (1) (a), any balance of assessed loss carried forward from the preceding year of assessment, which is attributable to an assessed loss in respect of which subsection (1) applied in that preceding year or any prior year of assessment, may not be set off against any income derived by that person otherwise than from carrying on the trade contemplated in subsection (1).'

The Explanatory Memorandum explains:

'Ring-fenced losses falling within section 20A are ring-fenced forever and may only be offset against income from that trade.



Taxpayers will never be able to use these ring-fenced losses against income from other trades either during the current tax year during which the ring-fenced losses occur or in a subsequent year (in the form of a carry forward).'

The following example, from the Explanatory Memorandum, illustrates the application of s 20A(5):

### **Facts**

The taxpayer is an accountant. He maintains a residential guesthouse that qualifies as a listed suspect trade under section 20A(2)(b). In the 2005 year of assessment he earns R530 000 in taxable income trading as an accountant. He suffers a R12 000 loss from his guesthouse. He is unable to demonstrate a reasonable prospect of generating any taxable income from his guesthouse.

### **Result**

The R12 000 loss from his guesthouse is ring-fenced in the 2005 year of assessment. This ring-fenced treatment of the R12 000 assessed loss will continue for all subsequent years after the 2005 year of assessment.

### **Assuming further:**

That in 2005 he has incurred a farming loss of R 550 000 (not a suspect trade). Then the assessed loss of R 20 000 (i.e. R 530 000 – R 550 000) must be carried forward separately from the assessed loss of R 12 000 (i.e. from the suspect trade).

## 6.7 Recoupments

Section 20A(6) permits the setting of the recoupments, attributable to the suspect trade, against its ring fenced loss, and reads:

'For the purposes of this section and section 20, the income derived from any trade referred to in subsections (1) or (5), includes any amount—

- (a) which is included in the income of that person in terms of section 8 (4) in respect of an amount deducted in any year of assessment in carrying on that trade; or
- (b) derived from the disposal after cessation of that trade of any assets used in carrying on that trade.'

The Explanatory Memorandum (at 30) makes the following comments:

'Generally, losses of a trade subject to ring-fencing under section 20A(1) can be freely used against income from that trade. Section 20A(6) clarifies that losses of a trade can similarly be used against income from recoupments under section 8(4)(a) associated with that trade, even if the recoupment income arguably does not otherwise qualify as income from conducting that trade.

This use of ring-fenced losses against recoupment income stems from the assumption that any recoupment most likely originates from depreciation or other losses that were ring-fenced. In contrast, ring-fenced losses cannot be offset against capital gains associated with the same trade because capital gains represent investment profits (as opposed to trading profits).'

## 6.8 Farming activities

In keeping with the section 26 and the First Schedule of the Income Tax Act, section 20A(7) provides:

'Notwithstanding anything to the contrary contained in this Act, all farming activities carried on by a person shall be deemed to constitute a single trade carried on by that person for the purposes of this section.'

The Explanatory Memorandum points (at 30) out that assessed losses from a single trade can be set off against income from only the same trade. Whether one or more related activities constitute the same trade or multiple trades is a question of fact. Section 20A(7), however, provides that multiple farming activities will be deemed to constitute a single trade for the purposes of s 20A. This unified treatment of all farming activities is appropriate because farming typically entails multiple diverse activities.

## 6.9 Disclosure

Section 20A(8) requires the taxpayer to indicate that he has conducted a suspect trade, and reads:

'Where the provisions of subsection (2) apply during any year of assessment in respect of any trade carried on by a person, that person must indicate the nature of the business in his or her return contemplated in section 66 for that year of assessment.'

The Explanatory Memorandum comments on this reporting requirement as follows:

'Section 20A(8) creates a reporting obligation for taxpayers subject to section 20A. Under this rule, a taxpayer must report in

the annual tax return each suspect trade as per the tax return form described under section 20A(2)(a) (that is, under the “three out of five year” test) or section 20A(2)(b) (that is, under the “suspected activity” list). This rule ensures that suspect trades are readily identifiable by SARS.’

#### **6.10 Commencement**

Section 20A(9):

‘For the purposes of subsections (2) (a) and (4), any assessed loss incurred in any year of assessment ending on or before 29 February 2004 shall not be taken into account.’

This means that in the application of the “three out of five year” and the ‘six out of ten year’ rules any assessed loss sustained before 1 March 2004 must not be taken into account.

#### **6.11 Definitions**

Section 20A(10) provides the following definitions:

- (a) “assessed loss” means “assessed loss” as defined in section 20 (2); and
- (b) “relative” in relation to a person means a spouse, parent, child, stepchild, brother, sister, grandchild or grandparent of that person

#### **6.12 The criticism of section 20A**

The enactment of section 20A is not without criticism. An online editorial by the Business Day has highlighted some of the concerns and pitfalls surrounding the introduction of the section. It quotes the following experts:

- Bob Williams, a tax expert at the University of Natal, as saying that the losses of genuine trades which ran for a number of years would also be ring-fenced. In addition, the new law might be open to constitutional challenge on the grounds that it discriminates between individuals on the highest tax rate who will be subject to the rules and those in lower tax brackets.
- Jean-Marie Mouton, a tax expert at Sonnenberg Hoffmann Galombik, as saying the law targets certain categories of taxpayers. It introduces an area of discretion or subjectivity in assessing the nature of a taxpayer's activities. It is submitted that this will lead to great inconsistencies.
- Robert Gad, a tax partner at law firm Sonnenberg Hoffmann Galombik, as saying it is possible the new rules might affect some regions in the country more than others. Gad points out that it might discourage legitimate secondary investment activities which, he says, are an increasingly important tool in personal retirement planning. In addition he says; "They might also discourage investment in the property rental market,"

## CHAPTER SEVEN

### CONCLUSION

This report aims to caution the reader of situations that cancels the relief from taxation, provided by an assessed loss. It is, however, submitted that three issues remain unclear:

- The capitalisation of debt by the issue of shares at a premium, and its effect on the balance of assessed loss.
- The impact on the balance of assessed loss, when entering into a subordination agreement.
- The Constitutional Courts view on the enactment of section 20A.

Harms JA, in the *Datakor* case (*supra*) declined to decide whether, in determining the amount of benefit, the fixed amount reflected in the taxpayer's balance sheet as share premium should be reduced by any future payments. Harms JA said:

'Because the issue was not raised in the notice of objection, the question whether on a proper interpretation of the provision the 'benefit' to the taxpayer should be valued with reference to the alleged cost of or the liability created by the redeemable preference shares, or, for that matter, the pre-compromise value of the creditors' claims against the taxpayer, does not require consideration and I prefer to say no more on the subject.'

It is, therefore, submitted that the Supreme Court of Appeal has not yet reviewed the views of Wunsh P, and that it remains unclear whether or not the capitalisation of a loan by the issue of shares at a premium gives rise to the accrual of a quantifiable benefit.

This report presented the conflicting views held on the issue of subordination agreements and its effect on the balance of an assessed loss. This uncertainty needs to be put to rest by a decision from our courts.

As noted by Bob Williams (*supra*) the enactment of the section 20A of the Act appears to target and victimise individuals whose income are subject to tax at the maximum marginal tax rate. It is submitted that these are not the only persons that abuse the provisions of the Act, in the manner which section 20A sets out to curb. Nowadays, individuals with comparatively less income resort to these *avoidance* measures. These individuals, while not subject to taxation at the maximum marginal rate, do contribute a significant percentage of their income as taxation.

It is, therefore, discriminatory to prevent one group of individuals while others may continue with the very same abusive action with impunity.

With the ever changing tax legislation, it is very possible that more provisions may be introduced that limits a taxpayers use of an assessed loss.

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