

The **draft legislation on the Ring-fencing of Assessed Losses** is released for public comment.

It would be appreciated if comments on the draft legislation could be furnished by **12 September 2003**. A further opportunity to comment on a further draft of the provisions will be allowed thereafter. Due to time constraints, it will not be possible to respond individually to comments received. However, receipt of comments will be acknowledged and fully considered by the National Treasury and SARS.

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Ring-fencing of assessed losses

Amendment of section 20 of Act 58 of 1962

. (1) Section 20 of the Income Tax Act, 1962, is hereby amended by the substitution in subsection (1) for the words preceding paragraph (a) of the following words:

“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—”.

(2) Subsection (1) shall come into operation on 1 March 2004 and shall apply in respect of any year of assessment commencing on or after that date.

Insertion of section 20A in Act 58 of 1962

. (1) The following section is hereby inserted in the Income Tax Act, 1962, after section 20:

“Ring-fencing of assessed losses of certain trades

20A. (1) Subject to subsection (3), where the circumstances in subsection (2) apply during any year of assessment in respect of any trade carried on by a natural person, any assessed loss incurred during that year in carrying on that trade may not be set off against any income of that person derived during that year otherwise than from carrying on that trade, notwithstanding section 20(1)(b).

(2) 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—

- (a) that person has, during 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); or
- (b) the trade contemplated in subsection (1), in respect of which the assessed loss was incurred constitutes—
 - (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 which is readily available for use by that person or any relative;

- (iv) the rental of transportation which is readily available for use by that person or any relative;
- (v) animal showing by that person or any relative;
- (vi) farming or animal breeding carried on by that person otherwise than 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.

(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 having special regard to—

- (a) 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;
- (b) the level of activities carried on by that person or the amount of expenses incurred by that person in respect of advertising or selling in carrying on that trade;
- (c) whether 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;
- (d) 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;
- (e) the business plans of that person and any changes thereto to ensure that taxable income is derived in future from carrying on that trade; and
- (f) 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.

(4) 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).

(5) 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).

(6) 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 which is included in the income of that person in terms of section

8(4)(a) in respect of an amount deducted in any year of assessment in carrying on that trade.

(7) 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.

(8) 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 in his or her return contemplated in section 66 for that year of assessment the nature of the business and whether subsection (2)(a) or (b) applies in respect of that trade.

(9) Where during any year of assessment a person fails to comply with subsection (8) in respect of any trade carried on by him or her, the provisions of subsection (1) shall, notwithstanding subsection (3), apply in respect of any assessed loss incurred by that person in carrying on that trade during that year, unless there were reasonable grounds for believing that the trade formed part of another trade carried on by him or her.

(10) 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.”.

(2) Subsection (1) shall come into operation on 1 March 2004 and shall apply in respect of any year of assessment commencing on or after that date.

EXPLANATORY NOTES ON RING-FENCING OF ASSESSED LOSSES

Present Law

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

Reasons for Change

Not every activity is a trade, even if intended or labeled 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 taxpayers disguise private consumption. More often than not, private consumption can be masqueraded as a trade (i.e., a hobby) so that individuals 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 wealthier individuals have 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.

Proposed Law (Section 20A)

I. General Rule: Subsection (1)

Section 20A aims to improve the integrity of the tax system by preventing expenditures and losses normally associated with suspect (i.e., disguised hobby) activities from being deducted as a means to reduce taxable income. Subsection (1) sets forth the general rule, which seeks to ring-fence assessed losses from suspect trades (as described in subsection (2)) to prevent these losses from being deducted against any other income that a taxpayer generates. This deduction limitation applies only to natural persons (not to other taxpayers such as companies or trusts).

Furthermore, the rules under this section do not prevent natural persons from using losses from a suspect trade against other income from that trade. However, these losses may be wholly disallowed if the losses stem from an

activity that fails to qualify as a trade after application of the general “facts and circumstances” test.

II. Threshold for Ring-Fencing; Subsection (2)

Section 20A ring-fencing involves a two-part threshold, which determines the level of taxable income at which the taxpayer will become subject to scrutiny. The first part of the threshold focuses on the taxpayer’s taxable income level, and the second part focuses on the loss-generating activity.

A. Part 1 - Maximum Marginal Rates

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 per cent imposed on taxable income exceeding R255 000). This part of the threshold is determined before set-offs of any assessed (i.e., net) losses incurred from any trade (not just from suspect trades described in paragraphs (a) and (b) of subsection (2)) that arise during the tax year 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. This threshold can be illustrated by the following example:

Facts. Individual is a medical practitioner and a dealer in collectible cars. In 2005, Individual generates R440 000 taxable income from the individual’s medical practice. The collectible car dealing activities incur an assessed loss of R30 000 in the same year.

Result. Individual’s income from the medical practice is the sole amount taken into account for purposes of the maximum marginal rate threshold. Current and prior losses from the collectible car dealing are ignored. Section 20A potentially applies as the R440 000 from the medical practice exceeds the maximum marginal rate threshold for natural persons in 2005.

B. Part 2 – Suspect Loss Trades

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.

1. “Three Out Of Five” Year Loss Trades

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

(i) Example:

Facts. Individual operates a trade during the 2005 to 2009 tax years, respectively generating assessed losses of R12 000, R15 000, R20 000, R6 000, and R3 000 in each of those years.

Result. The trade is a suspect trade from 2007 onwards. The trade has incurred assessed losses for three years.

(ii) Example:

Facts. Individual operates a trade from 2005 until 2009. The trade results in a R12 000 assessed loss in 2005, R4 000 of taxable income in 2006, R2 000 of taxable income in 2007, R20 000 of assessed loss in 2008, and R3 000 of assessed loss in 2009.

Result. The trade is a suspect trade in 2009. The taxable income arising in 2006 and 2007 count in individual's favour (thereby delaying suspect trade treatment), even if the R12 000 assessed loss remains partially unused as a loss carryover in 2006 and 2007.

Losses incurred in any year of assessment ending on or before 28 February 2004 will not count against a taxpayer.

2. Listed Suspect Trades

Under this aspect of the threshold, a loss activity is treated as suspect if the loss activity falls within one of the eight categories on the list. These listed activities have been selected based on past experiences in terms of revenue enforcement and in terms of international comparative administrative approaches. More often than not, this information suggests 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 in order to ensure that this list is not overly punitive. For instance, many of the activities described below 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; whereas, a mere passive investment in which the taxpayer has no active operational involvement does not.

The following suspect categories have been identified:

- (i) Sporting activities practiced by the taxpayer (or relative) include, for example, any form of sport, hunting, yachting or boat racing, horse racing, water-skiing and scuba diving.
- (ii) Dealing in collectibles by the taxpayer (or relative) include, for example, cars, stamps, coins, antiques, militaria, art and wine.
- (iii) The rental of residential accommodation is included if the accommodation is readily available for use by the taxpayer (or relative). Residential accommodation within this category is intended to include the rental of holiday homes, bed and breakfast establishments, guesthouses and dwelling houses if the taxpayer has ready access thereto for personal use throughout the tax period. For instance, townhouses and guesthouses subject to a long-term lease of 1-year or more would fall outside the suspect list because the taxpayer (or relative) cannot obtain access for private use. On the other hand, the bed and breakfast leasing of a few rooms within the taxpayer's main home would fall under the suspect list. Holiday homes used by the taxpayer regularly and available for personal use during portions of a year would be similarly suspect.
- (iv) The rental of transportation (for example, aircraft, cars and boats) constitutes a suspect activity if readily available for use by the taxpayer (or relative). This would include a charter plane regularly used by a taxpayer during weekends.
- (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 and animal breeding by the taxpayer other than on a full-time basis is suspect, such as weekend or casual farming. One notable activity within this suspect class would be game farming.
- (vii) Performing or creative arts practised 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, investment in commercial film making would not be suspect if the taxpayer (or relative) has no real involvement with the making of the film, whereas 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.

III. "Facts and circumstances" Escape Hatch: Subsection (3)

As stated above, the threshold qualification under subsection (2) generally results in ring-fenced treatment for the assessed losses (i.e., net losses) of a suspect trade. However, subsection (3) provides an escape route that allows the taxpayer to prevent ring-fenced deduction treatment by proving that the activity at issue is a legitimate trade despite suspect classification in subsection (2).

In order for an activity to escape the subsection (2) taint, the activity must constitute a "business" (as opposed to a hobby or a mere venture). 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" in respect of which the taxpayer has the onus of proving (see section 82 of the Income Tax Act of 1962). This "facts and circumstances" test must have "special regard" to the "facts and circumstances" outlined in paragraphs (a) to (f) of subsection (3). Other "facts and circumstances" may also be considered should unique circumstances arise.

The "facts and circumstances" to which special regard will be had are as follows:

- (a) *Proportionality of losses to income* - This factor focuses on the proportion of gross income the taxpayer derives from that activity in relation to the deductions arising in respect of that activity. If a taxpayer has relatively small amounts of gross income and claims large deductions, this disproportionality highlights a risk to the Fiscus. However, should the taxpayer be generating large amounts of gross income in relation to deductions, this proportionality will be a favourable factor.
- (b) *Advertising and selling* - Typically, trading requires regular selling and marketing initiatives in terms of time and expense (including advertisements). More often than not, hobby activities tend to incur large amounts of expenses/losses while the level of selling activities is minimal. The taxpayer must demonstrate selling/advertising efforts in terms of activities performed or expenses incurred.
- (c) *Commercial manner* - Consideration must be given to whether the activity is carried on in a business-like manner. A hallmark of a trade is the business-like system or method pursuant to which the activities are carried out. This factor takes into account:

- (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) which could involve relatives). Employees providing services of a domestic or private nature are excluded for this purpose (e.g., domestic servants and residential gardening workers regardless of whether they are also involved in the trade or not);
 - (ii) The commercial setting where the activity is situated (i.e., 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, such as yachts, will be excluded from qualifying as a favourable factor); and
 - (iv) The amount of time a taxpayer spends at the premises conducting the activity.
- (d) *Proportionality of period of losses to the duration of the activity* - Account will be taken of the number of years in which the activity incurs a loss in proportion to the total number of years that the taxpayer has been engaged in that activity. In determining the ratio, consideration will be given to:
- (i) Any unexpected or unforeseen events that may give rise to losses (for instance, 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 such as olive farming?).
- (e) *Taxpayer's future business plans* - Favourable consideration will be given to the business plans and steps put in place by the taxpayer to prevent or limit further losses. Consideration will also be given as to whether the taxpayer intervened strategically to ensure the activity will ultimately be profitable.
- (f) *Availability of property for recreational use or personal consumption* - This factor goes to the heart of the matter, but is often the most difficult to prove or disprove. A taxpayer will have to provide proof confirming that the asset was generally unavailable or not actually used by the taxpayer (or relative) for recreational use or personal enjoyment. For instance, where a taxpayer has a holiday home at the coast, 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 relatives) occupied the home during the tax year.

IV. "Six Out of Ten Year Loss Trades": Subsection (4)

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

This automatic prohibition for losses incurred 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 tax year ending on or before 28 February 2004 will not count against a taxpayer.

V. Permanent Ring-Fencing: Subsection (5)

Ring-fenced losses falling within section 20A are ring-fenced forever. Taxpayers will never be able to use these ring-fenced losses against income from other trades either during the current taxable year during which the ring-fenced losses occur or in a subsequent year (in the form of a carry forward), for example:

Facts. Taxpayer is an accountant and maintains a residential guesthouse that qualifies as a listed suspect trade under subsection (2)(b). In 2005, Taxpayer generates R530 000 taxable income as an accountant and R12 000 of assessed loss from the guesthouse.

Result. The R12 000 of assessed loss from the guesthouse is ring-fenced in 2004. This ring-fenced treatment of the R12 000 assessed loss will continue for all subsequent years after 2005.

VI. Set-Offs Against Recoupment: Subsection (6)

Generally, losses of a trade subject to ring-fencing under subsection (1) can be freely used against income from that trade. Subsection (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).

VII. Multiple Farming Activities Deemed to Qualify as a Single Trade: Subsection (7)

Assessed losses from a single trade can only be set off against income from the same trade. Whether one or more related activities constitute the same trade or multiple trades is a question of fact. However, subsection (7) provides that multiple farming activities will be deemed to constitute a single trade for purposes of section 20A. This unified treatment of all farming activities is appropriate because farming typically entails multiple diverse activities.

VIII. Reporting Requirement: Subsection (8)

Subsection (8) creates a reporting obligation for taxpayers subject to section 20A. Under this rule, a taxpayer must report each suspect trade as per the tax return form described under subsection (2)(a) (i.e., under the “three out of five year” test) or subsection (2)(b) (i.e., under the “suspected activity” list). This rule ensures that suspect trades are readily identifiable by SARS.

IX. Penalty for Failure to Report: Subsection (9)

Subsection (9) sets out the consequences for failure to report as set out in subsection (8). Under this section, failure to report under subsection (8) creates automatic ring-fencing under subsection 20A, even if the taxpayer can prove the legitimacy of the trade under the “facts and circumstances” test of subsection (3).

Only one circumstance exists in which the failure to report will not trigger automatic ring-fencing. This circumstance will arise if the taxpayer can demonstrate that reasonable grounds exist for believing that the suspect trade at issue was part of a bigger trade.

IX. Effective Dates

Section 20A will come into operation on 1 March 2004 and apply in respect of tax years commencing on or after that date. However, application of the “three out of five year” and the “six out of ten year” rules will be applied only by taking into account assessed losses for tax years commencing on or after 1 March 2004.