SOUTH AFRICAN REVENUE SERVICE

# GUIDE ON THE RING-FENCING OF ASSESSED LOSSES ARISING FROM CERTAIN TRADES CONDUCTED BY INDIVIDUALS

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**Guide on the Ring-Fencing of Assessed Losses**
**Arising from Certain Trades Conducted by Individuals**

# Foreword

This guide deals generally with the provisions relating to the ring-fencing of assessed losses arising from certain trades conducted by individuals. It is not meant to deal with the precise technical and legal detail that is often associated with taxation and should, therefore, not be used as a legal reference. It is not a binding general ruling issued under section 76P of the Income Tax Act 58 of 1962.

It provides individuals, whose income tax liability may be affected by the ring-fencing provisions, with a better understanding of what ring-fencing entails and enables them to determine how and to what extent the provisions may affect their income tax liability.

The ring-fencing provisions are applicable to a wide spectrum of trades conducted by individuals. It does not attempt to reflect on every scenario that could possibly exist, but does attempt to provide clarity on the majority of issues that are likely to arise in practice.

This guide reflects the law as at 30 September 2009 as amended by the Taxation Laws Amendment Act 17 of 2009.

Should you require additional information concerning any aspect of taxation you may

- visit the SARS website at www.sars.gov.za;
- visit your nearest SARS branch office;
- contact your own tax advisor / tax practitioner;
- if calling locally, contact the SARS Contact Centre on 0800 00 7277; or
- if calling from abroad, contact the SARS Contact Centre on +27 11 602 2093.

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# PART A – BACKGROUND AND LEGISLATION

## 1. Glossary

Unless the context indicates otherwise, the meaning of words, concepts and acronyms used in this guide, is the following:

| | |
|---|---|
| **Act** | Income Tax Act 58 of 1962 |
| **Assessed loss** | As defined in section 20(2) [section 20A(10)(*a*)]<br><br>Section 20(2) defines an "assessed loss" as "any amount by which the deductions admissible under section 11 exceeds the income in respect of which they are admissible".<br><br>An assessed loss from a trade carried on by a taxpayer for a specific year of assessment, therefore, means the amount by which the allowable deductions attributable to that trade exceeds income derived by that taxpayer from that trade for that year of assessment. |
| **Commissioner** | The Commissioner for the South African Revenue Service as defined in section 1. |
| **"Facts and circumstances" test** | The "facts and circumstances" test is an escape clause by means of which an individual can prevent an assessed loss from a trade to be ring-fenced. Various facts and circumstances are taken into account in considering whether that trade is a business, in respect of which there is a reasonable prospect of deriving a taxable income within a reasonable period. |
| **Maximum marginal rate** | The threshold at which the highest rate (percentage) of tax for individuals becomes payable as fixed by Parliament from time to time, contemplated under section 5(2). |
| **PAYE** | Pay-As-You-Earn<br><br>Employees tax which is deducted or withheld by the employer from remuneration paid or payable to an employee, in excess of the SITE threshold for a year of assessment. |
| **Potential ring-fencing** | When the pre-requisites for ring-fencing are present, but the facts and circumstances test has not yet been applied, an assessed loss from a trade is subject to potential ring-fencing. |

| | |
|---|---|
| **Pre-requisites for ring-fencing** | The pre-requisites, as stated in section 20A(2), must be met before an assessed loss from a trade may be ring-fenced. |
| **Relative** | The term "relative" is defined in section 20A(10)(*b*) to mean, in relation to a person, a spouse, parent, child, stepchild, brother, sister, grandchild or grandparent of that person. |
| **SARS** | South African Revenue Service |
| **Section or subsection** | Any section or subsection of the Act |
| **Section 1 of the Act** | This section defines the meaning that certain words and phrases are intended to bear for the purposes of the Act. |
| **SITE** | Standard Income Tax on Employees |
| **Suspect trade** | Any trade listed under section 20A(2)(*b*) |
| **Taxpayer** | The natural person or person referred to in section 20A |
| **Taxable income** | The term "taxable income" is defined in section 1 as "the aggregate of<br>• the amount remaining after deducting from the income of a person all the amounts allowed under Part I of Chapter II of the Act to be deducted from or set-off against such income; and<br>• all the amounts to be included or deemed to be included in the taxable income of any person under this Act;".<br>An assessed loss brought forward from the previous year of assessment and any assessed loss incurred in the current year of assessment will be deducted, under section 20 in arriving at the taxable income of a taxpayer. |
| **Year of assessment** | A "year of assessment" (also known as a tax year) is defined in section 1, as "any year or other period in respect of which any tax or duty leviable under the Act is chargeable, and any reference in this Act to any year of assessment ending the last day or the twenty-eighth or the twenty-ninth day of February shall, unless the context otherwise indicates, in the case of a company be construed as a reference to any financial year of that company ending during the calendar year in question''.<br>An individual's year of assessment, therefore, begins on the first day of March of one year and ends on the last day of February the following year. |

## 2. Background

The general deduction formula in section 11(*a*) read with section 23(*g*) provides the general rules for determining the deductibility of expenditure and losses for income tax purposes.

Section 11(*a*) is generally referred to as the positive test, as it deals with the general deductions which are allowed in the determination of taxable income, and section 23(*g*) is referred to as the negative test, as it deals with deductions which are not allowed in the determination of taxable income.

Section 11(*a*) requires that in the carrying on of trade the expenditure and losses must

- be actually incurred;
- in the production of income; and
- not be of a capital nature.

Section 23(*g*) prohibits the deduction of any moneys to the extent to which such moneys were not laid out or expended for the purposes of trade. Furthermore, section 23(*a*) and (*b*) prohibit the deduction of costs incurred in the maintenance of any taxpayer, the taxpayer's family or establishment and private or domestic expenses, respectively.

The term "trade" is defined under section 1 of the Act and includes every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent as defined in the Patents Act 57 of 1978, or any design as defined in the Designs Act 195 of 1993, or any trade mark as defined in the Trade Marks Act 194 of 1993, or any copyright as defined in the Copyright Act 98 of 1978, or any other property which is of a similar nature.

Although the term "trade" is widely defined in section 1, the determination of whether a trade is being carried on, can be problematic in some instances. Whether a specific activity amounts to the carrying on of a trade, is a question of law that depends on the facts and circumstances of the specific case. In considering whether or not an activity constitutes a trade, the intention of the person is important and this intention is usually coupled with a reasonable prospect of deriving a profit from that particular trade. When an immediate profit is not attainable owing to any reason, the prospect of deriving an ultimate profit from that trade should at least be based on reasonable circumstances. The test should, therefore, be a combination of a subjective test, that is, taking into account the intention of the person and an objective test, that is, considering the facts and circumstances of the specific case.

In *C: SARS v Smith*[1], the court had regard to the intention of a taxpayer in determining whether he was carrying on farming operations. The taxpayer's intention is a subjective test which on its own, places SARS in a difficult position, since it is an onerous task to determine whether a loss should be allowed if one only has regard to the intention of a person. Continuous assessed losses from activities masqueraded as trades undermine the "ability to pay" principle of taxation. Before the introduction of section 20A there was a considerable loss of revenue as a result of individual taxpayers claiming assessed losses from unprofitable activities. Certain activities are also often unlikely to ever be profitable despite having business characteristics under tax law.

[1] 2002 (6) SA 621 (SCA), 65 SATC 6.

Ring-fencing is not a new concept in South African income tax law. In essence, it is an anti-avoidance measure under which the expenditure incurred in conducting a trade is limited to the income of that trade. Any excess expenditure (assessed loss from a trade) is then carried forward and is only set off against any income derived from that trade in a subsequent year of assessment.

Many examples of ring-fencing provisions can be found in the Act, which include, amongst other things, the ring-fencing of certain allowances and/or losses in the mining industry, farming activities, toll-road operators, leasing activities, foreign trades and pre-trade expenses.

# 3. The law

### Section 20A

**20A. Ring-fencing of assessed losses of certain trades.**—(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 sum of the taxable income of a person for a year of assessment (determined without having regard to the other provisions of this section) and any assessed loss and balance of assessed loss which were set off in terms of section 20 in determining that taxable income, 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, 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.

(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, promoting 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—

(*a*) which is included in the income of that person in terms of section 8 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.

(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 the nature of the business in his or her return contemplated in section 66 for that year of assessment.

(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.

(10) For the purposes of this section—

(*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.

# PART B – RING-FENCING OF ASSESSED LOSSES

## 4. Overview

### 4.1 Effective date

Section 20A was inserted into the Act by section 36(1) of the Revenue Laws Amendment Act 45 of 2003 with effect from 1 March, 2004 and is applicable in respect of any year of assessment commencing on or after that date.

### 4.2 Impact on general deduction formula

Section 20A does not replace the purpose or the function of section 11(*a*) read with section 23(*g*). Thus an assessed loss from a trade could be disallowed in whole under section 11(*a*) read with section 23(*g*) if the activity carried on by the taxpayer is not a *bona fide* trade, and in such event section 20A will have no role to play. Section 20A comes into operation when assessed losses from a trade were allowed in earlier years of assessment. It is therefore applied after the application of sections 11(*a*) and 23(*g*) and provides a structure for determining whether or not a trade loss should be set off against other income, thereby reducing taxable income. Apart from specific circumstances, which will be dealt with later, a "ring-fenced" loss is not "lost" or "disallowed"; but merely carried forward to the next year of assessment and is available for set-off against any income derived from that specific trade in that year.

### 4.3 Applicable to natural persons only

The ring-fencing provisions only apply to an assessed loss from a trade carried on by a taxpayer who is a natural person. Natural persons trading in a partnership are thus included. Assessed losses incurred by companies, close corporations and trusts are not subject to the section 20A ring-fencing provisions. An individual who carries on a registered micro business contemplated in the Sixth Schedule to the Act will not generate an assessed loss from that micro business because all its receipts and accruals are exempt from tax under section 10(1)(*z*J) and any deductions will accordingly be prohibited under section 23(*f*).

### 4.4 The four steps to ring-fencing

Section 20A contains four steps which determine whether an assessed loss can be ring-fenced. These are as follows:

Step 1 [section 20A(2)] – The maximum marginal rate of tax requirement

Step 2 [section 20A(2)(*a*) and (*b*)] – The "three-out-of-five-years" requirement or alternatively, the "listed suspect trade" requirement

Step 3 [section 20A(3)] – The "facts and circumstances" test (the escape clause)

Step 4 [section 20A(4)] – The "six-out-of-ten-years" requirement (the "catch all" provision)

Steps 1 and 2 are pre-requisites to potential ring-fencing.

Step 3 is an escape clause. In other words, an assessed loss that qualified for potential ring-fencing under steps 1 and 2 can escape ring-fencing under step 3.

Step 4 is a “catch all” provision that applies even if a taxpayer has escaped ring-fencing under step 3. It does, however, not apply to farming operations.

## 5. Step 1 – The “maximum marginal rate” requirement [section 20A(2)]

Under this step it is first necessary to adjust taxable income by adding back any assessed loss and balance of assessed loss carried forward from the previous year of assessment.

If the amount so determined falls within the highest tax bracket for individuals, the taxpayer will have met the first step in the potential ring-fencing process.

Conversely, if the adjusted taxable income is below the level at which the maximum marginal rate of tax becomes payable, the assessed loss may not be ring-fenced, regardless of the number of years in which losses have been incurred and the the nature of the trade being carried on. In such event there is thus no need to proceed to steps 2 to 4.

The levels of taxable income above which the maximum marginal rate of tax becomes payable are as follows:

**Table 1 – Maximum marginal rate thresholds**

| Year of assessment ending on the last day of February | Taxable income above which the maximum marginal rate of tax applies |
|---|---|
| 2005 | R270 000 |
| 2006 | R300 000 |
| 2007 | R400 000 |
| 2008 | R450 000 |
| 2009 | R490 000 |
| 2010 | R525 000 |
| 2011 | R552 000 |

Section 20A(2) makes no reference to either a “secondary” or “primary” trade or to “active” or “passive” income. The amount arrived at after adding back the assessed loss to taxable income can thus arise from any source. No distinction is made, for example, between a rental loss incurred by a person in receipt of pension and interest income or a rental loss incurred by either a person who is in full-time employment or a person conducting another trade as a sole proprietor.

**Example 1 – Maximum marginal rate pre-requisite**

*Facts:*

B, an individual under the age of 65, disclosed the following information in his 2010 return of income:

| | R |
|---|---|
| Employment income | 575 000 |
| Allowable deductions (Pension fund contributions) | (43 125) |
| Interest received | 25 000 |
| Capital gain before annual exclusion | 31 500 |
| (The capital gain was made on the disposal of a fixed property.) | |
| Letting of property – Assessed loss incurred during 2010 year of assessment (suspect trade) | (21 000) |
| Balance of assessed loss brought forward from 2009 | (15 000) |

For the 2010 year of assessment the maximum marginal rate is 40% on taxable income exceeding R525 000.

*Result:*

| | R |
|---|---|
| Taxable income from employment (R575 000 – R43 125) | 531 875 |
| Taxable interest (R25 000 – R21 000 exemption) | 4 000 |
| Taxable capital gain (R31 500 – R17 500 annual exclusion) x 25%* | 3 500 |
| Letting of property - assessed loss** | (21 000) |
| Balance of assessed loss brought forward from 2009** | (15 000) |
| Taxable income | 503 375 |
| *Add back*: Assessed loss from letting of property | 21 000 |
| Balance of assessed loss brought forward from 2009 | 15 000 |
| Taxable income after adding back assessed losses [section 20A(2)] | 539 375 |

**Notes:**

R539 375 represents the taxable income after adding back the assessed loss incurred from letting of property during the 2010 year of assessment (R21 000) and the balance of assessed loss brought forward from the previous year of assessment (R15 000). This amount is used to determine whether the "maximum marginal rate" pre-requisite in section 20A(2) has been met. Since R539 375 exceeds R525 000 (the maximum marginal rate threshold), the taxpayer has met the first pre-requisite for potential ring-fencing.

* The taxable capital gain of R3 500 is included in taxable income under section 26A. (25% of the capital gain after first deducting the annual exclusion is included in taxable income under section 26A.)

** The assessed loss arising from letting of fixed property for the current year, and balance of assessed loss brought forward from the previous year of assessment are added to taxable income to determine the "sum of taxable income" referred to in section 20A(2).

## 6. Step 2 – Potential ring-fencing pre-requisites

Under step 2, a taxpayer will be subject to potential ring-fencing if either section 20A(2)(*a*) [the "three-out-of-five-years" pre-requisite] or section 20A(2)(*b*) [the suspect trade requirement] applies.

### 6.1 The "three-out-of-five-years" pre-requisite [section 20A(2)(*a*)]

Under section 20A(2)(*a*) an assessed loss will be subject to potential ring-fencing if assessed losses have been incurred in at least three out of the last five years of assessment.

The five year period includes the current and four previous years of assessment.

The "three-out-of-five-years" pre-requisite applies to a trade, that is not listed as a suspect trade in section 20A(2)(*b*) (see **6.2**).

A taxpayer who incurs assessed losses in the first three years of assessment in which the trade is carried on will be subject to potential ring-fencing in the third year, since even if profits are derived in years four and five the requirements of the pre-requisite will have been met. In other words, it is unnecessary to wait for five years before applying the provision. On the other hand, a profit made in any year of assessment delays potential ring-fencing.

Under section 20A(9) assessed losses incurred on or before 29 February 2004 are not taken into account. Thus the first year after the introduction of section 20A in which an assessed loss from a trade can be subject to potential ring-fencing is 2007, assuming that assessed losses were also incurred in the 2005 and 2006 years of assessment.

The "three-out-of-five-years" pre-requisite only triggers potential ring-fencing in the current year of assessment in which the requirements are met. Assessed losses allowed against other income in earlier years thus remain unaffected and the assessments for those years will not be revised as a result of a taxpayer being subject to ring-fencing in future years of assessment.

**Example 2 – "Three-out-of-five-years" pre-requisite: Assessed losses incurred before the 2005 year of assessment**

*Facts:*

On 1 March 2002 X, an individual, commenced carrying on a trade that is not listed as a suspect trade under section 20A(1)(*b*). The trade produced assessed losses in each of the 2003 to 2007 years of assessment. After adding back these assessed losses X's taxable income was above the threshold at which the maximum marginal rate of tax becomes payable.

*Result:*

X has met the maximum marginal rate requirement in each year, thus satisfying the first requirement for potential ring-fencing.

Under section 20A(9) the assessed losses incurred in the 2003 and 2004 years of assessment must be disregarded for the purposes of applying the "three-out-of-five-years" pre-requisite. The assessed losses will therefore only become subject to potential ring-fencing in the 2007 year of assessment.

**Example 3 – "Three-out-of-five-years" pre-requisite: Losses in three consecutive years of assessment**

*Facts:*

On 1 June 2007 Z, an engineer, commenced making and installing steel gates and fences at private residences after hours and on weekends.

For the 2008, 2009 and 2010 years of assessment the amount arrived at after adding back to taxable income any assessed loss and balance of assessed loss exceeds the amount at which the maximum marginal rate of tax becomes payable.

The activities result in the following assessed losses: 2008: R12 300; 2009: R11 800 and 2010: R14 200.

*Result:*

Z has met the maximum marginal rate requirement in each year, thus satisfying the first requirement for potential ring-fencing.

The manufacture and installation of gates and fences is not a suspect trade listed in section 20A(2)(*b*) and the taxpayer is therefore subject to the "three-out-of-five years" pre-requisite in section 20A(2)(*a*).

Z has incurred assessed losses in three consecutive years of assessment commencing in the 2008 year of assessment. The "three-out-of-five years" pre-requisite is therefore met in the 2010 year of assessment. The assessed loss of R14 200 incurred in that year is therefore subject to potential ring-fencing.

**Example 4 – "Three-out-of-five-years" pre-requisite: Counting of assessed losses in years in which the "maximum marginal rate of tax" pre-requisite does not apply**

*Facts:*

On 1 March 2007 an individual commenced carrying on a trade that is not listed as a suspect trade under section 20A(1)(*b*). The trade produced assessed losses as follows: 2008: (R80 000); 2009: (R100 000); 2010: (R120 000); 2011: (R140 000). After adding back the assessed losses the taxpayer derived taxable income as follows: 2008: R180 000; 2009: R200 000; 2010: R400 000 and 2011: R560 000.

The taxable income above which the maximum marginal rate of tax applies is as follows: 2008: R450 000; 2009: R490 000; 2010: R525 000; and 2011: R552 000.

*Result:*

After adding back the assessed loss incurred in each year, the taxpayer's taxable income for 2008, 2009 and 2010 fell under the level at which the maximum marginal rate of tax became payable. Thus, although the taxpayer met the "three-out-of-five-years" pre-requisite in 2010, the assessed loss for 2010 could not be ring-fenced because the first pre-requisite (the maximum marginal rate of tax pre-requisite) was not met in that year.

In the 2011 year of assessment the taxable income after adding back the assessed loss for that year exceeded the level at which the maximum marginal rate of tax becomes payable. The "three-out-of-five-years" pre-requisite has been met in 2011, since assessed losses were incurred in 2009, 2010 and 2011. The assessed losses in 2009 and 2010 are counted for the purposes of the pre-requisite notwithstanding that the taxpayer's taxable income was below the level at which the maximum marginal rate of tax is payable in those years. However, only the 2011 assessed loss will be subject to potential ring-fencing.

**Example 5 – "Three-out-of-five-years" pre-requisite: Delay of potential ring-fencing as a result of deriving a profit in a year of assessment**

*Facts:*

B is employed on a full-time basis by a bank and has a part-time lawn-mowing business which is not a listed suspect trade. The lawn-mowing business produced the following results: 2005: (R7 000); 2006: (R5 000); 2007: R12 000; 2008: (R4 000); 2009: R5 000 and 2010: (R6 000).

After adding back the assessed losses from the business, B's taxable income meets the maximum marginal rate of tax requirement in each year of assessment.

*Result:*

B has met the maximum marginal rate requirement in each year, thus satisfying the first requirement for potential ring-fencing.

Since a listed suspect trade is not being carried on, B is subject to the "three-out-of-five-years" pre-requisite under section 20A(2)(*a*), being the second requirement for potential ring-fencing.

The assessed losses incurred in 2005 and 2006 are not subject to ring-fencing as it is too soon to apply the "three-out-of-five-years" rule. The profit of R12 000 derived in 2007 has the effect of delaying potential ring-fencing by one year. In 2008 B meets the "three-out-of-five-years" pre-requisite, having incurred assessed losses in 2005, 2006 and 2008 (that is, in three out of four years). The 2008 assessed loss of R4 000 is carried forward and set off against the 2009 profit of R5 000. The assessed loss of R6 000 incurred in 2010 is also subject to ring-fencing because assessed losses have been incurred in three out of five years (2006, 2008 and 2010).

The assessments for the 2005 and 2006 years of assessment will not be amended to disallow the assessed losses that were set off in those years in calculating taxable income.

**Example 6 – “Three-out-of-five-years” pre-requisite: Effect of adjusted taxable income falling below the maximum marginal rate threshold**

*Facts:*

An individual incurred the following assessed losses in carrying on a trade that is not listed as a suspect trade under section 20A(2)(*b*): 2007: (R11 000); 2008: (R13 000); and 2009: (R15 000).

The taxpayer derived the following taxable income in each year of assessment after taking into account the assessed loss from the trade: 2007: R379 000; 2008: R422 000; 2009: R495 000.

The taxable income above which the maximum marginal rate of tax applies is as follows for the 2007 to 2009 years of assessment: 2007: R400 000; 2008: R450 000 and 2009: R490 000.

*Result:*

Since the assessed losses do not arise from a listed suspect trade the taxpayer is subject to the “three-out-of-five-years” pre-requisite. The assessed losses must be added back to taxable income for the purpose of determining whether the maximum marginal rate of tax applies in any of the years in question.

| Year of assessment | Amount after adding back assessed loss to taxable income<br>R | Current year assessed loss<br>R | Taxable income<br>R |
|---|---|---|---|
| 2007 | 390 000 (note 1) | (11 000) | 379 000 |
| 2008 | 435 000 (note 2) | (13 000) | 422 000 |
| 2009 | 510 000 (note 3) | (15 000) | 495 000 |

The taxpayer fell under the top marginal rate for 2007 and 2008 with the result that the ring-fencing provisions cannot be applied in those years. In the 2009 year of assessment the marginal rate is exceeded, and it then becomes necessary to apply the “three-out-of-five-years” test. For that purpose the assessed losses incurred in 2007 and 2008 are taken into account. Since the taxpayer has incurred assessed losses in three consecutive years of assessment, the “three-out-of-five-years” pre-requisite is met, and the taxpayer becomes potentially subject to ring-fencing.

## 6.2 The “suspect trade” pre-requisite [section 20A(2)(*b*)]

Under the alternative to the “three-out-of-five-years” pre-requisite in step 2, an assessed loss that arises from any one of the eight suspect trades listed in section 20A(2)(*b*) will be subject to automatic potential ring-fencing.

Thus the first year of assessment in which an assessed loss from a suspect trade could be subject to potential ring-fencing is the 2005 year of assessment.

Each of the eight suspect trades contains either a qualifier or disqualifier indicating the circumstances in which that trade will be regarded as a suspect trade.

The trades comprising any sport, collectibles, animal showing, performing or creative arts and gambling or betting will be suspect if practised by the taxpayer or any relative of the taxpayer. Relatives of a taxpayer are included in order to address the situation in which that taxpayer conducts an activity in partnership with a relative.

Rental of residential accommodation, vehicles, aircraft or boats comprise a suspect trade unless 80% of the asset is used by persons who are not relatives of that person for at least half of the year of assessment.

Farming or animal breeding is a suspect trade unless such activities (including activities of a similar nature) are carried out on a full-time basis.

A trade that is excluded as a suspect trade will be subject to the "three-out-of-five-years" pre-requisite.

a) *Any sport practised by the taxpayer or any relative of the taxpayer*

   Sporting activities in this category include any form of sport such as athletics, cricket, golf, rugby, soccer, water sports such as yachting, boat racing, water-skiing, scuba diving, country sports such as hunting and fishing. This category relates to sporting activities, which are physically practised by the taxpayer personally or by any relative of that taxpayer. The sport of racehorse ownership is, however, excluded as it is not usually physically carried on by the taxpayer or a relative of the taxpayer. The activity conducted by a racehorse owner will be subject to the "three-out-of-five-years" pre-requisite.

b) *Dealing in collectibles by the taxpayer or any relative of the taxpayer*

   This category includes the dealing in art, antiques, cars, coins, militaria, notes, wine, stamps or any other object of interest to a collector.

c) *Rental of residential accommodation*

   This category includes holiday homes, bed-and-breakfast establishments, guesthouses, dwelling houses or any other similar residential abode. An assessed loss arising from the rental of residential accommodation will arise from a suspect trade, unless

   - at least 80% of the residential accommodation is used by persons who are not relatives in relation to that taxpayer; and
   - the accommodation is used by persons who are not relatives of the taxpayer for at least half of the year of assessment.

   In order to be excluded as a suspect trade both the above requirements must be met.

   The exclusion from the first bullet point could apply to the letting of 80% or more of a taxpayer's main residence to non-relatives.

   The reference to "for at least half of the year of assessment" can either be a continuous period of at least six months or other periods which in total are equal to at least six months.

   The letting of 100% of residential accommodation to persons who are not relatives meets the "80% of the residential accommodation" exclusion. But to be excluded as a suspect trade, the property must also be occupied for at least six months, by persons who are not

relatives of the taxpayer. The letting of a holiday home, which is used by the taxpayer or any relative of the taxpayer which is also let during the year of assessment on an occasional basis, for example, during peak seasons for less than six months, will therefore comprise a suspect trade.

**Example 7 – Letting of residential accommodation**

*Facts:*

During the 2010 year of assessment, B, for the first time let two rooms within her main home on a bed-and-breakfast basis. Each bedroom has its own en-suite bathroom. The total area of the house (including garages and outbuildings) is 420 square metres, while the area, which is let, is 120 square metres. The rooms were let to persons who are not relatives to B for a total of 300 days during the year of assessment. B incurred an assessed loss from this activity.

*Result:*

The area let to non-relatives, expressed as a percentage of the total area of the house, is 28.57% (120/420 x 100).

Since the first element has not been met, the rental activity is a suspect trade for the 2010 year of assessment. Even though the second element has been met, the activity will still be a suspect trade for the 2010 year of assessment because both requirements for exclusion have not been met.

d) *Rental of vehicles, aircraft or boats*

An assessed loss incurred by a taxpayer in respect of the rental of these movable assets may be subject to potential ring-fencing if less than 80% of the assets are leased for at least half of the year of assessment, by persons who are not relatives of the taxpayer. The calculation of 80% will, as in the case of the rental of residential accommodation, be relevant when any of the assets in this category are subject to private use by the taxpayer or any relatives. As in the case of residential accommodation, the requirements relating to 80% of the use of the assets, by persons who are not relatives, and for at least half of the year of assessment, must both be met before the trade will qualify for exclusion as a suspect trade.

e) *Animal showing by the taxpayer or any relative of the taxpayer*

This category relates to the showing of animals in competitions and includes the showing of animals such as horses, cattle, dogs and cats. Animal showing activities may form part of farming or animal breeding, if a taxpayer conducts those activities and the progeny is shown, for example, at agricultural shows or other animal shows as part of the farming or animal-breeding activities. In other words, the animal-showing activities must not be conducted by the taxpayer as a separate business and must be merely incidental to farming or animal breeding. The latter activities are dealt with in item (f) below.

f) *Farming or animal-breeding, unless the person carries on farming, animal breeding or activities of a similar nature on a full-time basis*

The meaning of the term “full-time” is not described in either section 1 or section 20A and will be discussed below.

g) *Any form of performing or creative arts practised by the taxpayer or a relative of the taxpayer*

This includes, for example, acting, dancing, filmmaking, singing, photography, writing, pottery, painting, jewellery making, metal works, sculpturing, carpentry, architecture and music. This category requires the specific art to be practised by the taxpayer or any relative of the taxpayer and will therefore exclude the investment by a taxpayer, for example, in a commercial film, without being involved in the actual making of such film. For more information on the taxation of film owners, refer to the *Guide on the Taxation of Film Owners* on the SARS website.

h) *Gambling or betting practised by the taxpayer or any relative of the taxpayer*

This category includes card playing, gambling at a casino on a regular basis, lottery purchases and sports betting. Winnings in respect of systematic and regular betting transactions by a taxpayer who is also a racehorse owner may, in certain instances, be regarded as part of the income arising from the racing activities of the taxpayer. This includes betting on the owner's horses and on the horses of others. The inclusion in gross income of winnings by racehorse owners under certain circumstances is based on their special knowledge and close connection to trainers, jockeys and other owners.

Gambling or betting does not include dealing in securities on securities exchanges such as the JSE. These activities fall into the "three-out-of-five-years" pre-requisite.

*The ordinary meaning of "full-time"*

Section 20A does not define the term "full-time". Unless a statutory provision indicates otherwise, the meaning of words or phrases must be given their ordinary dictionary meaning having regard to the content and purpose of the specific provision. This section is aimed at ring-fencing sustained assessed losses in respect of certain activities which are carried on in addition to a taxpayer's other income-generating activities. The meaning to be attached to the term "full-time" should therefore advance the purpose of the legislator in enacting the section. The reference to "that person" refers to the taxpayer, and the section indicates that, unless the taxpayer carries on farming or animal breeding on a full-time basis, the taxpayer's activities will fall within the suspect trade category.

According to the *New Shorter Oxford English Dictionary* the term "full-time" is defined as[2]

> "the total normal working hours: occupying or using all one's working time."

*Collins English Dictionary* describes full-time as meaning[3]

> "for all of the normal working week, a full-time job".

A taxpayer will thus be carrying on farming or animal breeding on a full-time basis if these activities take up most or all of the taxpayer's normal working hours. Consequently SARS will regard farming or animal breeding activities which do not take up most or all of the taxpayer's normal working hours, as activities which fall within the list of suspect trades under section 20A(2)(*b*).

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[2] Edited by Lesley Brown 4 ed (1993) Oxford University Press Inc in Volume 1.

[3] See <http://www.collinslanguage.com/results.aspx?context=3&reversed=False&action=define&homonym=0&text=full-time> [Accessed 7 October 2010].

Section 20A(2)(*b*) specifically indicates that that person should carry on the activities on a full-time basis. The words "that person" are a direct reference to the taxpayer and exclude any other person who may be managing the taxpayer's farming or animal breeding activities on that taxpayer's behalf.

A *bona fide* farming activity will not cease to be *bona fide* merely because the taxpayer conducts the activity on a part-time basis. The activity may still escape ring-fencing if there is a reasonable prospect of deriving taxable income within a reasonable period [section 20A(3)].

While all other trades listed as suspect trades in section 20A(2)(*b*) are subject to automatic ring-fencing when assessed losses have been incurred in six out of ten-years, farming on a full-time basis is excluded from this provision [section 20A(4)].

**Example 8 – The "suspect trade" pre-requisite: Effect of adjusted taxable income falling below the maximum marginal rate threshold**

*Facts:*

A taxpayer carries on a listed suspect trade which produces the following results for the 2005 to 2008 years of assessment: 2005: (R11 000); 2006: R9 200; 2007: (R8 700); 2008: (R5 000). Before applying section 20A the taxpayer's taxable income was as follows: 2005: R284 000; 2006: R305 000; 2007: R405 000; and 2008: R440 000.

After applying the "facts and circumstances" test in 2005 and 2007, the taxpayer is not able to show that the trade constitutes a business with a reasonable prospect of deriving taxable income (other than taxable capital gain) within a reasonable period.

The amount of taxable income above which the maximum marginal rate of tax becomes payable for the 2005 to 2008 years of assessment is as follows: 2005: R270 000; 2006: R300 000; 2007: R400 000; 2008: R450 000.

*Result:*

The first step is to determine whether the first pre-requisite for potential ring-fencing has been met, that is the "marginal rate of tax" pre-requisite.

| **Tax year** | **Taxable income before section 20A R** | **Add back assessed loss R** | **Adjusted taxable income R** | **Marginal rate threshold R** | **Threshold exceeded?** |
|---|---|---|---|---|---|
| 2005 | 284 000 | 11 000 | 295 000 | 270 000 | Yes |
| 2006 | 305 000 | | 305 000 | 300 000 | Yes |
| 2007 | 405 000 | 8 700 | 413 700 | 400 000 | Yes |
| 2008 | 440 000 | 5 000 | 445 000 | 450 000 | No |

The 2005, 2006 and 2007 years of assessment will be subject to ring-fencing since the adjusted taxable income exceeds the level at which the maximum marginal rate of tax becomes payable. The assessed loss of R5 000 incurred in the 2008 year of assessment will not be subject to ring-fencing since the taxable income for that year falls below the maximum marginal rate threshold.

The ring-fenced assessed loss and balance of ring-fenced assessed loss in each year of assessment is as follows:

| Tax year | Balance of assessed loss b/f | Assessed loss | Used | Balance of assessed loss c/f |
|---|---|---|---|---|
| | R | R | R | R |
| 2005 | - | 11 000 | - | 11 000 |
| 2006 | 11 000 | - | (9 200) | 1 800 |
| 2007 | 1 800 | 8 700 | - | 10 500 |
| 2008 | 10 500 | - | - | 10 500 |

The profit of R9 200 derived in the 2006 year of assessment is applied against the balance of the ring-fenced assessed loss brought forward from 2005.

| | Taxable income before section 20A | Add back (allow) ring-fenced assessed loss | Taxable income after section 20A |
|---|---|---|---|
| | R | R | R |
| 2005 | 284 000 | 11 000 | 295 000 |
| 2006 | 305 000 | (9 200) | 295 800 |
| 2007 | 405 000 | 8 700 | 413 700 |
| 2008 | 440 000 | - | 440 000 |

In the 2006 year of assessment, R9 200 of the ring-fenced assessed loss brought forward from 2005 has been allowed against the profit of R9 200 included in the taxable income for that year.

The assessed loss of R5 000 incurred in the 2008 year of assessment has been allowed as a deduction because the taxpayer falls below the marginal rate threshold in that year.

# PART C – THE ESCAPE CLAUSE

## 7. Step 3 – The "facts and circumstances" test

Section 20A(3) provides that

> "The provisions of subsection (1) do not apply … 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—."

(Emphasis added.)

A trade, which constitutes a "business" that met the "three-out-of--five-years" pre-requisite or the listed suspect trade pre-requisite and exhibits a reasonable prospect of deriving taxable income within a reasonable period, will not be subject to the ring-fencing provisions of

section 20A. The factors to be taken into account are prescribed in section 20A(3) (the "facts and circumstances test").

## 7.1 The meaning of a "business"

The word "business" is not defined in the Act, but the word "trade" is defined in section 1 as including every profession, trade, business, employment, calling, occupation or venture, including the letting of property and the use or the granting of permission to use certain other assets. Not every activity included under the definition of a "trade", for example, employment can be regarded as what one would normally describe as a business. Although an employee will, by virtue of the inclusion of employment under the definition of a "trade", be regarded as carrying on a trade, such "trade" would not in ordinary commercial life be regarded as the carrying on of a business.

In determining whether a trade constitutes a business, it is necessary to look at the activities conducted as a whole. A general impression of the activities should indicate whether they would normally be regarded as a "business" in ordinary commercial life.

The basic features of an activity which may indicate that a business is being conducted are, amongst other things, the size or scale of the activities, whether the activities are planned and organised, whether they are regular and continuous, whether the object is to make a profit and whether property (movable or fixed) was acquired. The aforementioned features are, however, not the only aspects indicative of a business activity being conducted, and it is therefore not possible to generalise and indicate which aspect should carry more or the most weight as each case will depend on its own particular facts and circumstances.

In *Smith v Anderson*[4] Jessel MR gave a general definition of the term "business", which was adopted and has been applied in a number of South African decisions, namely,

> "anything which occupies the time and attention and labour of a man for the purpose of profit is business."

## 7.2 "Reasonable prospect" and "reasonable period"

Section 20A gives no indication as to what should be considered as a "reasonable prospect" or a "reasonable period" for any trade. The facts and circumstances of a trade in one category such as rental will differ from the facts and circumstances of a trade in another, such as farming. Whether there is a reasonable prospect of deriving taxable income within a reasonable period will, therefore, depend on the facts and circumstances of each specific trade. Taxable income in this instance excludes any taxable capital gain. Whilst the prescribed facts and circumstances must be taken into account, other facts and circumstances may also be considered in unique cases.

A general impression of the activities as a whole should be obtained and no single listed fact or circumstance will be decisive in determining whether the trade constitutes a business with a reasonable prospect of deriving taxable income within a reasonable period. All the prescribed facts and circumstances will, therefore, be considered in combination.

[4] (1880) 15 ChD 247 at 258.

### 7.3 Special factors to be taken into account

The special factors to be taken into account, in considering whether a trade constitutes a business in respect of which there is a reasonable prospect of deriving taxable income within a reasonable period, do not contain any elements relating to the "intention of the taxpayer". What constitutes a "reasonable prospect" and "a reasonable period" is therefore not determined by a subjective test, that is, the intention of the taxpayer, but rather by an objective test. This objective test comprises the following special factors that have to be taken into account:

a) *The proportion of gross income derived from a specific activity in relation to the allowable deductions incurred in carrying on the specific trade.*

   The claiming of large amounts for deductions despite the deriving of a relatively small amount of gross income highlights a disproportional risk to the *fiscus*. Should a taxpayer, however, be generating large amounts of gross income in relation to the deductions claimed, this proportionality will be a favourable factor. The nature of all the expenditure claimed will also be taken into account, for example, the fact that certain deductions such as accelerated depreciation allowances may have resulted in the creation of an assessed loss, that is, the trade would, but for the specific allowances, have generated a profit, will be viewed in a positive light. The incurral of continuous assessed losses because the taxpayer, for example, receives minimal income, but on a yearly basis incurs expenditure such as general administrative costs, which on their own cannot produce income as they are merely incidental to the carrying on of the trade, may result in the trade, in all likelihood, not being regarded as a business with a reasonable prospect of deriving taxable income.

b) *The level of activities carried on by the taxpayer or the amount of expenses incurred in respect of advertising, promoting or selling in carrying on the specific trade.*

   This aspect will depend on the actual nature of the trade, that is, whether the taxpayer in fact sells a product or provides a service. Minimal sales and the advertising of a relevant product done mostly on a word-of-mouth basis will tend to indicate that the activity is more in the nature of a hobby as there is no serious intention to conduct a trade. Profits do not come by chance, but have to be actively pursued. Whilst certain trades may, as indicated above, consist of selling a product and therefore require a greater level of advertising in order to produce income, other trades may consist of the rendering of a professional service, which may not require the same level of advertising in order to produce income. Taxpayers must, where applicable, be able to demonstrate their efforts in promoting the relevant trade.

c) *The trade must be carried on in a commercial manner taking into account the following:*

   i. *The number of full-time employees appointed for the purposes of the trade (other than persons partly or wholly employed to provide services of a domestic or private nature)*

      This aspect relates to the number of full-time employees appointed as opposed to persons hired on a part-time basis. In *Somers v Director of Indian Education and another* Broome J stated the following:[5]

[5] 1979 (4) SA 713 (D) at 715.

> "The distinction between 'full-time' and 'part-time' is, in the context of employment, well known and well understood. These expressions deal with the length of time devoted by a servant to his master each working day or week, and involve a comparison between the duration of the master's ordinary working day or week as the case may be, on the one hand, and on the other hand the duration of the period of service of the servant during such working day or week. If the latter equals the former then the servant is said to be employed on a full-time basis. If there is an appreciable difference between the two, the servant would probably be regarded as being employed on a part-time basis. Thus a university student who spends each Saturday morning working at a bottle store will, because he does not work there Mondays to Fridays, be regarded as working on a part-time basis."

Persons hired on a part-time basis do not refer to or include employees who are, by the nature of the trade, only required on a seasonal basis. For example, in the case of farming, additional workers may be required on a part-time basis as shearers or fruit pickers.

Employees appointed to provide services of a domestic or private nature will not be regarded as full-time employees appointed for the purpose of the trade. Services of a domestic or private nature, refers to services pertaining to the taxpayer's private home or household. This will include employees appointed to render services in the home and its surrounds.

ii. *The commercial setting of the premises where the trade is carried on*

This aspect relates to the physical location of the suspect trade. The question is whether the commercial setting of that trade is likely to promote or hamper the production of income for that trade. The nature of a specific trade will dictate whether its location is conducive to trade. For example, in the case of various farming activities factors such as the lack of water, inaccessibility, the absence of a potential market (products), the ecological carrying capacity of the land (animals) and unsuitable growing conditions (products), may determine the commercial viability of that specific farming activity. The location of the specific trade should, therefore, not have a negative impact on the profitability of that trade. Certain trades do not require that they be conducted from a specific location and the nature of that trade will therefore be taken into account in considering this factor. A feasibility study carried out before commencing with the suspect trade may also highlight whether the specific location would be appropriate for that trade.

iii. *The extent of the equipment used exclusively for the purposes of carrying on that trade*

Assets, which are used exclusively for the purposes of the suspect trade, will be a favourable factor, whereas assets subject to mixed use, that is, for business and private use are excluded as a favourable factor.

iv. *The time that the person spends at the premises conducting the specific trade*

This factor takes into account the time and effort expended on the suspect trade. The nature of a trade will dictate whether the time spent by the taxpayer in carrying on the suspect trade could in ordinary commercial life be regarded as sufficient to render the trade commercially viable.

*The meaning of "commercial manner"*

The number of full-time employees appointed, the commercial setting of the trade, the equipment used and the time spent in conducting the business, are not the only indicators as to whether the trade is conducted by the taxpayer in a commercial manner. A taxpayer, who claims a deduction in respect of an assessed loss incurred, must be able to show that the trade is carried on for commercial reasons and in a commercially-viable manner.

A general impression of the activities should indicate whether they would be regarded as a business in ordinary commercial life or whether such activities are more in the nature of a hobby or a lifestyle choice. A trade, which is carried on in a commercial manner, will have a commercial character and a commercial purpose.

The following factors may therefore be considered:

**Table 2 – Factors indicating commercial / non-commercial nature of trade**

| **Trade carried on in a commercial manner** | **Trade not carried on in a commercial manner** |
|---|---|
| The taxpayer has a business plan | No planning, of any nature, neither before nor after commencing with the activity |
| The main purpose is making a profit | Profit is not the main purpose |
| The taxpayer seeks the best prices or commercial markets for services or products | The activity is conducted on a casual basis sales/services to acquaintances and family |
| The size and scale of the activity is sufficient for the specific trade and exceeds any personal needs by far | The size and scale of the activity is not sufficient to render the activity profitable and satisfies the taxpayer's personal needs only |
| The activity is organised and records of all transactions are kept | The activity is not organised and no records of transactions are kept |
| There is repetition and regularity of activities | Transactions are irregular and isolated |

d) *The number of years of assessment in which assessed losses were incurred in carrying on the trade in relation to the total number of years that the taxpayer has conducted the specific trade, taking into account any unexpected events giving rise to any of the assessed losses and the nature of the business involved.*

Examples of unexpected events in the case of **farming activities** would include: diseases affecting livestock or crops, pest plagues, droughts, floods, hailstorms, destruction by fire and any other unexpected event which substantially impedes the profitability of the farming activities. The incurral of a loss as a result of circumstances that were beyond the taxpayer's control will be taken into account in determining the number of years in which assessed losses have been incurred.

Examples of unexpected events in the case of **any other trade** would include destruction of business property because of any natural disaster and any other event or circumstances, which substantially impedes the profitability of the business.

The nature of an activity will also be considered when an assessed loss has been incurred for a number of years. Certain trades have a longer start-up period, for example, citrus, nuts and olive farming and this factor will be taken into account.

e) *The business plans of the taxpayer as well as any changes thereto, to ensure that taxable income will be derived from carrying on that trade in future.*

The presence of a business plan could be relevant in considering whether the activity has a reasonable prospect of deriving taxable income within a reasonable period. Favourable consideration will therefore be given to business plans and changes to existing plans which indicate that the necessary steps have been put into place to either prevent or limit further assessed losses. A business plan should include the following basic elements:

- A business description, that is, the nature of the business.
- The anticipated income to be derived from the business.
- The capital outlay, that is, capital required for the acquisition of, for example, trading stock and equipment necessary to carry on the trade.
- The administration and running costs of the business, for example, salaries/wages, telephone costs, travel costs, lease payments (movable and immovable property) water and electricity.
- How the capital outlay and the running costs are to be financed, for example, in the case of a bank loan, the interest rate and period over which the loan will be paid back.

f) *The extent to which assets attributable to the specific trade are used or are available for use by the taxpayer or any relatives for private use.*

As indicated in c) iii above, assets which are used exclusively for the purposes of trade, will be a favourable factor. The taxpayer must, where necessary, be able to show that the relevant asset was not generally available for private use by either the taxpayer or any of the relatives of the taxpayer. Business assets could include assets such as a boat, a yacht, an aircraft or fixed property such as a holiday home. The taxpayer must be able to show that the relevant asset is not generally available for personal use where such asset, which is subject to business and private use, is used in a business in respect of which an assessed loss has been claimed. In the case of, for example, fixed property, the taxpayer must be able to show that property is not generally available for private use by means of furnishing details of the periods that the property was occupied for business purposes by persons other than the taxpayer or any relatives.

# PART D – AUTOMATIC RING-FENCING: THE END OF THE ESCAPE CLAUSE

## 8. Step 4 – The "six-out-of-ten-years" rule

Section 20A(4) provides that the "facts and circumstances" escape clause in section 20A(3) is not available where the taxpayer has incurred an assessed loss in at least six out of the last ten years of assessment, including the current year of assessment. This rule does not apply to farming.

In the year of assessment in which the rule applies the assessed loss will be permanently ring-fenced. The "facts and circumstances" test can, therefore, no longer be used to avoid ring-fencing, despite it having been avoided in earlier years of assessment. The ring-fenced assessed loss must be carried forward and will only be available for set-off against future income from the same trade.

The first year of assessment in which this rule can apply is 2010, assuming that successive assessed losses, have been incurred in the 2005 to 2010 years of assessment. A profit made in any number of years, will delay permanent ring-fencing by an equal number of years.

Under section 20A(9) any assessed loss incurred in any year of assessment ending on or before 29 February 2004 must not be taken into account for the purposes of this rule. This means that assessed losses incurred in years of assessment before 2005, may not count against the taxpayer as an assessed loss for the purposes of determining the number of years in which an assessed loss has been incurred.

**Example 9 – "Six-out-of-ten-years" rule**

*Facts:*

A taxpayer conducts a suspect trade. Assessed losses arose in the 2005 to 2010 years of assessment. After adding back the assessed losses the taxpayer's taxable income for each year of assessment falls within the bracket at which the maximum marginal rate of tax is payable. For each of the years in question the taxpayer has succeeded in showing that the business has a reasonable prospect of deriving taxable income within a reasonable period.

*Result:*

Commencing with the 2005 year of assessment, the ten-year period only ends in 2014. However, since an assessed loss has been incurred in each of the six successive years of assessment (2005 to 2010) the assessed loss incurred in 2010 will be permanently ring-fenced. Any profits derived in the 2011 to 2014 years of assessment cannot detract from this fact.

## 9. The application of section 20A in practice

The effect of the ring-fencing provisions on "taxable income" is illustrated in the example below.

**Example 10 – The application of section 20A in practice**

*Facts:*

1. In each of the 2005 to 2008 years of assessment the taxpayer is in receipt of employment income, which exceeds the taxable income above which the maximum marginal rate of tax becomes payable. The applicable thresholds are: 2005: R270 000; 2006: R300 000; 2007: R400 000; and 2008: R450 000.
2. The taxpayer also carries on a trade that has passed the trade test in section 11. This is a suspect trade listed in section 20A(2)(*b*).
3. The results from the suspect trade were as follows: Losses: 2005: R3 000 2006: R2 500 Profits: 2007: R6 000; 2008: R1 000.
4. The taxpayer's taxable income from employment was as follows: 2005: R273 001; 2006: R306 500; 2007: R410 000; 2008: R452 000
5. The assessed loss arising from the suspect trade is ring-fenced in 2005 as the taxpayer was not able to show that it constituted a business with a reasonable prospect of deriving taxable income within a reasonable period.

*Result:*

| Year of assessment | Income/(assessed loss) from suspect trade | Income from employment | Taxable income excluding suspect trade assessed loss | Balance of assessed loss ring-fenced to be carried forward to the next year of assessment |
|---|---|---|---|---|
| | R | R | R | R |
| 2005 | (3 000) | 273 001 (note) 1 | 273 001 | 3 000 |
| 2006 | (2 500) | 306 500 (note 2) | 306 500 | 5 500 |
| 2007 | 6 000 | 410 000 (note 3) | 410 500 | Nil |
| 2008 | 1 000 | 452 000 (note 4) | 453 000 | Nil |

**Notes:**

1. *The 2005 year of assessment*

   The amount arrived at after adding back the assessed loss for the current year to taxable income (R270 001 + R3 000 = R273 001) exceeds R270 000. The assessed loss from the suspect trade is ring-fenced and as a result, the assessed loss is carried forward to the 2006 year of assessment.

2. *The 2006 year of assessment*

   The amount arrived at after adding back the assessed loss for the current year and the balance of assessed loss carried forward from the previous year to taxable income (R301 000 + R3 000 + R2 500 = R306 500) exceeds R300 000. The loss is ring-fenced and the accumulated assessed loss of R5 500 is carried forward to the 2007 year of assessment.

3. *The 2007 year of assessment*

The income of R6 000 from the trade for the current year of assessment is reduced by the accumulated assessed loss of R5 500 from that trade brought forward from the 2006 year of assessment. The excess of R500, that is (R6 000 – R5 500) is added to the taxable income from employment of R410 000 adding up to the taxable income of R410 500 for the 2007 year of assessment.

4. *The 2008 year of assessment*

The income of R1 000 from the trade for the current year of assessment is added to the income from employment of R452 000 adding up to taxable income of R453 000.

As can be seen from Example 10, once an assessed loss from a specific trade is ring-fenced under the provisions of section 20A(1), the ring-fencing is permanent. This treatment of the assessed loss from that specific trade is in accordance with section 20A(5), which provides:

> "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)."

A ring-fenced assessed loss from a suspect trade in an earlier year of assessment will first be set off against any income from that trade in a current year of assessment. Any income which remains, after the assessed loss/accumulated assessed loss carried forward from a preceding year, has been deducted, will be added to other taxable income.

# PART E – OTHER MATTERS RELATING TO RING-FENCING

## 10. Multiple farming activities deemed to be a "single trade"

Section 20A(7) provides that, for the purposes of the ring-fencing provisions, all the taxpayer's farming activities are deemed to constitute a single trade.

**Example 11 – Farming activities**

*Facts:*

For the 2011 year of assessment a taxpayer earns R600 000 from his private practice and also carries on the following part-time farming activities on three different smallholdings.

| | 2011<br>R |
|---|---|
| Smallholding 1 – Cattle farming | 25 000 |
| Smallholding 2 – Sheep farming | (58 000) |
| Smallholding 3 – Fruit farming | (21 000) |
| Farming income/loss for the 2011 year of assessment | (54 000) |

The taxpayer's farming activities have in aggregate produced assessed losses in three out of the last five years, including the 2011 year of assessment.

The taxpayer is unable to show that the sheep and fruit farming activities have a reasonable prospect of producing taxable income within a reasonable period (excluding any taxable capital gain).

*Result:*

The farming activities conducted on all three smallholdings are, for the purposes of the ring-fencing provisions, deemed to constitute a single trade. The profits and assessed losses are therefore set off against one another to arrive at one amount representing the taxable income or assessed loss from farming activities. For the 2011 year of assessment the taxpayer's taxable income will be R600 000, and not R625 000 (R600 000 plus R25 000 which is the profit made on smallholding 1).

There is an overall assessed loss of R54 000 from all the farming activities. Since the activities on all three smallholdings are deemed to constitute one single trade, the "facts and circumstances" test must be applied to the farming activities on a collective basis. Neither the assessed loss from the sheep farming activities nor the assessed loss from the fruit farming can, therefore, under section 20A(7) be subject to potential ring-fencing as separate trades.

## 11. Activities, other than farming, can also be regarded as a single trade

While section 20A specifically deems all farming activities to constitute a single trade for the purposes of applying the ring-fencing provisions, the section is silent on the treatment of other activities.

Whether more than one related activity, other than farming, can be treated as a single trade for purposes of section 20A will depend on the facts of the specific case. The activities conducted will be looked at as a whole. A general impression of the activities and the way in which they are conducted will give some indication as to whether they are conducted as a single trade. The question whether certain activities comprise a business, is particularly relevant in the case of the letting of fixed property. A distinction must be made between property, which is predominantly held for long-term capital growth, and property, which is held as a business asset to be exploited for the purpose of gain, that is, property which is held with the intention of carrying on a business as a lessor of property.

**Example 12 – Activities constituting a single trade**

*Facts:*

A taxpayer buys five apartments in a block of flats with the intention of renting them out at a profit. These apartments were all purchased at the same time, with the same method of finance and with the same intention of conducting a rental trade.

*Result:*

The taxpayer will have a strong case in arguing that a single trade is being conducted, namely, a business as a lessor of fixed property, rather than five separate trades. On the other hand, if the apartments were bought over a period of time as separate investments they may be regarded as five separate trades. The profitability of each trade must be considered in deciding whether any loss may be ring-fenced.

Activities regarded as suspect trades, such as the occasional letting of one or more properties purchased as holiday homes, could constitute separate trades and the income and expenditure of each trade may, as a result, be examined on a separate basis in order to determine whether the assessed loss in respect of such activity should be ring-fenced.

## 12. Other amounts to be included as "income" from the trade

*Recoupment of deductions and allowances*

Section 8(4) provides for the recoupment of amounts previously allowed as a deduction against the income of a taxpayer. As a rule, the recoupment of an amount previously allowed as a deduction does not constitute income derived from conducting a trade.

However, in calculating the net profit or loss from a specific trade, that is, the taxable income or assessed loss of that trade, any amounts referred to in section 8 must be included as income from that trade [section 20A(6)(*a*)].

*Amounts derived from disposal of assets after cessation of trade*

Under section 20A(6)(*b*) the term "income derived from any trade" for the purposes of Section 20A(1) or (5) includes any amount

> "derived from the disposal after cessation of that trade of any assets used in carrying on that trade".

The above provision covers

- non-depreciable capital assets (that is, the taxable capital gain arising on disposal of such assets);
- depreciable assets (the taxable capital gain on disposal of such assets);[6] and
- trading stock (inclusion in gross income).

An important requirement for the set-off of a taxable capital gain on disposal of a capital asset or an amount included in income from the disposal of trading stock is that the asset must be disposed of after the cessation of trade. Taxable capital gains derived during the course of the trade may not be set off against a ring-fenced assessed loss.

[6] Amounts included in income as a result of the recoupment of allowances on depreciable assets are deemed to be income from the specific trade under section 20A(6)(*a*).

## 13. Reporting requirements

Section 20A(2) applies to a person who would be subject to the maximum marginal rate of tax after adding back any assessed loss and balance of assessed loss from carrying on a trade.

Such a person must indicate the nature of the loss-generating business in his or her return of income [section 20A(8)].

## 14. Spouses married in community of property

Section 7(2A) deals with the allocation of income derived by spouses married in community of property.

Income received or accrued from the carrying on of a trade (excluding the letting of fixed property) is deemed to constitute the income of the spouse who carries on the specific trade. The income of any trade conducted in partnership by the spouses, is deemed to have accrued to both spouses in the proportion determined by them under the agreement that regulates their joint trade. In the absence of an agreement, the income will be deemed to accrue in the proportion to which each spouse would reasonably be entitled taking into account the nature of the trade, the extent of each spouse's participation in the trade, the services rendered by each spouse or any other relevant factor.

In the case of income derived from the letting of fixed property, section 7(2A)(*b*) deems the income to have accrued to both spouses in equal shares. The rental income derived from property that does not form part of the joint estate will be included in the income of the spouse who owns the asset.

Paragraph 14 of the Eighth Schedule to the Act deals with the apportionment of capital gains and losses between spouses married in community of property.

The determination of which spouse must account for a taxable capital gain will only be relevant once the suspect trade has ceased [section 20A(6)]. For the purpose of determining a capital gain or capital loss the disposal of an asset falling in the joint estate is treated as being made in equal shares by each spouse. The disposal of an asset falling solely in the estate of one of the spouses is treated as having been made by the spouse who disposes of the asset.

# PART F – GENERAL ADMINISTRATIVE PROVISIONS

## 15. Provisional tax

The ring-fencing provisions will have an effect on the amount of provisional tax due in the 2005 and succeeding years of assessment, in the following cases:

1. The taxpayer incurred an assessed loss in respect of a listed suspect trade and the assessed loss is subject to potential ring-fencing with effect from the 2005 year of assessment. An assessed loss ring-fenced in 2005, cannot be set-off against income from any other source. The taxable income from other sources can therefore not be reduced by the assessed loss and the provisional tax liability is calculated on the taxable income excluding the ring-fenced assessed loss.

2. The taxpayer incurred an assessed loss in respect of a trade which is subject to the "three-out-of-five-years" pre-requisite. This assessed loss can only be subject to potential ring-fencing with effect from the 2007 year of assessment. An assessed loss which is subject to the three out of five-year pre-requisite will therefore not have an effect on the amount of provisional tax payable in the 2005 or the 2006 years of assessment, but can have an impact in subsequent years.

Taxpayers should exercise caution by keeping the ring-fencing provisions in mind when making their provisional tax payments. A short-payment of provisional tax may occur when an assessed loss from a suspect trade is taken into account and the assessed loss is ring-fenced. Penalties and interest could be payable on the short-payment if the estimated taxable income is not within the prescribed limits.

## 16. Tax directives

Paragraph 11 of the Fourth Schedule to the Act empowers the Commissioner, having regard to the circumstances of the case, to issue a tax directive authorising the employer to refrain from deducting employees' tax (or to deduct a smaller amount thereof) from remuneration owing to the employee. The purpose of such a directive is to alleviate hardship to the employee owing to circumstances outside the employee's control. An employee who has incurred an assessed loss may, therefore, apply for a tax directive which would enable the employer to deduct the assessed loss from the employee's remuneration in arriving at the amount of employees' tax to be withheld. The tax directive application form [IRP 3(*c*)] can be obtained from a SARS branch office or the SARS website. The Commissioner will not authorise such a directive if satisfied that the assessed loss is subject to ring-fencing under section 20A.

## 17. Objections and appeals

A taxpayer who has been issued with an assessment which ring-fences an assessed loss, has a right to object to the assessment if not satisfied with the decision made by SARS. In the event that the objection is disallowed or partially disallowed, that taxpayer has the right to lodge an appeal against such disallowance or partial disallowance.

Information on the objection and appeal procedures is available on the SARS website under All Publications ⇨ Alternative Dispute Resolution (ADR). It can also be obtained from any SARS branch office.

## 18. Conclusion

It is trusted that this guide will contribute to greater clarity about the application and interpretation of the provisions of the Act pertaining to the ring-fencing of assessed losses arising from certain trades conducted by individuals.

**Annexure – Checklist (flowchart) for the application of the ring-fencing provisions**