



SOUTH AFRICAN REVENUE SERVICE

INCOME TAX INTERPRETATION NOTE NO. 8

DATE: 28 MARCH 2002

ACT : INCOME TAX ACT, NO. 58 OF 1962 ("the Act")
SECTION : SECTION 25C
SUBJECT : INSOLVENT ESTATES

1. Background

It was the practice of the South African Revenue Service prior to 4 July 1997 to regard insolvent estates as taxable entities and to treat the trustees as representative taxpayers.

In the case *Thorne & Molenaar NNO v Receiver of Revenue Cape Town* 1976 (2) SA 50(C) (38 SATC 1) the Supreme Court held that the practice that had been followed, was not correct and neither the insolvent estate nor the trustees were liable to tax on income which was received by or accrued to the insolvent after the date of sequestration.

A number of amendments were subsequently made to the Act to ensure that in the case of insolvencies on or after 4 July 1997 any income that was received by or accrued to the insolvent estate is subject to tax.

The purpose of this interpretation note is to provide clarity regarding SARS's interpretation and application of the relevant provisions of the Act relating to insolvent estates.

2. The law and its application

2.1 Separate entities

Upon the sequestration of a taxpayer's estate as insolvent, his/her assets become vested in the trustee or administrator (hereinafter referred to as "trustee") who is appointed to take control of the administration and liquidation of the estate for the benefit of the creditors.

From a taxation point of view, the effect of insolvency is to terminate the tax-status of the taxpayer and to substitute in his/her place a new entity, viz the insolvent estate. In other words, a new entity comes into existence on the date upon which the insolvent surrendered his/her estate or, in the case of compulsory sequestration, the date of the provisional order if such order is later made final. See *ITC 349* (9 SATC 66 at page 69) in this regard.

The effect is, therefore, to create three potential taxpayers -

- the insolvent for the period prior to insolvency;
- the insolvent estate; and
- the insolvent for the period subsequent to insolvency.

The insolvent will be assessed as a natural person for the period prior to insolvency, as well as for the period subsequent to insolvency should any income accrue to him in his personal capacity. Rebates will only be allowed on a proportional basis.

2.2 The following specific provisions relate to the taxation of the insolvent estate:

(a) The insolvent estate as a separate taxpayer

The definition of "person" in section 1 of the Act was amended with effect from 4 July 1997 to specifically include an insolvent estate. An "insolvent estate" is defined in section 1 of the Act and means an insolvent estate as defined in section 2 of the Insolvency Act, 1936 (Act No. 24 of 1936). Section 2 of the

Insolvency Act defines an insolvent estate as an estate under sequestration. The insolvent estate must be registered for income tax purposes as a separate entity. For administrative purposes a new income tax reference number is allocated to the insolvent estate.

It is important to note that where there has been no order accepting the surrender of, or sequestration of a taxpayer's estate, but he/she merely assigns his/her assets for the benefit of his/her creditors, the provisions relating to insolvency do not apply. If, however, such assignment has the effect of a compromise by relieving the taxpayer of his/her liabilities to the creditors, the provisions of sections 20(1)(a) and 8(4)(m) of the Act must be kept in mind.

An insolvent estate does not qualify for the primary rebate [section 6 of the Act] and the investment income exemption [section 10(1)(i)(xv) of the Act]. These provisions are limited to natural persons.

The insolvency of a partner brings about the dissolution of the partnership. For income tax purposes the estate of each insolvent partner constitutes a separate "person".

(b) The representative taxpayer of an insolvent estate

With effect from 4 July 1997 an amendment was introduced to the definition of "representative taxpayer" in section 1 of the Act to include the trustee of an insolvent estate [paragraph (f)].

Section 95(1)*bis* was also amended in 1997 to make the trustee of an insolvent estate responsible for the tax affairs of the insolvent person for the period prior to the date of sequestration.

A trustee of an insolvent estate who fails to comply with the requirements of the Act relating to an insolvent estate, could be

held personally liable for any tax payable by him/her in his/her representative capacity if he/she alienates, charges or disposes of the income in respect of which the tax is chargeable or disposes of any fund or money which is in his/her possession from which the tax could legally have been paid [section 97 of the Act].

(c) Section 25C of the Act

Section 25C was inserted in the Act by section 21 of Act No. 28 of 1997 and amended by section 13 of Act. No. 5 of 2001.

This provision, prior to its amendment in 2001, provided that where the whole or a part of a business undertaking of an insolvent was transferred to the trustee of an insolvent estate that:

- An assessed loss incurred by the insolvent person can be set-off against the income of the insolvent estate.
- Expenditure and allowances claimed by the insolvent person prior to date of insolvency can be recouped in the estate, for example, depreciation allowance, doubtful debts allowance, hire purchase allowance, etc.
- Debts included in the income of the insolvent person prior to date of insolvency can be claimed as bad debts by the insolvent estate.
- The write-off of assets or allowances can continue to be deducted in the estate.
- There may be included in the income of the insolvent estate any amounts recovered during the winding up period in respect of debts written off as bad prior to sequestration.

Section 13 of Act No. 5 of 2001 amended section 25C in 2001 by:

- Removing the reference to business undertaking to cater for capital gains and losses as determined in terms of the Eight Schedule to the Act that can arise in circumstances other than where a business undertaking is carried on. This amendment has the effect of permitting an assessed loss [section 20(2) of the Act] and an assessed capital loss [Eight Schedule to the Act] determined in respect of the insolvent prior to date of insolvency to be carried forward to the insolvent estate.
- Adding a provision to provide that where the order of sequestration has been set aside, that person's insolvent estate and that person's estate after that order has been set aside will be deemed to be one and the same person. The effect thereof is that the tax position of the person continues as if his/her estate had not been sequestrated, except that any transactions entered into by the trustee of the insolvent estate will have to be accounted for by that person in the determination of his or her taxable income, taxable capital gain or assessed capital loss.

(d) The provisions of paragraph 19(5)(b) of the First Schedule to the Act

In terms of paragraph 19(5) of the First Schedule to the Act a farmer (natural person) may elect that the normal tax chargeable in respect of the taxable income from farming be determined in accordance with the formula as provided in section 5(10) of the Act, the so-called rating formula.

The trustee of the insolvent estate of a natural person may also elect that the normal tax chargeable in respect of the taxable

income from farming of the estate be determined in accordance with the rating formula if:

- The farming operations carried on by the estate, in the year of assessment immediately succeeding the year of assessment in which the person became insolvent, are merely a continuance of the operations carried on by the insolvent prior to the date of insolvency.
- The election is made within three months after the end of such period of assessment or within such further period as the Commissioner may approve. The election must be made no later than the time of submission of the tax return.

The brochure accompanying the tax return makes provision for the election. Once the election has been made it is binding on the estate for all future assessments. If the trustee made the election, the insolvent estate will be taxed in accordance with the rating formula. The average taxable income from farming will be calculated having regard to the figures determined for the insolvent prior to the date of insolvency.

(e) Other

Taxes and levies that are imposed in respect of income accrued or business conducted from the date of sequestration must be taken into account as costs of insolvency and thus included as expenses in the liquidation and distribution account. It is, therefore, not necessary that such costs be proven as a claim against the estate.

4. Illustrative example

The practical application of the provisions relating to insolvent estates is illustrated by way of the following example:

Details:

The creditors of Mr. Wannabee applied for the sequestration of his estate on 15 October 2001. Mr. Wannabee was the owner of a sports bar in Yuppie Park, Sandton. The trustee of his insolvent estate continued with the operation of the sports bar on behalf of the insolvent estate (and ultimately the benefit of the creditors) until 31 January 2002.

Mr. Wannabee purchased new furniture on 1 March 2000 for R 180 000. The furniture is written off on the straight line method over 6 years. The depreciation allowance has been taken into account as follows:

Period	Calculation	R
2001	180 000/6 years	30 000
2002 prior to insolvency	180 000/6 years x 228/365 days (1/3/2001 – 14/10/2001)	18 740
2002 insolvent estate	180 000/6 years x 109/365 days (15/10/2001 – 31/1/2002)	8 959

A depreciation allowance of R100 000 has previously been allowed in respect of kitchen equipment, which had a tax value of RNIL on 28 February 2001.

Sports bar income of R301 998 was generated for the period 1 March 2001 to 14 October 2001 and allowable expenditure (before any allowances have been taken into account) amounted to R310 667 for the same period. Interest income of R2 000 was received in respect of the same period.

Sports bar income of R100 081 was generated for the period 15 October 2001 to 31 January 2002 and allowable expenditure (before any allowances have been taken into account) amounted to R98 660 for the same period.

Interest income of R1 500 was received in respect of the period 15 October 2001 to 28 February 2002.

The sports bar was sold on an auction on 31 January 2002 for R400 000, of which R80 000 was paid for the furniture and R20 000 for the kitchen equipment.

Loss on sale of furniture

	R	R
Purchase price of furniture		180 000
<u>Less:</u> Depreciation allowed – 2001	30 000	
Depreciation allowed prior to insolvency	18 740	
Depreciation allowed insolvent estate	8 959	57 699
Tax value on date of sale		122 301
Sale price of furniture		80 000
Capital loss on sale of furniture		42 301

Note

No scrapping allowance may be claimed in respect of the loss on sale of the furniture. The loss will, however, qualify as an assessed capital loss for capital gains tax purposes. This loss may be set-off against future net capital gains of the estate.

Recoupment on sale of kitchen equipment

	R
Purchase price of furniture	100 000
<u>Less:</u> Depreciation allowed to date	100 000
Tax value on date of sale	NIL
Sale price of kitchen equipment	20 000
Recoupment on sale of kitchen equipment	20 000

Taxable income of the insolvent for the period prior to insolvency

	R
Income from sports bar for the period 1 March 2001 to 14 October 2001	301 998
<u>Less:</u> Allowable expenditure	310 776
	<hr/> 8 778
<u>Less:</u> Depreciation - Furniture (180 000/6 x 228/365 days)	18 740
Assessed loss for the period prior to insolvency (to be carried forward)	<hr/> 27 518 <hr/>

Note

Interest received or accrued of R2000 is exempt in terms of the basic investment exemption applicable to natural persons

Taxable income of the insolvent estate for the period 15 October 2001 to 28 February 2002

	R
Income from sports bar for the period 15 October 2001 to 31 January 2002	100 081
<u>Less:</u> Allowable expenditure	98 660
	<hr/> 1 421
<u>Less:</u> Depreciation - Furniture (180 000/6 x 109/365 days)	8 959
	<hr/> 7 538
<u>Add :</u> Recoupment: kitchen equipment	20 000
	<hr/> 12 462
<u>Add:</u> Investment income that accrued up to 28 February 2002	1 500
	<hr/> 13 962
<u>Less:</u> Assessed loss for the period prior to insolvency brought forward	27 518
Assessed loss to be carried forward	<hr/> 13 556 <hr/>

Note

The assessed loss of R13 556 calculated above may be carried forward for purposes of calculating the tax liability of the estate for future years of assessment. If no more income accrues to the estate and the estate is wound up, the balance of the assessed loss is forfeited.