



SOUTH AFRICAN REVENUE SERVICE

INTERPRETATION NOTE NO. 8 (ISSUE 2)

DATE: 22 March 2006

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

1 Purpose

The purpose of this Note is to set out the South African Revenue Services' interpretation and application of section 25C of the Act.

2 Background

Prior to 4 July 1997 it was the practice of SARS to regard insolvent estates as taxable entities and to treat the trustees of insolvent estates as their representative taxpayers.

However, in the case of *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. The Court had to decide whether a trustee of an insolvent estate was liable to pay income tax on income accruing to an insolvent estate, either in the capacity of a representative taxpayer or any other capacity.

The Court found that –

- the income derived by the trustees could not be said to be income of a person under a legal disability;
- merely because a person fell under the definition of a “trustee” as defined in section 1 of the Act did not necessarily mean that he was a representative taxpayer;
- as defined the term “trustee” could not be regarded as correlative to the term “trust” and for a trustee to be a representative taxpayer he had to be a trustee in respect of the income that was the subject of a trust; and
- therefore, the trustee of the insolvent not liable for tax on any income accruing to the insolvent estate in his personal capacity or in his capacity as a representative taxpayer.

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

3 The law and its application

3.1 Three separate entities exist for income tax purposes

Upon the sequestration of a taxpayer's estate as insolvent, his/her assets become vested in the trustee or administrator who is appointed to take control of the administration and sequestration 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 person 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.

Three separate taxpayers will, therefore, be liable for tax, namely:

- The insolvent person for the period prior to insolvency
- The insolvent estate (a new entity for tax purposes)
- The insolvent person for the period subsequent to insolvency.

The insolvent person 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 or her in his or her personal capacity. Rebates will only be allowed on a proportional basis.

3.2 The insolvent estate is a "person" for income tax purposes

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 as –

"an insolvent estate as defined in section 2 of the Insolvency Act, 1936 (Act No. 24 of 1936)".

Section 2 of the Insolvency Act, 1936 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 recoupment provisions contained in sections 20(1)(a)(ii) and 8(4)(m) of the Act must be kept in mind.

An insolvent estate does not qualify for the primary rebate as contemplated in section 6 of the Act or the investment income exemption as contemplated in section 10(1)(j)(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".

3.3 The representative taxpayer of an insolvent estate

With effect from 4 July 1997 paragraph (f) was added to the definition of "representative taxpayer", as defined in section 1 of the Act -

"(f) in respect of the income received by or accrued to an insolvent estate, the trustee or administrator of such insolvent estate;"

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

Section 97 of the Act, furthermore, provides that the trustee or administrator 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.

3.4 Section 25C of the Act

Section 25C was inserted in the Act in 1997 to provide that where the whole or a part of a business undertaking of an insolvent person was transferred to the trustee or administrator of an insolvent estate, the estate of the person prior to sequestration and the person's insolvent estate are deemed to be one and the same person for income tax purposes.

This section was amended in 2001 to provide for the removal of the reference to a business undertaking to also cater for capital gains and losses as determined in terms of the Eighth Schedule to the Act that can arise in circumstances other than where a business undertaking is carried on. This amendment has the effect of crystallising all capital gains and capital losses in the hands of the insolvent estate. It, furthermore, has the effect of permitting an assessed loss as contemplated in section 20(2) of the Act and an assessed capital loss as contemplated in the Eighth Schedule to the Act to be carried forward from the insolvent person prior to date of sequestration into his or her insolvent estate.

After its further amendment in 2003, section 25C provides that the estate of the person prior to sequestration and the person's insolvent estate are deemed to be one and the same person for purposes of –

- the amount of any allowance, deduction or set off to which that insolvent estate may be entitled;
- any amount which is recovered or recouped by or otherwise required to be included in the income of that insolvent estate; and
- any taxable capital gain or assessed capital loss of that insolvent estate.

This *inter alia* means that:

- An assessed loss incurred by the insolvent person can be set-off against the income of the insolvent estate (the provisions of section 20(1)(a)(i) are, therefore, not applicable in respect of the estate).
- Expenditure and allowances claimed by the insolvent person prior to date of insolvency can be recouped in the insolvent estate, for example, the 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.
- There may be included in the income of the insolvent estate any amount that is required to be included in the income of the insolvent person, for example, the amount allowed as an allowance in respect of doubtful debts in the previous year of assessment, the value of closing stock, etc.
- There is not a disposal of the person's assets on the date of sequestration and capital gains and capital losses are, therefore, determined in the hands of the insolvent estate when the assets are disposed of to third parties.

3.5 Submission of returns

Section 66(13)(a)(b) of the Act prescribes that where the estate of a person is sequestrated, separate returns must be submitted for the periods –

- commencing on the first day of that year of assessment and ending on the date preceding the date of sequestration; and
- commencing on the date of sequestration and ending on the last day of that year of assessment.

The first period of assessment of an **insolvent estate** will commence on the date of sequestration and end on the last day of February that follows thereafter. The second

and subsequent years of assessment will commence on 1 March of that year and end on the last day of February that follows thereafter, until the estate is finally wound up. The year of assessment during which the estate is wound up, will commence on 1 March of that year and end on the date when the estate is finally wound up.

The “date of sequestration” is defined in section 1 as –

<p>“(a) the date of voluntary surrender of an estate, if accepted by the Court; or (b) the date of provincial sequestration of an estate, if a final order of sequestration is granted by the Court;”</p>

The individual whose estate is sequestrated must submit returns in respect of the periods prior to sequestration and after the date of sequestration (see also par 3.1).

3.6 Withdrawal of assessments

When an order of sequestration has been set aside, the effect thereof would be that the tax position of the person continues as if his/her estate had not been sequestrated.

The effect of the setting aside of the order of sequestration is to terminate the existence of the insolvent estate *ab initio*. Any transactions that took place in the insolvent estate while it was in existence must, therefore, be accounted for in the hands of the individual who has been released from sequestration.

Section 79B(1A) has been inserted in the Act in 2002 to provide that where an order of sequestration is set aside, the Commissioner must withdraw all assessments issued in respect of –

- the estate of a person for the period prior to the date of sequestration; and
- the insolvent estate of that person.

A new assessment(s) will simultaneously be issued in respect of that person as if the sequestration never took place. It is, therefore, necessary that a return(s) of income must be submitted by that person in respect of the relevant years of assessment.

These provisions will, however, only be applicable where the provisional order of sequestration has been set aside and will not be applicable where a person has become rehabilitated through an application for rehabilitation or through the effluxion of time.

3.7 Paragraph 19(5)(b) of the First Schedule to the Act

In terms of paragraph 19(5) of the First Schedule to the Act any natural person that derives income from farming operations 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 person prior to the date of insolvency; and
- 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 person prior to the date of insolvency.

3.8 Capital Gains Tax

The estate of a person prior to sequestration and his or her insolvent estate are deemed to be one and the same person for determining any taxable capital gain or assessed capital loss of the insolvent estate. The 25 per cent inclusion rate applicable to an individual is also applicable to his/her insolvent estate.

In terms of paragraph 83(1) of the Eighth Schedule the disposal of an asset by an insolvent estate is treated in the same manner as if that person whose estate has been sequestrated has disposed of that asset. This ensures that the insolvent estate will be entitled to the same exemptions and exclusions that the insolvent person would have been entitled to when he/she had disposed of the assets of the insolvent estate.

The purpose of this provision is to ensure that the insolvent estate will not be taxed on the disposal of the personal assets of the insolvent person, such as his or her primary residence, furniture or private motor vehicles.

The insolvent estate and the person prior to sequestration have to share the annual exclusion (paragraph 5 of the Eighth Schedule) and the primary residence exclusion (paragraph 45 of the Eighth Schedule). Therefore, to the extent that the insolvent person for the period prior to sequestration has not used the annual exclusion and/or primary residence exclusion during his/her period of assessment (commencing on 1 March and ending on the date preceding the date of sequestration), the excess will be available for set-off against capital gains and capital losses arising in the insolvent estate.

The effect thereof is, furthermore, that to the extent that a person prior to sequestration and the insolvent estate have not used the annual exclusion and/or primary residence exclusion during a period commencing on 1 March and ending on the last day of the following February, the excess will be available for set-off against any capital gains and

capital losses derived during the same period by the person subsequent to sequestration.

Paragraph 83(2) of the Eighth Schedule provides that no person whose estate has been voluntarily or compulsorily sequestered may carry forward any assessed capital loss incurred prior to the date of sequestration.

However, as section 25C of the Act *inter alia* provides that the person whose estate is sequestered and his/her insolvent estate is regarded as one and the same person for determining any taxable capital gain or assessed capital loss of the insolvent estate, an assessed capital loss in the hands of the insolvent person prior to sequestration may be carried forward to the insolvent estate. Any assessed capital loss remaining in the insolvent estate will, however, be forfeited.

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 assessments raised in respect of the insolvent person and the insolvent estate must be withdrawn and a new assessment issued as if the sequestration never took place. Any assessed capital loss must, therefore, be determined *de novo*.

3.9 Taxes constitute costs of insolvency

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 must be 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 Value-Added Tax

Section 53 of the Value-Added Tax Act, No. 1991 (the VAT Act) provides that where after the sequestration of a vendor's estate, any enterprise previously carried on by the vendor –

- continues to be carried on by or on behalf of the trustee or administrator of his/her estate; or
- anything is done in connection with the termination of the enterprise,

the insolvent estate, as represented by the trustee of the insolvent estate, will for the purposes of the VAT Act be deemed to be the vendor in respect of the enterprise.

The vendor whose estate is sequestered and the insolvent estate will for purposes of the VAT Act be deemed to be one and the same person. This means that the insolvent estate does not have to be registered as a vendor under a new registration number. The representative vendor being the executor or administrator of the insolvent estate will be liable to perform the duties as imposed by the VAT Act.

5 Employees' Tax, Skills Development Levies and Unemployment Insurance Fund Contributions

Where, after the sequestration of a person's estate, any enterprise previously carried on by the person continues to be carried on by or on behalf of the trustee or administrator of his/her estate, the insolvent estate of the person shall for the purposes of the duties, responsibilities and liabilities relating to employees' tax, skills development levies and unemployment fund contributions be deemed to be the same employer in respect of the enterprise. This means that the insolvent estate does not have to be registered as an employer under a new registration number.

The trustee or administrator of an insolvent estate will be the representative employer of an insolvent estate for these purposes.

6 Illustrative example

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

Details:

The creditors of X applied for the sequestration of his estate on 15 September 2002. The court granted a provisional order of sequestration on 15 October 2002 and this was made final on 13 December 2002. X was the owner of a sports bar. 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 7 February 2003 when the estate was finally wound up.

During the period 1 March 2002 to 14 October 2002:

- An assessed loss of R50 000 was brought forward from the 2002 year of assessment.
- Sports bar income of R301 998 was generated and allowable expenditure (before any allowances have been taken into account) amounted to R310 776.
- Interest income of R2 000 was received.
- A capital gain of R50 000 was made on the sale of listed shares on 31 July 2002.
- X purchased new furniture on 1 March 2002 for R180 000. The furniture is written off on the straight line method over 6 years.

During the period 15 October 2002 to 7 February 2003:

- Sports bar income of R100 081 was generated and allowable expenditure (before any allowances have been taken into account) amounted to R98 660.
- Interest income of R1 500 was received.
- The sports bar was sold at an auction on 31 January 2003 for R400 000, of which R300 000 was paid for the business premises, R80 000 for the furniture and R20 000 for the kitchen equipment. The business premises of the sports bar were

bought for R120 000 on 15 November 2001. The kitchen equipment was bought on 1 March 1994 for R100 000 and was written off over a period of 6 years.

- X's primary residence which was bought on 2 November 2001 for R600 000 was also sold at the auction for R1 700 000.

Solution:

Capital gain/loss on sale of furniture

	R	R
Purchase price of furniture		180 000
<u>Less:</u> Depreciation allowed – 2003		<u>(28 274)</u>
Depreciation allowed 2003 - prior to insolvency		
R180 000/6 years x 228/365 days	18 740	
Depreciation allowed 2003 - insolvent estate		
R180 000/6 years x 116/365 days	<u>9 534</u>	
Tax value on date of sale		151 726
Sale price of furniture		<u>80 000</u>
Capital loss on sale of furniture		<u>(71 726)</u>

(The capital loss of R71 726 does not qualify for the deduction in terms of section 11(o) of the Act as the furniture was disposed of upon cessation of the trade.)

Capital gain/loss on sale of kitchen equipment

	R
Purchase price of kitchen equipment	100 000
Tax value of kitchen equipment on 31/01/2003	NIL
Sale price of kitchen equipment	20 000
Recoupment on sale of kitchen equipment	20 000
Capital profit on sale of kitchen equipment	NIL

Capital gain/loss on sale of business premises

	R
Sale price of business premises	300 000
Purchase price of business premises	<u>120 000</u>
Capital profit on sale of business premises	<u>180 000</u>

**Taxable income: insolvent person for the period prior to insolvency
(1 March 2002 – 14 October 2002)**

	R
Income from sports bar	301 998
<u>Less:</u> Allowable expenditure	<u>(310 776)</u>
	(8 778)
<u>Less:</u> Depreciation - Furniture	<u>(18 740)</u>
	(27 518)
<u>Less:</u> Assessed loss brought forward on 01/03/2002	(50 000)
<u>Add:</u> Capital gain on sale of listed shares (R50 000 – R10 000) x 25%	<u>10 000</u>
Assessed loss (to be carried forward)	<u>(67 518)</u>

**Taxable income: insolvent estate
(15 October 2002 to 7 February 2003)**

	R
Income from sports bar	100 081
<u>Less:</u> Allowable expenditure	<u>(98 660)</u>
	1 421
<u>Less:</u> Depreciation: Furniture	<u>(9 534)</u>
	(8 113)
<u>Add:</u> Recoupment: kitchen equipment	<u>20 000</u>
	11 887
<u>Add:</u> Investment income	<u>1 500</u>
	13 387
<u>Add:</u> Capital gain premises less capital loss furniture (R180 000 – R71 726) x 25%	<u>27 068</u>
	40 455
<u>Add:</u> Capital gain residence (R1,7m – R0,6m – R1m) x 25%	<u>25 000</u>
	65 455
<u>Less:</u> Assessed loss for the period prior to insolvency brought forward	<u>(67 518)</u>
Assessed loss	<u>(2 063)</u>

Notes

- (1) The estate of the person before sequestration and his insolvent estate are regarded to be one and the same person for purposes of the determination of deductions/allowances. The deduction in respect of the depreciation of assets, therefore, continues in the insolvent estate.
- (2) The estate of the person before sequestration and his insolvent estate are not regarded to be one and the same person for purposes of determining any exemption. As the insolvent estate is not regarded a natural person, the total amount of interest is taxable in the insolvent estate. However, the R2 000 interest, which the insolvent person (being a natural person) received prior to insolvency qualifies for the interest exemption in terms of section 10(1)(i)(xv) of the Act.
- (3) The estate of the person before sequestration and his insolvent estate are regarded to be one and the same person for purposes of the determination of a capital loss/gain. The insolvent estate, therefore, enjoys the same exemptions and exclusions applicable to natural persons. The effect thereof is that the insolvent estate qualifies for the exclusion of the R1million applicable to the primary residence and any other capital gain will be taxed at an inclusion rate of 25%.
- (4) The assessed loss of R2 063 calculated above may not be carried forward to the insolvent person for the purposes of determining his tax liability for the period after sequestration. The balance of the assessed loss is, therefore, forfeited.

7 Conclusion

For income tax purposes, a new taxable entity comes into existence when a person's estate is sequestrated. However, the estate of the person prior to sequestration and the person's insolvent estate are deemed to be one and the same person for certain purposes, for example, the determination of the deductions and allowances that the insolvent estate may be entitled to and the determination of a taxable capital gain or assessed capital loss in the insolvent estate.

For purposes of value-added tax, employees' tax, skills development levies and unemployment insurance fund contributions, the insolvent estate and the person whose estate is sequestrated are regarded to be one and the same person. The trustee or administrator of the insolvent estate will take over the duties and responsibilities in respect of these taxes, duties, levies or contributions.