

INTERPRETATION NOTE: NO. 33 (Issue 4)

DATE: 22 July 2014

ACT : INCOME TAX ACT NO. 58 OF 1962
SECTION : SECTION 20(1)(a)
SUBJECT : ASSESSED LOSSES: COMPANIES: THE “TRADE” AND “INCOME FROM TRADE” REQUIREMENTS

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Preamble

In this Note unless the context indicates otherwise –

- “**section**” means a section of the Act;
- “**the Act**” means the Income Tax Act No. 58 of 1962; and
- any word or expression bears the meaning ascribed to it in the Act.

1. Purpose

This Note clarifies when a company may forfeit its right to carry forward its assessed loss from the preceding year of assessment as a result of it –

- not carrying on a trade during the current year of assessment, or
- having carried on a trade during the current year of assessment, but not deriving any income from trade during that year of assessment.

2. Background

Under section 20(1)(a) a company that does not carry on a trade during a year of assessment forfeits the right to carry forward its assessed loss from the immediately preceding year of assessment (the “trade” requirement). A further question arises whether a company that has traded during the current year but has derived no income from trade during that year is denied the opportunity to carry forward its assessed loss from the preceding year (the “income from trade” requirement).

3. The law

Section 20(1)(a)

20. Set-off of assessed losses.—(1) For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall, subject to section 20A, be set off against the income so derived by such person—

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

Section 20(2) – Definition of “assessed loss”

(2) For the purposes of this section “**assessed loss**” means any amount by which the deductions admissible under section 11 exceeded the income in respect of which they are so admissible.

Section 1(1) – Definition of “trade”

“**trade**” 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 or any design as defined in the Designs Act or any trade mark as defined in the Trade Marks Act or any copyright as defined in the Copyright Act or any other property which is of a similar nature;

4. Application of the law

4.1 The “trade” requirement

4.1.1 The meaning of “assessed loss” and “balance of assessed loss”

The term “assessed loss” is defined in section 20(2), and refers to the tax loss that arises in the current year of assessment after deducting the admissible deductions in section 11 from the income against which they are admissible. The definition does not contain either a “trade” or an “income from trade” requirement, but the carrying on of a trade is generally a requirement for deductibility under section 11.

A “balance of assessed loss” refers to the assessed loss that is brought forward from the preceding year of assessment. The methodology for determining a balance of assessed loss was described by Schreiner ACJ in *CIR v Louis Zinn Organization (Pty) Ltd*.¹

“Wherever there has been a trading loss in the tax year, or where there has been a balance of assessed loss brought forward from the previous year, there has to be a determination of the balance of assessed loss to be carried forward into the next year. There may have been a profit in the tax year but not large enough to obliterate the balance of assessed loss carried over from the previous year. Then the new balance of assessed loss will be smaller than the previous one. If there has been a working loss in the tax year the balance to go forward will be increased. If there has been no previous balance the assessed loss in the tax year will be the balance of assessed loss carried forward. The point to keep in mind is that, although at the stage where it is to be used, i.e. when it is to be set off against a profit, a balance of assessed loss looks back to the past, at the stage where it is being determined, i.e. when its amount is being calculated, it looks forward to the future when it will be used. At the determination stage it is being prepared for future use, and it has then no effect on the taxpayer’s liability in respect of the tax year for which the relative notice of assessment is issued.”

4.1.2 The need to carry on trade during the current year of assessment

Before a company can carry forward its assessed loss from the immediately preceding year of assessment (the “balance of assessed loss”), it must have carried on a trade during the current year of assessment. If it fails to do so, it will forfeit the right to carry forward its balance of assessed loss under section 20(1)(a). This principle was firmly entrenched in our law by the landmark case of *SA Bazaars (Pty) Ltd v CIR*.² In 1941 the appellant company closed down its general dealer’s business. From 1941 to 1947 it did not trade, but kept itself alive by maintaining a bank account, paying its annual duty and complying with the Companies Act and Income Tax Act applicable at the time. In 1948 the company resumed trading and sought to set off the assessed loss from earlier years. The court refused to allow the company to set off its assessed loss. Centlivres CJ stated the following:³

“The mere fact that it kept itself alive during that and subsequent periods does not mean that during those periods it was carrying on a trade. It is clear from the stated case that it closed down its business and as long as it kept its business closed it cannot be said to have been carrying on a trade, despite any intention it might have had to resume its trading activities at a future date.”

¹ 1958 (4) SA 477 (A), 22 SATC 85 at 95.

² 1952 (4) SA 505 (A), 18 SATC 240.

³ At SATC 245.

Although the “trade” requirement may have been firmly established, difficulties still arise in determining whether a company’s activities constitute the carrying on of a trade. This can happen when –

- the nature of the activity itself does not fall within the meaning of “trade” as defined in section 1(1);
- the company’s activities have taken place before the commencement of trade;
- the company conducts non-trade activities after it has ceased trading; or
- the anti-avoidance provisions of section 103(2) apply.

4.1.3 Non-trade income

As pointed out in *Silke on South African Income Tax* –⁴

“In spite of its wide meaning, the term ‘trade’ does not embrace all activities that might produce income, for example, income in the form of interest, dividends, annuities or pensions.”

The watching over of investments does not constitute a trade.⁵

The earning of interest on funds advanced by a holding company to its subsidiary was held not to constitute the carrying on of a trade.⁶

The definition of “trade” in section 1(1) includes the word “business”, and the issue frequently arises whether a company’s investing activities constitute a business of moneylending. If they do, the company would be able to meet the “trade” requirement. The same would apply to a company carrying on share-dealing.⁷

As to what constitutes a moneylending business the following remarks of Nicholas AJA in *Sentra-Oes Koöperatief Bpk v KBI* are useful:⁸

“Whether a person is a money-lender is a question of fact. It is not enough that a person has on several occasions lent money at interest. To qualify as a moneylender it is requisite that he should be in the business of money-lending. That imports a certain degree of system and continuity about the transactions and that he is a person who is ready and willing to lend to all and sundry if they are acceptable to him. See *Secretary for Inland Revenue v Crane* 1977 (4) SA 761 (T) at 768C–F,⁷ which was cited with approval by Friedman AJA in the *Solaglass* case at 271C–D.8.”

In ITC 957⁹ a company that derived interest income from loans to its shareholders was held not to be carrying on a business of moneylending.

Under certain circumstances it is possible for a company to carry on a business of investment. In ITC 770 Dowling J stated the following:¹⁰

“A business of investment in shares in companies is a well-established occupation in the business world and in my opinion it falls under all or some of the words ‘trade’,

⁴ A P de Koker & R C Williams *Silke on South African Income Tax* [online] (My LexisNexis: August 2013) in § 7.2.

⁵ ITC 1275 (1978) 40 SATC 197 (C).

⁶ ITC 496 (1941) 12 SATC 132 (U).

⁷ ITC 1274 (1977) 40 SATC 185 (T).

⁸ 1995 (3) SA 197 (A), 57 SATC 109 at 117.

⁹ (1960) 24 SATC 637 (O).

¹⁰ (1953) 19 SATC 216 (T) at 217.

'business', 'occupation', or 'venture' used in the definition of 'trade', which is obviously intended to embrace every profitable activity and which I think should be given the widest possible interpretation."

The case of *C: SARS v Tiger Oats Ltd*¹¹ involved a company's liability for regional establishment levies on its dividend income under the Regional Services Councils Act, No. 109 of 1985. The court held that the company was carrying on business as an investor of money and was not merely a passive holder of shares. It was accordingly held liable for the RSC levies. In arriving at its decision the court took into account that the company appointed the boards of directors of its subsidiaries and acted as the group's banker.

In ITC 1802¹² the issue to be decided was whether a holding company had carried on trade during the 2001 year of assessment in order that it may –

- carry forward its assessed loss of R1 282 117 from the 2000 year of assessment under section 20(1), and
- deduct expenditure of R84 262 under section 11(a) incurred in the 2001 year of assessment.

The facts showed that –

- the holding company had no banking accounts in its own name,
- no moneys passed through it for funding its subsidiaries, financing its own activities, meeting administration costs or remunerating its directors,
- the payment of interest by subsidiaries had been erratic,
- there had been a failure to declare dividends, and
- there had been an absence of any loans made by or to the taxpayer to or from any of the subsidiaries.

Satchwell J held that a company "keeping itself alive" by holding meetings, appointing directors or arranging for financial statements to be prepared, cannot constitute a "trade". The taxpayer did not carry on "trade" through the medium of its subsidiaries since it had not provided any evidence of a "controlling mind".¹³ In this regard there was no activity of a continuing nature pertaining to loans made nor was there any involvement in the affairs of the subsidiaries or control or dominance exercised by the taxpayer over the subsidiaries. There was also no evidence of strategic management or direction of policy formulated by the taxpayer which was implemented by the subsidiaries. The appeal was accordingly dismissed.

Expenditure associated with share investments that produce exempt dividend income (for example, local shares) is prohibited as a deduction under section 23(f). Any expenditure incurred in the production of income in the form of foreign dividends is prohibited under section 23(q).

Whether a company is carrying on business as an investor of money will depend on the facts and circumstances of the particular case. Much will depend on the scale

¹¹ [2003] 2 All SA 604 (SCA), 65 SATC 281.

¹² (2005) 68 SATC 67 (G).

¹³ *Solaglass Finance Co (Pty) Ltd v CIR* 1991 (2) SA 257 (A), 53 SATC 1 at 26.

and nature of its activities. In this regard, the *Tiger Oats* case should be contrasted against ITC 496, ITC 957 and ITC 1802 already cited.

4.1.4 Amounts disguised as trade income

Amounts disguised as trade income will not be accepted as having been earned from the carrying on of a trade. This was the result in *C: SARS v Contour Engineering (Pty) Ltd*¹⁴ in which the company was purported to have derived an amount of commission income from a single transaction. The court, suspecting the amount to be fictitious, refused to accept that it had been derived from carrying on a trade.

4.1.5 The extent of effort or money expended

In ITC 777 Nesor J stated the following:¹⁵

“The extent of the effort or the amount of money expended cannot, however, be the test whether a company or person was trying to get business. It is sufficient if there was some attempt, even if no money was expended.”

Even though the above comments may have some basis in theory, they are of little assistance to a company seeking to discharge the burden of proof resting upon it under section 102 of the Tax Administration Act. A company that has expended minimal amounts in its efforts to obtain business will find it more difficult to prove that it was trading.

The lack of expenditure can be an indicator of inactivity.¹⁶ South African courts have also had regard to the nature of the expenditure incurred in deciding whether a company has traded. For example, expenses such as audit and secretarial fees, bank charges, depreciation, interest paid and stationery are not necessarily indicative of trading. See, for example, the *SA Bazaars* case cited in 4.1.2 in which the company kept itself alive by paying its annual duty.¹⁷

Although it is accepted that any period of trading during the current year will meet the “trade” requirement, a company that purports to trade for a few days in the year of assessment for the purpose of keeping its assessed loss alive will have to prove that such activity was genuine and not a tax avoidance scheme under section 103(2).

4.1.6 The “active step” requirement

Trading involves more than a mere intention to trade (see *SA Bazaars* case cited above).

In ITC 777¹⁸ it was held that the mere intention to let property does not constitute the carrying on of a trade. In ITC 1476 Kirk-Cohen J stated the following:¹⁹

“In my view the carrying on of a trade involves an active step – something far more than merely watching over existing investments which are not, and are not intended or expected to be, income producing during the year in question.”

¹⁴ 1999 (E), 61 SATC 447 at 451.

¹⁵ (1953) 19 SATC 320 (T) at 322.

¹⁶ ITC 1476 (1989) 52 SATC 141 (T), *C: SARS v Contour Engineering (Pty) Ltd* 1999 (E), 61 SATC 447.

¹⁷ ITC 1275 at 199, ITC 1476 at 149 and the *Contour* case above at 456.

¹⁸ (1953) 19 SATC 320 (T).

¹⁹ (1989) 52 SATC 141 (T) at 148.

The active step must comprise more than the mere laying of plans. In this regard Eksteen AJ stated the following in the *Contour* case:²⁰

“There is, however, . . . a vast difference between the mere laying of plans for the . . . future, on the one hand, and the commencement of preparatory activities for a future venture, on the other . . .”

The reference to preparatory activities raises the question whether the preproduction phase of a business constitutes the carrying on of a trade. This issue is explored below.

4.1.7 When does trade commence?

Expenditure incurred before the commencement of and in preparation for carrying on a trade is now provided for in section 11A (see **4.1.8**).²¹

Despite section 11A, the date when trade commences is important because in some cases it can take several years before a company is in a position to earn income. If the activities in the current year are preliminary to the commencement of trade, the company stands to lose any pre-existing balance of assessed loss. This could be an issue with the termination by a company of one business while preparing to start another. The date when trade commences is also important because expenditure incurred after the commencement of trade is not ring-fenced under section 11A.

There is very little guidance in South African case law on when trade commences.

In the United States of America (USA) there have been quite a few cases dealing with when a business commences in the context of section 162(a) of the Internal Revenue Code which allows a deduction for –

“all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business”.

The only consistent principle to be extracted from these cases is that the question must be decided on the facts and circumstances of the particular case.

One of the cases most often cited in the USA when dealing with start-up costs is that of *Richmond Television Corp. v Commissioner*,²² The appellant was one of a number of companies competing for a television licence. It sought to deduct the cost of training employees before the licence was granted.

The court began its discussion by stating that –²³

“the issue therefore is at what point of time did its business begin, and whether at this doubtful, prefatory stage it was carrying on a business”.

After reviewing various cases the court concluded as follows:²⁴

“The uniform teaching of these several cases is that, even though a taxpayer has made a firm decision to enter into business and over a considerable period of time spent money in preparation for entering that business, he still has not ‘engaged in carrying on any trade or business’ within the intendment of section 162(a) until such

²⁰ Above at 456.

²¹ See Interpretation Note No. 51 (Issue 3) dated 22 July 2014 “Pre-trade Expenditure and Losses”.

²² 345 F.2d 901 (4th Cir. 1965).

²³ At 905.

²⁴ At 907.

time as the business has begun to function as a going concern and performed those activities for which it was organized.”

A similar result prevailed in *Madison Gas and Electric Co. v Commissioner*.²⁵ In that case a utility that had formed a joint venture to construct a nuclear plant could not deduct employee training expenses paid until actual business operations commenced. The expenses were held to be pre-operational and had to be capitalised.

However, the USA courts have not always insisted that a company have opened its doors for business before it can be said to be carrying on business. In *United States v Manor Care Inc*²⁶ deductions were sought for pre-opening expenses for new nursing homes, before licences were received. The court distinguished the case from the *Richmond Television* case cited above on the grounds that the company was virtually assured of obtaining its licence if certain objective regulatory standards were met. The expenses were normal operating expenses and produced benefits in the same taxable year, whilst in the *Richmond Television* case the expenses were incurred once-off over several years.

The court cited the following passage from a USA Regulation with approval:²⁷

“Ordinarily, a corporation begins business when it starts the business operations for which it was organized. * * * If the activities of the corporation have advanced to the extent necessary to establish the nature of its business operations, however, it will be deemed to have begun business. For example, the acquisition of operating assets which are necessary to the type of business contemplated may constitute the beginning of business.”

In *Brotherman v United States*²⁸ a partner in a cable television business was held to be carrying on business as he had acquired the necessary equipment even though the required licence had not at that stage been obtained. In *Blitzer v United States*²⁹ a partner in a low income housing project was allowed to deduct an administration fee before construction had commenced. The partnership had, however, acquired the land, prepared the construction plans and obtained the necessary finance.

In South Africa the absence of productive assets has been found to be an indicator of the absence of trading activity. In ITC 697 Price J stated:³⁰

“If a taxpayer has no asset with which he can trade then he cannot be trading.”

See also the *Contour Engineering* case cited in 4.1.4:³¹

“What the evidence does clearly establish is that during 1988 the respondent had no premises, no equipment, no stock, no staff and, save for book debts, no assets. This is clearly indicative of a company which is not trading.”

²⁵ 633 F.2d 512 (7th Cir. 1980).

²⁶ 490 F. Supp. 355; 1980 U.S. Dist. LEXIS 9143; 80-2 U.S. Tax Cas. (CCH) P9547; 46 A.F.T.R.2d (RIA) 5331.

²⁷ At 362.

²⁸ 6 Cl. Ct. 407; 84-2 U.S. Tax Cas. (CCH) P9846; 54 A.F.T.R.2d (RIA) 6179; 1984 U.S. Cl. Ct. LEXIS 1286.

²⁹ 684 F.2d 874 (Ct. Cl. 1982).

³⁰ (1950) 17 SATC 93 (T) at 96.

³¹ At 456.

In the USA in the case of service businesses, it is generally required that persons must at least hold themselves out as ready to provide services.

In Australia, one of the key requirements for the carrying on of a business is the level of commitment of the taxpayer. In *Esso Australia Resources Ltd v FC of T* the following was stated:³²

“In cases where it is necessary to discern between activity constituting the carrying on of a business and activity which is preliminary to the carrying on or recommencement of a business it is the element of commitment that establishes the requisite nexus between the expenditure claimed to be deductible and the business said to be carried on for the purpose of gaining or producing assessable income: see *Softwood Pulp and Paper Ltd v FC of T* 76 ATC 4439 at 4450 per Menhennitt J; Inglis at ATC 4004; FLR 195-196 per Brennan J and at ATC 4008; FLR 201 per Davies J; *Goodman Fielder Wattie Ltd v FC of T* 91 ATC 4438 at 4448; (1991) 29 FCR 376 at 387 per Hill J; *FC of T v Brand* 95 ATC 4633 at 4649 per Tamberlin J.”

In the United Kingdom (UK) there is not much case law on when trading commences. But it would seem that a far stricter approach is taken in the UK than in the USA and Australia, and that as a general rule a company will only be regarded as trading if its doors are open for business. In *J. & R. O’Kane & Co. v The CIR*³³ the court said that the act of keeping open a shop was essential to the carrying on of the business of a seller. And in *Ransom v Higgs*³⁴ the court emphasised the active nature of trading, namely, the need to be dealing with someone engaged in buying or selling activity or the provision of services.

SARS will assess each case on its merits in deciding whether a company has commenced the carrying on of a trade. Much will depend on the nature of the company’s activities.

4.1.8 Deduction of pre-trade expenditure and losses under section 11A

Section 11A provides a deduction in the year of assessment in which trade commences for qualifying pre-trade expenditure and losses. In other words, the relevant pre-trade expenses are not claimed in the year in which they are incurred but in the year in which trade commences. Despite the introduction of section 11A, the time when trade commences is of importance because pre-trade expenses qualifying under section 11A are ring-fenced against income from the particular trade to which they relate under section 11A(2) and can therefore not create or increase an assessed loss. For more details see Interpretation Note No. 51 (Issue 3) dated 22 July 2014 “Pre-trade Expenditure and Losses”.

4.1.9 When does trade cease?

Companies in liquidation

The question frequently arises whether a company will be entitled to use its balance of assessed loss once it has been placed in liquidation. In many cases the only income derived by such a company will be post-liquidation interest. Since this will usually not comprise “income from trade” the focus switches to the company’s other activities (such as the collection of debts) in order to pass the trade test and achieve a set-off of the balance of assessed loss against the interest income. Companies in liquidation are frequently the target of offers of compromise under section 155 of the

³² 98 ATC 4768, (1998) 39 ATR 394 at 396.

³³ 12 TC 303 (HL) at 341/2.

³⁴ [1974] 50 TC 1.

Companies Act No. 71 of 2008. It is in the interests of the new shareholders to keep the assessed loss alive, though even if the company passes the trade test it must still run the gauntlet of section 103(2).

The collection of debts

In *Timberfellers (Pty) Ltd v CIR*³⁵ the company had carried on the business of selling agricultural equipment under franchise agreements prior to its liquidation on 20 September 1982. As at 30 June 1983, its financial year end, it had a large assessed loss. On 5 October 1983 the company was discharged from liquidation after a successful compromise was sanctioned under section 311 of the Companies Act, 1973. During the period 5 October 1983 to 30 June 1984 the company earned no income, had no employees, stock, franchises or fixed assets of significance. Its sole activity consisted of collecting its pre-liquidation debts through a firm of attorneys and its accountant. Approximately R200 000 was collected from these pre-liquidation debts.

The net proceeds were not used for any trading activities and were merely used to repay the shareholder's loan account.

The Commissioner refused to allow the appellant to carry forward its assessed loss to 1984. The appellant argued that the collection of debts constituted a trade. The court held that the balance of assessed loss could not be set off. This case established the principle that the collection of debts by a company that has no intention of continuing to trade does not constitute trading. The decision in *COT, SR v Pan African Roadways Ltd*³⁶ in which the collection of debts was held to constitute trading was distinguished on the facts.

Moneylending company in liquidation

In ITC 1751³⁷ a moneylending company was placed in liquidation but continued to collect money from persons to whom money had been advanced and to repay monies to persons from whom it had borrowed money for a decade after date of liquidation. The court permitted the set-off of the balance of assessed loss against post-liquidation interest income. The case shows that the activities undertaken by a company after it has been placed in liquidation can constitute a trade for income tax purposes. This, however, remains a question of fact.

Trade v realisation

In *Robin Consolidated Industries Ltd v CIR*³⁸ a company in liquidation derived income only from two isolated sales during the 1988 year of assessment against which it sought to set off its balance of assessed loss. The court refused to allow the set-off, drawing a distinction between trade and realisation. It was held that they are normally viewed as different, sometimes even opposed concepts. The principle to be drawn from this case is that isolated sales made by a company in liquidation on terms not normally adopted, and in a manner that eliminates risk, will not constitute income from trade. The case must not, however, be seen as establishing a general principle that a company in liquidation can never conduct trading activities.

³⁵ 1994 (N), 59 SATC 153.

³⁶ 1957 (2) SA 535 (SR), 21 SATC 236.

³⁷ (2002) 65 SATC 294 (C).

³⁸ [1997] 2 All SA 195 (A), 59 SATC 199.

4.1.10 Section 103(2)

A company can fail to meet the “trade” requirement in section 20(1)(a) if the anti-avoidance provisions of section 103(2) are applied to any tainted income introduced into the company following a change in shareholding. In *New Urban Properties Ltd v SIR*³⁹ a land-dealing company was hopelessly insolvent and had accumulated a large assessed loss during the year ending 30 June 1958. From 1 July 1958 to 31 December 1958 the company was dormant.

On 1 January 1959 the company underwent a change of shareholding and income was diverted to the company for the purpose of using its assessed loss. The court refused to allow the set-off of the balance of assessed loss against the tainted income. The result was that the company forfeited its balance of assessed loss as it had no other trade with which to accomplish a set-off. Beyers JA stated the following:⁴⁰

“According to both decisions [*CIR v Louis Zinn Organization (Pty) Ltd* 1958 (4) SA 477 (A), 22 SATC 85, and *SA Bazaars supra*] subsection (3)⁴¹ envisages a continuity in setting off an assessed loss in every year succeeding the year in which it was originally incurred, so that in each succeeding year a balance can be struck to the satisfaction of the Secretary which can then be carried forward from year to year until it is exhausted; if, for any reason, the assessed loss cannot be so set off and balanced in any particular year, there is then no ‘balance of assessed loss’ for that year which (viewed from that year of assessment) can be carried forward to the succeeding year, or (viewed from the succeeding year of assessment) there is no ‘balance of assessed loss which has been carried forward from the preceding year of assessment;’ in other words, the essential continuity has been fatally interrupted.”

4.2 The “income from trade” requirement

For many years a debate has raged around whether a company that has traded during the current year but has derived no income from trade in that year will be entitled to set off its balance of assessed loss from the preceding year. Within this debate there is a further question on what is meant by the word “income”. Does it mean income in the defined sense of gross income less exempt income, or income in the sense of a taxable profit? To date these issues have still not been finally resolved.

4.2.1 The argument in favour of the “income from trade” requirement

The wording of section 20

Those who argue in favour of the “income from trade” requirement point to the wording of section 20(1) which requires that an assessed loss be “set off against the income so derived”. They argue that if there is no income then no set-off can be achieved. They also argue that section 20(2A) recognises the requirement because it extends the “income from trade” requirement to include non-trade income in the case of persons other than companies.

³⁹ 1966 (1) SA 217 (A), 27 SATC 175.

⁴⁰ At SATC 183.

⁴¹ Section 11(3) of the Income Tax Act No. 31 of 1941, the equivalent of section 20(1)(a).

Case law supporting the “income from trade” requirement

In ITC 664⁴² a company had traded up to 1929 at which point it had an assessed loss. From 1929 to 1945, the company did not trade nor derive any income. The Commissioner refused to allow the assessed loss to be carried forward during the years in question. On appeal, the Commissioner's decision was upheld. Ingram CJ stated the following:⁴³

“The next question to be determined is what will be the position if there is no income in the next succeeding year. Here it is important to note that the section operates by way of set-off, i.e., the apposition of one amount against the other. It does not envisage the addition of the ‘balance of assessed loss’ to a loss on the year’s trading or its accumulation therewith. Section 11(1) provides that there shall be set off against the income the amounts permitted under sub-section (3). It follows, therefore, that in any given year there must be some income, i.e., an amount received in terms of section 7, against which the set-off can operate. Further, the income must be derived from trade.”

The income from trade requirement was also recognised in ITC 1679.⁴⁴ In that case the appellant, a close corporation, carried on business as a travel consultancy. At the end of the 1994 year of assessment it had an assessed loss. In the 1995 year it had interest income of R4 708 but no trade income, and had incurred expenditure of R36 006. It was held that a set-off of its balance of assessed loss was not permissible. The court found it unnecessary to decide whether the appellant had traded. It held that section 20(1) contains two requirements to accomplish a set-off, namely –

- a “trade” requirement; and
- an “income” requirement.

The court rejected the argument that it was sufficient to trade without earning trade income, and rejected the decision in ITC 777.⁴⁵

The Supreme Court of Appeal considered the “income from trade” requirement in *C: SARS v Megs Investments (Pty) Ltd & another*.⁴⁶ In that case the respondent companies carried on the business of a central buying organisation on behalf of their members comprising various wholesale and retail supermarket and grocery outlets. Their income was the difference between the discounts they received and the discounts they passed on to their members. The company’s year of assessment ended on 31 December. On 1 January 1996 the appellants sold their entire business as a going concern for R21 million. The proceeds were dealt with as follows:

- R6 million – placed on call with ABSA Bank
- R6 million – distributed as a dividend
- R9 million – lent interest free to three Namibian companies

⁴² (1948) 16 SATC 125 (U).

⁴³ At 126/7.

⁴⁴ (1999) 62 SATC 294 (O).

⁴⁵ (1953) 19 SATC 320 (T).

⁴⁶ 2005 (4) SA 328 (SCA), 66 SATC 175.

The appellant's activities during 1996 consisted of –

- exploring the possibility of starting a similar central buying business in Angola and other countries to the north through the Namibian companies in which they had invested; and
- attempting to exploit certain firearm and liquor licences.

Considerable money, time and effort were expended by the appellants' directors on these activities, but no contracts were concluded, no organization was established, no active trading was done, and no income was earned.

During the year ended 31 December 1996 the companies sought to set off their assessed losses brought forward from 1995 against their interest income. The set-off was disallowed by the Commissioner on the grounds that the company had not traded nor earned any income from trade during 1996.

The court accepted for purposes of the appeal that the companies' activities constituted trading. However, the court rejected the argument that the interest income was derived from carrying on the trade of an investment company. On the basis that the respondents had conceded that for a set-off to occur there must be some income from trade, the appeal was upheld and the set-off of the assessed losses disallowed. Jones AJA emphasised that his judgment should not be seen as confirming the principle that a company that had traded but failed to earn any trade income was not entitled to set off its assessed loss. He stated that his decision was based on the concession made by the respondents, namely, their acceptance of the "income from trade" requirement. The question therefore remains unresolved and no binding precedent has been established by the Supreme Court of Appeal.

In ITC 1830⁴⁷ a company sought to carry forward an assessed loss of R3 338 742 from the 2003 to the 2004 year of assessment. The loss arose from expenditure incurred in developing a computer program for licensing to the security industry. In the 2004 year of assessment a further loss of R424 057 was incurred. The only income derived by the company during the 2004 year of assessment comprised interest and other sundry income of R12 302 which the taxpayer had conceded for the purpose of the appeal was unconnected to trading activities. For the purposes of adjudicating the case the court assumed that the "trade" requirement of section 20(1) had been met. The sole issue for determination was whether, assuming the company had traded during the 2004 year of assessment, it was necessary for it to have derived some income from trade in order to achieve a set-off of the assessed loss carried forward from the 2003 year of assessment. The court confirmed the existence of the "income from trade" requirement and dismissed the taxpayer's appeal. Some commentators have incorrectly suggested that SARS departed from the view expressed in this Note by taking the matter on appeal. However, at no stage did SARS concede that the taxpayer had carried on a trade, and in these circumstances SARS will invoke the "income from trade" requirement (see 5).

⁴⁷ (2007) 70 SATC 123 (G).

Change of shareholding – section 103(2)

In *Conshu (Pty) Ltd v CIR*,⁴⁸ a case dealing with section 103(2), the company had entered into an agreement for the acquisition of a business on the last day of the 1985 year of assessment. A change of shareholding also took place at this time. In the 1986 year of assessment it sought to set off its balance of assessed loss against the income generated from the business it had acquired in the previous year. Harms JA stated the following:⁴⁹

“It follows, in my view, from this analysis that the word ‘income’, as used in the introductory part of s 20(1), is not used in its defined sense (cf *Commissioner for Inland Revenue v Simpson* 1949 (4) SA 678 (A) at 692) but rather as the income taxable but for the set-off. This all simply means that a set-off in terms of s 20 can only arise if there would otherwise have been taxable income, ie pre-tax profit. I find it impossible to perceive how, in an assessment to tax, set-off of an assessed loss can operate in relation to, say, an individual item of income such as the recoupment on the sale of an asset.”

SARS accepts that in the context of section 103(2) it is the tainted “pre-tax profit” that is ring-fenced, and not an individual item of tainted “income” as defined. But SARS does not accept as a general principle that a set-off of a balance of assessed loss can only take place against a “pre-tax profit”. To do so would lead to unintended and draconian results.⁵⁰ For example, a company that incurs a loss from trading in year two – even having derived some income from trade in that year – would not be permitted to carry forward its balance of assessed loss from year one. Yet it would be permitted to carry forward its year two assessed loss to year three if it derived a pre-tax profit in year three.

4.2.2 The argument against the “income from trade” requirement

Those who argue against the existence of the “income from trade” requirement seem to rely mainly on the irrationality of the requirement from a policy perspective. They point to the fact that in the case of section 11(a) it is sufficient for a taxpayer to secure a deduction if the purpose of the expenditure is to produce income, and that income need not be derived in the same year of assessment (*Sub-Nigel Ltd v CIR*⁵¹). They also cite ITC 777⁵² as authority for their interpretation that no income from trade is required. In that case a property owning company derived no income despite attempts to let its property. It was held that the company was entitled to carry forward its assessed loss. The court found that an unsuccessful endeavour to let constitutes trading even if no expenditure is outlaid. The question whether it was necessary to derive some income from trade before set-off can occur was not decided as this issue was not contested by the Commissioner. The use of this case as authority on this point is therefore questionable.

The crux of the argument, however, is that a company should be able to strike a balance even if its “income so derived” (that is, tax profit or loss) is nil. Support for this view can be found in the dictum of Schreiner ACJ in *CIR v Louis Zinn*

⁴⁸ 1994 (4) SA 603 (A), 57 SATC 1.

⁴⁹ At SATC 10.

⁵⁰ See SARS’s statement following the case, as cited by H Coetzee in “Assessed Losses – The Final Blow?” (October 1998) *Accountancy SA* 19 at 33.

⁵¹ 1948 (4) SA 580 (A), 15 SATC 381.

⁵² (1953) 19 SATC 320 (T).

*Organization (Pty) Ltd*⁵³ in which it was accepted that a set-off could take place when an assessed loss was incurred in the current year (see 4.1.1).

5. SARS's view

SARS is of the view that section 20 contains a trade requirement and an income from trade requirement. Both these requirements must be satisfied before an assessed loss may be carried forward. SARS does, however, accept that this may have some unintended results.

In dealing with the problem SARS will accept that as long as the company has proved that a trade has been carried on during the current year of assessment, the company will be entitled to set off its balance of assessed loss from the preceding year, notwithstanding the fact that income may not have accrued from the carrying on of that trade. This concession is limited to cases in which it is clear that trade has been carried on. SARS will apply an objective test in order to determine that a trade has in fact been carried on. It will not be sufficient that there was a mere intention to trade or some preparatory activities. The fact that no income was earned during the year of assessment must be incidental or result from the nature of the trade carried on by the company.

Example – Carry-forward of an assessed loss when trade carried on but no income derived from trade

Facts:

Pecan Nut (Pty) Ltd was formed on 1 March 2009 with a February year-end for the purpose of operating a pecan nut farm. On 1 April 2009 it acquired a suitable piece of land and began planting small pecan nut trees during the months that followed. It was expected that the trees would only be ready for harvesting in four years' time.

During the 2010 to 2013 years of assessment the company derived no income although it incurred considerable expenditure in each of these years in cultivating the nut trees.

During the 2014 year of assessment the company started harvesting nuts and sold them to a number of retail outlets.

Result:

Despite the fact that the company derived no income from trade during the 2010 to 2013 years of assessment, SARS will permit the company to carry forward its 2010 to 2013 assessed losses and set them off against the income derived in the 2014 year of assessment. The reason for the failure to derive any income during the years in question clearly stems from the nature of the company's trade.

Although SARS is prepared to accept that the absence of income from trade (that is, gross income less exempt income) should not in all cases prevent the set-off of a balance of assessed loss, a company that derives no income from trade will have to discharge the onus that it did in fact trade during the current year. The absence of income from trade may well indicate that the company did not trade during the year in question.

⁵³ 1958 (4) SA 477 (A), 22 SATC 85 at 95.

6. Conclusion

While the views of SARS as contained in this Note provide direction in interpreting the legislation, each case will be considered on its merits in deciding whether a company has commenced or carried on a trade and much will depend upon the nature and the extent of the company's activities.

Cognisance should be taken of the view expressed in **5** when a company has clearly carried on a trade during the current year of assessment but has not derived any trade income during that year.

Legal and Policy Division
SOUTH AFRICAN REVENUE SERVICE
Date of first issue: 4 July 2005
Date of second issue: 30 June 2010
Date of third issue: 4 February 2014

ARCHIVED