

Ring Fencing

Ring Fencing
of Assessed Losses

Arising from Certain Trades
Conducted by Individuals

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FOREWORD

This document is a general guide dealing with the provisions relating to the ring-fencing of assessed losses arising from certain trades conducted by individuals. It serves the purpose of a guideline only and should therefore not be used as a legal reference.

It has been prepared to give individuals whose income tax liability may be affected by the ring-fencing provisions a better understanding of what ring-fencing is and also to enable them to determine how and to what extent the provisions may affect their personal income tax liability.

The ring-fencing provisions are applicable to a wide spectrum of trades conducted by individuals and the information and examples in this document do not attempt to deal with every possible situation that could arise. Where necessary, further brochures and/or interpretation notes will be published in future to either clarify any aspects which may still not be clear and/or to address specific problems encountered in the application of the ring-fencing provisions.

This brochure is based on legislation as at 28 February 2005.

If an answer to your specific situation is not provided in this document, or you require additional information, you may:

- Contact your local SARS branch office
- Contact your own advisor
- Visit the SARS website <http://www.sars.gov.za>

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BACKGROUND and LEGISLATION

1. Glossary

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

Act

Income Tax Act, 1962 (Act No. 58 of 1962 as amended)

Assessed loss is "assessed loss" as defined in section 20(2) of the Act, which states that an assessed loss means any amount by which the deductions admissible under section 11 to 19, inclusive, exceeded the income in respect of which they are so admissible. An assessed loss in relation to any activity carried on for a specific tax year, therefore, means the excess of allowable deductions attributable to that activity over the income received from that activity for the specific year of assessment.

Facts and circumstances test

The facts and circumstances test is an escape clause by means of which a taxpayer can prevent a trade loss from being ring-fenced. Various facts and circumstances are taken into account in considering whether a 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.

PAYE

Pay-As-You-Earn. Employees tax which is deducted by the employer from the amount of full-time employment income 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, a loss is subject to potential ring-fencing.

Pre-requisites for ring-fencing

The circumstances that must be present before a loss may be ring-fenced are: taxable income, which is subject to the maximum marginal rate of tax, and either an assessed loss arising from a suspect trade or a loss incurred in at least 3 out of the last 5 years of assessment.

Relative in relation to a person means a spouse, parent, child, stepchild, brother, sister, grandchild or grandparent of that person.

SARS

South African Revenue Service

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

A trade which is listed in section 20A(2)(b) of the Act

Taxable income

Taxable income is defined in section 1 of the Act. For normal tax purposes, a taxpayer's taxable income includes all the amounts to be included, e.g. taxable capital gains, or amounts deemed to be included, and is arrived at by deducting from the income received/accrued for the specific year of assessment, all the amounts that are allowed to be deducted or set-off in terms of the Act. An assessed loss brought forward from the previous year of assessment as well as any assessed loss incurred in the current year of assessment are, therefore, also deducted in arriving at taxable income. Section 20A, however, requires that the losses incurred during the year of assessment as well as an assessed loss brought forward from a previous year of assessment must be excluded from taxable income. The purpose of determining the taxable income without losses is to determine whether the taxable income requirement explained in paragraph 8.1 has been met.

2. The general deduction formula

The general deduction formula provides for the general rules that any expenditure and losses must comply with in order to be deductible for normal income tax purposes. The general deduction formula is contained in section 11(a) read with section 23(g) of the Act. Section 11(a) is generally referred to as the positive test, as it lays down what expenditure can be deducted, and section 23(g) is referred to as the negative test, as it lays down what expenditure cannot be deducted in the determination of taxable income.

Section 11(a) requires that-

- the person (taxpayer) must carry on a trade; and
- the expenditure and loss must be actually incurred-
 - during the year of assessment;
 - in the production of income; and
 - must 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. The Act therefore prohibits the deduction of any expenditure, which is incurred for purposes other than trade and in this regard sections 23(a) and (b) also prohibits the deduction of private and domestic expenditure as well as costs incurred in the maintenance of the taxpayer, his family or establishment.

3. The trade test

The requirement in section 11, namely that a trade must be carried on can in certain instances be problematic. Trade is widely defined in section 1 and the question whether or not any specific activity can be regarded as 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 the particular trade. Where an immediate profit is not attainable due to any number of reasons, the prospect of deriving an ultimate profit from the trade should at least be based on reasonable circumstances. The test should therefore be a combination of a subjective test, i.e. taking into account the intention of the person and an objective test, i.e. considering the facts and circumstances of the specific case.

In the case of *C: SARS v Smith* (2002 (6) SA 621 (SCA)), 65 SATC 6, the court had regard to the intention of the taxpayer which is a subjective test. In applying a subjective test only, SARS is placed in a difficult position, as 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 losses from activities masqueraded as trades undermine the ‘ability to pay’ principle of taxation and as a result of the wide interpretation of current income tax law there has been a considerable loss of revenue as a result of individual taxpayers who claim losses in respect of unprofitable activities. Certain activities are also often unlikely to ever be profitable notwithstanding the fact that they have business characteristics under existing tax law.

4. New legislation

Section 20A of the Act, which incorporates a more stringent facts and circumstances test, was inserted into the Act by the Revenue Laws Amendment Act, No 45 of 2003 and was promulgated on 22 December 2003.

The facts and circumstances test, which is an objective test, will be applied in considering whether a specific trade loss may be allowed as a deduction in the calculation of a taxpayer’s taxable income for the specific year of assessment or whether the specific loss should in fact be ring-fenced.

The section does not change the existing law with reference to ‘what constitutes the carrying on of a trade’, when is expenditure incurred ‘in the production of income’ or when is expenditure incurred ‘for the purposes of trade’. The section operates in addition to existing law and targets losses arising from certain suspect trades (hobby like trades) and continual loss trades. The section however provides an escape clause by means of which a taxpayer can prevent the ring-fencing of a loss. If the taxpayer can show that the trade carried on by him/her, constitutes a business in respect of which there is a reasonable prospect of deriving taxable income within a reasonable period, the ring-fencing of the loss can be prevented. Section 20A applies as from 1 March 2004 and will be applicable to any year of assessment commencing on or after that date.

5. Section 20A of the Act

Section 20A of the Act, which was inserted into the Act by section 36(1) of the Revenue Laws Amendment Act, No 45 of 2003 reads as follows:

“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 taxable income of a person for a year of assessment

(before taking into account the set-off of any assessed losses incurred in carrying on any trade during that year and the balance of assessed loss carried forward from the preceding year) equals or exceeds the amount at which the maximum marginal rate of tax chargeable in respect of the taxable income of individuals becomes applicable, and where—

- (a) that person has, during the five year period ending on the last day of that year of assessment, incurred an assessed loss in at least three years of assessment in carrying on the trade contemplated in subsection (1) (before taking into account any balance of assessed loss carried forward); or
- (b) the trade contemplated in subsection (1), in respect of which the assessed loss was incurred constitutes—
 - (i) any sport practised by that person or any relative;
 - (ii) any dealing in collectibles by that person or any relative;
 - (iii) the rental of residential accommodation, 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 (4) 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.”

RING-FENCING OF ASSESSED LOSSES

6. What is ring-fencing?

Ring-fencing is a concept which is not foreign to our income tax law. In essence ring-fencing is an anti-avoidance measure in terms of which the expenditure incurred in conducting a trade is limited to the income of that specific trade. Any excess expenditure (loss) is then carried forward and is 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 the ring-fencing of certain allowances and/or losses in the mining industry, farming activities, toll-road operators, leasing activities, foreign trades and also in the case of pre-trade costs.

Section 20A and in particular the 'facts and circumstances test' replaces neither the purpose nor the function of sections 11(a) and 23(g) of the Act. Whereas a loss could be disallowed in whole in terms of sections 11(a) and 23(g) if the activity carried on by the taxpayer is not regarded as a bona fide trade, section 20A comes into operation where there is an existing allowable trade loss. Section 20A is therefore applied after the provisions of sections 11(a) and 23(g). Section 20A provides a structure for determining whether or not a trade loss should be set off against other income and thereby reduce the taxable income. Section 20A operates in addition to sections 11(a) and 23(g). A trade loss is therefore disallowed in terms of section of 11(a) read with section 23(g) and not in terms of section 20A. Section 20A merely ring-fences an otherwise allowable trade loss. Apart from specific circumstances, which will be dealt with later, a 'ring-fenced' loss does not mean that the loss is 'lost' or 'disallowed'; the loss is merely carried forward to the next year and subsequent years of assessment and is available for set-off against any income received from that specific trade in the next year of assessment.

7. To whom will ring-fencing apply?

The ring-fencing provisions are applicable to natural persons only. It therefore includes natural persons trading in a partnership. Assessed losses incurred by companies, close corporations and trusts are not subject to the section 20A ring-fencing provisions.

8. The pre-requisites for ring-fencing to be applied

The ring-fencing of a trade loss can only occur when the pre-requisites in subsection (2) are present. As soon as these circumstances are present, the loss will be subject to potential ring-fencing. These circumstances are the following -

- the taxable income, before deducting assessed losses, for the year of assessment in question must be equal to, or exceed the amount at which the maximum marginal rate of tax chargeable for individuals becomes payable;

and either one of the following requirements is met -

- the taxpayer has, during a period of five years ending on the last day of that year of assessment, incurred an assessed loss in at least three years of assessment [section 20A(2)(a)];

or

- the trade in respect of which an assessed loss was incurred falls within the suspect trades listed in section 20A (2)(b).

Ring-fencing can, therefore, only be applied if the taxpayer is a natural person whose taxable income is subject to the maximum marginal rate of tax and he/she either had an assessed loss in at least 3 out of the last 5 years of assessment or the assessed loss stems from one of the suspect trades listed in subsection (2)(b). This is, therefore, a dual requirement and both requirements must be met before the ring-fencing provisions can be applied.

8.1 The taxable income requirement

The section requires that the 'taxable income' must be equal to, or exceed the amount at which the maximum marginal rate for individuals becomes payable. The section makes no reference to a 'secondary' or a 'primary' trade nor to 'active' or 'passive' income.

Taxable income can therefore arise from either employment or from sources other than employment, e.g. from investments or any other trade which constitutes the taxpayer's main source of income. Taxable income can, therefore, consist of any income from any source and no distinction is made e.g. between a rental loss incurred by a person in receipt of pension and/or 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

The taxpayer is an individual under the age of 65.
 The maximum marginal rate is 40% on taxable income exceeding R270 000
 Assume for the purposes of the example that the taxpayer has a balance of assessed loss of R15 000 brought forward from the 2004 year of assessment. The taxpayer also had a capital gain of R30 000 arising from the sale of an asset that was used in a rental trade conducted during the 2005 year of assessment.

Income from employment (less deductions)	R261 000
Interest R23 000 – R11 000 exemption	R12 000
Taxable capital gain (R30 000 less R10 000 exclusion) X 25%	R5 000
Taxable income, before deducting any losses. (Note 1)	R278 000
Rental loss incurred during period 1/3/2004 to 28/2/2005*	(R21 000)
Balance of assessed loss brought forward from 2004*	(R15 000)
Normal taxable income (Note 2)	R242 000

Notes

1. R278 000 represents the taxable income before deducting any current year losses or any losses brought forward from the previous year. This amount will therefore also represent taxable income for the purposes of determining whether the first requirement in section 20A(2) has been met.

2. R242 000 represents the taxable income for normal income tax purposes. The tax due will be calculated on this amount if the rental loss of R21 000 is taken into account for tax purposes, i.e. if the provisions of section 20A are ignored.

*Neither the rental loss for the current year, nor the balance of assessed loss brought forward from the previous year is taken into account in determining 'taxable income' for the purposes of the ring-fencing provisions. 25% of the capital gain is included in taxable income in terms of section 26A of the Act.

8.1.1 Can a loss be ring-fenced where the taxable income is below the required threshold?

Where a person incurs a loss from a trade in a particular year, but the taxable income for the year of assessment is less than the amount at which the maximum marginal rate of tax is applicable, the ring-fencing provisions cannot be applied, as one of the pre-requisites for the application of the ring-fencing provisions is not present.

Although the ring-fencing provisions cannot be applied in a year of assessment in which the taxable income is below the amount at which the maximum marginal rate of tax is payable, the year of assessment in which a loss is incurred can be taken into account in calculating the number of years in which losses were incurred for the purposes of the three out of five- year time rule.

Example 2

Assume for the purposes of the example that the trade is not listed as a suspect trade. The trade loss is therefore subject to the 3 out of 5-year time rule. Also assume that the amount at which the maximum marginal rate of tax is payable, is R270 000 for all three the years of assessment.

Year of assessment	Taxable income (Before loss)	Current year loss	Taxable income for assessment purposes
2005	R250 000 (note 1)	R11 000	R239 000
2006	R265 000 (note 2)	R13 500	R251 500
2007	R275 000 (note 3)	R15 000	R275 000

Notes:

- Year 2005, the taxable income is less than R270 001 and, therefore, less than the amount at which the maximum marginal rate of tax is payable. The ring-fencing provisions cannot be applied to the current year's loss and the loss of R11 000 is set-off against other income.
- Year 2006, the taxable income is less than R270 001, the amount at which the maximum marginal rate of tax is payable. The ring-fencing provisions cannot be applied to the current year's loss and the loss of R13 500 is set-off against other income.
- Year 2007, the taxable income exceeds R270 000, the amount at which the maximum marginal rate of tax is payable and the loss of R15 000 is therefore subject to potential ring-fencing as 2007 is the third year in which a loss has been incurred.

It is important to note that, although for the purposes of the three out of five-year time rule, the ring-fencing provisions cannot be applied in 2005 or 2006, these years can however be taken into account for the purposes of determining the total number of years in which losses were incurred for the specific trade. Section 20A(9) provides for the exclusion only of losses incurred in any year of assessment ending on or before 29 February 2004. The losses for years of assessment prior to the 2004 year of assessment may therefore not count against the taxpayer. Losses incurred after 29 February 2004, must however be taken into account in calculating the number of years in which losses were incurred.

8.1.2 The effect of a fluctuating taxable income on ring-fencing

As indicated in the above example losses incurred in years of assessment where the taxable income was below the amount at which the maximum marginal rate of tax is payable can be taken into account in determining the number of years in which losses were incurred. However, a loss cannot be ring-fenced where the taxable income for a specific year of assessment is not equal to or in excess of the required threshold. The pre-requisites for ring-fencing must therefore be present. Where the taxable income, for any year of assessment subsequent to the year of assessment in which a loss is ring-fenced, is less than the amount at which the maximum marginal rate of tax is payable, the loss for that specific year cannot be ring-fenced.

Example 3

Assume for the purposes of the example that the loss arose from a suspect trade. After having applied the facts and circumstances test, the taxpayer is not able to show that the trade constitutes a business with a reasonable prospect of deriving taxable income within a reasonable period. The loss is, as a result ring-fenced in 2005. Assume that the amount at which the maximum marginal rate of tax is payable, is R270 000 for all the relevant years of assessment.

Year of assessment	Taxable income (Before loss)	Current year loss	Taxable income for assessment purposes	Balance of assessed loss to be carried forward to following year
2005	R273 000	R7 500	R273 000 (note 1)	R 7 500
2006	R265 000	R9 200	R255 800 (note 2)	R 7 500

2007	R290 000	R8 700	R290 000 (note 3)	R16 200
2008	R245 000	R12 000	R233 000 (note 4)	R16 200
2009	R297 000	R10 780	R297 000 (note 5)	R26 980

Notes:

- Year 2005, the taxable income of R273 000 (before current year loss) exceeds R270 000, the amount at which the maximum marginal rate of tax is payable. The loss is ring-fenced and is carried forward to the 2006 year of assessment.
- Year 2006, the taxable income of R265 000 (before current year loss) is less than R270 001. The loss cannot be ring-fenced as one of the pre-requisites for the application of the ring-fencing provisions is not present. The loss of R9 200 is as a result set off against the other income and the ring-fenced loss of R7 500 brought forward from 2005, is carried forward to the 2007 year of assessment.
- Year 2007, the taxable income of R290 000 (before current year loss) exceeds R270 000, the amount at which the maximum marginal rate of tax is payable. The loss for 2007 is ring-fenced and this loss together with the R7 500 brought forward from 2006, is carried forward to the 2008 year of assessment.
- Year 2008, the taxable income of R245 000 (before current year loss) is less than R270 001. The loss cannot be ring-fenced as one of the pre-requisites for the application of the ring-fencing provisions is not present. The loss of R12 000 is as a result set off against the other income and the cumulative loss of R16 200 is carried forward to the 2009 year of assessment.
- Year 2009, the taxable income of R297 000 (before current year loss) exceeds R270 000. The loss of R10 780 is ring-fenced and together with the ring-fenced loss of R16 200 brought forward from 2008, the cumulative loss carried forward to 2010 is R26 980.

It should however be noted that where the pre-requisites for ring-fencing were present in a previous year of assessment and a loss is ring-fenced after having applied the facts and circumstances test, that ring-fenced loss remains ring-fenced notwithstanding the fact that the ring-fencing provisions cannot be applied in a subsequent year of assessment due to the absence of any one of the pre-requisites for ring-fencing.

Example 4

As in example 3, assume for the purposes of this example that the loss arose from a suspect trade. After having applied 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 within a reasonable period. The loss is, as a result ring-fenced in each one of these years of assessment. Assume that the amount at which the maximum marginal rate of tax is payable, is R270 001 for all the relevant years of assessment.

Year of assessment	Taxable income (Before loss)	Current year profit	Current year loss	Taxable income for assessment purposes	Balance of assessed loss to be carried forward to following year
2005	R273 000		R11 000	R273 000 (note 1)	R 11 000
2006	R280 000	R9 200		R280 000 (note 2)	R 1 800
2007	R290 000		R8 700	R290 000 (note 3)	R10 500
2008	R265 000		R5 000	R260 000 (note 4)	R10 500

Notes:

- Year 2005, the taxable income of R273 000 (before current year loss) exceeds R270 000, the amount at which the maximum marginal rate of tax is payable. The loss is ring-fenced and is carried forward to the 2006 year of assessment.
- Year 2006, the taxable income of R280 000 (before current year loss) exceeds R270 000, the amount at which the maximum marginal rate of tax is payable. The ring-fenced loss of R11 000, brought forward from the 2005 year of assessment is set off against the profit of R9 200 and the balance of the loss i.e. R1 800 is carried forward to the 2007 year of assessment.
- Year 2007, the taxable income of R290 000 (before current year loss) exceeds R270 000, the amount at which the maximum marginal rate of tax is payable. The loss for 2007 is ring-fenced and this loss together with the R1 800 brought forward from 2006, is carried forward to the 2008 year of assessment.
- Year 2008, the taxable income of R265 000 (before current year loss) is less than R270 001. The loss of R5 000 cannot be ring-fenced as one of the pre-requisites for the application of the ring-fencing provisions is not present. The loss of R5 000 is as a result set off against the other income and the cumulative ring-fenced loss, i.e. from 2005 (balance R1 800) as well as from 2007 (R8 700) is carried forward to the 2009 year of assessment.

8.2 The '3 out of five 5-year' time rule in subsection (2)(a)

Whereas the first part of the pre-requisite for the application of the ring-fencing provisions deals with the taxable income requirement, the second part of the pre-requisite is generally referred to as the 'either or' test. A loss can, therefore, only be ring-fenced if the trade is either a trade where losses have been incurred in at least three out of the last five years of assessment or the trade is one of the suspect trades listed in subsection (2)(b).

The 3 out of 5-year time rule applies to any other trade, which is not included in the subsection (2)(b) list of suspect trades. The listed trades all contain certain qualifiers indicating the circumstances in which the trade may be excluded as a suspect trade. A trade, which qualifies for exclusion, will therefore also be subject to the 3 out of 5-year time rule. In terms of the 3 out of 5-year time rule, a trade will be subject to potential ring-fencing only where that trade has incurred a loss in at least 3 out of the last 5 years of assessment. When calculating the 3 and the 5-year totals, the current year of assessment is taken into account. A trade loss can be subject to potential ring-fencing with effect from the 2007 year of assessment.

Example 5

ZX, an engineer, commences with a part-time activity in which he makes and installs steel gates and fences at private residences after hours and/or during weekends. This activity is not a listed suspect trade in subsection (2)(b) and is therefore subject to the 3 out of 5-year time rule in terms of subsection (2)(a). Assume for the purposes of the example that the taxable income is subject to the maximum marginal rate of tax. The activities result in:-

- A loss of R12 300 in 2005
- A loss of R11 800 in 2006
- A loss of R14 200 in 2007

The 2007 year of assessment is the third year in which a loss is incurred and the loss of R14 200 is, therefore, prior to applying the facts and circumstances test, subject to potential ring-fencing in 2007.

8.2.1 When can the 3 out of 5-year time rule be applied?

The ring-fencing provisions are applicable with effect from the 2005 year of assessment. For the purposes of the 3 out of 5-year time rule, subsection (9) provides that any assessed loss incurred in any year of assessment ending on or before 29 February 2004 shall not be taken into account. The losses incurred in the 2004 and prior years of assessment may therefore not count against the taxpayer. Notwithstanding the fact

that, counting as from the 2005 year of assessment, the five-year period only ends on 28 February 2009, a loss is subject to potential ring-fencing in 2007 if losses were incurred in three continuous years of assessment. (See example 4 above) The fact that losses were incurred in three continuous years of assessment has the effect that the 3 out of 5-year time rule is met in 2007. The fact that the specific trade may still generate profits in the subsequent year/s of assessment will not have an effect on the fact that the pre-requisite for the application of the ring-fencing provisions have been met, i.e. the trade has already incurred losses in at least three out of five years of assessment. The loss incurred in 2007 will however only be ring-fenced after the facts and circumstances test has been applied and the taxpayer is not able to show that the trade constitutes a business in respect of which there is a reasonable prospect of deriving taxable income within a reasonable period of time.

8.2.2 Will ring-fencing in 2007 affect any assessments raised for previous years?

If a trade, which is subject to the three out of five-year time rule, has incurred losses in at least three out of the last five years of assessment and the loss is ring-fenced in 2007, the losses which were allowed as a deduction against other taxable income in the two previous years of assessment will not be affected.

The 2005 and 2006 assessments will, therefore, not be amended to disallow the losses allowed as a deduction for these years of assessment. A profit made in any particular year will also delay the potential ring-fencing of losses arising from that specific trade.

Example 6

The part-time activity conducted by ZX, referred to in example 4 above, had the following results:

- A loss of R12 300 in 2005
- A loss of R11 800 in 2006
- A profit of R14 200 in 2007
- A loss of R13 000 in 2008

The 2008 year of assessment will, in this case, be regarded as the third year in which the activity has incurred a loss and the loss will therefore be subject to potential ring-fencing in 2008. The profit of R14 200 in 2007 has the result that the potential ring-fence treatment of the trade loss is delayed by one year. Every year in which a profit is generated therefore delays the potential ring-fence treatment with the same number of years.

The 2005 and 2006 years of assessment will not be amended to disallow the losses that were set-off in calculating the taxable income. Ring-fencing of a loss in the third year in which a loss is incurred will not affect losses that were set-off against income in terms of section 20(1).

8.3 The listed suspect trades: subsection (2)(b)

The listed suspect trades form part of the second part of the dual requirement, i.e. the 'either or test' and a trade loss incurred in respect of any one of the eight categories of trades listed under (2)(b), is, with effect from the 2005 year of assessment subject to potential ring-fencing. A loss arising from a listed trade could therefore already be ring-fenced in the 2005 year of assessment if that trade does not satisfy the facts and circumstances test.

8.3.1 The 8 trades listed as suspect trades

The following trades, which are listed as suspect trades, contain certain qualifiers indicating the circumstances in which every trade will be regarded as a suspect trade. For example, sport, collectibles, animal showing, performing or creative arts and gambling or betting, are regarded as suspect only if the taxpayer or any relative of the taxpayer practises the activity. The relatives of the taxpayer are included in order to address the situation where a taxpayer conducts an activity in partnership with a relative. Rental activities as well as farming or animal showing activities also contain certain qualifiers and could therefore be excluded as suspect trades. Any one of the listed suspect trades can, therefore, be excluded as a suspect trade and such activity will then be subject to the three out of five-year time rule.

- **Any sport** practised by the taxpayer or any relative of the taxpayer. Sporting activities for the purposes of 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 him/herself or by any relative of the taxpayer and will as a result not include the activities carried out by, e.g. a racehorse owner, which activities are also generally known as sporting activities. The activity conducted by a racehorse owner will as a result be subject to the 3 out of 5-year time rule.
- **Dealing in collectibles** by the taxpayer or any relative of the taxpayer. This category includes the collecting of art, antiques, cars, coins, militaria, notes, wine, stamps, or any other object regarded as being of interest to a collector.
- **Rental of residential accommodation.** This category includes holiday homes, a bed and breakfast establishment, a guesthouse, a dwelling house or any other similar residential abode. A loss arising from the rental of residential accommodation will be subject to potential ring-fencing with effect from the 2005 year of assessment, unless persons who are not relatives of the taxpayer use at least 80% of the accommodation for at least half of the year of assessment. The qualification for exclusion as a suspect trade contains two elements, and both elements must be present before the rental activity can be excluded as a listed suspect trade in 2005.

The **two elements** are:

1. Persons who are not relatives of the taxpayer must use at least 80% of the accommodation. The calculation of the percentage is relevant where property is also used either by the person/owner leasing the property or by persons who are the relatives of such owner/lessor. This percentage will therefore be relevant in the case of, e.g. accommodation leased within the taxpayer's main home.
2. The accommodation must be used by persons who are not relatives of the taxpayer for at least half of the year of assessment. The period can be a continuous period of at least six months or other periods which in total are equal to at least six months.

Where 100% of the accommodation, e.g. a holiday home or an apartment is let, and no portion of the property is used by the taxpayer during the rental period, the element relating to the '80% of residential accommodation' has been met. Where the first element has been met, compliance with the second element, i.e. the use of the property for at least six months, by persons who are not relatives of the taxpayer, is required before the activity can be excluded as a suspect trade. The rental of a holiday home, which is used by the taxpayer or his/her relatives and is let during the year of assessment on an occasional basis, e.g. during peak seasons (less than 6 months), will therefore also be regarded as a suspect trade with effect from the 2005 year of assessment.

The calculation in respect of the '80% of residential accommodation' will be calculated on the basis as indicated in the following example:

Example 7

During the 2005 year of assessment, B let two rooms within her main home on a bed and breakfast basis. Each bedroom has its own on-suite bathroom. The total area of the house (including garages and outbuildings) is 420 square metres, whereas the area, which is let, is 120 square metres. The area let, expressed as a percentage of the total area of the house, is 28.57%. The rooms were let for a total number of 114 days during the year of assessment. B incurred a loss in respect of this activity and claimed this loss for income tax purposes.

28.57% and not the required 80% of the residential accommodation was let. As the first element has not been met, the rental activity will be regarded as a suspect trade with effect from the 2005 year of assessment. Where the first element of the qualification is not met, compliance or non-compliance with the second element will have no effect on the fact that the activity is regarded as a suspect trade with effect from the 2005 year of assessment.

- **Rental of vehicles, aircraft or boats.** A 'boat' is defined in the Eighth Schedule to the Act and means any vessel used or capable of being used in, under or on the sea or internal waters, whether it is self-propelled or not, or equipped with an inboard or outboard motor. A loss incurred in respect of the rental of these movable assets may be subject to potential ring-fencing in the 2005 year of assessment if less than 80% of the assets are leased for less than 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 in the case where any of the assets in this category are subject to private use by the taxpayer and/or his/her relatives. As in the case of residential accommodation, the requirements relating to 80% 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.
- **Animal showing by the taxpayer or any relative.** This category relates to the showing of animals in competitions and includes the showing of horses, cattle, dogs, cats, etc. If a taxpayer conducts farming or animal breeding activities and the progeny is shown, for example, at agricultural shows or other animal shows as part of the farming/animal breeding activities, i.e. the animal showing activities are not conducted by the taxpayer as a separate business then such animal showing activities can be regarded as part of the farming or animal breeding activities. A taxpayer must however be able to show that the animal showing activities do not constitute a separate business and that they are in fact incidental to the farming or animal breeding activities.
- **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 words 'full-time' is not described in either section 1 or section 20A. Where neither a statute nor the Interpretation Act, No 33 of 1957 provides a definition, words or expressions must be given their ordinary dictionary meaning, unless the context of the section indicates a contrary intention. The meaning of 'full-time' is discussed in paragraph 8.3.1.1 below.
- **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 and will therefore exclude the case where the taxpayer only invests, 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 "Taxation of Film Owners" guide published on the SARS website.

- **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, sports betting, etc. 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 own horse/s as well as betting on the horses of other owners. The inclusion of winnings by racehorse owners under certain circumstances is based on the fact that owners, trainers and jockeys have special knowledge and are usually closely connected with the racing activities.

Gambling or betting does not include activities relating to dealings on the JSE Securities Exchange. These activities will therefore fall into the 3 out of 5-year time rule.

8.3.1.1 The ordinary meaning of 'full-time'

Section 20A does not provide the meaning of full-time and unless the provisions of a section indicate 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. Section 20A is aimed at ring-fencing sustained 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 word full-time should therefore be a meaning, which would 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, his activities will fall within the suspect trade category.

The New Shorter Oxford English Dictionary defines the meaning of 'full-time' as '*...the total normal working hours: occupying or using all one's working time.*'

The Collins Essential English Dictionary defines the meaning as '*...full-time work or study takes up the whole of each normal working week rather than just part of it: if you say that an activity or task is a full-time job, you mean that it takes up a lot of your time*'

The Oxford Advanced Learners Dictionary defines full-time as '*...occupying all normal working hours: a full-time worker; working full-time. It's a full-time job, one that leaves no time for leisure or other work.*'

From the above definitions it appears that, the ordinary meaning of full-time, when used with reference to an activity carried on, on a full-time basis, remains the same. Subsection

(2)(b) does not only refer to the fact that the activities should be carried on, on a full-time basis, but specifically indicates that, that person, should carry on the activities on a full-time basis. The use of the words 'that person' is a direct reference to the taxpayer and, therefore, appears to exclude any other person who may, for example, be managing the taxpayer's farming or animal breeding activities on his/her behalf.

Carrying on farming or animal breeding on a full-time basis would for the purposes of section 20A, appear to indicate that the carrying on of these activities should take up most or all of the taxpayer's normal working hours. SARS will, as a result, 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 subsection (2)(b).

It is important to note that the escape clause is available to all trades, which are subject to the ring-fencing provisions and the fact that farming or animal breeding activities are conducted on a part-time and not a full-time basis is not a deciding factor in considering whether the trade constitutes a business with a reasonable prospect of deriving taxable income within a reasonable period. A bone fide farming activity will, therefore, not cease to be bona fide merely because the taxpayer conducts the activity on a part-time basis. Whereas all other trades listed as suspect trades in subsection (2)(b) will be subject to automatic ring-fencing where losses have been incurred in 6 out of 10 years, farming is excluded from this automatic ring-fencing provision.

THE ESCAPE CLAUSE

9. Will losses be ring-fenced automatically?

Losses arising from one of the categories of the listed suspect trades will not be ring-fenced automatically. Subsection (3) provides an escape clause, namely the ‘facts and circumstances test’ by means of which a taxpayer can prevent a loss, arising from any suspect trade, from being ring-fenced. Where a taxpayer is able to show that the particular trade is in fact a business with a reasonable prospect of deriving taxable income within a reasonable period, despite the fact that the activity has been classified as a suspect trade, the ring-fencing of the loss can be avoided.

Automatic ring-fencing of a loss will, however, occur where a suspect trade has generated losses in at least 6 out of 10 years of assessment. The loss is, therefore, ring-fenced notwithstanding the fact that the relevant trade, by means of the escape clause, escaped ring-fencing in the previous years of assessment. Also refer to paragraph 11 for the 6 out of 10-year rule.

10. The ‘facts and circumstances’ test

Subsection (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) The factors to which special regard must be had are prescribed in section 20A(3) and, in essence, these factors constitute the ‘facts and circumstances test’.

10.1 The meaning of trade constitutes a ‘business’

The meaning of ‘business’ is not described in the Act. ‘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 granting of permission to use certain other assets. Not every activity included under the definition of 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 ‘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, 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, whether property (movable or fixed) was acquired, etc. The aforementioned listed features are however not the only aspects indicative of a business activity being conducted. It is however 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* (1880), 15 ChD 247 at 258, Jessel, MR, gave a general definition of the word ‘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.”

10.2 ‘Reasonable prospect’ and ‘reasonable period’

Section 20A gives no indication as to what should be considered as a ‘reasonable prospect’ or even a ‘reasonable period’ for any trade. The facts and circumstances of a trade in one category, e.g. rental will obviously differ from the facts and circumstances of a trade in another category, e.g., 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 special regard must be had to the prescribed facts and circumstances, other facts and circumstances may also be considered where unique circumstances arise.

As indicated under the meaning of ‘business’, 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.

10.3 Special factors to be taken into account

The special factors that have 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 time, 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 means of a subjective test, i.e. the intention of the taxpayer, but is determined by means of an objective test. This objective test is contained in 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. If a relatively small amount of gross income is derived, but large amounts are claimed for deductions, this disproportionality highlights a 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 e.g. the fact that certain deductions such as accelerated depreciation allowances may have resulted in the creation of a loss, i.e. the trade would, but for the specific allowance, have generated a profit, will be viewed in a positive light. Where continuous losses are however incurred because the taxpayer, e.g., 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, such trade may in all likelihood not be 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, i.e. whether the taxpayer in fact sells a product or provides a service. Where a taxpayer, for example, has minimal sales and the advertising of the relevant product is done mostly on a word of mouth basis, this 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 to you 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. Where applicable, the taxpayer must be able to demonstrate his/her efforts in promoting the relevant trade.
- (c) The trade must be carried on in a commercial manner taking into account :
- 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 nature. This aspect relates to the number of full-time employees appointed as opposed to persons hired on a part-time basis. (Persons hired on a part-time basis do not refer to or include employees who are, by virtue of the nature of the trade, only required on a seasonal basis, e.g., in the case of farming, additional workers would 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 as well as its surrounds.

- The commercial setting of the premises where the trade is carried on. This aspect relates to the actual location of the specific trade and the question is whether the commercial setting of the specific trade is likely to promote or hamper the production of income for that trade. The nature of a specific trade will however dictate whether the specific 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), unsuitable growing conditions (products), etc, 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 the trade will therefore be taken into account in considering this factor. A feasibility study carried out prior to commencing with the specific trade, may also highlight the fact whether the specific location would be appropriate for the specific trade.
- The extent of the equipment used exclusively for the purposes of carrying on that trade. Assets, which are used exclusively for the purposes of trade, will be a favourable factor, whereas assets subject to mixed use, i.e. for business and private use will be excluded from qualifying as a favourable factor.
- 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 specific trade. The nature of a trade will however dictate whether the time spent by the taxpayer in carrying on the specific trade could in ordinary commercial life be regarded as sufficient to render the trade commercially viable.

(i) The meaning of 'commercial manner'

The abovementioned factors, i.e. 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. Where a taxpayer claims a deduction in respect of a loss incurred, he/she 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 obviously have a commercial character and a commercial purpose.

The following factors may therefore be considered:

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 prior to nor after commencing with the activity
The main purpose is making a profit	Profit is not the main purpose
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 sufficient for the specific trade and exceeds any personal needs by far	The size and scale of the activity not sufficient to render the activity profitable and satisfy the taxpayer's personal needs only
The activity is organised and records of all transactions are kept	The activity is not organised and records of transactions are not kept
There is repetition and regularity of activities	Transactions are irregular and isolated

- (d) The number of years of assessment in which the trade incurred a loss 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.
- (i) 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 fact that a loss was incurred 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 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 where losses have been incurred for a number of years. Certain trades have a longer start-up period, e.g., 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 the specific trade in future. The fact that a business plan has been drawn up 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 as well as changes to existing plans which indicate that the necessary steps have been put into place to either prevent or limit further losses. A basic business plan should include the following basic elements:

- A business description, i.e. the nature of the business.
- The anticipated income to be derived from the business.
- The capital outlay, i.e. capital required for the acquisition of, for example, stock and/or equipment necessary to conduct the trade.
- The administration/running costs of the business, for example, salaries/wages, telephone costs, travel costs, lease payments (movable/fixed property) water and electricity, etc.
- How the capital outlay as well as the running costs are to be financed. 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 his/her relatives for private use. As indicated previously, assets, which are used exclusively for the purposes of trade, will be a favourable factor. Where necessary, the taxpayer must be able to show that the relevant asset was not generally available for private use by either the taxpayer or his/her relatives. Business assets could include assets such as, e.g., a boat, a yacht, an aircraft or fixed property such as a holiday home. Where an asset, which is subject to business and private use, is used in a business in respect of which a loss has been claimed, the taxpayer must be able to show that the relevant asset is not generally available for personal use. In the case of, e.g., 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 his/her relatives.

AUTOMATIC RING-FENCING: THE END OF THE ESCAPE CLAUSE

11. The '6 out of 10-year' rule

In terms of subsection (4), the 6 out of 10-year rule is applicable to all the listed suspect trades, excluding farming. This subsection provides that the escape clause, which is available to a taxpayer in order to avoid or escape the ring-fencing of losses in respect of a suspect trade, will not be available where the taxpayer has incurred losses in at least 6 out of the last 10 years of assessment. This means that with effect from the 6th year in which a loss arises from the suspect trade, the loss will be ring-fenced permanently. The escape clause can therefore no longer be used to avoid ring-fencing, notwithstanding the fact that ring-fencing was avoided in the previous 5 years of assessment. The 2010 year of assessment will be regarded as the 6th year should continuous losses, as from the 2005 year of assessment, arise from the suspect trade.

Subsection (9) states that for the purposes of the three out of five-year time rule and the six out of ten-year rule, any assessed loss incurred in any year of assessment ending on or before 29 February 2004 shall not be taken into account. This means that a loss incurred in the 2004, 2003, 2002 or earlier years of assessment, may not count against the taxpayer as a loss for the purposes of determining the number of years in which a loss has been incurred. This effectively means that any loss that may have been incurred in a year of assessment ending on or before 29 February 2004 may not be counted as one of the three years or one of the six years in which losses were incurred.

11.1 When will the 6 out of 10-year rule apply?

The application of the six out of ten-year rule means that the loss arising from a suspect trade (excluding farming) is ring-fenced permanently. A taxpayer can, by means of the escape clause, avoid the ring-fencing of a suspect trade loss. In terms of subsection (4), this escape clause will however not be available to any taxpayer where the trade conducted by that taxpayer is a suspect trade and a loss has arisen from that trade in at least six years out of the last ten years of assessment.

Example 8

The taxpayer conducts a suspect trade. Losses arise in the 2005 up to and including the 2010 year of assessment. Counting as from the 2005 year of assessment, a ten-year period only ends in 2014. Where losses are incurred in six successive years of assessment, the 2010 and not the 2014 year of assessment will however be the first year in which the loss can be ring-fenced permanently. The reasons for this are the following:

- 1 The fact that the trade may be profitable in the 2011 and subsequent years of assessment will not have any effect on the fact that losses have already been incurred in at least 6 years of assessment, i.e. 2005 to 2010. If the 6 out of 10-year rule could only be applied after a period of 10 years has elapsed, that would mean that a decision, which affects a specific (prior) year of assessment could only be made in a future year of assessment. For obvious reasons this cannot be done and SARS could find itself in a position of not being able to amend an assessment for a previous year due to prescription.
- 2 Subsection (9) only provides that losses incurred on or before 29 February 2004 may not be taken into account. This subsection therefore does not prohibit the actual year of assessment being counted as a year for the purposes of calculating the 10-year period.

The permanent ring-fencing of a loss in the 2010 year of assessment will only be applicable where the suspect trade gave rise to a loss in six consecutive years of assessment. A profit made in any number of years, will delay the permanent ring-fencing by an equal number of years. A loss will therefore be ring-fenced permanently only if, and when losses have been incurred for at least six years out of a ten year period ending on the last day of the current year of assessment.

11.2 To whom will the 6 out of 10-year rule apply?

Where a loss is ring-fenced, such ring-fencing is permanent. Any loss incurred for the specific trade may therefore not be set off against any other income.

Losses will be carried forward and may only be set off against the future income derived from the specific trade. As previously indicated farming has been excluded from the 6 out of 10-year permanent ring-fencing provisions. The six out of ten-year rule therefore applies to all losses arising from the suspect trades (other than farming), listed in subsection (2)(b).

12. The application of the ring-fencing provisions in practice

The effect that the ring-fencing provisions will have on 'taxable income' will be as indicated in the example below.

Example 9

The following facts are assumed for the purpose of this example:

1. The taxpayer is in receipt of employment income, which is in excess of R270 000 at which the maximum marginal rate of tax applies.
2. The trade has passed the trade test in section 11 of the Act
3. The trade conducted by the taxpayer is a suspect trade in terms of subsection (2)(b)
4. The loss arising from the suspect trade is ring-fenced in 2005 as the taxpayer was not able to show that the trade constituted a business with a reasonable prospect of deriving taxable income within a reasonable period

Year	Profit or loss from activity	Income from employment	Taxable income	Cumulative loss carried forward
2005	Loss R3 000	R270 000	R270 000 note 1	R3 000
2006	Loss R2 500	R295 000	R295 000 note 2	R5 500
2007	Profit R6 000	R315 000	R315 500 note 3	Nil
2008	Profit R1 000	R375 000	R376 000 note 4	Nil

Notes:

1. Year 2005, the loss is ring-fenced and as a result, the loss is carried forward to the 2006 year of assessment to be set off against the profit or loss for the specific trade in the 2006 year of assessment.
2. Year 2006, the ring-fenced loss is added to the loss incurred in the 2005 year of assessment. The cumulative loss to be carried forward to 2007 is R5 500. [R3000, for 2005 + R2500, for 2006].
3. Year 2007, the loss carried over from 2006 is first set off against the profit of R6000 and the excess profit of R500 [R6 000 – R5 500] is added to the other income of R315 000 making the total taxable income R315 500 for the 2007 year of assessment. No loss remains to carry forward to the 2008 year of assessment.
4. Year 2008, the profit is added to the other income, making the total taxable income R376 000.

As can be seen from the above example, once a loss from a specific trade is ring-fenced in terms of the provisions of section 20A(1), the ring-fencing is permanent. This treatment of the assessed loss for the specific trade is in accordance with section 20A(5), which provides that –

'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).'

Where the loss from a specific trade has been ring-fenced, the loss incurred in respect of that specific activity in a prior year will first be set off against any profit made from the same activity in a current year. Any profit which remains after the loss/cumulative loss carried forward from a preceding year has been deducted will be added to other taxable income.

OTHER MATTERS RELATING TO RING-FENCING

13. Multiple farming activities deemed to be a 'single trade'

Where a loss arising from a suspect trade is ring-fenced, that loss is carried forward to the following year of assessment and can only be set-off against any income derived from that specific trade. In the case of farming, however, section 20A(7) provides that, for the purposes of the ring-fencing provisions, all the taxpayer's farming activities will be deemed to constitute a single trade. This deeming provision has the following effect:

Example 10

A taxpayer earns R350 000 from his private practice and also carries on the following part-time farming activities on 3 different smallholdings.

	2005
Smallholding 1 – Cattle farming	Profit R25 000
Smallholding 2 – Sheep farming	Loss R58 000
Smallholding 3 – Fruit farming	Loss R21 000
Farming income/loss for the 2005 year of assessment	Loss R54 000

The farming activities conducted on all three smallholdings are, for the purposes of the ring-fencing provisions, deemed to constitute one single trade. The profits and losses are therefore set-off against one another to arrive at one amount, which represents the income/loss from farming activities for the 2005 year of assessment. The taxpayer's taxable income will therefore be R350 000, and not R350 000 plus R25 000 which is the profit made on smallholding 1.

In this example there is an overall loss of R54 000 from all the farming activities. In view of the fact that 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 loss from the sheep farming activities nor the loss from the fruit farming can, therefore, in terms of subsection (7) be subject to potential ring-fencing as separate trades.

14. Can other activities, other than farming, also be regarded as a single trade?

Whereas 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 with regard to the treatment of other activities.

Whether or not more than one related activity, other than farming, can in fact be treated as a single trade for assessment purposes will depend entirely on the facts of the specific case. The activities conducted will be looked at as a whole. A general impression of the activities as well as the way in which they are conducted will give some indication as to whether they are in fact conducted as a single trade. The question whether or not certain activities can be regarded as a business, becomes relevant in the case of, for example, the letting of fixed property. A distinction must be made between property, which is held as an investment, and property, which is held as business assets to be exploited for the purpose of gain, i.e. property which is held with the intention of carrying on a business as a lessor of property.

Example 11

A taxpayer buys 5 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. A taxpayer in this position will have a strong case in arguing that he is conducting a single trade, i.e. the business as a lessor of fixed property, and not 5 separate trades. On the other hand, if the apartments were bought over a period of time as separate investment decisions they may be regarded as 5 separate trades. The profitability of each trade will therefore be considered in deciding whether any loss may be ring-fenced.

Activities, which are 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 loss/es in respect of such activity/ies should be ring-fenced.

15. Other amounts to be included as 'income' from the trade

For the purposes of calculating either the net profit or the net loss, i.e. the taxable income or assessed loss of the specific trade, any amounts to be included in terms of the provisions of section 8(4) will be regarded as income from the specific trade. Section 8(4) refers to the recoupment of amounts that were previously allowed as a deduction against the income of the taxpayer. As a rule, the recoupment of an amount previously allowed as a deduction does not constitute income derived from conducting a trade. For the purposes of section 20A, however, the recoupment of amounts previously allowed as a deduction in that specific trade will be regarded as 'income' from that trade.

Where the taxpayer ceases a specific trade and disposes of the assets, which were used for the purposes of carrying on the specific trade, the amounts derived from such disposals, will be regarded as income derived from carrying on the trade. Where a loss is, for example, ring-fenced in the 2007 year of assessment and the taxpayer ceases the specific trade in the 2009 year of assessment, any balance of an assessed loss carried forward from the 2008 year of assessment to the 2009 year of assessment will be set off against the amounts derived from the disposal of the trade assets in the 2009 year of assessment.

The amounts regarded as income from the disposal of assets will however be limited to so much as was previously allowed for the purposes of depreciation for the specific asset/s. Amounts which are derived in excess of the original cost price of the assets, i.e. a capital gain, will not be regarded as income but will be subject to capital gains tax. Amounts derived from the disposal of stock will however be subject to the general rule, i.e. such amounts in any event constitute income derived from trade.

16. Reporting requirements

Subsection (8) requires that, where the provisions of subsection (2) apply, the taxpayer must indicate the nature of his/her business in his/her yearly return of income. Where a person therefore has a taxable income, which is subject to the maximum marginal rate of tax, and a loss was incurred in respect of any trade, the nature of the business must be indicated in the return.

As indicated earlier in this document, the taxable income excludes any balance of assessed loss that may have been carried forward from a previous year or any assessed loss incurred in respect of a trade during the current year of assessment. The yearly return of income will however provide the space in which the required information must be furnished.

17. 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. Where spouses conduct any trade in partnership, the income is deemed to have accrued to both spouses in the proportion determined by them in terms of the agreement that regulates their joint trade. If no agreement was concluded, 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) of the Act deems the income to have accrued to both spouses in equal shares. Where income is derived from property that does not form part of the joint estate, the rental income will be included in the income of the spouse who owns the asset.

GENERAL ADMINISTRATIVE PROVISIONS

18. 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 a loss in respect of a suspect trade and the loss is subject to potential ring-fencing with effect from the 2005 year of assessment. If the loss is in fact ring-fenced in 2005, it cannot be set-off against any other income. The taxable income from other sources can therefore not be reduced by the loss and the provisional tax liability is calculated on the taxable income excluding the ring-fenced loss.
2. The taxpayer incurred a loss in respect of a trade which is subject to the three out of five year time rule. This loss can only be subject to potential ring-fencing with effect from the 2007 year of assessment. A loss which is subject to the three out of five year time rule will therefore not have an effect on the amount of provisional tax to be paid in the 2005 or the 2006 years of assessment.

Taxpayers should exercise caution by keeping the ring-fencing provisions in mind when making their second provisional tax payment. Where a loss from a suspect trade is taken into account and the loss is ring-fenced, there may be a short payment of provisional tax. Penalties and interest could as a result be payable on the short payment if the estimated taxable income is less than 90% of the final taxable income.

19. Tax directives

In terms of paragraph 11 of the Fourth Schedule to the Act the Commissioner may, having regard to the circumstances of the case, issue a tax directive authorising the employer to refrain from deducting (or to deduct a smaller amount) employees' tax from remuneration due to the employee in order to alleviate hardship to the employee due to circumstances outside his/her control. A taxpayer may, therefore, apply for a tax a directive (on form IRP 3(c) obtainable from a SARS branch office or the website, www.sars.gov.za) where an assessed loss will be set off against his/her income from employment and he/she can satisfy the Commissioner that the deduction of employees' tax at the statutory rates will lead to hardship to him/her due to circumstances outside his/her control.

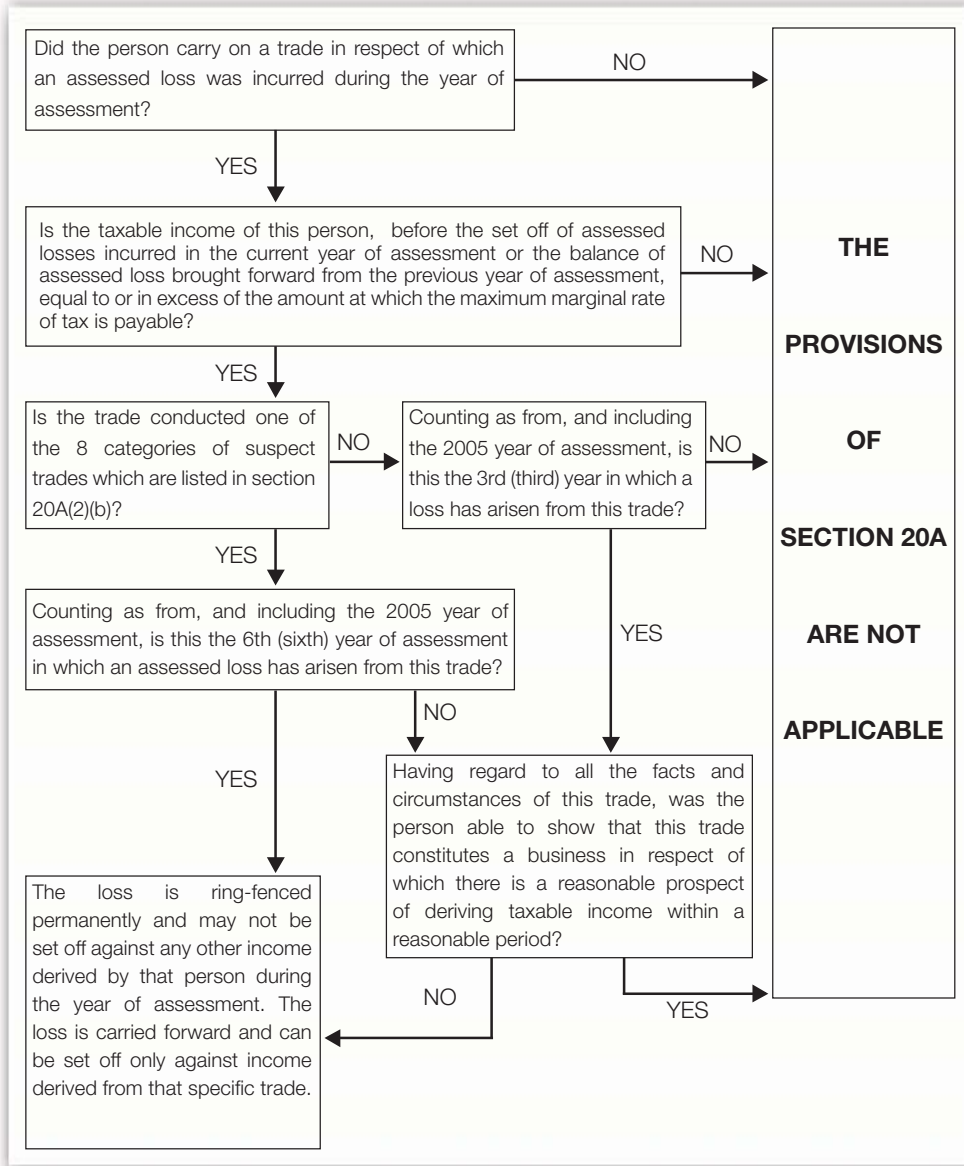
20. Objections and appeals

Where an assessment, which ring-fences an assessed loss, is issued to a person, that person has a right to object to the relevant assessment if he/she is not satisfied with the decision made by SARS. If the objection is disallowed or partially disallowed, that person has the right to lodge an appeal against such disallowance or partial disallowance.

Information regarding the objection and appeal procedures is available on the SARS website www.sars.gov.za under 'dispute resolution' and can be obtained from any SARS branch office located in your area.

ANNEXURE 1

Checklist (Flowchart) for the application of the ring-fencing provisions





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