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SCHOOL OF ACCOUNTANCY

University of the Witwatersrand, Johannesburg

Research report submitted to the Faculty of Commerce, Law andManagement in partial fulfilment of the requirements for the degree of Master of Commerce (Taxation)

Disallowing the utilisation of an assessed loss: a survey of South African case law

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ABSTRACT

The purpose of this report is to examine the circumstances in which the utilisation of an assessed tax loss can be disallowed. This research evaluates the provisions of section 20 of the Income Tax Act 58 of 1962 to the effect that the set-off of any balance of assessed loss incurred by a taxpayer (such as a company) in any previous year of assessment is admissible only against income derived by the taxpayer from carrying on a trade. The report focuses on how companies should have regard to the general legal principles laid down in the case law in considering whether they have satisfied the "carrying on [of] a trade" requirement in order to carry forward an assessed loss. The research suggests that taxpayers should also be aware that the South African Revenue Service ("SARS") may nevertheless invoke the provisions of section 103(2) of the Act to disallow the utilisation of an assessed loss.

Key Words: assessed tax loss, utilisation, disallowed, section 20, carrying on a trade, "trade" requirement, "income from trade" requirement, established principles, case law, carry forward an assessed loss, section 103(2), commercial justification, solely or mainly.

DECLARATION

I declare that this research report is my own unaided work. It is submitted for the degree of Master of Commerce (specialising in Taxation) at the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination in any other university.



_____

Sharolta Schreuder

26 January 2023

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TABLE OF CONTENTS

Chapter 1 - Introduction 1
1.1 The statement of the problem 2
1.2 The sub-problems 3
Chapter 2 - The meaning of 'assessed loss' and 'balance of assessed loss' 5
2.1 Introduction 5
2.2 Meaning of 'assessed loss' 5
2.3 Meaning of 'balance of assessed loss' 7
2.4 Conclusion 10
Chapter 3 - Treatment of an assessed loss in terms of Section 20 11
3.1 Introduction 11
3.2 Section 20 11
3.2.1 Assessed losses from trade in the same year of assessment 13
3.2.2 The continuity requirement 14
3.3 Limitations regarding the set-off of assessed losses 14
3.3.1 Sequestration of a natural person 14
3.3.2 Foreign assessed losses 15
3.3.3 Retirement lump sum benefits 15
3.4 Ring-fencing of assessed losses from certain trades (Section 20A) 16
3.5 Conclusion 18
Chapter 4 - Principles taken from case law on the utilisation of an assessed loss 19
4.1 Introduction 19
4.2 The "trade" requirement 19
4.2.1 *SA Bazaars (Pty) Ltd v CIR* 21
4.2.2 *Robin Consolidated Industries Ltd v CIR* 24
4.2.3 *Timberfellers (Pty) Ltd v CIR* 28
4.2.4 *C:SARS v Contour Engineering (Pty) Ltd* 30
4.2.5 *ITC 1751* 32
4.2.6 *C:SARS v MEGS Investments (Pty) Ltd and Another* 34
4.2.7 *ITC 1802* 38
4.3 The "income from trade" requirement 40
4.3.1 Argument in 'favour' 41
4.3.2 Argument for 'against' 45
4.3.3 SARS' view 46
4.3.4 Implications of Interpretation Note 33 47
4.4 Conclusion 47

Chapter 5 - The role of section 103(2) 49
5.1 Introduction 49
5.2 *Conshu (Pty) Ltd v CIR* 50
5.3 *CSARS v Digicall Solutions (Pty) Ltd* 55
5.4 *New Urban Properties v SIR* 61
5.5 Conclusion 64
Chapter 6 – Limitations on the use of assessed losses 66
6.1 Introduction 66
6.2 Amendment to section 20 66
6.3 Conclusion 68
Chapter 7 - Conclusion 70
REFERENCE LIST 72
Books 72
Journals 72
Practitioner Notes 73
Explanatory Memoranda 74
Statutes 74
Cases 75

Chapter 1 - Introduction

In most instances, every company aspires to deliver a profit at the end of the financial year. On the other hand, a tax loss is a valuable asset, since it can (if certain requirements are met) be carried forward and set off against future income derived from carrying on any trade.[1]

The ability of a company to carry forward assessed tax losses is impacted by the 'trade requirement' as set out in section 20 of the Income Tax Act 58 of 1962 (the Act). Where a company wishes to preserve a tax loss, it must ensure that the nature of business is appropriately assessed and evaluated in accordance with the provisions of the Act as currently enacted, and interpretations of the Act as pronounced in the courts of South Africa to determine if the company has 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.

> This raises a few questions in tax law, first, what does "carrying on a trade" mean?[2] Secondly, can a company be considered to be carrying on a trade even if no income has been earned in that year of assessment?[3] Thirdly, are there any anti-avoidance provisions that prevent the utilisation of an assessed tax loss?[4]

SARS has provided guidance on these issues in Interpretation Note No. 33 (IN 33). There is a need to carry on a trade during the current year of assessment before a company can carry forward its assessed loss, however, difficulties can still arise even if the "trade" requirement has been met. These difficulties can occur when the nature of the activity itself does not fall within the meaning of "trade," as defined in section 1(1) of the Act; 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.[5]

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[1] SAICA (2004) 1244. The carrying forward of tax losses: trade and trade income essential
[2] South African Revenue Services: Interpretation Note 33 (Issue 5) (5 May 2017) – pg. 3.
[3] Cucciolillo, D. (09 May 2013) SAIT News & Press: TaxTalk Business (Assessed losses: Companies versus other taxpayers)
[4] Govindsamy, K. (6 May 2021) Cliffe Dekker Hofmeyr: Tax & Exchange Control Alert (pdf download pg. 3.)
[5] South African Revenue Services: Interpretation Note 33 (Issue 5) (5 May 2017) – pg. 4.

The question of 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, has been one that remains open to interpretation and has still not been fully resolved.

There has also been much debate over what is meant by the word "income" - whether it means income in the defined sense of gross income *less* exempt income, or income in the sense of a taxable profit.[6]

Regarding the "income from trade" requirement, we should look at both sides of the arguments that are in favour and those that argue against the "income from trade" requirement. These arguments both point to the wording of the sections in the Act from a policy perspective, as well as cite case law on the interpretation of the "income from trade" requirement where both sides of the argument have been recognised and upheld in the courts. Ultimately, the use of case law as authority on this point remains somewhat questionable.

The research aims to provide clarity on the abovementioned aspects to assist in determining what principles have been established as a result of case law in which the utilisation of an assessed loss can be disallowed, as it is evident that while the views of SARS, as contained in IN33, provides 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.[7]

1.1 The statement of the problem

This research assesses the meaning of "carrying on a trade" in order to discover what principles have been established in South African case law where the utilisation of an assessed loss was disallowed.

[6] South African Revenue Services: Interpretation Note 33 (Issue 5) (5 May 2017) – pg. 11.
[7] South African Revenue Services: Interpretation Note 33 (Issue 5) (5 May 2017) – pg. 16.

1.2 The sub-problems

The structure of this report is as follows:

The first sub-problem (Chapter 2) analyses what is meant by an 'assessed loss' and a 'balance of assessed loss' within the provisions of section 20(1)(*a*).

The second sub-problem (Chapter 3) evaluates the treatment of assessed losses per section 20 of the Act. The essence of the set-off of an assessed loss from the preceding year of assessment is that it may only be set off against income derived from 'carrying on any trade.' In the case of a person other than a natural person, the inference to be drawn from section 20(2A)(*b*) is that an assessed loss from a previous year may not be set off or carried forward if the person does not derive income in the year of assessment.

The third sub-problem (Chapter 4) evaluates the application of the law that governs the utilisation of an assessed loss. The research delves deeper into the relevant case law, where principles have been established to clarify when a company may forfeit its right to carry forward its assessed loss. The research focuses on case law where the taxpayer was considered not to be 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.

The fourth sub-problem (Chapter 5) pertains to examining the role that section 103(2) of the Act plays in the disallowance of the utilisation of an assessed loss. 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 and certain factors are present.

The fifth sub-problem (Chapter 6) is to understand the new rules pertaining to the limitation on the use of assessed losses, as announced by the Finance Minister during the 2022 Budget. The new rules are applicable for years of assessment ending on or after 31 March 2023 and are applicable for South African companies and branches of foreign incorporated companies.

Please note, that the analysis that follows takes into account the provisions of the Income Tax Act 58 of 1962, as amended and as currently enacted, and interpretations of the Act, as pronounced in the courts of South Africa. References to sections are to sections of the Act, unless otherwise indicated.

In addition, this research does not examine in further detail the carry forward of an assessed loss by taxpayers other than companies.

Chapter 2 - The meaning of 'assessed loss' and 'balance of assessed loss'

2.1 Introduction

The previous chapter provided a comprehensive summary on the research topic and the purpose of the research (i.e., the statement of the problem and sub-problems). The report mainly focuses on a survey of South African case law that may prevent the utilisation of an assessed loss by a company. Therefore it is useful to understand what is meant by an 'assessed loss' and a 'balance of assessed loss' within the provisions of section 20(1) of the Act.

This chapter focuses on the two definitions, as well as a general introduction into the understanding of assessed losses in the context of tax law.

2.2 Meaning 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 (read in conjunction with section 23) 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[8] (refer to chapter 4.2 for the definition of 'trade' in s 1).

The determination of an 'assessed loss' was confirmed by Centlivres CJ in *SA Bazaars (Pty) Ltd v CIR* 1952 (4) SA 505 (A) 18 SATC 240 at 245:

> 'For the purposes of this subsection "assessed loss" means any amount, as established to the satisfaction of the Commissioner, by which the deductions admissible under this section exceed the income in respect of which they are so admissible.'

Section 11(*x*) of the Act permits the deduction of 'any amounts which in terms of any other provision in this Part [that is, ss 5 to 37H], are allowed to be deducted from the

[8] South African Revenue Services: Interpretation Note 33 (Issue 5) (5 May 2017) – pg. 3.

income of the taxpayer'. Thus, s 11(*x*) brings all other allowable deductions in terms of Part 1 of the Act (normal tax) into the scope of section 11, and means that all such deductions must also be taken into account when the assessed loss is determined.[9] It then follows that the scope of the deductions for the purpose of calculating an assessed loss extends to all admissible deductions, notwithstanding the limitation imposed by the definition of 'assessed loss' in section 20(2).[10]

In practice, a company's taxable income is calculated on the basis of the income tax computation that must be submitted in the company income tax return (ITR14). This calculation requires the taxpayer to calculate its taxable income (or alternatively, assessed loss) using the accounting profit before tax, as indicated in the statement of Statement of Profit or Loss (P&L) and Other Comprehensive Income (OCI) of the Annual Financial Statements (AFS) as a starting point. The effects of certain income or expenses included in the profit before tax for accounting purposes should be reversed and replaced with the amount of the relevant income or deduction determined in accordance with the Act. The level of detail of the adjustments required depends on the size and tax status of the company.[11]

Framework for the calculation of a company's taxable income: [12]

Profit or loss as reflected on the Statement of profit or loss (P&L)	xxx
Debit adjustments: - Less: Non-taxable amounts credited to the Statement of P&L - Less: Allowances available for tax purposes that were not claimed in the Statement of P&L	 (xxx) (xxx)
Credit adjustments - Add: Non-deductible amounts debited to the Statement of P&L - Add: Amounts not credited to the Statement of P&L (i.e., amounts that are taxable but not credited to the Statement of P&L)	 xxx xxx xxx

[9] *SILKE: South African Income Tax*, Chapter 7: Natural persons, 7.1.1 - pg.142.
[10] *SILKE on South African Income Tax*, Chapter 8 Special deductions, § 8.125 Assessed losses — introduction.
[11] *SILKE: South African Income Tax*, Chapter 19: Companies and dividends tax, 19.2.2 - pg.694.
[12] *SILKE: South African Income Tax*, Chapter 19: Companies and dividends tax, 19.2.2 - pg.694.

- Add: Allowances / deductions granted in previous years of assessment that are reversed in the current year of assessment - Add: Recoupment of allowances or expenses previously allowed as deductions - Add: Amounts specifically to be included in the determination of taxable income before s 18A donations	xxx xxx
Add: Taxable capital gains (section 26A)	xxx
Less: Assessed losses brought forward from previous years of assessment (***Note 1***)	(xxx)
Less: s 18A donations deduction	(xxx)
TAXABLE INCOME OR (ASSESSED LOSS) FOR THE YEAR OF ASSESSMENT	**XXX**

Note 1

This amount relates to the assessed loss incurred by the taxpayer in a previous tax year to be carried forward and set off only against income derived from carrying on any trade in the relevant year of assessment in accordance with section 20(1) read with s 20(1)(*a*) of the Act.

An assessed loss therefore arises when the 'taxable income' of a taxpayer for a specific year of assessment is a negative amount (and an assessment was issued to this effect).[13]

This report focuses on the events that may prevent the utilisation of an assessed loss brought forward from a previous year of assessment by a company (i.e., the 'balance of assessed loss' as referred to in Note 1 above).

2.3 Meaning of 'balance of assessed loss'

The expression 'balance of assessed loss' has not been defined in the Act but, it is submitted, contemplates the aggregation of the portions of any assessed losses incurred in the carrying on of a trade exceeding the taxable income derived from the carrying on of a trade and any other taxable income.[14][15]

[13] *SILKE: South African Income Tax*, Chapter 7: Natural persons, 7.1.1 - pg.142.
[14] *ITC 664* (1948) 16 SATC 125 (U); *CIR v Louis Zinn Organization (Pty) Ltd* 1958 (4) SA 477 (A), 22 SATC 85.
[15] AP De Koker, RC Williams *Silke on South African Income Tax* in 8.125.

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* 1958 (4) SA 477 (A), 22 SATC 85 as follows[16]:

> '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.'[17]

The main principle established from the *Louis Zinn Organization* case is that a balance of assessed loss is simply the assessed loss you carry forward from one tax year to the next.[18] 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 and it looks forward to the future when it will be used. [19]

Since the term 'assessed loss' has been defined in section 20(2) of the Act, it may be apparent that it is then only a requirement to establish the meaning of the word 'balance', which was described by E.S. Henochsberg, Q.C., for the appellants in *SA Bazaars (Pty) Ltd v CIR*: [20]

> 'Throughout the Act the word 'balance . . .' is related to the close of the accounting period. The Act clearly envisages 'balance. . .' not as an unnatural calculation but in its normal commercial meaning; see sections 11(3), 28(*b*) and 20 of Act 31 of 1941 and cf. Simon, *Income Tax* (1949 ed., para. 154). The

[16] South African Revenue Services: Interpretation Note 33 (Issue 5) (5 May 2017) – pg. 3.
[17] *CIR v Louis Zinn Organization (Pty) Ltd* 1958 (4) SA 477 (A), 22 SATC 85 at 95.
[18] ML Stein, C Divaris *South African Income Tax Guide* (2020/2021 Edition): Chapter 10 Income from business and professions [10.71 Assessed losses]
[19] *CIR v Louis Zinn Organization (Pty) Ltd* 1958 (4) SA 477 (A), 22 SATC 85 at 95.
[20] *SA Bazaars (Pty) Ltd v CIR* 1952 (4) SA 505 (A) (18 SATC 240) at 241 – 242.

> normal commercial meaning of 'balance' is 'the net total carried forward' at the close of the accounting period, i.e. the tax year or year of assessment.

To sum up the above on the meaning of the word 'balance', an assessed loss therefore becomes a 'balance of assessed loss carried forward' at the instant of close of the accounting period and will immediately rank for set off until it has been completely set off. It is important to distinguish that because the 'balance of assessed loss carried forward' changes from being an 'assessed loss' into a 'balance of assessed loss carried forward' at the end of the accounting period, there is no recalculation required in the assessment twelve months later, i.e. at the end of the following accounting period.

On the other hand, 'balance of assessed loss' was described by P. F. O'Hagan, Q.C., for the respondent in *SA Bazaars (Pty) Ltd v CIR*:[21]

> 'A balance of assessed loss is carried forward from year to year by setting it off in each succeeding year against the amount of the income less the amount of the deductions. Where the income (less deductions) exceeds the loss carried forward, the loss is finally extinguished. But where the loss exceeds the income, the amount of the excess is the balance of the loss which is carried forward to the next succeeding year of assessment.'

The main principle established from the above may be explained in the following example: if in year 1 there is an assessed loss from trading of R50,000 and in year 2 a taxable income of R30,000, the balance of assessed loss in year 1 = R50,000, and in year 2 = R20,000. This is calculated by taking the R50,000 assessed loss from year 1 that is brought forward into year 2 less the R30,000 taxable profit accrued in year 2. The net of these amounts equals a R20,000 assessed loss that may be carried forward into year 3. If in year 3, there is an assessed loss for the current year of R60 000, then the balance of assessed loss in year 3 is equal to R80 000 (i.e., R60,000 current year assessed loss plus the year 2 assessed loss brought forward of R20,000). [22]

[21] *SA Bazaars (Pty) Ltd v CIR* 1952 (4) SA 505 (A) 18 SATC 240 at 242/3
[22] *SILKE on South African Income Tax*, Chapter 8 Special deductions, § 8.125 Assessed losses — introduction.

2.4 Conclusion

From the above, it is evident that the term 'assessed loss' is defined in section 20(2), whilst the term 'balance of assessed loss' is not. 'Balance of assessed loss' refers to the assessed loss that is brought forward from the preceding year of assessment. This is the excess of any assessed losses incurred by a company in a specific year of assessment over the taxable income derived by that company and its balance can be carried forward to future assessment periods to reduce the taxable income in future assessment periods, provided that it meets the requirements set forth in section 20.[23]

[23] Cucciolillo, D (09 May 2013) SAIT News & Press: TaxTalk Business (Assessed losses: Companies versus other taxpayers)

Chapter 3 - Treatment of an assessed loss in terms of Section 20

3.1 Introduction

The purpose of this chapter is to set out the law that is applicable where a taxpayermay set off an assessed loss for the purposes of determining the taxable incomederived by that taxpayer from carrying on a trade, including consideration of but not limited to, the following: foreign assessed losses, retirement lump sum benefits and the ring-fencing of assessed losses in terms of the Act.

3.2 Section 20

The treatment of assessed losses is found in section 20 of the Act. Section 20(1), and read with s 20(1)(*a*), allows an assessed loss incurred by the taxpayer in a previous tax year to be carried forward and set off only against income derived from carrying on any trade. Hence, the carrying forward and the setting-off of an assessed loss is possible only if the taxpayer has derived some income during the year in which the set-off is to apply and only if that income was derived from trading. The set-off of those prior losses is then permitted to operate only against the taxpayer's trading income for the current year, and not against non-trading income. Nevertheless, s 20(2A)(*a*) and (*b*) makes these restrictions applicable only to companies and not to individuals.

The essence of the set off of an assessed loss from the preceding year of assessment is that it may be set off only against income derived from carrying on any trade. In the case of a person other than a natural person, the inference to be drawn from section 20(2A)(*b*) is that an assessed loss from a previous year may not be set off or carried forward if the person does not derive income in the year of assessment.

This principle is confirmed by our courts:

> 'During the year ending on 30th June 1944, therefore, the appellant did not carry on, within the meaning of section 11(1), a trade within the Union and it derived no income from any trade. Under that sub-section a deduction or set-off is admissible only against income derived from carrying on a trade. As the

appellant carried on no trade during the year under consideration it was not competent for it to set off in its income tax return for that year the balance of assessed loss incurred by it in previous years.'[24]

A company is permitted to deduct an assessed loss from the preceding year of assessment and carry forward any remaining balance of the assessed loss if it has carried on a trade and derived income from the conduct of such trade.

SARS has provided guidance on these issues in Interpretation Note No. 33. As regards to the 'carrying on of trade', much of the technical discussion relates to determining when a company has commenced trade and when it is regarded as having ceased to trade.

Nevertheless, there are useful guidelines in this regard. If a company has started the business for which it was organised, it is carrying on a trade. If it ceases to carry on business for a period, there may be a question whether it is carrying on a trade, but this is a question of fact. In one matter, a company had sold its only business and invested the proceeds while the directors looked to establish a suitable new business. It was accepted that the company was carrying on trade. [25] The "trade" requirement is the focus in chapter 4.2 of this report.

With regard to the "income from trade" question, there has long been a distinction between trading and the investment of money to earn interest. The concept of trade demands that the taxpayer takes active steps to derive income (The "active step" requirement)[26]. In the matter referred to in the *SA Bazaars* case, the Supreme Court of Appeal (SCA) expressed a view that the assessed loss might have been allowed as a deduction if the taxpayer had not accepted that it was required to prove that it derived income from trade.[27] It appears that SARS' view is that there must be substantive evidence that the taxpayer was continuing its operational existence and was not simply mothballed. In such an event, SARS may be prepared to allow the set-off of an assessed

[24] *SA Bazaars (Pty) Ltd v CIR* 1952 (4) SA 505 (A) 18 SATC 240
[25] *C: SARS v Megs Investments (Pty) Ltd and Another* 2005 (4) SA 328 (SCA), 66 SATC 175
[26] *ITC 1476* (1989) 52 SATC 141 (T)
[27] *SA Bazaars (Pty) Ltd v CIR* 1952 (4) SA 505 (A) 18 SATC 240 at 245

loss. It must be emphasised that any such decision would be a concession and is not supported in law.[28]

An example where the courts were not prepared to allow the set-off of an assessed loss is the following:[29]

> '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.'

This indicates that it is simply not enough to keep the company in existence, without having employees, premises, etc.

Effectively, section 20(1) has two requirements, before an assessed loss may be carried forward, namely that a taxpayer must:

- carry on a trade during the current year of assessment (referred to as the "trade" requirement), (discussed in chapter 4.2) and
- have derived income from that trade during that year of assessment (namely the "income from trade" requirement) (discussed in chapter 4.3)

3.2.1 Assessed losses from trade in the same year of assessment[30]

An assessed loss incurred by a person, during the same year of assessment in carrying on any trade either alone or in partnership with others, otherwise than as a member of a company whose capital is divided into shares (s 20(1)(*b*)) can be set off against his income so derived (s 20(1)(*b*)).

The central part of 'ring-fencing' assessed losses lies in s 20A(1) of the Act (discussed in further detail in 3.4), which prohibits the setting off of an assessed loss incurred from a trade against any income derived during the same year from a non-trading activity. This rule applies 'notwithstanding s 20(1)(*b*)', which allows a

[28] South African Revenue Services: Interpretation Note 33 (Issue 5) (5 May 2017) – pg. 15.
[29] *C: SARS v Contour Engineering (Pty) Ltd* (1999) 61 SATC 447 (E).
[30] *SILKE on South African Income Tax*, Chapter 8 Special deductions, § 8.125 Assessed losses — introduction.

taxpayer, either alone or in a partnership with others, who incurs an assessed loss in one trade, to set it off against income from any other trade that he may have derived during the same year of assessment.[31]

3.2.2 The continuity requirement[32]

Section 20(1)(*a*) implicitly envisages a continuity in the setting-off of an assessed loss against income in every year succeeding the year in which it was originally incurred, so that in each succeeding year a balance of assessed loss can be determined, which can be carried forward until the assessed loss is exhausted.[33] In this regard, the Commissioner is not vested with a discretion as to whether or not the loss can be carried forward.[34]

3.3 Limitations regarding the set-off of assessed losses

3.3.1 Sequestration of a natural person[35]

An assessed loss incurred prior to the date of sequestration of a natural person (the insolvent) can be set off against the income of the insolvent estate from carrying on of any trade in South Africa (provisio to s 20(1)(*a*)). This is because, in terms of s 25C, the insolvent, prior to sequestration, and the insolvent estate are deemed to be the same person for the purposes of determining any deduction or set-off to which the insolvent estate may be entitled.

An assessed loss of the insolvent incurred prior to sequestration cannot be carried forward to the insolvent as a natural person for the period subsequent to sequestration unless the order of sequestration has been set aside. If this happens, the amount to be carried forward will be reduced by the amount that was allowed to be set off against the income of the insolvent estate from carrying on a trade (provisio to s 20(1)(*a*)).

[31] *SILKE on South African Income Tax*; Chapter 8 Special deductions; § 8.130 Assessed losses — ring-fencing
[32] *SILKE on South African Income Tax*, Chapter 8 Special deductions, § 8.125 Assessed losses — introduction.
[33] *New Urban Properties Ltd v SIR* 1966 (1) SA 217 (A), 27 SATC 175.
[34] *C: SARS v Dunblane (Transkei) (Pty) Ltd* 2002 (1) SA 38 (SCA), 64 SATC 151.
[35] *SILKE: South African Income Tax*, Chapter 7: Natural persons, 7.1.1 (pg.143)

3.3.2 Foreign assessed losses

An assessed loss incurred by a taxpayer during a year of assessment, or any balance of assessed loss incurred during a previous year in carrying on a trade outside the Republic may not be set off against income derived by him from carrying on a trade in the Republic (proviso (*b*) to s 20(1)).[36] This restriction on the set-off of a foreign assessed loss against local income applies to both individuals and companies. A further, more specific, effect is to prevent the setting off of an assessed loss incurred by a loss-making foreign branch which will subsequently be converted to a subsidiary company once the operation becomes profitable. The restriction does not prevent losses incurred in one foreign country from being set off against income from another foreign country; nor does it prevent South African losses from being set off against foreign income.[37][38]

In a case where a taxpayer, in his spare time, carried on a trade as a foreign exchange dealer and claimed set-off against his income of a loss which arose from his foreign exchange dealings, the court found that although certain elements of his trading occurred outside South Africa, it was nevertheless the exercise of his wits and labour that had played the essential role in his 'foreign' trading activities. These had been exercised by him in South Africa when he made the crucial decisions in respect of the transactions and accordingly, he was allowed to set off the loss incurred against his other income.[39] [40]

3.3.3 Retirement lump sum benefits

A balance of assessed loss incurred in a previous year of assessment or assessed loss incurred in the current year before taking into account any lump sum benefit, retirement fund lump sum withdrawal benefit or severance benefit from a retirement fund may not be set off against such lump sum benefit included in taxable income (proviso (*c*) to s 20(1)). That is, the lump sum benefits are taxed separately using their own rate schedule

[36] Effective as from 1 January 2001 and applies in respect of years of assessment commencing on or after that date.
[37] Explanatory Memorandum on the Revenue Laws Amendment Bill, 2000 [WP 2-'00] at 23.
[38] *SILKE on South African Income Tax*, Chapter 8 Special deductions, § 8.125 Assessed losses — introduction
[39] *ITC 1779* (2004) 66 SATC 353
[40] *SILKE on South African Income Tax*, Chapter 8 Special deductions, § 8.125 Assessed losses — introduction

and are thus unaffected by any assessed loss. [41]

Basically, the person will keep these amounts in separate columns in the subtotal method and then tax these amounts separately in terms of the specific tax tables without taking any assessed loss into consideration.

3.4 Ring-fencing of assessed losses from certain trades (Section 20A)[42]

Section 20(1) applies 'subject to s 20A', which provides a methodology for the ring-fencing of the assessed losses from certain trades. The ring-fencing of an assessed loss from certain trade applies only to certain natural persons (not to companies or trusts).[43]

The negative portion of the so-called general deduction formula contained in s 23(*g*) prohibits as a deduction 'any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended wholly or exclusively for the purposes of trade'. Section 23(*g*) must be read together with section 11(*a*) when the deductibility of an amount is being determined.

In *Ticktin Timbers CC v CIR*[44] Hefer JA noted that:

> '. . . the purpose for which the expenditure was incurred is the decisive consideration in the application of s 23(*g*).'

The expression 'expended for the purposes of trade' has also been considered in the United Kingdom, and the courts there have interpreted it to mean 'for the purpose of enabling a person to carry on and earn profits in the trade' or, in other words, 'for the purpose of earning the profits'.[45] The word 'profits' in this sense has a much wider meaning than 'income' as defined in s 1 of the Act. It follows that expenditure incurred for the express purpose of conducting a hobby or pastime, which masquerades as a trade, will not qualify as expenditure incurred for the purpose of earning 'income' as defined in s 1 of the Act.

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[41] *SILKE on South African Income Tax*, Chapter 8 Special deductions, § 8.125 Assessed losses — introduction
[42] *SILKE on South African Income Tax*; Chapter 8 Special deductions; § 8.130 Assessed losses — ring-fencing
[43] *SILKE: South African Income Tax*, Chapter 7: Natural persons, 7.1.1 - pg.144.
[44] *Ticktin Timbers CC v CIR* [1999] 4 All SA 192 (A), 61 SATC 399 at 401
[45] *Strong & Co of Romsey Ltd v Woodifield (Surveyor of Taxes)* [1906] AC 448, 5 TC 215

The objective of s 20A[46] is to prevent expenditure and losses associated with suspect trades, such as 'hobby activities', from being deducted as a means to reduce taxable income. To this end, it assists in the enquiry as to whether expenditure has been expended wholly or exclusively for the purposes of trade in circumstances where it is doubtful whether the taxpayer's activities constitute genuine trading activities or whether they are merely for his own mode of living or hobby. In this process, it sets out specific circumstances in which losses resulting from carrying on such activities are excluded from set-off against income derived from other sources. Effectively, therefore, it restricts the setting off of assessed losses from suspect trades against taxable income by 'ring-fencing' the losses of certain trades.

Section 20A does not prevent the setting-off of losses from a suspect trade against other income from that trade, but these losses may be wholly disallowed if they stem from an activity that fails to qualify as a trade after application of the general 'facts and circumstances' test discussed below.

An 'assessed loss' means an 'assessed loss' as defined in s 20(2), that is, an amount by which the deductions admissible under ss 11 to 19 inclusive exceed the income from which they are so deductible (s 20A(10)).

The heart of this 'ring-fencing' doctrine lies in s 20A(1), which provides that when the circumstances in s 20A(2) apply to a trade carried on by a natural person, any assessed loss incurred during a year of assessment in carrying on that trade may not be set off against his income derived during that year otherwise than from carrying on that trade. In other words, it prohibits the setting off of an assessed loss incurred from a trade against any income derived during the same year from a non-trading activity. This rule applies notwithstanding s 20(1)(*b*), which empowers a taxpayer, either alone or in a partnership with others, who incurs an assessed loss in one trade, to set it off against income from any other trade that he may have derived during the same year of assessment.

[46] Effective as from 1 March 2004 and applies in respect of any year of assessment commencing on or after that date.

The ‘s 20A(2)-circumstances test’ involves an enquiry into two matters. The first focuses on the sum of the taxpayer's taxable income and any assessed loss and balance of assessed loss that was set off in determining that taxable income. The ‘ring-fencing’ of an assessed loss applies only to natural persons (not companies or trusts) whose taxable income and any assessed loss and balance of assessed loss for a year of assessment equals or exceeds the amount at which the maximum marginal rate of tax becomes applicable. This threshold is determined without regard to the other provisions of s 20A.

The second part of the enquiry focuses on the loss-generating activity. Only losses from suspect trades are subject to potential ring-fencing. This aspect represents an ‘either or’ test. Under this ‘either or’ test, the taxpayer is engaged in a ‘suspect trade’ if the trade fails the ‘three-out-of-five-year’ loss rule described in s 20A(2)(*a*) or alternatively, has been explicitly listed as a suspect trade, more discursively described in s 20A(2)(*b*).

The report does not go into further detail on the ‘three-out-of-five-year’ loss rule or the specific suspect trade list, neither the escape clause mentioned in s 20A(3) or any of the remining provisions in s 20A that have not already been mentioned above.

3.5 Conclusion

This chapter presented an overview of the detailed requirements for the carrying forward of an assessed loss and the relationship between sections s 20(*a*) and (*b*), whilst touching on the ring-fencing principles contained in s 20A.

The first requirement for the carrying forward of assessed losses for companies, is that the taxpayer has to trade, and the second requirement is that the taxpayer has derived income from that trade during that relevant year which is the focus of the next chapter.

Chapter 4 - Principles taken from case law on the utilisation of an assessed loss

4.1 Introduction

This chapter examines the legislative, judicial and administrative approaches adopted by the courts of South Africa with particular reference to the problems and sub-problems outlined in Chapter 3 above.

When considering whether a company is entitled to carry forward an assessed loss (and whether they have satisfied the "trade" and "income from trade" requirements), a taxpayer should have regard to established principles which emanate from case law over the years. The disputed matters that required intervention from the courts in relation to s 20 are discussed in further detail.

The chapter examines the cases in more detail, in order to ascertain what will satisfy the trade and income from trade requirements before relying on the provisions of section 20(1)(*a*) to carry forward an assessed loss from the previous year of assessment.

An incorrect determination could result in SARS disallowing the carry forward of the assessed loss, resulting in significant adverse consequences for the taxpayer's business.

4.2 The "trade" requirement

The term "trade" is defined in section 1 of the Act and it has a wide meaning. Section 1(1) of the Act defines "trade" as follows:

> '"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;'

As pointed out in *Silke on South African Income Tax*:[47]

> "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."

Section 20(1) read with s 20(1)(*a*) allows an assessed loss incurred by the taxpayer in a previous tax year to be carried forward and set off only against *income derived from carrying on any trade*. Hence the carrying forward and the setting-off of an assessed loss is possible only if the taxpayer has derived some income during the year in which the set-off is to apply and only if that income was derived from trading. The set off of those prior losses is then permitted to operate only against the taxpayer's trading income for the current year, and not against non-trading income.

A scrutiny of this provision reveals that the first hurdle to be overcome by a taxpayer who wishes to set off an assessed loss carried forward from the preceding tax year is that the taxpayer must be '*carrying on a trade*' in the current tax year. Thus, if a taxpayer ceases, for the whole of the tax year, to carry on a trade, any assessed tax loss carried forward from the previous year is permanently forfeited. But this restriction applies only to companies and has been relaxed in relation to individuals. In terms of section 20(2A), an individual taxpayer does not forfeit a carried-forward tax loss if he or she fails to trade or derive income for the whole of the current year.[48]

It is not essential that a company must have carried on a trade during the whole year; any period of trading during the year will suffice.[49] However, the moment a company does not carry on a trade in a subsequent year, the assessed loss is forever lost. It is not a requirement that a taxpayer company should not trade for a number of years before the loss is denied. For example, if an assessed loss is incurred in year one, no trading is carried on year two, and in year three trade is conducted again, the loss cannot be deducted in year three. The reason for this is that an assessed loss must be carried forward from the preceding year of assessment (*ITC 664* 16 SATC 125; *SA Bazaars*

[47] AP de Koker & RC Williams *Silke on South African Income Tax* [online] (My LexisNexis: September 2021) in Chapter 7 General deductions § 7.2 Expenditure under s 11 deductible only if trade carried on
[48] SAICA (2004) 1244. The carrying forward of tax losses: trade and trade income essential
[49] *SILKE: South African Income Tax*, Chapter 12: Special deductions and assessed losses, 12.12.2 (pg.350)

(Pty) Ltd v CIR 18 SATC 240 and *New Urban Properties Ltd v SIR* 1966 (1) SA 217 (A)).[50]

4.2.1 *SA Bazaars (Pty) Ltd v CIR*[51]

In *SA Bazaars (Pty) Ltd v CIR* 1952 (4) SA 505 (A) 18 SATC 240, the company had carried on a business as a general dealer for a number of years, and as the result of losses incurred, had closed down its business on 16th November 1941. During the succeeding years, up to the year ended 30th June 1947, the company maintained its existence, continued its banking account, obtained a transfer of its trading licences to other premises and renewed them annually, paid its company tax and licence duty and complied with all the requirements of the Income Tax and Companies Acts; but it did not carry on any ordinary trading operations. [52]

During the year of assessment ended 30th June 1948, the company resumed active business operations and in that year and the following year, it earned a profit from those operations.

The company claimed that it was entitled to carry forward, year by year, the accumulated loss resulting from its trading operations prior to the closing down of those operations and to set such loss off against the profits earned by it on the resumption of active business. The Commissioner for Inland Revenue (CIR) refused to admit any such carry forward for set-off and ruled that on the company's ceasing to trade, the assessed loss to be carried forward from the last year of trading was *nil*.[53]

[50] Revision Service 19, 2014 *JUTA'S INCOME TAX* 20-3
[51] *SA Bazaars (Pty) Ltd v CIR* 1952 (4) SA 505 (A) 18 SATC 240; The facts pertaining to the case were summarised in my own words, but in some instances crucial elements to the case and the discussion thereof could not be expressed in words other than what was included in the extract of the actual court case.
[52] Page 240 of 18 SATC 240
[53] Page 240 of 18 SATC 240

The Decision

In *SA Bazaars (Pty) Ltd v CIR* at 245, the court held that:

> 'During the year ending on 30th June, 1944, the appellant did not carry on any trade. 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. During the year ending on 30th June, 1944, therefore, the appellant did not carry on, within the meaning of section 11(1), a trade within the Union and it derived no income from any trade. Under that subsection a deduction or setoff is admissible only against income derived from carrying on a trade. As the appellant carried on no trade during the year under consideration it was not competent for it to set off in its income tax return for that year the balance of assessed loss incurred by it in previous years.'

Principles Established and Conclusion

The *SA Bazaars* case is considered to be the pioneering case in tax law for the need to "carry on a trade" in the context of section 20. The principle that was established in the *SA Bazaars* case, is that an effect of section 20(1)(*a*) of the Act, was to prevent a taxpayer who in any year of assessment did not carry on a trade from carrying forward to that year any balance of assessed loss established in the immediately preceding year of assessment. While this decision has been overturned in relation to persons other than companies by section 20(2A), it remains valid for companies.[54]

Therefore, a company failing to carry on a trade for an entire year of assessment is prohibited from carrying forward to that year any balance of assessed loss established in the preceding year (*ITC 1476* (52 SATC 141) at 144), with the result that it loses forever the right to carry forward that balance, even if it subsequently recommences

[54] *Income Tax Practice Manual,* Contributor: Prof. Terry McCarthy, Archive (Handbook), A – Practice, [A:L23] Losses – Trading

trading.[55]

It is, however, worth noting that although it is accepted that any period of trading during the current year will meet the "trade" requirement, a company that claims 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 as part of a tax avoidance scheme under section 103(2).[56]

The case further demonstrates that a company which seeks to set off an assessed loss from a previous year of assessment cannot merely "keep itself alive" in the year of assessment which it seeks to carry forward the assessed loss. Compliance with minimum regulatory obligations and the maintenance of a bank account will not constitute the carrying on of a trade even if the taxpayer intended to resume trading in the future.[57]

The case is also important, as another principle established from the judgement follows that the applicant (SA Bazaars) specifically mentions in each of the tax years 1944 to 1947, there should have been carried forward from the preceding year of assessment (i.e., 1943) the balance of assessed loss incurred by SA Bazaars in the previous years. However, the learned judge of appeal, Centlivres CJ at 245 states that:

> 'To simplify matters, I shall in the first instance consider whether it was competent for the appellant to carry forward into the year ending on 30th June, 1944, the balance of the assessed loss (i.e. £7,623) from the year ending 30th June, 1943. If it was not competent for it to do this, then it follows that it was not entitled to carry forward the balance of the annual loss of £7,623 into the succeeding years.'

Therefore, it is only necessary to assess in the first year where the balance of assessed loss is carried forward whether the company was *carrying on a trade* or not, as the outcome of this assessment would be the same for the following years where the company had ceased to trade. As a result, the company would not be entitled to carry

[55] *Income Tax Practice Manual,* Contributor: Prof. Terry McCarthy, Archive (Handbook), A – Practice, [A:L23] Losses – Trading
[56] South African Revenue Services: Interpretation Note 33 (Issue 5) (5 May 2017) – pg. 6.
[57] Govindsamy, K (6 May 2021) Cliffe Dekker Hofmeyr: Tax & Exchange Control Alert (pdf download pg. 2.)

forward the loss into the subsequent years and would not be able to offset the loss against the income in the 1948 tax year.

4.2.2 *Robin Consolidated Industries Ltd v CIR*[58]

In *Robin Consolidated Industries Ltd v CIR* [1997] 2 All SA 195 (A), 59 SATC 199, the company ('appellant') was a manufacturer, wholesaler and retailer of stationery and associated products, operating shops throughout the country through subsidiary companies.

By 1986, the appellant had become insolvent and was running at a loss. On 16 September 1986, the appellant was placed in provisional liquidation and three officers of a firm of liquidators, Westrust, were appointed joint provisional liquidators. Their powers included that of carrying on business in so far as it might be necessary for beneficial winding up in terms of s 386(4)(*f*) of the Companies Act 61 of 1973.

The creditors were of the opinion that it would be most beneficial for them if the business were to be sold as a going concern and, in order to make this possible, the liquidators continued to trade as before from the date of liquidation, 16 September 1986 to 30 September 1986 which was the day before the effective date of the sale of the business.

The appellant's activities until 30 September 1986, before and after liquidation, resulted in it having had a trading income for the 1987 year of assessment but it was the 1988 year of assessment that was in issue in this case.

The sale of the business already referred to, took place on 3 October 1986. The sale was a 'lock, stock and barrel' sale although certain assets were excluded – stock on hand was included in the sale but stock in transit or in a bonded or state warehouse on 1 October 1986 was to remain the appellant's property and the liquidators were left with these and some other remnants. The business had, however, passed into new

[58] *Robin Consolidated Industries Ltd v CIR* [1997] 2 All SA 195 (A), 59 SATC 199; The facts pertaining to the case were summarised in my own words, but in some instances crucial elements to the case and the discussion thereof could not be expressed in words other than what was included in the extract of the actual court case.

hands.[59]

While the appellant was in a state of limbo, between 1 October 1986 and 15 March 1988, there were two sales which the appellant contended constituted 'trading' during the 1988 year of assessment.

Both had been sales of goods that had been in bond and, in accordance with the arrangements made for the sale of the business, the stock in bond remained in the hands of the liquidators.

The evidence revealed that the creditors did not wish for the appellant to continue trading after the sale of the business on 3 October 1986 'because of the losses that would be incurred' if trading did continue. The liquidators kept the business going long enough for it to be sold as a going concern which they regarded as the most advantageous mode of realisation.

On the question of trading after the business had been sold, the liquidators were of the view that they could offer for sale goods over which they retained control and, as far as stock was concerned, it was 'in the normal course of trading for a liquidator' to sell off stock in bulk.

The CIR contended that the appellant had not carried on trade during the 1988 year of assessment and, therefore, on a proper construction of s 20(1) of the Income Tax Act 58 of 1962, the appellant would not be able to set off assessed losses accumulated prior to the 1988 year of assessment against the income of succeeding years.

The appellant had appealed against the Commissioner's assessment to the Transvaal Special Court for Hearing Income Tax Appeals which upheld the Commissioner's contention and then obtained special leave to appeal to the Appellate Division in terms of s 86A(5) of the Income Tax Act 58 of 1962. [60]

In other words, the Commissioner contended that a tax year of mercantile abstinence

[59] Page 200 of 59 SATC 199
[60] Page 201 of 59 SATC 199

by a company entails the loss forever of an assessed loss in terms of s 20(1) of the Income Tax Act 58 of 1962.

The Commissioner contended further that, in effecting the two sales, the liquidators were merely realising assets in the course of liquidation.

The appellant contended that the sales in question were effected in the course of their trading activities and that, accordingly, it did carry on trade in the 1988 year of assessment and accordingly it was entitled to carry forward the assessed loss.

The appellant's other ground of appeal was that the series of decisions made in the Appellate Division construed s 20(1) of the Act to mean that if there is no income or loss from trading in a given year, the machinery for setting off an assessed loss cannot operate and therefore as a result the assessed loss disappears. The appellant contended that this interpretation is clearly wrong and should not be followed.

The appellant maintained, therefore, that it was entitled to carry forward the assessed loss even though there was no trading income during 1988 against which it could be set off and this entailed an assault on the rule in *SA Bazaars (Pty) Ltd v Commissioner for Inland Revenue* 18 SATC 240.[61]

The relevant portion of s 20(1) of Act 58 of 1962 provided at the relevant time–

> 'Set-off of assessed losses.
>
> 20 (1) For the purpose of determining the taxable income derived by any person from carrying on any trade within the Republic, there shall 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'[62]

[61] Page 201 of 59 SATC 199
[62] Page 202 of 59 SATC 199

The Decision

In the *Robin Consolidated Industries* case, two issues had to be considered by the court. The first issue was whether the taxpayer, a company, had '*carried on a trade*' during a particular year and second, whether it derived '*income*' from carrying on the trade in that particular year.

The taxpayer contended that there were two sales in the relevant period that constituted "trading". Both were sales of goods which were in bond and the stock in bond had remained in the hands of liquidators. The liquidators had continued to trade after the taxpayer's business had been sold. [63]

However, a decision had been taken by the creditors of the company to bring an end to trading, the business of the company having been sold.

The court held that while it may have been in the normal course of trading for a liquidator to sell off assets in bulk, 'trade' and 'realisation' are different concepts and sometimes even opposed concepts.

The disposal of the stock in bond was designed to allow others to trade in that stock and to release the taxpayer from the risks entailed in doing so itself. The stock in bond had been kept at a distance and the opportunity offered to others to make a profit and risk a loss. Accordingly, the court held that the two transactions in issue did not constitute the carrying on of trade.

The second issue before the court was whether the taxpayer would be entitled to carry forward its assessed loss to later years even though it neither traded nor earned any income from trade in the particular year of assessment. [64]

The court held that s20(1) implies that, if there is no income or loss from trading in a

[63] Income Tax Practice Manual, Contributor: Prof. Terry McCarthy, Archive (Handbook), A – Practice, [A:L23] Losses – Trading
[64] *SILKE: South African Income Tax*, Chapter 12: Special Deductions and assessed losses, 12.12.2 (pg.349)

specific year, the assessed loss disappears. [65] The decision in the *SA Bazaars* case was upheld and the court pointed out that, in accordance with the doctrine of *stare decisis*, the SCA should not depart from its own judgments unless it is clear that it had erred.[66]

The taxpayer's appeal accordingly was unsuccessful.

Principles Established and Conclusion

The *Robin Consolidated* case confirms the principle laid down in the *SA Bazaars* case in relation to the prerequisites in term of s 20(1) of the Act, for the carrying forward the balance of an assessed loss, for income tax purposes, but held that the taxpayer's sale of trading stock was a mere realisation and not '*trade*', thereby failing to meet those prerequisites.[67]

In addition, 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.[68]

4.2.3 *Timberfellers (Pty) Ltd v CIR*[69]

In *Timberfellers (Pty) Ltd v CIR* 1994 (N), 59 SATC 153 the issue was whether the collection of debts by the taxpayer through its attorney and accountants had constituted the carrying on of trade.

The company had carried on the business of selling agricultural equipment under franchise agreements prior to its liquidation on 20 September 1982. As of 30 June

[65] *SILKE: South African Income Tax*, Chapter 12: Special Deductions and assessed losses, 12.12.2 (pg.349)
[66] Income Tax Practice Manual, Contributor: Prof. Terry McCarthy, Archive (Handbook), A – Practice, [A:L23] Losses – Trading
[67] RC Williams 'Carry forward the balance of an assessed loss for income tax purposes: section 20(1) of the Act of 1962 '(1999) 116 The South African Law Journal 11
[68] South African Revenue Services: Interpretation Note 33 (Issue 5) (5 May 2017) – pg. 11.
[69] *Timberfellers (Pty) Ltd v CIR* 1994 (N), 59 SATC 153; The facts pertaining to the case were summarised in my own words, but in some instances crucial elements to the case and the discussion thereof could not be expressed in words other than what was included in the extract of the actual court case.

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.[70]

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. [71]

The Decision

The court held that the collection of debts by the taxpayer did not constitute carrying on a trade. It held that the fact that the collection was carried out by someone else on the taxpayer's behalf did not disqualify the activity from being classified as the carrying on of a trade. However, as the collection was carried out with only one purpose, namely, to enable the taxpayer to recover amounts due and not one cent of the money collected was utilised or available for any trading activity or intended for that purpose, the activity did not constitute the carrying on of a trade.[72]

Principles Established and Conclusion

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*[73] in which the collection of debts was held to constitute trading was distinguished on the facts.[74]

[70] South African Revenue Services: Interpretation Note 33 (Issue 5) (5 May 2017) – pg. 10.
[71] South African Revenue Services: Interpretation Note 33 (Issue 5) (5 May 2017) – pg. 10.
[72] Income Tax Practice Manual, Contributor: Prof. Terry McCarthy, Archive (Handbook), A – Practice, [A:L23] Losses – Trading
[73] *COT, SR v Pan African Roadways Ltd* 1957 (2) SA 535 (SR), 21 SATC 236.
[74] South African Revenue Services: Interpretation Note 33 (Issue 5) (5 May 2017) – pg. 10.

In addition, the discontinuation of a taxpayer's main business operations may not in itself be deemed to be the cessation of trading if the taxpayer undertook other activities such as the continued employment of staff to realise assets and collect trade receivables. However, where a taxpayer's only activities comprised the collection of trade receivables and it had no stock, employees, or fixed assets of any significance, it is likely that the taxpayer will not meet the "trade" requirement.[75]

4.2.4 *C:SARS v Contour Engineering (Pty) Ltd*[76]

In *C: SARS v Contour Engineering (Pty) Ltd* (1999) 61 SATC 447 (E), the taxpayer, prior to its liquidation, had sustained losses for a number of years but in the relevant year of assessment, the Commissioner disallowed its assessed loss as it had not carried on a trade as defined in section 1 of the Income Tax Act.

The onus rested on the taxpayer to show that it had carried on a trade during the tax year concerned and that the Commissioner had been wrong in disallowing the carrying forward of the assessed loss on the basis that it had not.

The evidence had been that after the taxpayer had been discharged from liquidation, it had started to collect from its outstanding debtors and this required paying attention to maintenance work and structural faults in contracts which had previously been performed by it. Moreover, it had embarked on new commercial activities including the selling of engineering equipment for commission.[77]

The Decision

The court noted that it was clearly correct that the venture must be viewed as a whole and that it may straddle more than one tax year. There was a significant difference between the mere laying of plans for the taxpayer's future, on the one hand, and the

[75] Govindsamy, K (6 May 2021) Cliffe Dekker Hofmeyr: Tax & Exchange Control Alert (pdf download pg. 3.)
[76] *C: SARS v Contour Engineering (Pty) Ltd* (1999) 61 SATC 447 (E); The facts pertaining to the case were summarised in my own words, but in some instances crucial elements to the case and the discussion thereof could not be expressed in words other than what was included in the extract of the actual court case.
[77] Income Tax Practice Manual, Contributor: Prof. Terry McCarthy, Archive (Handbook), A – Practice, [A:L23] Losses – Trading

commencement of preparatory activities for a future venture on the other, as was contemplated in the *Robin* case, supra, and at least some activity is required.

The court stressed that the mere laying of plans could not constitute the carrying on of a trade in the absence of some positive act aimed at promoting the plans.[78]

Moreover, the evidence clearly established that, in the relevant period, the taxpayer had no premises, no equipment, no stock, no staff and, save for book debts, no assets and this was clearly indicative of a company which was not trading.

Also, the activities of the liquidator during the period of liquidation did not constitute trading as his conduct was not aimed at carrying on a trade but, on the contrary, was aimed at winding up the affairs of the company pursuant to his obligations under the Insolvency Act 24 of 1936.

The court held that the taxpayer had failed to establish that it in fact traded as was required by section 20 and in the circumstances had failed to discharge the onus which rested on it.[79]

Principles Established and Conclusion

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 *Contour Engineering* case[80] 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.[81]

The *Contour Engineering* case also established the principle that if a taxpayer does not have any assets with which it can engage in a trade then it will be difficult to argue that it is actively carrying on a trade. For example, in circumstances where a taxpayer has

[78] Income Tax Practice Manual, Contributor: Prof. Terry McCarthy, Archive (Handbook), A – Practice, [A:L23] Losses – Trading
[79] Income Tax Practice Manual, Contributor: Prof. Terry McCarthy, Archive (Handbook), A – Practice, [A:L23] Losses – Trading
[80] (1999) 61 SATC 447 (E) at 451.
[81] South African Revenue Services: Interpretation Note 33 (Issue 5) (5 May 2017) – pg. 6.

no premises from which to trade, no equipment, no stock and no staff, it is likely that a court will deem this indicative of a company which is not trading.[82]

This is evidenced in the *Contour Engineering* case at 456 where the court held that:

> 'It follows that, in my view, the expenses set out above are not comparable to the activities contemplated by the learned judge of appeal in *Robin*'s case. On a proper analysis of the evidence it would appear that Cohen has no personal knowledge of a number of expenses or of the alleged activities of the respondent relating to sales of equipment. 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.'

4.2.5 *ITC 1751*[83]

Many of the court cases that have been mentioned previously within the 'trade' requirement pertain to cases where the decisions made by the courts have been found to be in the favour of the Commissioner for SARS, whereby the taxpayer is considered not to have been carrying on a trade and consequently the assessed losses could not be carried forward. However, it is important to mention that there are some cases where it has been decided in favour of the taxpayer on the 'trade' requirement and specifically, in *ITC 1751* (2002) 65 SATC 294 (C), the judge found that post-liquidation activities do constitute a trade. The background and decision of this case is examined further.

In *ITC 1751*, the taxpayer, a company carrying on trade as a moneylender, had been placed in liquidation but its liquidators had continued to collect money from persons to whom money had been advanced and to repay moneys to persons from whom the taxpayer had borrowed money. The Commissioner for SARS had initially raised no objection to the liquidation and distribution accounts in which no provision had been made for tax on post-liquidation income of the taxpayer. The Commissioner thereafter

[82] Govindsamy, K (6 May 2021) Cliffe Dekker Hofmeyr: *Tax & Exchange Control Alert* (pdf download pg. 3.)
[83] *ITC 1751* (2002) 65 SATC 294 (C); The facts pertaining to the case were summarised in my own words, but in some instances crucial elements to the case and the discussion thereof could not be expressed in words other than what was included in the extract of the actual court case.

objected on the basis that the balance of assessed loss should not be set off against the taxpayer's post-liquidation income as it had not carried on trading post liquidation.[84]

The Decision

Davis J held at 302:[85]

> 'It had employed capital to make loans and thus its capital was of a circulating nature; that is trading-stock. For almost a decade after liquidation it had continued to employ its circulating capital accordingly. The liquidators were required to allow the circulating capital to be used accordingly and as the management of the appellant had done previously, namely, manage the process by way of collecting the repayment of interest and return of capital.
>
> In my view, appellant was in a similar position to a trader who decides to close his business at a particular point, not acquire further stock but trade until its existing stock was sold. In these circumstances the appellant had for a decade continued to trade as it continued to conduct its business.'

The court held that if it is accepted that a liquidated company can continue to trade, then the facts as to the operation of the taxpayer in each case becomes the determining factor. The taxpayer was in a similar position to a trader and had for a decade continued to conduct its business and, accordingly, it had continued to trade in the relevant years of assessment and was entitled to set off its balance of assessed loss against its post liquidation income. [86]

Principles Established and Conclusion

The principle established from the *ITC 1751* case is that a taxpayer may be considered to be "carrying on a trade" while in liquidation, provided that the liquidator continues with the taxpayer's normal trading operations.

[84] (Lexis Library - online) Archive (Handbook), A – Practice, [A:L23] Losses – Trading
[85] Page 302 of 65 SATC 294
[86] (Lexis Library - online) Archive (Handbook), A – Practice, [A:L23] Losses – Trading

This case took place a few years after the decision in the *Robin Consolidated* case, where it expressly stipulated that the *Robin* case must not be seen as establishing a general principle that a company in liquidation can never conduct trading activities. If it is accepted that a liquidated company can continue to trade, then the facts as to the operation of the taxpayer in each case becomes the determining factor; in other words the principles articulated by Schutz JA in the *Robin* case need to be applied to the particular facts of each case.[87]

Therefore, where a taxpayer finds itself in liquidation in the current year and during that relevant year the taxpayer would like to carry forward any assessed loss from the previous year (i.e. pre-liquidation), in accordance with section 20 of the Act, it is imperative that the liquidators who assume control over the liquidation continue with the trading activities of the taxpayer.

This further establishes the principle that to assess whether a taxpayer is considered to be carrying on a trade, the facts as to the operation of the taxpayer in each case becomes the determining factor'[88] and this further proves that the "trade" requirement is not necessarily a "one size fits all" assessment.

4.2.6 *C:SARS v MEGS Investments (Pty) Ltd and Another*[89]

In *C: SARS v Megs Investments (Pty) Ltd and Another* 2005 (4) SA 328 (SCA), 66 SATC 175, the SCA had to decide whether the taxpayer-companies (the appellants) in question who had not traded during the 1996 tax year would be allowed to set off the assessed loss that they had accumulated in previous years against the interest income derived in the 1996 year. In interpreting section 20(1) of the Act, the Appellate Division had decided in *SA Bazaars (Pty) Ltd v CIR* 1952 (4) SA 505 (A) (18 SATC 240 at 245-6) that a company cannot carry forward an assessed loss from a previous year to the current year if it has not traded during the current year.[90]

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[87] Page 302 of 65 SATC 294
[88] Page 296 of 65 SATC 294
[89] *C: SARS v MEGS Investments (Pty) Ltd and Another* 2005 (4) SA 328 (SCA), 66 SATC 175; The facts pertaining to the case were summarised in my own words, but in some instances crucial elements to the case and the discussion thereof could not be expressed in words other than what was included in the extract of the actual court case.
[90] (Lexis Library - online) Archive (Handbook), A – Practice, [A:L23] Losses – Trading

In the *MEGS Investments* case, the appellants had 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

They were obliged to make payments to suppliers and collect payments from members during a transition period, but they did not carry on their normal trading activity of recovering a portion of the discounts for their own account during the relevant tax year. During 1996, the taxpayers derived interest income and carried on various activities which were directed at exploring the possibility of a business in Angola and other countries to the north through the Namibian companies in which they had invested.

Considerable money, time and effort were expended by the appellants' directors on these activities, but the taxpayer-companies concluded no contracts, no active trading was done and no income was earned. The taxpayers sought to carry forward and set off the balance of an assessed loss from 1995 against the interest income earned in 1996. [91]

[91] (Lexis Library - online) Archive (Handbook), A – Practice, [A:L23] Losses – Trading

The Decision

Jones AJA, held at 180 that:

> 'the respondents derived some income from investments in past years, and that they did so during the year in question does not, without more, show that they carried on the business of an investment company. It is settled that in ordinary circumstances income in the form of interest on an investment is not income derived from carrying on a trade within the meaning of the Act. It was, in any event, not the respondents' case that they carried on business as an investment company in 1996. On the contrary, they led evidence designed to establish that they intended to carry on the same kind of trade that they had conducted before because that was the area of their expertise.'[92]

The court held that the taxpayer-companies did not carry on the business of an investment company and in ordinary circumstances, income in the form of interest on an investment was not income derived from carrying on a trade within the meaning of the Act. The court held that the taxpayers had not shown that section 20(1) of the Income Tax Act permitted set-off of their assessed loss from trading during previous years against their income from interest on investments. [93]

Principles Established and Conclusion

Based on my research and further investigation into the *MEGS Investments* case, it would appear that many believe that the crux of the *MEGS Investments* case, was whether the trade carried on by a taxpayer in a subsequent year of assessment should be the same trade carried on in the year during which the assessed loss arose, to utilise the balance of assessed loss brought forward.[94]

However, in my opinion, this is not necessarily the crux of this case. Instead, s 20 of

[92] Page 180 of 66 SATC 175
[93] (Lexis Library - online) Archive (Handbook), A – Practice, [A:L23] Losses – Trading
[94] SAICA (July 2005) Issue 71: Deductions 1309. Forfeiture of assessed losses carried forward from the exploration phase

the Act requires that there be trading activities, it is not a requirement that the same trade must be carried on.

This case merely assessed whether the respondent companies would be allowed to set off the assessed loss that they had accumulated in previous years (i.e. from trading activities) against the interest income it derived in the 1996 year (i.e. where no active trading was done) and it was held that the taxpayer companies did not carry on the business of an investment company and in ordinary circumstances, income in the form of interest on an investment was not income derived from carrying on a trade within the meaning of the Act.

In addition, the court held that the respondents had not discharged the onus of proving that they had carried on the business of an investment company or any other business and upheld the Commissioner's disallowance of the carry forward of the assessed loss.

As a result, the taxpayer companies were not permitted to set off their assessed loss from trading during previous years against the income from interest.

Therefore, the principle to be established from the *MEGS Investments* case is that unless a company is doing business as an investment company, the receipt of interest on money that has been invested by the company would ordinarily not be regarded as income derived from the carrying on a trade and as a result, any balance of assessed loss carried forward from a previous year may not be set off against the interest, since the company cannot be regarded as carrying on the trade of an investment company.

The case also delved into the question of whether an assessed loss can be carried forward to a subsequent year where there has been a trade carried on, but no income has been derived from that trade. The court argued in favour of this view, but did not decide on the point. The report goes into more detail on the "income from trade" requirement in the next sub-chapter.

4.2.7 *ITC 1802*[95]

ITC 1802 (2005) 68 SATC 67 (G) essentially required the Court to deal with what constitutes "trade".

The facts of the case involved the taxpayer (appellant) appealing against the Commissioner's 2001 assessment which disallowed:

- an assessed loss brought forward from 2000 on the grounds that the company did not trade and did not derive income; and
- certain claimed expenditure on the basis that it was not incurred in the course of trade. [96]

The original AFS of the taxpayer showed no income in the 2001 year of assessment. After the disallowance, the taxpayer revealed income in the form of interest earned on loans to subsidiaries, which had previously been omitted.

The taxpayer was a company, incorporated in 1985, and converted to a public company and its shares listed on the JSE in 1992. The company claimed its main object to be that of a holding company. The company and its subsidiaries manufactured and marketed luggage and commercial trailers and trailer components. The taxpayer objected to the assessment on the basis that it had traded in the year under review.[97]

The taxpayer contended that it had traded in the year in question in that it, as a holding company, had ensured continuation of the operations of its subsidiaries in a number of ways and had traded through its subsidiaries. [98]

[95] *ITC 1802* (2005) 68 SATC 67 (G); The facts pertaining to the case were summarised in my own words, but in some instances crucial elements to the case and the discussion thereof could not be expressed in words other than what was included in the extract of the actual court case.
[96] SAICA (January 2007) Issue 89: General 1474 What constitutes "trade"?
[97] SAICA (January 2007) Issue 89: General 1474 What constitutes "trade"?
[98] (Lexis Library - online) Archive (Handbook), A – Practice, [A:L23] Losses – Trading

The Decision[99]

The court held that the taxpayer had not traded in the particular year and accordingly held that the assessed loss could not be carried forward.

In reaching its decision, it held that in determining if the taxpayer had traded in the year, the court must look to the activities of the taxpayer, the functions performed by it and the impact which any such activities of the taxpayer had on the activities of its subsidiaries.

Moreover, there was no authority which required no more than existence as a holding company in order to constitute the "carrying on of a trade."

It was both possible and permissible for the taxpayer to have carried out "trade" through the medium of its subsidiaries, but the question was whether or not it actually did and whether and to what extent the carrying on of "trade" could be attributed to the taxpayer would depend upon the link between it and its subsidiaries and the nature of the arrangements made.

The court was of the view that the mere fact of the taxpayer "keeping itself alive" cannot constitute "trade" and thus to hold annual general meetings, ensure that directors are appointed, arrange for financial statements to be prepared, remunerate the directors and auditors constituted no more than ensuring that the taxpayer did not become statutorily moribund, and these activities constituted no more than compliance with the statutory requirements for "life" as a legal entity.

Also, the taxpayer had not evidenced, during the year of assessment, any indication of a "controlling mind", there was no evidence of involvement in the affairs of the subsidiaries during the year, there was no control or dominance exercised over the subsidiaries and no evidence of strategic management or direction of policy formulated by the taxpayer which was implemented by the subsidiaries.

[99] (Lexis Library - online) Archive (Handbook), A – Practice, [A:L23] Losses – Trading

Principles Established and Conclusion

The principle established in the *ITC 1802* case is that the holding of meetings, appointment of directors and/or arranging for financial statements to be prepared, will (on its own) unlikely constitute the carrying on of a "trade." Passive behaviour that is absent of any active endeavour to carry on a trade will not be sufficient to argue that a trade is being conducted.

Whether a company is carrying on a trade will depend on the facts and circumstances of the particular case. Much will depend on the scale and nature of its activities.[100]

4.3 The "income from trade" requirement

Assessed losses are incurred by a taxpayer when the company's tax deductions exceed the income that accrues or is received in a tax year. Section 20 of the Act allows taxpayers to carry forward the balance of assessed loss from a previous tax year and set it off against the taxpayer's income to determine the company's taxable income for the year.[101]

The debate on the "income from trade" requirement remains open to this day and still has not been fully resolved. A company that has traded during the year but has derived no income from trade in that year may or may not be entitled to set off its balance of assessed loss from the preceding year. There has also been much debate over what is meant by the word "income". "Income" in the defined sense of gross income *less* exempt income, or income in the sense of a taxable profit.[102] It was held in *Conshu (Pty) Ltd v CIR* 1994 (4) SA 603 (A), 57 SATC 1 by Harms JA, that the word 'income', as used in the introductory part of s 20(1), is not in its defined sense but, rather, as the income of the taxpayer which would be taxable but for the set off, that is, the amount of the taxpayer's gross income less the deductions allowable under the Act but before any set off of an assessed loss or balance of assessed loss.[103]

[100] South African Revenue Services: Interpretation Note 33 (Issue 5) (5 May 2017) – pg. 6.
[101] *De Rebus - SA Attorneys' Journal*, Archived issues, 2008, September, Other updates, Tax law, Assessed losses:
[102] South African Revenue Services: Interpretation Note 33 (Issue 5) (5 May 2017) – pg. 11.
[103] Page 10 of 57 SATC 1.

It is imperative that we should look at both sides of the arguments that are in favour of the "income from trade" requirement and those that argue against the "income from trade" requirement, as these arguments both point to the wording of the sections in the Act from a policy perspective, as well as these arguments cite case law on the interpretation of the "income from trade" requirement where both sides of the argument have been recognised and upheld in the courts and ultimately, the use of this case law as authority on this point remains somewhat questionable.

4.3.1 Argument in 'favour'

The wording of section 20

Those who argue in favour of the "income from trade" requirement point out that the wording of section 20(1) 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 of persons other than companies. [104]

Case law in favour of the "income from trade" requirement

A taxpayer may not be considered to be carrying on a trade if no income is earned. In the *SA Bazaars* case, the court did not decide on the question of whether a taxpayer must actually derive income from the trade carried on in order to be entitled to carry forward the previous year's assessed loss. But in *ITC 664* (1948) 16 SATC 125, which was decided prior to the *SA Bazaars* case and to the dismay of taxpayers, it was held that it is indeed essential that a taxpayer derive income from the carrying on of a trade.[105]

In the *ITC 664* case, 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. For each

[104] South African Revenue Services: Interpretation Note 33 (Issue 5) (5 May 2017) – pg. 12.
[105] *SILKE on South African Income Tax*; Chapter 8 Special deductions; § 8.127 Assessed losses — balance set off by companies

of the years of assessment, 1930 to 1945 inclusive, the assessed loss of the company was determined by the Commissioner to be *nil*. On appeal, the Commissioner's decision was upheld. Ingram CJ stated the following:

> '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).[106]

The verdict of *ITC 664* concluded that in any given year, there must be some income against which the balance of assessed loss can be set-off, as well as the income must be derived from trade.

In *ITC 777* (1953) 19 SATC 320 (T), on the other hand, it was held that the assessed loss can be carried forward if a trade has been carried on irrespective of whether income was earned as a result (refer 4.3.2 for further details on the case). In *ITC 1679* (1999) 62 SATC 294 (O), the court once again took the position that 'income from trade' was a requirement (however, this decision appears to have been based on a misinterpretation of other case law.)[107]

In the *ITC 1679* 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

[106] *ITC 664* (1948) 16 SATC 125 (U) at 126/7.
[107] *De Rebus - SA Attorneys' Journal*; Archived issues (2005) October; Other updates; Tax Law Update; A little less likely to lose that loss?

- 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*.[108]

Interestingly, in both the other two cases (*ITC 664* and *ITC 1679*) quoted from by Gildenhuys J, the taxpayers were also found not to be trading during the tax years in question. Nevertheless, the court refers to these judgments to emphasise its point that 'set-off' operates as an apposition of one amount against the other. The wording of section 20(1), it was held, does not “envisage the addition of the ‘balance of assessed loss’ to a loss on the year's trading or its accumulation therewith” (as per *ITC 664*).[109]

The SCA considered the “income from trade” requirement in the *C: SARS v Megs Investments (Pty) Ltd & Another* case.[110] This case was considered under the “trade” requirement in chapter 4.2.6. However, from an “income from trade” perspective, 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.[111]

Jones AJA in the *C: SARS v Megs Investments (Pty) Ltd & Another* case emphasised that his judgement 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. [112]

In addition, further to the *C: SARS v Megs Investments (Pty) Ltd & Another* case, the court in *obiter* remarked that

[108] South African Revenue Services: Interpretation Note 33 (Issue 5) (5 May 2017) – pg. 12.
[109] *De Rebus - SA Attorneys' Journal*, Archived issues (2008) September, Other updates, Tax law, Assessed losses:
[110] *C: SARS v Megs Investments (Pty) Ltd & Another* 2005 (4) SA 328 (SCA), 66 SATC 175
[111] South African Revenue Services: Interpretation Note 33 (Issue 5) (5 May 2017) – pg. 13.
[112] South African Revenue Services: Interpretation Note 33 (Issue 5) (5 May 2017) – pg. 13.

> '… the correctness of the argument by the Commissioner that the point left open in the *SA Bazaars* case - whether set-off can operate if a trade is carried on but no income is derived from it - should be answered . in favour of the Commissioner.'

This suggested, without firmly deciding the issue that the SARS view would be supported by the courts and that the 'income from trade' requirement was a prerequisite for carrying forward an assessed loss. Clearly this case would have been of great persuasive value were the issue ever again to come before a court.[113] Then along came the judgment in *ITC 1830* (2007) 70 SATC 123 (G). In this judgement, the court held that the derivation of income from trade is indeed a requirement before an assessed loss may be carried forward in terms of s 20(1).

In *ITC 1830*, 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 programme for licencing 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 not connected to the trading activities.[114]

For the purposes of deciding 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.[115]

Essentially the court supported its decision held with the conclusions made in earlier cases, including *Conshu (Pty) Ltd v CIR* 1994 (4) SA 603 (A) (refer to 5.2 for further details) and *C: SARS v Megs Investments (Pty) Ltd & another* 2005 (4) SA 328 (SCA)

[113] *De Rebus - SA Attorneys' Journal*; Archived issues (2005) October; Other updates; Tax Law Update; A little less likely to lose that loss?
[114] South African Revenue Services: Interpretation Note 33 (Issue 5) (5 May 2017) – pg. 13.
[115] South African Revenue Services: Interpretation Note 33 (Issue 5) (5 May 2017) – pg. 13/14

(refer 4.2.6), as well as the judgments of *ITC 664*, 16 SATC 125 and *ITC 1679*, 62 SATC 294).

4.3.2 Argument for 'against'

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*[116]).[117]

They also cite *ITC 777* as authority for their interpretation that no income from trade is required. In the *ITC 777* 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 of 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" is nil.[118]

Professor GJ Swart, in his article (Swart, 1996), explains the unintended consequences that construction companies may face, especially in lean trading periods, where, for example, their contracts are structured in a way that they neither receive nor accrue any income before a certificate of completion is issued and other obligations are complied with. Where that company's activities were limited to that one project for a period exceeding one year, it would have incurred deductible expenditure. This expenditure may have been financed by means of bank loans, but no income would have accrued during that period. Should the accrual then take place in year two, that company would not be able to claim the losses generated in year one.[119] Those that argue against the 'income from trade' requirement, submit that this could have not

[116] *Sub-Nigel Ltd v CIR* 1948 (4) SA 580 (A), 15 SATC 381
[117] South African Revenue Services: Interpretation Note 33 (Issue 5) (5 May 2017) – pg. 14.
[118] South African Revenue Services: Interpretation Note 33 (Issue 5) (5 May 2017) – pg. 14/15
[119] *De Rebus - SA Attorneys' Journal*, Archived issues, 2008, September, Other updates, Tax law, Assessed losses:

been the intention of the legislature.

4.3.3 SARS' view

SARS has always been of the view that section 20 contains both a trade requirement and an 'income from trade' requirement that must be met before an assessed loss may be carried forward. In other words, SARS considers that a company will be entitled to set off the balance of an assessed loss from the preceding year only where it has traded during the current year and has derived income from such trade. Tax commentators, however, have long disputed that section 20 contains the requirement that income must be derived before the assessed loss can be carried forward.[120]

In an attempt to resolve this issue, SARS issued Interpretation Note 33 (Issue 5) that contains a compromise. SARS will accept that as long as the company has proof that a trade had been carried on during the year of assessment, the company will be entitled to set off its balance of assessed loss from the preceding year. SARS will however, 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.'[121]

In principle, if it may be proven that the failure to derive income is not due to a lack of activity by the company but rather is a function of the lack of activity in the sector, it may be possible to persuade SARS to grant a concession and allow deduction of an assessed loss where income has not been derived in a year of assessment. That said, SARS would still have to be satisfied that the necessary "infrastructure" to trade remained intact.

From a policy perspective, therefore, SARS does not adopt an uncompromising approach, but seems willing to allow a balance of assessed loss to be carried forward where the company can clearly demonstrate that the lack of income was reasonable in

[120] *De Rebus - SA Attorneys' Journal*, Archived issues, 2008, September, Other updates, Tax law, Assessed losses:
[121] South African Revenue Services: Interpretation Note 33 (Issue 5) (5 May 2017) – pg. 15.

the circumstances, provided of course that a trade has been carried on.[122]

4.3.4 Implications of Interpretation Note 33[123]

In the briefing note to the Interpretation Note, SARS says that 'it will not disallow a company's assessed loss when it has genuinely traded but has derived no income from trade.'

It is not an absolute exception, though. SARS does however alert taxpayers, that the absence of income from trade may indicate that a company has not traded, and SARS may still attempt to apply 'the income from trade' requirement in cases where the taxpayer has not carried on a trade.

Still, the Interpretation Note serves as an indication of SARS's policy with regard to companies that claim assessed losses. It suggests that, in genuine cases of companies that trade, SARS will unlikely disallow assessed losses for the mere reason that no income was earned during the relevant year of assessment.

The publication of this Note would also assist taxpayers, should a case like this ever come to court. It is well-established that Interpretation Notes have legal consequences which SARS is bound to observe. In particular, it is widely viewed that SARS may not easily issue assessments against its own Interpretation Notes.[124]

4.4 Conclusion

In summation of the above, whilst the "trade' requirement has been extensively tried and tested in court, the courts on the other hand, have provided little guidance on the "income from trade" requirement and in some cases, the case law has been slightly conflicting.

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[122] *Silke on South African Income Tax*, Chapter 8 Special deductions, § 8.127 Assessed losses - balance set off by companies

[123] *De Rebus - SA Attorneys' Journal*; Archived issues (2005) October; Other updates; Tax Law Update; A little less likely to lose that loss?

[124] *De Rebus - SA Attorneys' Journal*; Archived issues (2005) October; Other updates; Tax Law Update; A little less likely to lose that loss?

Whether trade should precede income or *vice versa* may become a bit of a chicken-and-egg argument. In my view, one of the key requirements should be whether the taxpayer has traded during the tax year in question. Whether the taxpayer earned income from that trade is irrelevant, as long as the taxpayer had the intention to derive income therefrom, the company should be entitled to carry forward its assessed loss. The onus remains with the taxpayer to prove that there is a genuine reason that no income was earned during the year of assessment. This is an important principle which has been established as a result of the decision held in the *ITC 777* case, coupled with SARS's view in Interpretation Note 33.

Whilst a company may be considered to be trading in accordance with s20(1)(*a*), SARS may nevertheless invoke the provisions of section 103(2) of the Act to disallow the utilisation of an assessed loss where a change in shareholding has been effected or an agreement has been entered into for the sole or main purpose of utilising an assessed loss. This is the focus of the next chapter.

Chapter 5 - The role of section 103(2)

5.1 Introduction

This chapter focuses on how the Act also contains provisions to counter abusive transactions which accelerate the opportunity to set off assessed losses against income derived. These are found in section 103, notably section 103(2).

Section 103(2) of the Act is an anti-avoidance provision which essentially allows the Commissioner to disallow the setting-off of an assessed loss or balance of an assessed loss against the taxpayer's income if certain requirements are met. More specifically, s103 deals with transactions, operations or schemes which have been entered into for the purposes of avoiding or postponing liability for or reducing amounts of taxes on income and provides that any assessed loss must be disallowed by the Commissioner if he is satisfied that:

- any agreement has been concluded affecting any company, or that a change in the shareholding of a company has taken place;
- as a direct or indirect result thereof, income has been received by or accrued to that company during the year of assessment; and
- that agreement was concluded or the change in the shareholding effected solely or mainly for the purpose of utilising any assessed loss incurred by the company, in order to avoid or reduce any tax liability.[125]

For section 103(2) to apply, a number of elements must align. There must be a change in shareholding or a contract affecting a company. Income must flow to, or a capital gain must be realised by that company as a direct or indirect result of that contract or change in shareholding. The contract or change in shareholding must have been effected for the purpose of deriving a tax benefit from the assessed loss. Should all the aforementioned elements be present, the Commissioner may disallow the deduction of the assessed loss.

The tax avoidance, as opposed to taxation nature of section 103 of the Act was

[125] Nyanin, G (12 October 2018) Cliffe Dekker Hofmeyr: Tax & Exchange Control Alert (pdf download pg. 2)

demonstrated in *Glen Anil Development Corporation Ltd v Secretary for Inland Revenue* 1975 (4) SA 715 (A) where the taxpayer had been trafficking in an assessed loss. The court held that the anti-avoidance section is directed at defeating tax avoidance schemes. It does not impose a tax, nor does it relate to the tax imposed by the Act. The section was designed to suppress the misconduct against which the section is directed. Further the courts had this to say in the finding:

> 'The discretionary powers conferred upon the Secretary should, therefore, not be restricted unnecessarily by interpretation.'[126]

Meaning that, as long ago as 1975, when the *Glen Anil Development* case took place, there was already a tendency emerging from the courts to enquire as to the perceived intention of the legislature and to interpret the legislation accordingly.[127]

Considering the above understanding and relevant factors of s 103(2), a taxpayer should have regard to the facts, arguments and established principles which have emanated from case law over the years to assist with the interpretation and applicability of the section. The disputed matters that required intervention from the courts in relation to s 103(2) are discussed in further detail.

5.2 *Conshu (Pty) Ltd v CIR*[128]

In *Conshu (Pty) Ltd v CIR* 1994 (4) SA 603 (A) 57 SATC 1, the court examined the interpretation of s 103(2) and the matter disputed was whether, in the circumstances of the case, the Commissioner for Inland Revenue, not having applied the provisions of the subsection during the tax year in which an agreement of the kind referred to in the section had been entered into, was entitled to apply it in respect of an ensuing tax year.[129]

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[126] *Glen Anil Development Corporation Ltd v Secretary for Inland Revenue* 1975 (4) SA 715 (A) at 626
[127] SAICA (December 2008) Issue 112: General 1682. Interpretation of tax legislation
[128] *Conshu (Pty) Ltd v CIR* 1994 (4) SA 603 (A) 57 SATC 1; The facts pertaining to the case were summarised in my own words, but in some instances crucial elements to the case and the discussion thereof could not be expressed in words other than what was included in the extract of the actual court case.
[129] Page 2 of 57 SATC 1

Background to the matter[130]

The facts were that the assessed loss of the taxpayer company in the 1984 year of assessment was determined at R5 856 947[131] and had increased to almost R9,9 million at the end of the 1985 year of assessment.[132]

During the 1984 year of assessment, the taxpayer's business was that of a tyre retreader and dealer, and it conducted the same type of business during 1985 when its trading results were poorer still. On the last day of the 1985 year of assessment, the taxpayer had entered into an agreement which fell within the ambit of the provisions of s 103(2). This agreement involved the changing of its name to 'Conshu Holdings (Pty) Ltd' and a change in its shareholding. The new company acquired all the trading assets and liabilities of another company and thereafter disposed of the bulk of its business.[133]

In the 1985 year of assessment no attempt had been made by Conshu to utilise the assessed loss because there had been no income in that year, but during the 1986 year of assessment, Conshu earned a taxable income of some R6,6 million. At the end of that year of assessment, it sought to utilise the provisions of s 20 of the Act in the determination of its taxable income, by setting off against the 1986 income, the balance of the assessed loss from the 1985 year of assessment.[134]

The Commissioner for Inland Revenue disallowed the set-off by applying s 103(2) on the basis that the agreement in terms of which the business had been acquired in 1985 had been entered into solely or mainly for the purpose of utilising the assessed loss. [135]

Conshu contended that the Commissioner could not apply s 103(2) in the 1986 year of assessment because the agreement had been entered into in 1985 and, since the Commissioner had failed to apply s 103(2) in the 1985 year of assessment, he was not

[130] *Silke on South African Income Tax*, Chapter 19 Tax avoidance, § 19.51 Conshu (Pty) Ltd v CIR
[131] Page 1 of 57 SATC 1
[132] EM GROSSKOPF JA, Page 12 of 57 SATC 1
[133] HARMS JA, Page 4 of 57 SATC 1
[134] HARMS JA, Page 5 of 57 SATC 1
[135] HARMS JA, Page 5 of 57 SATC 1

permitted to apply the section for the first time in the 1986 year of assessment.[136]

In the Special Court for Hearing Income Tax Appeals (now the Tax Court), Melamet J held that it was competent for the Commissioner to apply s 103(2) for the first time in respect of the 1986 year of assessment.[137] Conshu, as the appellant, preferred to obtain a final determination of this point and, with the leave of the President of the Special Court, appealed directly to the Appellate Division (now the Supreme Court of Appeal).

The Decision[138]

In the Appellate Division, it was held as per Harms JA (with whom Nestadt JA and Olivier AJA concurred, EM Grosskopf JA and Hoexter JA dissenting) was of the view that the Special Court was correct in finding that it was competent for the Commissioner to apply s 103(2) for the first time in respect of the 1986 year of assessment.[139]

He noted that the Income Tax Act 58 of 1962 came into operation on 1 July 1962 and, on the plain wording of the section, the Commissioner was entitled to apply s 103(2) thereafter to an agreement entered into before that date and, that being so, 'it is difficult to understand why, by way of extension, he was not entitled to apply it during 1986 in respect of an agreement entered into during the preceding tax year'.[140]

Moreover, if regard is had to the wording of the tax avoidance provision, it contains no limitation as to time and s 103(2) does not state that the failure of the Commissioner to have applied its provisions in the year of the agreement prevents him from doing so in any future year. [141]

The learned judge of appeal continued at Page 11 of 57 SATC 1:

> 'I have shown that the [taxpayer] did not claim the benefit of s 20 in 1985. He did so for the first time in 1986. There was consequently no occasion for the

[136] HARMS JA, Page 6 of 57 SATC 1
[137] Page 2 of 57 SATC 1
[138] *SILKE on South African Income Tax*, Chapter 19 Tax avoidance, § 19.51 Conshu (Pty) Ltd v CIR
[139] Page 3 of 57 SATC 1
[140] HARMS JA, Page 9 of 57 SATC 1
[141] HARMS JA, Page 9 of 57 SATC 1

> Commissioner to disallow the set-off of any assessed loss or balance of assessed loss during the former year. In addition, the [taxpayer] had no otherwise taxable income during 1985 against which the assessed loss could have been set-off. To hold that, because the Commissioner could not have applied s 103(2) to the 1983 year entails that he could also not have done it in relation to 1986, would be destructive of the purpose of the provision. It would also allow for the evasion of the provision.'

EM Grosskopf JA, with Hoexter JA concurring, disagreed on the basis that the Commissioner was entitled to apply s 103(2) only in respect of the taxpayer's 1985 year of assessment.

Principles Established and Conclusion

In the *Conshu* case, the Court was ultimately divided with a split decision (three judges versus two judges), however, the principle that was established as a result of the majority judgement was that s 103(2) contains no limitation about the timeframe in which the provision can be invoked. This means that if an agreement (i.e., the kind referred to in section 103(2)) for the utilisation of an assessed loss is reached in a particular year, but the assessed loss is utilised only in subsequent years, the Commissioner may still apply s 103(2) in the later years.

First, the word "whenever", in section 103(2) is meaningful. It does not necessarily apply to the time that the ownership changes or the contract is entered into. Rather, its ordinary meaning includes, "if, at any time". This is stated in *Conshu (Pty) Ltd v CIR* 57 SATC 1 (A) at 9:

> 'To paraphrase, the subsection states that at whatever time the Commissioner is satisfied that any agreement has at any time been effected, he may disallow the attempted set-off.'

Secondly, further to what is mentioned at page 9 of 57 SATC 1, the word "any" is mentioned a few times in the provision of s 103(2). That the set off of 'any such assessed loss or balance of assessed loss' (i.e., one mentioned in para 2) against 'any such income' (i.e., income of the sort mentioned in para 1) shall be disallowed. The Court thus ruled

that the Commissioner was entitled to apply section 103(2) for the first time in respect of the 1986 year, being the first year in which the taxpayer had earned "tainted income" from the agreement and set off the assessed loss against such income.

Lastly, it is important to mention that the minority judgement (i.e., EM Grosskopf JA, with Hoexter JA) put forward that an assessed loss has an effective existence for only one year. The balance of an assessed loss established at the end of one year is a loss entirely separate and distinct from a loss that may exist at the end of the subsequent year. The minority judgement, in this case, held that to ascribe a different meaning to the term 'income' than the definition in s 1 would result in the anomaly that, where a company incurs a loss in years one and two, the loss in year one could not be carried forward to year three because a continuity of set-off is required (as referred to in 3.2.2).

After the *Conshu* decision, the South African Revenue Service (SARS) indicated that it would determine a company's assessed loss without regard to the majority decision, the reason being that to do otherwise 'would have a draconian effect' in that an assessed loss could only be carried forward if the taxpayer has taxable income, 'i.e. a pre-tax profit'.[142] SARS acknowledged the problem with the practical implementation of the "income from trade" requirement and it is exactly for that reason Interpretation Note 33 was issued.[143]

In conclusion, it would appear from the *Conshu* case that the Commissioner is still in a position, in certain circumstances, to disallow the set off of an assessed loss long after an agreement or change in shareholding, as envisaged by section 103(2), has taken place.

[142] 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.
[143] *De Rebus - SA Attorneys' Journal*, Archived issues, 2008, September, Other updates, Tax law, Assessed losses

5.3 *CSARS v Digicall Solutions (Pty) Ltd*[144]

In one of the more recent court cases, *Commissioner for the South African Revenue Service v Digicall Solutions (Pty) Ltd* (927/2017) ([2018] 4 All SA 647 (SCA)) 81 SATC 97, the Supreme Court of Appeal (SCA) was requested to consider whether the Commissioner for the South African Revenue Service (Commissioner) was correct in disallowing the utilisation by Digicall Solutions (Pty) Ltd (Taxpayer) of certain assessed losses, in terms of s103(2) of the Act.

Summary

In the *Digicall* case, there were successive changes in the taxpayer's shareholding in consecutive years of assessment. The court found that the sole or main purpose in purchasing the shares had been to use the assessed loss for set off against income in the subsequent years of assessment. The taxpayer, therefore, failed to discharge the onus of proving that the first change in the shareholding was not effected solely or mainly for the assessed loss. Accordingly, SARS disallowed the set-off of such assessed loss against such income. The case is also important as the other requirement of s 103(2), namely the first change in shareholding in the taxpayer had the 'direct or indirect' result that income was received by, or had accrued to the taxpayer, during any year of assessment, was also found to have been established on the facts of the case. [145]

For the purposes of this case, section 103(2) reads the same as mentioned in Chapter 5.1 above, at the relevant time of the *Digicall* case.

Background to the matter[146]

The Taxpayer, a South African resident company and wholly owned subsidiary of an Australian company, established a call centre facility in Cape Town, which sold cellular network service provider contracts for two cellular network providers, via the call

[144] *C: SARS v Digicall Solutions (Pty) Ltd* ([2018] 4 All SA 647 (SCA)) 81 SATC 97; The facts pertaining to the case were summarised in my own words, but in some instances crucial elements to the case and the discussion thereof could not be expressed in words other than what was included in the extract of the actual court case.
[145] *SILKE: South African Income Tax* (Paperback), Chapter 32: Tax avoidance, 32.5.8 (pg.1129)
[146] Nyanin, G (12 October 2018) Cliffe Dekker Hofmeyr: Tax & Exchange Control Alert (pdf download pg. 3 - 5)

centre to customers. In December 2001, the Taxpayer, which had an assessed loss of approximately R48 million, terminated its service provider contracts and disposed of its subscriber bases (which were its main source of business) to the two cellular network providers.[147]

In order to create an exit event for the Australian shareholder that wished to disinvest from South Africa, it was proposed that an investment company named Global Capital would acquire the shares in the Taxpayer and provide services to a rival cellular network provider. During the financial and legal due diligence commissioned by Global Capital in relation to the Taxpayer, it was revealed that one of the cellular network providers (mentioned above) had instituted proceedings against the Taxpayer. As a result, Global Capital could not take over the Taxpayer. As Global Capital always intended to buy the shares directly in the Taxpayer, it was decided that Global Capital would set up a new company for this purpose.[148]

Global Capital acquired a shelf company, Sell direct Marketing Pty Ltd (SDM). The plan was for SDM to acquire the assets and employees of the Taxpayer and take over the lease in respect of the call centre. In addition, SDM would be granted an option to acquire all the shares in the Taxpayer, to be exercised once the litigation had been resolved. [149] The option would endure for 18 months from the date of the sale agreement, the purchase price being the par value of the shares. [150] It is important to note that based on evidence presented to the SCA, SDM was aware:

- of the Taxpayer's assessed loss in respect of the tax year ending 30 June 2001, which had not as yet been assessed; and
- that in terms of s20 of the Act, any assessed loss could only be carried forward to a future year of assessment, where the company in question (i.e. Taxpayer) traded. Accordingly, in order to utilise the assessed loss, the Taxpayer would "as it were, have to be brought back from the grave and start trading again" [151]

[147] Page 97/98 of 81 SATC 97.
[148] Page 107 of 81 SATC 97 [SWAIN JA: 18]
[149] Page 107 of 81 SATC 97 [SWAIN JA: 18]
[150] Page 107 of 81 SATC 97 [SWAIN JA: 19]
[151] Page 107 of 81 SATC 97 [SWAIN JA: 20]

SDM conducted the Taxpayer's business in Cape Town and took over the lease from the Taxpayer. It is stated that once SDM started conducting the business, it realised that the facilities in the call centre exceeded what was required by SDM. [152] Consequently, SDM decided that it would need to sell the call centre and lease back only the facilities it required (i.e. 30 seats out of the 120 seats available in the call centre) from the relevant purchaser. [153] Global Capital initiated the sale process of the Taxpayer and the call centre and was in discussions with a company named Glasfit. Glasfit, together with its rival PG Glass, were looking to set up a business process outsourcing venture (Venture), which would require a call centre. Glasfit made multiple offers to SDM for the acquisition of the Taxpayer and call centre, however SDM did not accept these on the basis that the offers substantially undervalued the Taxpayer.

Having ensured that the Taxpayer was trading at 30 June 2002, the assessed loss was carried forward to the 2003 year of assessment. SDM then exercised the option to purchase all the shares in the Taxpayer on 19 September 2002, although at such time, there was nothing left in the Taxpayer, other than the assessed loss.[154] It is important to note that although the option was exercised on 19 September 2002, SDM only purchased the shares by way of a formal agreement entered into on 5 March 2003. [155] A further agreement was concluded on 7 May 2003 between SDM and the Taxpayer, where the Taxpayer reacquired its business from SDM. [156]

SDM and Glasfit resumed negotiations for the sale of the shares in the Taxpayer and on 3 October 2003, SDM accepted the offer of Glasfit to acquire the shares in the Taxpayer to Glasfit. The sale agreement was concluded on 25 November 2003. [157]

During the period 2004 to 2008, Glasfit was able to inject income from the Venture located in the consolidated call centre into the Taxpayer, enabling the Taxpayer to utilise the existing assessed loss in the Taxpayer.

The Commissioner issued additional assessments against the Taxpayer, during

[152] Page 108 of 81 SATC 97 [SWAIN JA: 22]
[153] Page 108 of 81 SATC 97 [SWAIN JA: 22]
[154] Page 109 of 81 SATC 97 [SWAIN JA: 27]
[155] Page 110 of 81 SATC 97 [SWAIN JA: 34]
[156] Page 111 of 81 SATC 97 [SWAIN JA: 38]
[157] Page 113 of 81 SATC 97 [SWAIN JA: 47]

November 2010 in respect of the 2005-2008 income tax periods, disallowing the utilisation by the Taxpayer of the assessed loss, in terms of s103(2) of the Act. The Taxpayer lodged an objection which was disallowed by the Commissioner, against which disallowance, the Taxpayer appealed to the Tax Court.

The Decision

Findings of the Tax Court[158]

The Tax Court found that the first change in shareholding did not directly or indirectly result in income being received by or accruing to the Taxpayer. The Tax Court submitted that the income was derived not from the first change in shareholding, but from a later intervening event, being the second change in shareholding and the income was not contemplated at the time when SDM acquired the shares from the Australian shareholder. The Tax Court, while referencing the breaking of the chain of causation referred to in delictual cases as a *nova causa interveniens* ("new intervening act or cause"), reasoned that income was not the 'result' of the first change in shareholding.

Accordingly, the Tax Court granted an order setting aside the assessments and referred the matter back to the Commissioner for reassessment on the ground that the taxpayer was entitled to set off the assessed loss against its income during the relevant years. The Commissioner appealed against this decision to the full court of Western Cape Division of the High Court (High Court).

Findings of the High Court[159]

Similar to the Tax Court, the High Court found that the first change in shareholding did not directly or indirectly result in income being received by or accruing to the Taxpayer. The High Court was even more explicit in its reliance upon the delictual test of causation, concluding that although the first change in shareholding may have been the *sine qua non* ("an essential condition") of the receipt of income by the taxpayer, it was not the *causa causans* ("the immediate cause; the last link or causation"). The High Court concluded that it was the second change in shareholding that was the effective cause and dismissed the appeal with costs on the ground that the requirements ofs103(2)

[158] Nyanin, G (12 October 2018) Cliffe Dekker Hofmeyr: Tax & Exchange Control Alert (pdf download pg. 5)
[159] Nyanin, G (12 October 2018) Cliffe Dekker Hofmeyr: Tax & Exchange Control Alert (pdf download pg. 5 - 6)

of the Act were not satisfied.

Decision of the SCA[160]

The SCA provided that s103(2) states that the change in shareholding must result, directly or indirectly, in income being received by, or accruing to the taxpayer, during any year of assessment. Finding in favour of the Commissioner, the SCA held that:

> 'the direct or indirect receipt of income by the taxpayer, does not have to occur in the same tax year as the change in shareholding of the taxpayer. It may occur in any year of assessment, provided it results directly or indirectly from the change in shareholding.'

The Commissioner was accordingly correct in concluding that the provisions of s103(2) of the Act were satisfied and in disallowing the taxpayer's claim to set off the assessed loss against such income, during these years of assessment.

Principles Established and Conclusion

Unlike the *Conshu* case, this Court held a unanimous decision, with all four judges concurring on the judgement held by Swain JA, and the principle that was established as a result of the judgement was that the determination of whether an assessed loss was utilised for purposes of reducing or avoiding tax is an entirely factual enquiry and accordingly, the necessary evidence (e.g., board minutes, correspondence and other documentation) to support the commercial objective must be documented.[161]

In proving the purpose element, SARS is aided by section 103(4). The effect of section 103(4) is that, where SARS can demonstrate that there has been a tax benefit from setting off an assessed loss against income derived from a contract/change of ownership which introduced that income to the company, the law presumes that the purpose of the contract/change of ownership was to obtain the benefit of tax relief. The burden is then cast upon the taxpayer to establish that the sole or main purpose of the contract/change of ownership was not to derive such benefit.

[160] Nyanin, G (12 October 2018) Cliffe Dekker Hofmeyr: Tax & Exchange Control Alert (pdf download pg. 6)
[161] Nyanin, G (12 October 2018) Cliffe Dekker Hofmeyr: Tax & Exchange Control Alert (pdf download pg. 6)

The interpretation of the term "solely or mainly" is a critical element in any examination of purpose. The word "solely" connotes that the contract or change in ownership was entered into for one purpose alone, namely, to derive a tax benefit from the assessed loss. The term "mainly" applies where there may have been more than one purpose to the transaction or change in ownership.

Our courts have considered that the term should require that the purpose of tax avoidance should have been the principal or most important purpose for entering into the transaction. The following statement explains the requirement:

> 'In a case such as the present, where at most two purposes have been suggested (a saving on income tax and a saving on estate duty), if one purpose preponderates over the other it cannot be said that the other is a main purpose.'[162]

Essentially, the avoidance of tax must have been either the only or the predominant purpose of the transaction or change in ownership.

Further to the above, the application of the principles is well illustrated in *ITC 1347* (1981) 44 SATC 33 (EC). X, a garment manufacturer in city C wished to expand operations to city D. It was able to acquire the shares in company Y at a relatively low cost. Y continued operations in city D for a short period, but altered economic circumstances caused X to determine that the operations of Y should be moved to city C and integrated into the production line of X. Thereafter, Y continued to operate as a distributor of the branded garments it had previously manufactured. The Commissioner sought to disallow the set-off Y's assessed loss against the income that it derived. The court determined that the purpose of X had to be determined subjectively and that the evidence of its director was important but not decisive. However, having regard to all of the facts, the court found that X had discharged the burden of proof that its purpose in acquiring the shares in Y and in rationalising operations was not to utilise the assessed loss to avoid tax.

In summation, if there is clear evidence that a taxpayer derived income from its trade

[162] *ITC 1307* (1979) 42 SATC 147 at 153

during the year, and that the level of income was comparable to that of the immediately preceding year of assessment, it is therefore considered that the assessed loss carried forward from the prior year may be offset against income derived in the current year unless the provisions of section 103(2) may successfully be invoked by SARS.

Should section 103(2) be applicable, there is therefore a presumption that the sole or main purpose of the change in ownership and/or the contracts was to avoid tax by utilising the existing assessed loss. The taxpayer must rebut this presumption on a balance of probability.

5.4 *New Urban Properties v SIR*[163]

Background to the matter[164]

The *New Urban Properties* case was due to an appeal from a decision in the Special Court for hearing Income Tax Appeals.

The appellant company (New Urban Properties Ltd), which was registered in 1945, had carried on the business of dealing in land. As a result of a large transaction entered into in 1948, it had made heavy losses and by the end of its financial year ending on 30th June 1958, it was hopelessly insolvent.

For the year of assessment ending on that date, the Commissioner for Inland Revenue issued an assessment on the company showing an assessed loss of £767,709, having brought forward an assessed loss of £268,000 from the preceding year.

During the period 1st July to 31st December 1958, the company was dormant and carried on no business, but as at the 1st January 1959, a controlling interest in the shareholding of the company was acquired by five parties who were interested in other land-dealing companies. The intention of the new shareholders was to divert income from their other companies to the appellant company and make use of the accumulated

[163] *New Urban Properties Ltd v SIR* 1966 (1) SA 217 (A), 27 SATC 175; The facts pertaining to the case were summarised in my own words, but in some instances crucial elements to the case and the discussion thereof could not be expressed in words other than what was included in the extract of the actual court case.
[164] Page 175 of 27 SATC 175

loss of that company to avoid tax on that income.

During the period 1st January to 30th June 1959, after the change in shareholding, the appellant company carried out certain business transactions which realized an income of approximately £5,640. In its return of income for the year of assessment ended on 30th June 1959, the company disclosed this income but claimed to set off against it the accumulated loss brought forward from the previous year.

The Commissioner for Inland Revenue refused to allow the set off claimed on the grounds that the income had been received as the direct result of a change in the shareholding in the company effected solely or mainly for the purpose of utilising the assessed loss incurred by the company in order to avoid liability on the part of the company on that income, within the terms of section 90(1)(*b*) of the Income Tax Act, No 31 of 1941, as amended.

On appeal to the Special Court for hearing income tax appeals from this decision, it was admitted on behalf of the appellant company that the income had been received as a result of arrangements effected for the purpose of utilising the assessed loss to avoid liability for tax on that income, but it was claimed that while the balance of assessed loss could not be utilised as a set-off against the income in question, the assessment should show that balance as available for set-off against future income.

The Special Court having dismissed the appeal, on appeal from that decision led directly to the Appellate Division.

The Decision

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 that subsection (3)[165] 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

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

year to year until it is exhausted. [166]

If, for any reason, the assessed loss cannot be so set off in any particular year, then there is no 'balance of assessed loss' for that year which can be carried forward to the succeeding year, or alternatively, viewed from the succeeding year of assessment, then 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.

Principles Established and Conclusion

The principle established in the *New Urban Properties* case is that, if a balance of assessed loss incurred by a company is prohibited from being set off against income accruing to the company through the operation of s 103(2), that balance of assessed loss may fall away completely. This may happen if the company does not maintain its traditional activities. It was held that this continuity is also interrupted by the operation of s103(2).[167]

The decision in the *New Urban Properties* case means that, even if a company does carry on trading during a year in respect of which the Commissioner has successfully invoked s 103(2), this trading will not entitle it to carry forward the balance of assessed loss to the next year of assessment. The balance of assessed loss will be retained only if the traditional trading activities are maintained. [168]

For example, if a clothing manufacturer (Company A), buys all the shares of a vehicle manufacturer (Company B) and then transfers the closing manufacturing business to Company B. Company A has been profitable in the past and pays taxes annually, whilst Company B has suffered losses in the past and therefore, as a result, has an assessed loss. Company B at the end of the year of assessment has generated taxable profits of R250,000 from the clothing manufacturing operations, while vehicle manufacturing has ceased.

In these circumstances, Company B will not be allowed to off-set the profits of

[166] At SATC 183.
[167] *SILKE: South African Income Tax*, Chapter 32: Tax avoidance, 32.5.3 (pg.1128)
[168] *SILKE: South African Income Tax*, Chapter 32: Tax avoidance, 32.5.3 (pg.1128)

R250,000 against the previous assessed loss from the vehicle manufacturing operations as no vehicle manufacturing operations were carried on during the year. The assessed loss will thus be forfeited.

5.5 Conclusion

The above case law demonstrates the principles that have been established in which the utilisation of an assessed tax loss can be disallowed in terms of s 103(2). Although the research focuses on circumstances where the utilisation of an assessed loss has been disallowed or forfeited, there are cases where it has been found to be in favour of the taxpayer, whereby the courts found that the sole or main purpose of the acquisition was not for obtaining the benefit of the assessed loss and thus not for the avoidance or reduction of tax.

This was demonstrated in *ITC 983* (1961) 25 SATC 55 and *ITC 989* (1961) 25 SATC 122. In *ITC 983,* the court held that, based on the facts established in evidence, the main purpose of the holding company for acquiring the shares in another company was to enable the holding company to obtain a productive manufacturing unit that could go into immediate operation to supplement its own productive capacity, not the avoidance or reduction of tax. Section 103(2) was therefore not applicable.[169] Similarly, in *ITC 989*, the taxpayer had shown that his main purpose for purchasing the shares of a company with an assessed loss was not to avoid tax. While the taxpayer derived some advantage by purchasing the shares and thus acquiring the benefit of the assessed loss, this did not constitute its sole or main purpose. [170] Therefore, the provision of section 103(2) can be applied successfully only if the sole or main purpose of the acquisition of shares is to utilise an assessed loss.

In summation, that whilst it may be beneficial for companies to try to utilise an assessed loss within a group of companies, companies should be aware that if there is not a strong commercial justification for the utilisation of the assessed loss, then there is a risk that SARS will invoke the provisions of section 103(2).

[169] *SILKE: South African Income Tax*, Chapter 32: Tax avoidance, 32.5.2 (pg.1128)
[170] *SILKE: South African Income Tax*, Chapter 32: Tax avoidance, 32.5.2 (pg.1128)

It is important to highlight that the use of an assessed loss in a scheme for the avoidance of tax need not be challenged by the Commissioner exclusively in terms of s 103(2), but may in appropriate circumstances also be challenged in terms of the provisions of ss 80A-80L.[171] Sections 80A-80L of the Act are, however, not within the scope of this research report.

[171] *SILKE: South African Income Tax*, Chapter 32: Tax avoidance, 32.4 (pg.1127)

Chapter 6 – Limitations on the use of assessed losses

6.1 Introduction

South Africa has historically taken a generous position on the use of assessed losses by taxpayers by allowing the full extent of assessed losses to be set off against current income and any remaining balance to be carried forward to be set off against future income. [172]

The purpose of providing for the deductibility of assessed losses for corporate taxpayers is to smooth the tax burden for companies whose primary business is cyclical in nature, not in line with a standard tax year and for start-up companies that are not profitable in the early years of trading.

6.2 Amendment to section 20[173]

Over the past few years, there has been an international trend to restrict the use of assessed losses and reduce the corporate income tax rate. To improve the country's competitiveness, reduce the appeal of base erosion and profit shifting, encourage investment and promote economic growth, the Minister of Finance announced (in the 2020 Budget Review) Government's intention to restructure the corporate income tax system over the medium term by broadening the base and reducing the corporate income tax rate in a revenue neutral manner.

These measures included "tightening" of the interest deduction limitation rule in section 23M of the Act and the introduction of a limit on the amount of assessed loss that may be set off against taxable income. However, this was delayed owing to the COVID pandemic.

Delivering the 2022 Budget, the South African Government confirmed that it intended to proceed with its previously announced cut to the corporate tax rate, from 28 percent to 27 percent, for companies with years of assessment ending on or after 31 March

[172] Mukumba, T (19 August 2021) Cliffe Dekker Hofmeyr: Tax & Exchange Control Alert (pdf download pg. 5 - 6) (online)
[173] Arbuthnot, C and Smith, C (17 August 2021) BDO Articles: New limitation on use of corporate assessed losses

2023. The base-broadening provisions (interest deduction and assessed loss limitation) also take effect for such years of assessment.

The amendment to section 20 stipulates that the offset by companies of the balance of assessed losses carried forward is now limited to 80 per cent of taxable income. The limitation is determined before taking into account the application of the provision.

A *de minimis* threshold has been included in the assessed loss limitation to provide breathing room for small companies that may experience cash-flow challenges at different times. The *de minimis* threshold is the higher of R1 million or 80 per cent of taxable income. Thus, to the extent that the balance of assessed loss exceeds 80 per cent of current-year taxable income, companies will be able to set off the higher of R1 million or 80 per cent of taxable income.

This means that companies with an assessed loss balance that is equal to or exceeds their current-year taxable income and the taxable income before the set-off of the assessed loss exceeds R1 million will need to pay tax on up to 20% of their taxable income.

The new rule applies for years of assessment ending on or after 31 March 2023. The Explanatory Memorandum makes it clear that the new limitation will apply to a company's 'balance of assessed loss' as at the date of the enactment of the amendment and not only to assessed losses accumulated from the date of the enactment.

While the proposal does remove some of the shielding provided to taxpayers who have suffered significant assessed losses, it allows the majority of an assessed loss to be utilised and the balance carried forward to subsequent tax years, meaning the full assessed loss may still be utilised, but over a longer period. [174]

The indications from the policy announcements are that the proposals are part of a set of measures aimed at ensuring there is sufficient fiscal space for a reduced corporate income tax rate from 28% to 27%. However, it remains to be seen whether corporates

[174] Mukumba, T (19 August 2021) Cliffe Dekker Hofmeyr: Tax & Exchange Control Alert (pdf download pg. 5 - 6) (online)

and investors value the certainty of a lower corporate income tax rate more than flexibility in the system of taxation, which considers the economic position of businesses that have suffered significant losses in the past and may yet struggle with cash flow constraints in order to pay the effective rate of 20% on taxable income. [175]

This assessed loss proposal goes hand in hand with a decrease in the corporate income tax rate to 27% and both are seen as part of a 'corporate income tax package' aimed at facilitating the reduction in the corporate tax rate in a revenue neutral manner. Therefore, it will be interesting to witness the fiscal impact that it will have over the long term on taxpayers and the wider South African economy.

6.3 Conclusion

South Africa (SA) will be in a small minority of countries that, while imposing a limit on either the time to use tax losses or the amount that can be used, have no group tax system. Without group tax, the proposed regime for tax losses will, arguably, be one of the most onerous in the world, thereby significantly impacting South Africa's competitiveness from a tax perspective.

When one compares SA's tax loss regime to international benchmarks, it is important to do this in a holistic manner and not to focus on one element i.e., the limitation on the amount of losses that can be used. SA is proposing a regime with a low *de minimis*; whilst the 80% restriction is relatively generous, many other countries have group tax systems in place and allow the carry back of losses. For example, the United Kingdom limits the offset of losses to 50% of current year profits with a *de minimis* of GBP 5 million. However, it also allows companies to carry losses back one year and has a group tax system that allows losses in one company to be transferred to another group company. When one takes all of these factors into account, the SA assessed loss regime is not as generous as it appears at face value.

This threshold may ultimately mean that the corporate income tax package will not move too far away from its aim of revenue neutrality, given the currently constrained

[175] Mukumba, T (19 August 2021) Cliffe Dekker Hofmeyr: Tax & Exchange Control Alert (pdf download pg. 5 - 6) (online)

fiscal space.

Chapter 7 - Conclusion

In terms of section 20(1)(*a*), a company is only allowed to set off its assessed loss from the previous year against its taxable income in the current year if the company has carried on a trade during the current year and has derived income from that trade during that year.

When considering whether a company is entitled to carry forward an assessed loss (and whether they have satisfied the "trade" and "income from trade" requirements), the company should have regard to established principles which emanate from case law, in summary, here are a few highlights from each of the cases discussed above.

A company which seeks to set off an assessed loss from a previous year of assessment cannot merely "keep itself alive" in the year of assessment which it seeks to carry forward the assessed loss.

Compliance with minimum regulatory obligations and the maintenance of a bank account will not constitute the carrying on of a trade even if the taxpayer intended to resume trading in the future.

The holding of meetings, appointment of directors and/or arranging for financial statements to be prepared, will, on its own, unlikely constitute the carrying on of a "trade". Passive behaviour absent of any active endeavour to carry on a trade will not be sufficient to argue that a trade is being conducted.

If a taxpayer does not have any assets with which it can engage in a trade then it will be difficult to argue that it is actively carrying on a trade. For example, in circumstances where a taxpayer has no premises from which to trade, no equipment, no stock and no staff, it is likely that a court will deem this indicative of a company which is not trading. Accordingly, the absence of productive assets has been found to be an indicator of the absence of trading activity.

In respect of the income from trade requirement, courts have found that even an

unsuccessful endeavour to trade can constitute trading even if no expenditure is outlaid (in certain circumstances) and no income is derived. The crux of the argument is that a company should be able to strike a balance even if its income so derived is nil, provided that there was some attempt to trade.

The discontinuation of a taxpayer's main business operations may not in itself be deemed to be the cessation of trading if the taxpayer undertook other activities such as the continued employment of staff to realise assets and collect trade receivables. However, where a taxpayer's only activities comprised the collection of trade receivables and it had no stock, employees, or fixed assets of any significance, it is likely that the taxpayer will not meet the "trade" requirement.

In regard to the "income from trade" requirement, the conclusion we can draw from the above is that whether the taxpayer earned income from that trade is irrelevant, as long as the taxpayer had the intention to derive income therefrom, the company should be entitled to carry forward its assessed loss; this is in line with SARS's view in Interpretation Note 33.

Finally, once a company has considered section 20 and the implications thereof, they should also take into account, in certain circumstances, whether the anti-avoidance provisions that prevent the utilisation of an assessed tax loss in s103(2) are applicable.

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