

TAX & EXCHANGE CONTROL ALERT

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JUMPING FENCES: SECTION 20A OF THE INCOME TAX ACT AND RING-FENCED LOSSES

In South Africa's current challenging economic climate, the risk of suffering losses in business is higher than normal. From a tax perspective, persons are generally allowed to set off losses incurred in respect of one trade against the income derived from another trade, to reduce their tax liability. However, the extent to which taxpayers can do this is limited and in this regard taxpayers, specifically natural persons, should be aware of the provisions of s20A of the Income Tax Act, No 58 of 1962 (Act). In terms of s20A, losses incurred by natural persons in respect of certain trades will be ring-fenced under certain circumstances, meaning that such losses cannot be offset against income derived from other trades carried on by such natural persons.

CUSTOMS HIGHLIGHTS

This week's selected highlights in the Customs and Excise environment since our last instalment.

JUMPING FENCES: SECTION 20A OF THE INCOME TAX ACT AND RING-FENCED LOSSES

Losses incurred by natural persons in respect of certain trades will be ring-fenced under certain circumstances, meaning that such losses cannot be offset against income derived from other trades carried on by such natural persons.

When a loss is ring-fenced, that loss may not be set off against the other income of the natural person in order to reduce his tax liability.



In South Africa's current challenging economic climate, the risk of suffering losses in business is higher than normal. From a tax perspective, persons are generally allowed to set off losses incurred in respect of one trade against the income derived from another trade, to reduce their tax liability. However, the extent to which taxpayers can do this is limited and in this regard taxpayers, specifically natural persons, should be aware of the provisions of s20A of the Income Tax Act, No 58 of 1962 (Act). In terms of s20A, losses incurred by natural persons in respect of certain trades will be ring-fenced under certain circumstances, meaning that such losses cannot be offset against income derived from other trades carried on by such natural persons.

Rationale behind s20A

In terms of the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2003 (Memorandum), s20A was introduced to curb the practice where natural persons pursued ventures that, for the most part, consisted of hobbies disguised as trades, referred to in the Memorandum as suspect trades. The Memorandum states that private consumption can be disguised as trade so that individuals, especially wealthier individuals, can set-off the expenditures from this trade against other income such as salaried or professional income. Section 20A addresses this by stating that losses incurred in respect of a trade will be ring-fenced under certain circumstances.

When a loss is ring-fenced, that loss may not be set off against the other income of the natural person in order to reduce his tax liability. The loss may only be set off against the future income derived from the trade to which the loss relates. It follows that any balance of assessed loss pursuant

to conducting that trade may, in future, also only be set off against the income derived from that trade.

When will section 20A apply to a loss?

Section 20A(2) sets out the requirements that, if met, will result in the relevant loss being ring fenced.

The first requirement: Taxable income threshold

The sum of the taxpayer's taxable income in a year of assessment and any assessed loss or balance of assessed loss of the taxpayer must be equal to, or exceed, the amount at which the maximum marginal rate of tax is applicable. Effectively, this will be the taxable income of the taxpayer, before taking into account any current or preceding year's assessed loss from any trade. The taxpayer must therefore fall within the highest income tax bracket for this section to apply, which means that in the 2018 year of assessment, the person's taxable income must be equal to or exceed R1,5 million.

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Both requirements must be met in order for s20A to apply to losses incurred in respect of a specific trade.



The second requirement: The nature of the trade

In addition to the above, one of the following must apply to the natural person:

- a) The natural person has, during the preceding five-year period (ending on the last day of the relevant year of assessment), incurred an assessed loss in at least three of those years of assessment (see s20A(2)(a)); or
- b) The trade in which the natural person engages constitutes one of the following trades listed in s20A(2)(b) of the Act:
 - Any sporting activity practised by that person or any relative;
 - Any dealing in collectibles by that person or any relative;
 - The rental of residential accommodation, unless at least 80% of the accommodation is used by persons who are not relatives of the natural person for at least half the year of assessment;
 - The rental of vehicles, aircraft or boats, unless at least 80% of the vehicles, aircraft or boats are used by persons who are not relatives of the taxpayer for at least half the year of assessment;
 - Animal showing by that person or any relative;
 - Farming or animal breeding unless such activities are engaged in on a full-time basis;
 - Any form of performing or creative arts practised by that person or any relative; or
 - Any form of gambling or betting practised by that person or any relative.

It is important to note that both requirements must be met in order for s20A to apply to losses incurred in respect of a specific trade. However, even if the requirements of s20A(2) are met, it is still possible for a taxpayer to escape the application of s20A, as discussed under the next heading.

The exception: When will s20A(2) not apply?

Where a loss qualifies as a ring-fenced loss in terms of s20A(2), a taxpayer may, in terms of s20A(3), escape the provisions of s20A if the trade carried on by the taxpayer has a reasonable prospect of producing taxable income within a reasonable period of time.

A taxpayer wishing to rely on s20A(3) will have to prove to SARS that there is a reasonable prospect of taxable income being produced in a reasonable period of time, having regard to:

- a) The proportion of gross income derived in relation to the allowable deductions for the relevant year of assessment;
- b) The level of activity and the expenditure relating to advertising and promoting the trade;
- c) Whether the trade is carried on in a commercial manner, taking into account:
 - The number of full time employees;
 - The commercial setting of the premises where the trade is carried on;
 - The extent of the equipment used exclusively for purposes of carrying on that trade; and
 - The time the taxpayer spends at the premises conducting that business;

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Section 20A(3) cannot be used to escape the application of s20A, where the trade in question constitutes a suspect trade in terms of s20A(2)(b).



- d) The number of years during which losses were incurred in proportion to the period in which the trade activities were carried on, taking into account:
 - Any unexpected events giving rise to any of the assessed losses; and
 - The nature of the business involved;
- e) The business plans of the taxpayer and any changes thereto to ensure that taxable income is derived in future from carrying on that trade; and
- f) The extent to which any asset of the business is available for recreational and personal use by the taxpayer or a relative of the taxpayer.

Importantly, s20A(3) cannot be used to escape the application of s20A, where the trade in question constitutes a suspect trade in terms of s20A(2)(b) and in carrying on that trade the person has, in the last ten years (ending on the last day of the relevant year of assessment), incurred assessed losses in at least six of those years of assessment.

Specific rule for farming activities

All of the farming activities conducted by one taxpayer on a full-time basis are deemed to constitute a single trade and as such, any loss incurred in one farming activity can be set off against the income of any other farming activity.

Some practical considerations

One of the classes of persons to whom section 20A can apply is a person who receives a large part of his income in the form of a salary. The word "trade" includes the employment of a taxpayer. Therefore, if a taxpayer is employed and simultaneously carries on another trade, such as renting out a residential property and makes losses from the rental business, the taxpayer will be conducting multiple trades and will not be able to set off the loss from that trade against his employment income, if s20A applies.

Furthermore, those taxpayers who conduct a suspect trade listed in s20A(2)(b) and who foresee making consistent losses should be especially mindful of this section. From a tax perspective, such a trade should only be conducted if there is a likelihood that the trade will generate taxable income in future or if the taxpayer is content with incurring losses from which he will derive no tax benefit. Where there is a strong likelihood that taxable income will be derived, the taxpayer may be able to escape the ambit of s20A by relying on those factors set out in s20A(3), failing which the taxpayer can at the very least set off any ring-fenced losses against future income derived from the suspect trade.

Who's Who Legal

Emil Brincker has been named a leading lawyer by Who's Who Legal: Corporate Tax – Advisory and Who's Who Legal: Corporate Tax – Controversy for 2017.

Mark Linington has been named a leading lawyer by Who's Who Legal: Corporate Tax – Advisory for 2017.

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A natural person who foresees incurring losses from a particular trade, which does not constitute a suspect trade in s20A(2)(b), should consider structuring his business so as to avoid s20A from applying.

A natural person who foresees incurring losses from a particular trade, which does not constitute a suspect trade in s20A(2)(b), should consider structuring his business so as to avoid s20A from applying. In other words, he should avoid incurring assessed losses in respect of a particular trade, in three or more years of assessment within a five-year period. One way in which this could be potentially be done is to reduce the interest paid on any loans incurred to carry on the trade.

Lastly, taxpayers must remember that both requirements in s20A(2) must be met in each year of assessment in order for a loss to be ring-fenced. Therefore, if s20A applied to a natural person in previous years, it may not apply to that natural person in the 2018 year of assessment if his total income does not place him in the new highest income tax bracket of R1.5 million.

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Louis Botha and Louise Kotze



CHAMBERS GLOBAL 2018 ranked our Tax & Exchange Control practice in Band 1: Tax.

Gerhard Badenhorst ranked by CHAMBERS GLOBAL 2014 - 2018 in Band 1: Tax: Indirect Tax.

Emil Brincker ranked by CHAMBERS GLOBAL 2003 - 2018 in Band 1: Tax.

Mark Linington ranked by CHAMBERS GLOBAL 2017- 2018 in Band 1: Tax: Consultants.

Ludwig Smith ranked by CHAMBERS GLOBAL 2017 - 2018 in Band 3: Tax.



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CUSTOMS AND EXCISE HIGHLIGHTS

Please note that this is not intended to be a comprehensive study or list of the amendments, changes and the like in the Customs and Excise environment, but merely selected highlights which may be of interest.

In the event that specific advice is required, kindly contact our Customs and Excise specialist, Director, Petr Erasmus.



This week's selected highlights in the Customs and Excise environment since our last instalment:

1. Amendments to Rules to the Customs & Excise Act, No 91 of 1964 (Act) (certain sections quoted from the SARS website):
 - 1.1 Draft rules under s39B and s41 of the Act (which deals with incomplete and provisional entries) were published for comment. The draft rules deal (inter alia) with:
 - 1.1.1 Exclusion of certain classes or kinds of goods from incomplete or provisional entry;
 - 1.1.2 Particulars to be contained in incomplete and provisional bills of entry;
 - 1.1.3 Supporting documents for incomplete and provisional bills of entry;
 - 1.1.4 Conditions subject to which approvals for incomplete or provisional entry are granted;
 - 1.1.5 Delivery and form of supplementary bills of entry; and
 - 1.1.6 Applications for extension of timeframe for submission of supplementary bills of entry.
 - 1.2 Comments must please be submitted on or before 21 February 2018 and must be sent to [C&E legislativecomments@sars.gov.za](mailto:C&E_legislativecomments@sars.gov.za).
2. Amendments to Schedules to the Act (certain sections quoted from the SARS website):
 - 2.1 Schedule 3:
 - 2.1.1 Substitution of rebate items under 320.12 in order to provide for the importation of raw materials for the manufacture of baby diapers as well as adult diapers.
 - 2.2 Schedule 4:
 - 2.2.1 Substitution of item 412.13/00.00/01.00 in order to exclude adult diapers from rebate;
 - 2.2.2 Substitution of items 460.17/87.00/04.02 and 460.17/87.00/02.04 in order to reduce the period of disposal of motor vehicles designed for the transport of physically disabled persons from 5 years to 3 years.

CUSTOMS AND EXCISE HIGHLIGHTS

CONTINUED

In the event that specific advice is required, kindly contact our Customs and Excise specialist, Director, Petr Erasmus.



2.3 Schedule 6:

2.3.1 Substitution of items 630.20 and 630.22 as a consequence of the amendment in Schedule 4 (above) in order to reduce the period of disposal of motor vehicles designed for the transport of physically disabled persons from 5 years to 3 years.

3. SARS circular re: 13th Deferment payment:

3.1 On 7 February 2018 SARS issued a circular regarding the 13th payment for deferment account holders for the 2017/18 financial year. The statement period for this financial year will close on 26 March 2018 at midnight. Payments must be made by 15h00 on 28 March 2018.

Payments must be made in advance in order for delays in (electronic) payments not to result in late payments. Clients who may have difficulty in meeting this deadline must send written motivation to Group Executive, Vonani Ntlhabyane by 20 March 2018 at VNtlhabyane@sars.gov.za. Each case will be considered and dealt with on its own merits and late payments will only be allowed in exceptional circumstances.

4. Please advise if additional information is required.

Petr Erasmus



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