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Video Transcription: Introduction to Assessed Losses

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Hi, I'm Shaun Parsons, and in this video we are going to be talking about assessed losses.

An assessed loss arises when your deductible expenditure and allowances exceed your income, and this generally means that you have been unsuccessful in whatever profit-making activity you are engaged in.

But there is hope. An assessed loss has value. Having an assessed loss means that you can offset the assessed loss against other taxable income, reducing the income tax that you pay on that income. The value of your assessed loss is therefore the amount by which it can reduce your future taxable income.

So, let's look at when and how you can offset an assessed loss against other taxable income.

The utilisation of an assessed loss is governed by sections 20 and 20A of the Income Tax Act. Assessed losses for natural persons (or individuals) are treated very differently to other taxpayers (like companies or trusts), so let's look at individuals first.

An individual's taxable income is often the product of multiple trades, as well as non-trade activities. A trade is essentially an income-earning activity. So running a business is a trade, as is renting property, and so is having a job where you earn a salary or wage. Non-trade activities that affect your taxable income include things like making tax-deductible donations.

As each of these trades have different characteristics, an individual must first determine the taxable income of each trade. If all of the trades have generated a positive taxable income, then the question of assessed losses is irrelevant. If one of these trades resulted in an assessed loss, the question is whether the individual can offset the assessed loss from that trade against the taxable income from the other successful trades in determining his total taxable income.

If the taxpayer is not allowed to offset the assessed loss against other taxable income, that loss is referred to as being "ring-fenced". Ring-fencing means that the loss may not be set off against taxable income from other trades, and can only be set off against taxable income arising in the future from the same trade from which that loss arose.

So, how does a taxpayer know whether an assessed loss will be ring-fenced?

If the taxpayer has a trade with an assessed loss, the total taxable income after reversing the effect of that loss must first be determined. If the total is not high enough to place the taxpayer in the highest tax bracket, then the assessed loss can automatically be utilised, reducing the total taxable income. If the taxpayer is in the top tax bracket, additional questions need to be answered before the assessed loss can be utilised.

Taxpayers in the top tax bracket need to consider whether the trade that resulted in the assessed loss is what is referred to as a "suspect trade". Suspect trades are activities in the Income Tax Act specifically identified as activities that people may engage in not only to earn income, but also for other reasons – usually their love of that activity itself. The list of suspect trades is contained in section 20A of the Income Tax Act.

For example, dealing in antiques is a suspect trade. Taxpayers may deal in antiques because it is a good business opportunity, or they may deal in antiques because of their love of antiques. If the antique trading results in an assessed loss, there is a question around whether the trade was pursued with the true goal of making a profit, or whether the love of antiques clouded the taxpayer's judgement.

For this reason, an assessed loss of a taxpayer in the highest marginal tax bracket from a suspect trade is automatically ring-fenced. The taxpayer cannot offset this loss against other profitable trades. The loss must be carried forward, and can only be utilised against taxable income from that same trade in the future, if and when that trade becomes profitable. This means that, if the trade is profitable in the future, he can enjoy the benefit of the assessed loss reducing his taxable income. If it is not profitable, then SARS does not lose by allowing the loss to be off set against other taxable income.

So, for a taxpayer in the highest marginal tax bracket, an assessed loss from a suspect trade is immediately ring-fenced, while an assessed loss from any other trade is ring-fenced from the third year of losses in a rolling five-year period.

The taxpayer may however not have to wait until the trade becomes profitable to utilise the assessed loss. If the taxpayer is able to prove that there is a reasonable prospect of that trade making a profit in the future, the assessed loss will not be ring-fenced and that loss can be utilised immediately. This is often referred to as the "facts and circumstances" test, and depends on considerations such as the number of people employed by the taxpayer in that trade, its location, and the past history of profits and losses.

So, the taxpayer can avoid ring-fencing by passing the "facts and circumstances" test. However, if the trade in question is a suspect trade, he can only rely on this test five times. From the sixth year within a rolling ten-year period that the trade makes a loss, that loss is ring-fenced and the taxpayer has no alternative but to wait for the trade to be profitable in the future.

The only suspect trade not subject to the 6-out-of-10 year rule is part-time farming. If the trade is not a suspect trade, the taxpayer can rely on the facts and circumstances test indefinitely, although the longer the trade continues to generate losses, the harder it probably becomes to prove that there is a reasonable prospect of the trade making a profit in the future.

So, let's look at an example. Our taxpayer has two trades – a job from which he earns a salary, and a struggling laundry business. The history of his taxable income is as follows: Each year he earns a salary of R1 million, except in 2016, when he took a period of unpaid leave, and only earned a salary of R500 000.

The laundry business has been making losses since 2013. However, although his R1 million salary is enough to put him in the highest marginal tax bracket, his losses in 2013 and 2014 will not be ring-fenced, because a laundry is not a suspect trade. For regular trades, losses are not ring-fenced until the third year of losses in a rolling five year period. His losses are therefore allowed to reduce his total taxable income in these two years.

In 2015, he is still in the highest marginal tax bracket. As this is the third time the trade has resulted in a loss within a rolling five-year period, the loss is ring-fenced, unless he is able to prove that there is a reasonable prospect of the laundry being profitable within a reasonable period, the loss will be ring-fenced. Assume that he is unable to prove this, so the loss is ring-fenced and carried forward.

In 2016, his lower salary means he is no longer in the maximum marginal tax bracket. The assessed loss arising from the laundry in 2016 can be set off against his other taxable income. However, the loss from the prior year remains ring-fenced.

In 2017, the laundry finally generates taxable income. The ring-fenced losses from laundry trade can now be set off against the taxable income from the same trade. If there is any loss left, that loss continues to be carried forward.

Lastly, it is important to know that if an individual is sequestrated (i.e. declared bankrupt), then the balance of their assessed loss falls away and cannot be utilised in the future.

Now, let's consider when a company (or any taxpayer other than a natural person) can utilise an assessed loss.

Whatever activities a company is involved in, it is usually safe to say that it is doing its best to make a profit. For this reason, there are not really any restrictions about offsetting the assessed loss from one trade against the taxable income of another trade if they exist within the same company. In fact, the only restriction is that an assessed loss from a foreign trade cannot be offset against the taxable income of a profitable local trade within the same company.

So when we consider companies, we focus on whether an assessed loss for the company as a whole can be offset against its taxable income in a subsequent year. Can it maintain that assessed loss, or does it fall away? The answer is that its assessed loss remains available through every subsequent year in which it continues to trade. If it does not trade in a year of assessment, then the assessed loss falls away in that year.

So, a company with an assessed loss last year can carry forward that loss to next year as long as it continues trade this year. If the company does not trade this year, then the assessed loss falls away, and it cannot be utilised next year.

The company does not have to trade for the *whole* of the year of assessment, but it must trade *during* the year of assessment. So what is enough to satisfy this requirement?

This question usually arises when a company performs poorly and incurs losses, and the decision is taken to liquidate a company. A period of time passes, and then the decision is reversed. Can the company still utilise the losses it incurred in previous years?

The courts have held that to satisfy the trade requirement, the company must have done more than merely 'stayed alive'. Maintaining a bank account and paying bank charges, or being audited during the year, does not mean that the company traded during that year. It must have undertaken business activities with a profit motive at some point during the year.

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If it hasn't, then the assessed loss falls away in that year and is no longer available if and when the company starts to make profits.

An assessed loss has value, so a company that believes it will be able to turn its business around will often make sure that it continues trading so that any assessed loss does not fall away, and will be able to reduce its income tax payable at some point in the future.

However, there are other ways that taxable income could arise in that company, other than through turning its existing business around. The company could start a new business, or purchase a new and profitable business. Someone could purchase the shares in that company and transfer a business they own into the company and set off the taxable income earned by that business against the assessed loss already in the company.

This sounds a bit like tax avoidance, and there are a number of provisions in the Income Tax Act to prohibit impermissible tax avoidance. The thinking behind these provisions is that we want people making business decisions for business reasons, not for tax reasons.

So, there are provisions in section 103 of the Income Tax Act that restrict the utilisation of assessed losses in companies. Where an agreement or change in shareholding results in income being received by a company solely or mainly for the purpose of utilising any assessed loss within that company, the set-off of the assessed loss against that income will be disallowed, and the assessed loss will fall away.

This means that if someone buys a company and transfers another business into that company primarily to use up the assessed loss, they will be prohibited from doing so. However, if they purchase a company and transfer another business into that company primarily for another reason, for example because the company has an established brand that customers know and trust, then they will be allowed to offset the assessed loss against income from that business, because the sole or main purpose of transferring it was not to utilise the assessed loss, but to use the established brand of the existing company.

So I hope this has helped you understand why an assessed loss has value and when an assessed loss can be set off against a taxpayer's taxable income. Thanks for watching.