

An analysis of ring-fencing of tax losses from the perspective of farmers

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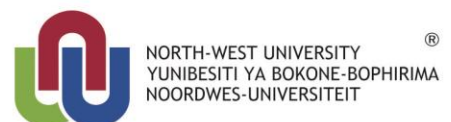
Mini-dissertation submitted in partial fulfilment of the requirements for the degree *Magister Commercii* in **South African and International Taxation** at the Potchefstroom Campus of the North-West University

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APPROACH OF THE STUDY

According to the North-West University (General Academic Rule A4.1) a dissertation could be submitted in the 'traditional book format' or in the more contemporary 'article format'. As the author of the study is of the opinion that the study has practical value for tax practitioners and other researchers, the last-mentioned format was chosen.

Chapter 1 of the study is the introduction, Chapter 2 the article and Chapter 3 provides a summary and conclusion to the study. In order to present the article in a logical manner, it was necessary to repeat certain information that is also presented in Chapters 1 and 3.

This is a mini-dissertation submitted in partial fulfilment of the requirements for this Master's Degree which means that the scope is limited. There is therefore only one main focus, which justifies a single article.

NOTE: The dissertation part of the study (chapters 1 and 3) was referenced in line with the requirements of the North-West University (Harvard style).

The article was referenced in line with the house style as required by the *Journal of economic and financial sciences*.

DECLARATION

I hereby declare that the mini-dissertation titled *AN ANALYSIS OF RING-FENCING OF TAX LOSSES FROM THE PERSPECTIVE OF FARMERS*, which I herewith submit to the North-West University in partial fulfilment of the requirements for the M.Com South African and International Taxation degree, is my own work, has been text-edited, and has not been submitted to any other university. I understand and accept that the copies that are submitted for examination become the property of the University.

Ms Marie Ferreira (Student number: 26748452)

26 April 2017, Potchefstroom

ABSTRACT

Tax losses claimed from hobby-like or artificially labelled trades have become more problematic during 2002 after the court ruling in the Smith case. The legislator found that the tests laid down by the courts in the application of section 11(a), the carrying on of a trade principle, read together with section 23(g) (expenses which can only be claimed to the extent that they were for trade purposes), were not sufficient to address this problem. Section 20A was introduced to ring-fence these losses through a more stringent test. To escape ring-fencing, a taxpayer must prove that the losses have passed this more stringent 'facts and circumstances test'.

In this study, the application of the 'facts and circumstances test' to escape ring-fencing in the case of tax losses from part-time farmers was analysed by considering academic writing, court cases, and other material relevant to the topic. The objective was to analyse the escape clause from ring-fencing to determine whether the legislation set out to achieve the outcome as explained in the *Explanatory Memorandum*. It was found that the wording, if applied to part-time farming losses, could still be problematic. If a taxpayer formulates a convincing argument, a hobby-like farming loss can possibly escape ring-fencing and a legitimate bona fide part-time farming loss can possibly be ring-fenced. The summary indicates that the wording used in the application to ring-fence part-time farming losses seems to go beyond the intention of the legislature and creates uncertainty in the tax treatment of part-time farming losses.

Keywords: Farming; taxation; ring-fencing; losses; section 20A.

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LIST OF ABBREVIATIONS

CIR	Commissioner for Inland Revenue
Commissioner	The Commissioner for South African Revenue Service
<i>Explanatory Memorandum</i>	Explanatory Memorandum on the Revenue Laws Amendment Bill, 2003 issued by National Treasury Republic of South Africa
First Schedule	First Schedule to the Income Tax Act, No. 58 of 1962
IAS	International Accounting Standards
IFRS	International Financial Reporting Standards
ITC	Income Tax Court
<i>SARS Guide</i>	South African Revenue Service Guide on the Ring-fencing of Assessed Losses Arising from Certain Trades Conducted by Individuals, as issued 8 October 2010
The Act	Income Tax Act, No. 58 of 1962, as amended

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CHAPTER 1: INTRODUCTION

1.1 INTRODUCTION, BACKGROUND, AND LITERATURE REVIEW

1.1.1 Introduction and background

Agriculture in South Africa plays a vital role in building a strong economy. The mission and vision statements of the Department of Agriculture, Forestry and Fisheries (DAFF) emphasise the importance of food security for all. This can be achieved by, amongst others, promotion of efficient production of food, effective regulatory services, increased contribution of the sector to economic growth and development, and effective and efficient governance (DAFF, 2016).

It has been shown in various studies that the appropriate policy and support framework can stimulate agricultural growth. Agricultural growth can provide the necessary stimulus for widespread job creation and increased household income. The role of agriculture in food security and poverty reduction depends to a large extent on the policy and institutional framework of all sectors of our economy (Bresciani & Valdés, 2007:211).

The Minister of Finance, Mr Pravin Gordhan, in the Budget Review of 2016, stated that South Africa was in the midst of its worst drought in at least two decades, which was threatening agricultural output and causing an escalation in food prices. Five provinces were declared disaster areas in 2015. The importance of agriculture to the government was illustrated in the budget where R1 billion was set aside for drought relief in 2015/2016 and R2.8 billion was allocated for a food security initiative. The aim of this initiative was to benefit 145 000 subsistence and smallholder producers each year and to bring 120 000 hectares of land into productive use. The budget also made provision for feed and support for livestock farming (Leuvennink, 2016).

To promote farming operations in South Africa, various tax benefits have been introduced over the years in the Income Tax Act, Number 58 of 1962 (hereafter referred to as 'the Act'). The taxable income of farmers is determined in accordance with section 26(1) and in the manner set out in the First Schedule of the Act. One tax benefit under paragraph 2 is that farmers must account for livestock at the end of the year at standard

value. This value is a nominal value, which is a relatively low value compared to the market value (Croome, 2013:444). For example, the standard value of a bull is R50 (Government Notice, 1976) whereas a stud bull could easily fetch tens of thousands if not hundreds of thousands of rands in 2016. The same goes for game farming, where for tax purposes a value of R Nil may be allocated (SARS, 2013:11) whilst a farmer could buy scarce game species like buffalo for hundreds of thousands or even millions of rand in 2016. Another one of the most valuable tax benefits available only to farmers is the right to claim an outright tax deduction in terms of paragraph 12 of the First Schedule for capital expenditure, such as, amongst others, expenditure incurred by building dipping tanks and dams, and erecting irrigation systems and fences (Williams, 2009a:3). Section 11(a) prohibits the deduction of expenditure of a capital nature from taxable income. In *CIR v D & N Promotions (Pty) Ltd* (1993), it was stated by Levinsohn J that it might seem as if the intention of the tax legislature was to place farmers in a privileged position regarding their entitlement to deduct capital expenditure from farming income. This could underline the importance of successful farmers for the country.

The tax benefits that are applicable to farmers may potentially result in an accounting or business profit converted to a useful tax loss (Kotzé, 2010). Farming operations may be used as a tax-saving measure if assessed losses from farming operations are claimed against other taxable income (Arendse, 2005:12). Therefore a tax loophole was identified and an anti-avoidance tax measure was introduced through section 20A to prevent the offsetting of certain tax losses against taxable income.

Section 11(a), read together with section 23(g) of the Act, generally deals with the 'trade' principle and allows deductions, although they may result in a taxable loss. These sections were used to address tax avoidance by way of trade losses through determining whether a taxpayer was in fact carrying on a trade.

Determining whether a trade is being carried on can become problematic in some instances (SARS, 2010:4). The application of a subjective test with reference to the facts and circumstances and the intention of the taxpayer place SARS in a difficult position, since it is an onerous task to determine whether or not a loss should be allowed. In the *SARS Guide*, SARS explains the difficult position it finds itself in after the judgement handed down in the Smith case (*CSARS v Smith*, 2002). This seemed to be the last straw in terms of the abuse of the beneficial tax treatment of farmers. In this case, a medical doctor claimed part-time farming losses against his income from his

medical practice. Section 11 permits a deduction of expenses only if the taxpayer is engaged in the carrying on of a trade and section 23(g) prohibits the deduction to the extent where such moneys were not laid out or expended for the purposes of a trade. To determine whether a taxpayer is carrying on a trade the principal features of the specific trade will have to be examined (Van Zyl, 2015:137). Over the years various court cases laid down principal features which may indicate the carrying on of a trade. These rules are generally referred to a 'facts and circumstances test'. The 'facts and circumstances' test in terms of section 11(a), read with section 23(g), was applied in the Smith case (CSARS v Smith, 2002) and the judge relied on a 'subjective' test and ruled in favour of the taxpayer.

A considerable loss of revenue was experienced by the revenue service as a result of the set-off of losses from unprofitable activities or hobby-like activities against taxable income (SARS, 2010:3).

In 2003, the National Treasury explained the situation in its *Explanatory Memorandum* (2003:24-25):

More often than not, private consumption can be masqueraded as a trade (i.e. a hobby) so that individuals can set off these expenditures and losses against other income (usually salary or professional income). This attempt to deduct hobby-like expenses undermines the 'ability to pay' principle of the Income Tax system because wealthier individuals have more means to disguise hobby expenses as a trade. Hence, a more stringent 'facts and circumstances' test will be introduced as a means to uncover these artificially labelled trades.

Section 20A, Ring-fencing of assessed losses of certain trades, was introduced in the Act with effect from 1 March 2004 as an anti-tax avoidance measure. The limitation of the expenditure incurred in conducting a trade to the income of that specific trade is referred to as 'ring-fencing' (SARS, 2010:4).

Tax legislation has a direct impact on people and their reactions. The design of tax policy may be significantly influenced by certain principles of taxation (Smith, A explained by Soares, 2007:639). One of these principles is the certainty principle. Uncertainty about the tax treatment of a certain transaction or trade loss may erode this principle. This may also have a profound impact on the economy of a country (Bronkhorst, 2015:1189). Uncertainty may discourage legitimate start-up activity as secondary investment activities (Temkin, 2004). A further basic concept of designing tax legislation is the simplicity principle, which determines that tax assessment and

determination should be easy to understand and eliminate confusing tax loopholes. (ITEP, 2012)

Figure 1-1 below is a flowchart which illustrates the working of section 20A. It briefly illustrates that a higher income individual (note 1) with an assessed loss from a suspect trade (note 2), may be ring-fenced (section 20A is applicable) (note 5). Ring-fencing can be 'escaped' (section 20A is not applicable) if the taxpayer is not a higher-income individual (note 1) or the trade is not suspect or there are no losses for three out of a five-year period (note 2) or there is a reasonable prospect to generate taxable income within a reasonable period (note 3).

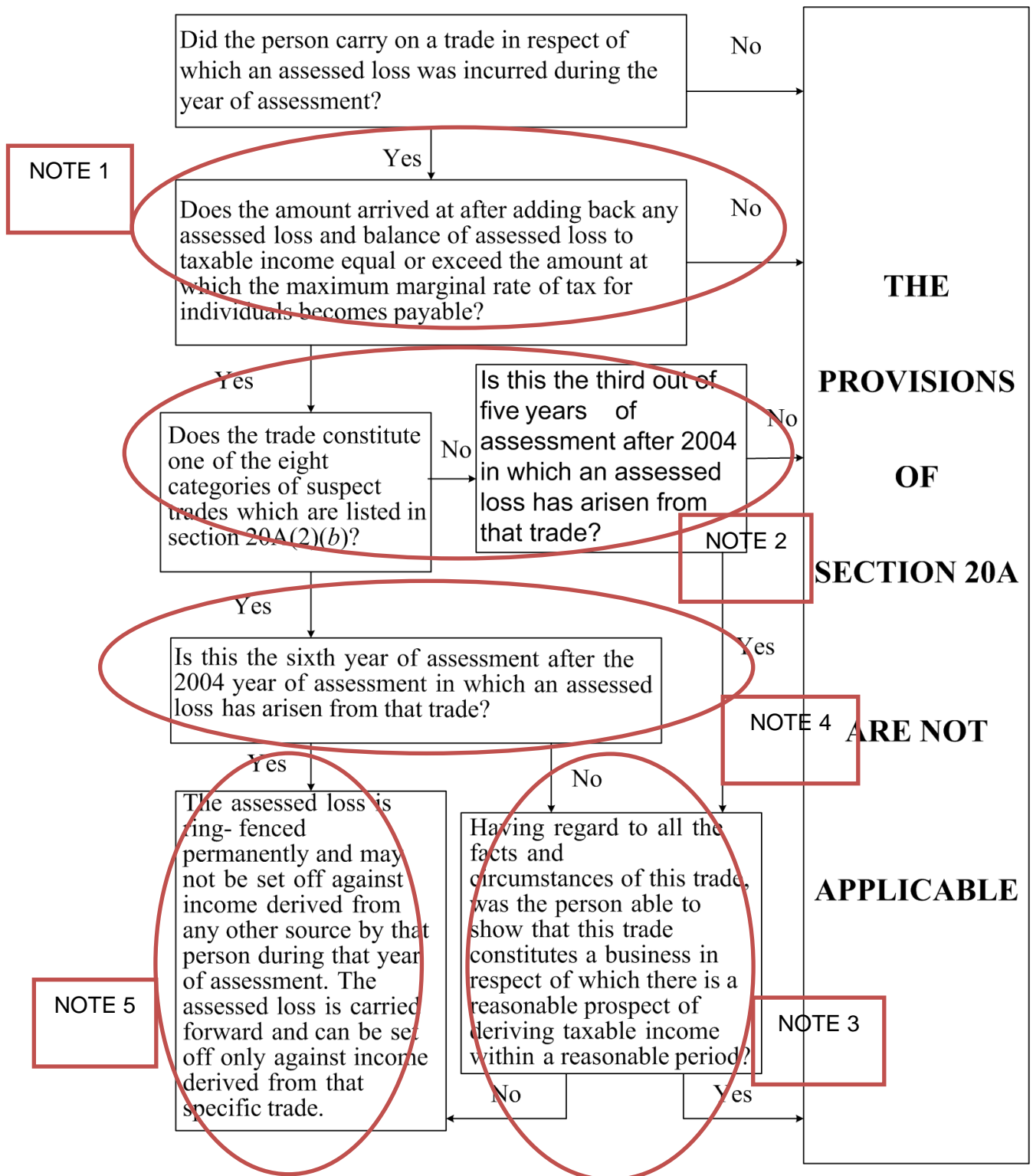


FIGURE 1-1: Flowchart illustrating the working of section 20A

Source: Guide on ring-fencing of assessed losses arising from certain trades conducted by individuals (SARS, 2010:30)

- Note 1 – Refer below to par (a) and where reference is made to higher-income individuals.
 - Note 2 – Refer below to par (b) and where reference is made to suspect trades.
 - Note 3 – Refer below to par (c) and where reference is made to the ‘escape clause’ and ‘facts and circumstances’ test.
 - Note 4 – Refer below to par (c) and where reference is made to the ‘catch all’ provision.
 - Note 5 – Section 20A is applicable and indicates that the loss will be ring-fenced.
- (a) Section 20A is aimed at a wide variety of trades which include farming operations. With reference to Figure 1, in note 1, this section applies only to individuals carrying on more than one trade whose taxable income is above the maximum marginal tax rate threshold, which is R701 301 for the 2016 year of assessment. These individuals are further referred to as higher-income individuals.
- (b) Note 2 of Figure 1 indicates that it applies to all trades which incurred a tax loss in three of the last five years (preceding the current year of assessment), section 20A(2)(a) or trades specifically listed as a ‘suspect’ trade in section 20A(2)(b). If a taxpayer is a higher-income individual (note 1 of Figure 1) who carries on a trade with losses as per subsection 20A (2) (note 2 of Figure 1), he/she may potentially be prohibited to set off these losses against other taxable income (for example a part-time farming loss may potentially be ring-fenced and setting it off against the income from a professional practice will not be allowed).

The reason provided in the *Explanatory Memorandum* for the three-out-of-five-year rule is that

... sustained losses of this kind are frequently an indicator of a suspect trade because natural persons would rarely continue with a trade generating losses on a long-term scale as it does not make sense from an economic perspective unless tax motives are present (National Treasury, 2003:26).

- (c) Note 3 of the Figure 1 indicates that an assessed loss which may potentially be ring-fenced in terms of section 20A (1) and (2) can escape ring-fencing under section 20A(3) if certain requirements have been met. This section, also referred

to as an 'escape clause', is applicable to all trades and sets out a stringent 'facts and circumstances' test to prohibit higher income individuals from setting off losses from 'suspect' trades against other income. Section 20A(4) determines, with reference to Figure 1, note 4, that losses from 'suspect' trades will be ring-fenced irrespective of the outcome of the 'facts and circumstances' test if a person incurred assessed losses in at least six of the last ten years of assessment, also referred to as the 'catch-all' provision. Farming losses are specifically excluded from this 'catch-all' provision.

Section 20A(3) offers an escape from ring-fencing (see note 3 of Figure 1) if 'that trade constitutes a **business** in respect of which there is a **reasonable prospect** of deriving taxable income within a **reasonable period** having special regard to ...'. The section lists six factors which should also be considered. Paragraphs (c) and (e) of section 20A (3), which are two of the six factors, state that the following factors should be taken into account: (c) 'whether that trade is carried on in a **commercial manner**'; and (e) '**the business plan** of that person and any changes thereto to ensure that taxable income is derived in **future** from carrying on that trade'. The wording used in this piece of legislation may compromise the certainty and simplicity principle of tax policy design.

Some of the comments on this new legislation came from Bob Williams, a tax expert at the University of KwaZulu-Natal, who stated that losses from genuine trades which operated for a number of years would also be ring-fenced. He specifically raised this concern with reference to farmers who may make losses for years (Temkin, 2004:2).

Agricultural activities in South Africa include intensive crop production (field crops and horticulture). The largest area of arable farmland is planted with maize, followed by wheat, sugar cane, sunflowers, fruit, citrus, wine, vegetables and other miscellaneous products, cattle ranching, sheep farming and mixed farming. Livestock is the largest agricultural sector in South Africa and includes, amongst others, cattle ranches, sheep farming and game farming. The type of farming depends on the climate, natural vegetation, soil type and farming practices (SouthAfrica.info, 2008). Farming activities may be unique in comparison to other trades as they may take longer to generate profits; for example citrus, nuts and olive farming have a longer start-up period (SARS, 2010:22).

1.1.2 Literature review

1.1.2.1 Non-empirical study

A non-empirical study was conducted reviewing available literature. The available literature reviewed and analysed includes tax legislation, textbooks relating to taxation, income tax guides, tax commentaries, case law, legal opinions, journals and academic and commercial articles. These were reviewed to identify possible shortcomings as listed in the problem statement below.

The first shortcoming was investigated through a literature review of the Act, textbooks, individual articles and journals containing articles to seek clarity on the difference between accounting profit and taxable income of farmers and the effect of the term 'taxable income' used in the context of a business, business plan and a reasonable prospect to derive taxable income as opposed to profit. The *outcome* of this investigation was applied to a hypothetical scenario in Chapter 2 paragraph 5.

To escape ring-fencing, section 20A(3) requires that a taxpayer should prove that the trade constitutes a business in respect of which there is a reasonable prospect to derive taxable income in a reasonable period. Although six so-called objective factors are listed in the section, the meaning of phrases like 'reasonable prospect to generate taxable income', 'reasonable period to generate taxable income', 'business', 'commercial manner', and 'business plan' is not clear and was investigated. No research could be found to clarify the meaning of these phrases and therefore they remain vague. The outcome of this investigation was applied to a hypothetical scenario in Chapter 2 paragraph 5.

This research also makes reference to certain relevant foreign tax cases where deemed necessary and applicable.

1.1.2.2 Limitation of the scope of the review

This study is limited to the ring-fencing of tax losses of higher-income individuals in South Africa and is further limited to part-time farming losses only.

1.1.2.3 Assumptions

For the purposes of this study, it was assumed that the part-time farmer is, as referred to in section 20A (2) (b) (vi), 'farming or animal breeding, unless that person carries on farming, animal breeding or activities of a similar nature on a full-time basis'. It is also assumed that the part-time farmer has already passed the 'farmer, pastoral, agricultural or farming operations' test as per section 26(1) and has also passed the 'carrying on a trade' test as per section 11(a), read together with section 23(g), as is also stated in the *SARS Guide* (2010:6).

It is assumed that SARS is correct in its interpretation (SARS, 2010:15) that a taxpayer carries on farming or animal breeding on a full-time basis if these activities take up most or all of the taxpayer's normal working hours. The reference to 'part-time' farmer for the purpose of this study is to a taxpayer who conducts farming activities which do not take up most or all of the taxpayer's normal working hours.

For the purposes of this study, it was assumed that a higher-income farmer refers to a natural person where the sum of the taxable income of that person, without the assessed loss as per section 20A, equals or exceeds the amount at which the maximum marginal rate (41% for 2016 year of assessment) of tax chargeable in respect of the taxable income is applicable.

1.2 RESEARCH METHOD AND DESIGN

1.2.1 Ontology and epistemology

Ontological assumptions are concerned with how knowledge is viewed (Bryman, 2016:4). The ontological assumptions for this study were that a farmer can either be ring-fenced or not. The research is based on a historical approach combined with a comprehensive qualitative literature review aimed at answering the research question.

Epistemological issues refer to what is considered to be knowledge (Bryman, 2016:4). Theoretical research was considered as a source of evidence to assist in forming conclusive views on the research question.

1.2.2 Research paradigm

The aim of this research has been to determine whether the use of the wording and application of section 20A(3) as an anti-tax-avoidance measure to ring-fence part-time farming losses provide a suitable objective solution to prevent the claiming of hobby-like farming losses against other taxable income.

The paradigm that forms the basis of this research is the interpretivist paradigm as it is unlikely to find a solution to the research question but is a way to gain insight into the research problem. The outcome of this study is to raise concerns about uncertainty created by the use of the wording in section 20A(3) that could result in further research or initiate change in legislation as the certainty principle in tax policy design may be compromised. A qualitative approach was used to gain clarity on the research problem.

1.2.3 Research methodology

Mouton (2012:175) describes conceptual analysis as the analysis of the meaning of words to bring conceptual clarity. A non-empirical study was conducted to critically analyse the wording and phrases of section 20A (3).

A qualitative approach was followed to analyse the difference between 'taxable income' and 'profit' of a farming operation. Both numerical and textual data and hypothetical case scenarios were used to compare and analyse the meaning of words and phrases used in the application of the 'facts and circumstances' test. Qualitative research was also conducted to critically analyse the facts and circumstances that could prevent the ring-fencing of farming losses. The approach is also referred to as 'black letter' law as it concentrates on the systematic exposition of the principles, rules and concepts governing a particular legal field and analyses the relationship between these principles, rules and concepts with a view to solving uncertainties and eradicating loopholes in the existing law (Smits, 2015:5). The data used were obtained through a literature review of primary and secondary data.

1.3 PROBLEM STATEMENT

The problem that can be deduced from the above is that the ring-fencing of losses dealt with in section 20A (3) may create uncertainty and may have an unintended outcome if

applied to part-time farming losses. Two main problems in the ring-fencing of part-time farming losses are identified:

1.3.1 Taxable income versus profit from farming activities

The use of the term 'taxable income' in relation to 'business' and 'business plan' may not be suitable to determine the financial or economic viability of bona fide farming activities. A comparison and analysis of the difference between 'taxable income' and 'profit' from farming operations will be done to investigate the possibility of an unintended outcome when ring-fencing a part-time farmer's tax loss. Farming tax losses of a legitimate bona-fide part-time farmer may be ring-fenced in terms of section 20A.

1.3.2 Reasonability test

Words such as 'business', 'reasonable prospect', and 'reasonable period' provide no clarity on the burden of proof placed on bona fide part-time farmers. It is not clear when and how this reasonability test will be satisfied to avoid the ring-fencing of tax losses from part-time farmers, or when and where the end of the escape from ring-fencing for farmers is. The possible uncertainty that may be created in the application of section 20A (3) was analysed.

1.4 RESEARCH QUESTION

The research question that arises is whether the current wording and application of section 20A(3) as an anti-tax-avoidance measure to ring-fence part-time farming losses provides a suitable objective solution to the original intent of the legislature to close the tax loophole experienced with the application of section 11(a) read together with section 23(g).

1.5 OBJECTIVES

The primary objective of this study was to analyse the wording used in the tax legislation to ring-fence part-time farming losses. The research explored whether SARS and taxpayers were still in a difficult position to apply the 'facts and circumstances test' to the ring-fencing of part-time farming losses due to the uncertainty in the wording used in section 20A(3). This main objective was addressed by the following secondary objectives:

1. Consider the difference between the taxable income of a farmer and the profit from farming operations. Before the introduction of section 20A in 2004, the profitability of a trade or 'profit-making scheme' under section 11(a) was the issue in many court cases. Section 20A (3) shifted the goal posts to 'taxable income'. The aim of this study was to show that there may be a substantial difference between taxable income and profit from farming operations and that the wording used in section 20A (3) in regard to 'taxable income' is not suitable when applied to farming losses.
2. Analyse the meaning of the words used in section 20A(3) and not defined in the Act, such as 'business', 'business plan', and 'commercial manner', in relation to generate taxable income within a 'reasonable period' and 'reasonable prospect'. It is shown that higher income individuals with part-time farming activities experience a potential problem to determine when and under what circumstances their part-time farming losses may be ring-fenced. The study aimed to investigate the wording used and raised concerns about the simplicity principles of tax policy design and the uncertainty created by the wording.

1.6 SIGNIFICANCE OF THE STUDY

Farmers receive beneficial tax treatment to promote farming operations and stimulate economic growth. It is important to obtain clarity on the application of the ring-fencing of part-time losses as it may discourage start-up farmers or frustrate legitimate bona fide farmers, which may have a profound impact on the economy of the country. On the other hand, it will still be an onerous task for SARS to determine whether or not a loss should be ring-fenced and there may still be a considerable loss of revenue to SARS because the hobby-like or artificially labelled tax losses cannot be ring-fenced. The need for clarity is also important due to the fact that ring-fencing may prejudice the taxpayer as a heavy burden of proof is placed on the taxpayer who already pays tax at the maximum rate of 41%. The ring-fencing of a tax loss may result in a decrease in cash flow receivable in the form of a tax refund, equal to 41% of the tax loss that is ring-fenced.

1.7 CHAPTER OUTLINE

To address the research question as to whether the use of the wording and application of section 20A (3) is an anti-tax-avoidance measure to ring-fence part-time farming losses provides a suitable, objective solution to the problem experienced with the application of section 11(a), read with 23(g), it was decided to express this study in an article format through the aid of case scenarios as set out in Chapter 2. Concluding remarks are summarised in Chapter 3.

CHAPTER 2: RESEARCH ARTICLE

AN ANALYSIS OF THE RING-FENCING OF TAX LOSSES FROM THE PERSPECTIVE OF FARMERS

ABSTRACT

Agriculture plays a vital role in building a strong economy, creating jobs and providing food security. Therefore many beneficial tax concessions are available to farmers. Tax losses claimed from hobby-like or artificially labelled trades, however, became a problem to the fiscus and section 20A of the Income Tax Act ('the Act') was introduced in 2004 to close the tax loophole and ring-fence tax losses emanating from such trades. A taxpayer may escape the ring-fencing of tax losses if a 'facts and circumstances' test is passed. This article aims to analyse the wording used in section 20A (3) to escape ring-fencing if applied to part-time farming losses. It was found that the wording used may create uncertainty and may not be suitable if applied to all farming losses. A concern will be raised that this ring-fencing provision seems to go beyond the intention of the legislature to ring-fence hobby-like trades and that legitimate farming losses might also be ring-fenced which may discourage part-time farming.

Keywords: Farming; taxation; ring-fencing; losses; section 20A.

1 INTRODUCTION

The set-off of losses from unprofitable activities or hobby-like activities against taxable income results in a considerable loss of revenue to SARS (SARS, 2010:3). In 2003, National Treasury explained the situation in its *Explanatory Memorandum*:

'More often than not, private consumption can be masqueraded as a trade (i.e. a hobby) so that individuals can set off these expenditures and losses against other income (usually salary or professional income). This attempt to deduct hobby-like expenses undermines the 'ability to pay' principle of the Income Tax system because wealthier individuals have more means to disguise hobby expenses as a trade. Hence, a more stringent 'facts and circumstances' test will be introduced as a means to uncover these artificially labelled trades' (National Treasury, 2003:25).

The issue of deciding whether ring-fencing in terms of profit set off against other income is fraught with difficulty and will be examined in this article. Various authors have

commented on this in an effort to arrive at an equitable and fair definition of the practice of ring-fencing.

On the application of the facts and circumstances tests, Wilcocks (in SILKE, 2015:216) stated that 'The use by the legislature of expressions such as 'business' and 'reasonable prospect' is singularly unhelpful,' while Stein (2003) believes that the principle of ring-fencing losses is wrong as it is a violation of the principle of the ability to pay. In his view there is no need for the change of legislation as there is already a rule that prevents taxpayers from deducting for tax purposes expenses or losses incurred in an activity that does not constitute a trade. Another criticism is that the problem experienced with the claiming of losses from artificial and hobby-like trades could have been addressed by a change in the definition of 'trade'. It seems unfair that compliant taxpayers with genuine trades are put at risk of being ring-fenced and they and their tax practitioners have to deal with the uncertainty around the application of section 20A (Ger., 2004). The issue of potential profitability has many angles, including the one stated by Joubert (2013:562) on the 'reasonable prospect' that companies may be profitable in future and thus business rescue should be allowed.

This article therefore seeks to assess the fairness of the practice of ring-fencing losses suffered by especially part-time farmers.

2 APPROACH AND METHOD

A non-empirical study with both numerical and textual data, combined with hypothetical case scenarios, was used to compare and analyse the meaning of words and phrases used in the application of the 'facts and circumstances' test. This was done through a critical analysis of the wording used to ring-fence part-time farming losses. The interpretivist paradigm forms the basis of this research. A qualitative approach was followed to analyse the difference between 'taxable income' and 'profit' of a farming operation. Qualitative research was also done to critically analyse the facts and circumstances that could prevent the ring-fencing of farming losses. The approach is also referred to as 'black letter' law as it concentrates on the systematic exposition of the principles, rules and concepts governing a particular legal field and analyses the relationship between these principles, rules and concepts with a view to solving uncertainties and gaps in the existing law (Smits, 2015:5). The aim of this article is to highlight concerns that could result in further research or initiate change in legislation as

the certainty and simplicity principle in tax policy design may be compromised. A literature review approach was followed, supported by hypothetical case scenarios. The literature reviewed and analysed includes tax legislation, textbooks, income tax guides, tax commentaries, case law, journals, and academic and commercial articles. Conclusions are based on quantitative data used.

This study is limited to the ring-fencing of tax losses of higher-income individuals in South Africa and is further limited to part-time farming losses only and for the purposes of this study, it is assumed that the part-time farmer is, as referred to in section 20A (2)(b)(vi), 'farming or animal breeding, unless that person carries on farming, animal breeding or activities of a similar nature on a full-time basis'. It is also assumed that the part-time farmer has already passed the 'farmer, pastoral, agricultural or farming operations' test as per section 26(1) and has also passed the 'carrying on a trade' test as per section 11(a), read together with section 23(g), as is also stated in the *SARS Guide* (2010:6).

3 DEFINITIONS

It is assumed that SARS is correct in its interpretation (SARS, 2010:15) that a taxpayer carries on farming or animal breeding on a full-time basis if these activities take up most or all of the taxpayer's normal working hours. For the purpose of this study, it is assumed that a higher-income farmer refers to a natural person where the sum of the taxable income of that person, without the assessed loss as per section 20A, equals or exceeds the amount at which the maximum marginal rate of tax chargeable in respect of the taxable income is applicable. Section 20A, ring-fencing of assessed losses of certain trades, was introduced in the Act, with effect from 1 March 2004, and Figure 1 below is a flowchart which illustrates the working of section 20A indicating that a higher-income individual with an assessed loss from a suspect trade, may be ring-fenced (section 20A is applicable). Ring-fencing can be 'escaped' (section 20A is not applicable) if the taxpayer is not a higher-income individual or the trade is not suspect or there are no losses for three years out of a five-year period or there is a reasonable prospect to generate taxable income within a reasonable period of time.

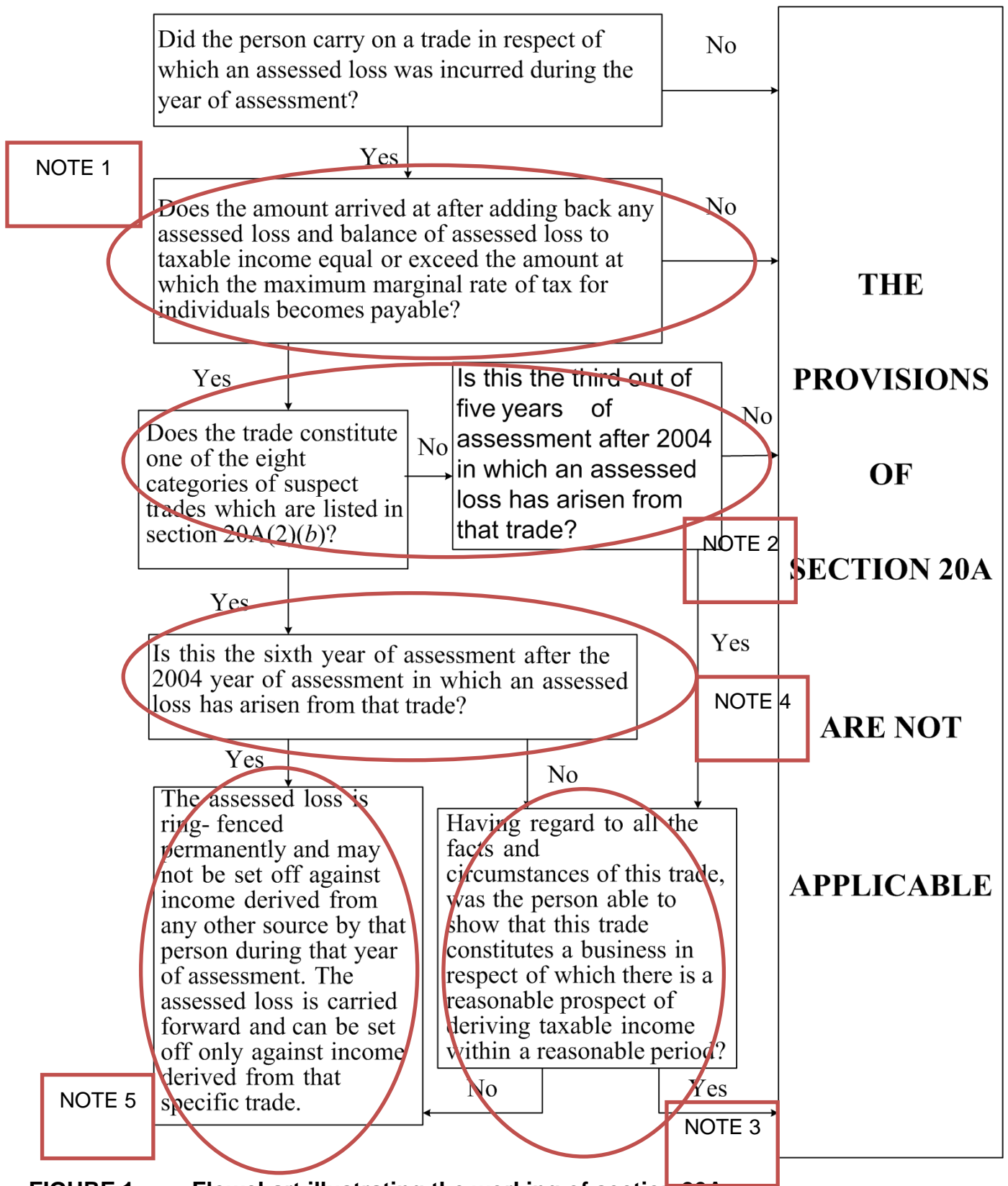


FIGURE 1: Flowchart illustrating the working of section 20A

Source: Guide on ring-fencing of assessed losses arising from certain trades conducted by individuals (SARS, 2010:30)

Note 1 in the figure above shows that section 20A applies only to individuals carrying on more than one trade whose taxable income is above the maximum marginal tax rate threshold, which is R701 301 for the 2016 year of assessment and for the purpose of this study are referred to as higher-income individuals. The aim of section 20A is to prohibit higher-income individuals from claiming hobby-like expenses and losses from artificially labelled trades against other income (for example professional income) thereby effecting a considerable tax benefit (National Treasury, 2003:25). This section of ring-fencing tax losses is not only designed for farmers but is applicable to any secondary trade which can be considered to be a suspect trade. Losses from part-time farming operations is one of the eight listed suspect trades as per note 2 Figure 1. For the purpose of this article, this suspect trade will be referred to as 'part-time farming'.

Section 20A(4) determines, with reference to Figure 1, note 4, that losses from 'suspect' trades will be ring-fenced irrespective of the outcome of the 'facts and circumstances' test if a person incurred assessed losses in at least six of the last ten years of assessment, also referred to as the 'catch-all' provision. Farming losses are specifically excluded from this 'catch-all' provision.

With reference to Figure 1, note 3, a higher-income individual who experiences a tax loss from part-time farming activities may offset the loss against other taxable income if he can prove the section 20A (3) criteria (also referred to as the facts and circumstances test) that the trade constitutes a business in respect of which there is a reasonable prospect of deriving a taxable income within a reasonable period having special regard to various factors.

The following six factors should be considered by the taxpayer for the particular trade, viz. the proportion of gross income in relation to the amount of allowable deductions, the level of activities carried on by the taxpayer or the advertising, promotion, or selling expenses incurred, whether the trade is carried on in a commercial manner, the number of years of assessment during which assessed losses have been incurred, the business plan of the person concerned to ensure that taxable income is derived and the extent to which assets are used or available for use for recreational purposes or personal consumption. For the years ended on or after 1 March 2004, the loss from suspect trades has been ring-fenced in terms of section 20A but section 20A (3) offers an escape from ring-fencing if the taxpayer can provide certain proof to pass the facts and circumstances test. Whatever the proof is to escape ring-fencing, section 20A(4)

determines that there is no escape for suspect trades available after ten years if losses were incurred for six out of the ten-year period, and reference is also made to the 'catch-all' provision. Section 20A(4) thus puts a halt to any arguments as per subsection 20A (3). With the legislation having been introduced in 2004, the 2014 tax year marked the end of the ten-year 'escape clause' provided for in section 20A (4). If a suspect trade had assessed losses in six years out of the ten-year period, then the losses from this trade will be ring-fenced and any losses may only be off-set against future taxable income from this same trade.

The taxpayer bears the onus of proof on a balance or a preponderance of probabilities (CIR v Middelman, 1991) that the criteria as per section 20A (3) are complied with in order to escape ring-fencing. This study will also analyse the burden to prove 'reasonability' criteria as per section 20A (3) to obtain clarity or raise concerns regarding the certainty principle of tax policy design. This analysis is important as uncertainty about the tax implications may discourage part-time farming operations, which may have a negative effect on agricultural development in South Africa and the economic contribution of part-time farmers. The analysis may also reveal the possibility that the legislation achieves more than just ring-fencing hobby-like or artificially labelled trades as bona fide, legitimate farming losses may also be ring-fenced to the detriment of the farmer.

When it comes to trade that constitutes a business, the first criterion to escape ring-fencing is to prove that the trade in reality does constitute a business. This may imply that a tax loss incurred from carrying on a trade which does not constitute a business cannot escape ring-fencing. The use of the wording 'trade that constitutes a business' is unclear as Williams indicated that in practice the courts and the literature use the terms 'trade' and 'business' (and 'trading' and 'carrying on business') as synonyms (Williams, 2009b:245).

The definition of a 'trade' as per section 1 of the Act includes every profession, trade, business, employment, calling, occupation, or venture, including the letting of property and the use or the granting of permission to use certain other assets. It seems as per this definition that the concept of 'trade' is a much wider concept than 'business'. There is no definition of 'business' in the Act. The *Merriam-Webster Dictionary* (2016) defines business as 'the activity of making, buying, or selling goods or providing services in exchange for money' or 'work that is part of a job'. In the case of a farmer, the onus is to

prove that the trade as a farmer constitutes a business. There is also no definition of 'farming operations' in the Act. Case law should therefore be considered. In *Smith v Anderson* (1880) 15ChD247 at 258, it was held that 'anything which occupies the time, attention, and labour of a man for the purpose of profit is business'. Part-time farmers, it is assumed, do not personally spend all their time, attention or labour on their farming operations. It was not held that the taxpayer him or herself should be occupied but just 'a man', which may indicate that an employee may well spend time, attention and labour on the farming operation. *Goodall et al.* (2016 at 25.9.5.1.3) stated that the taxpayer would have to show that the trade is in fact 'a business' (that it is not a hobby or tax-avoidance scheme) and that inherent in the concept of 'a business' is the purpose to make a profit. The concept of making a profit is an important factor to determine the carrying on of a trade or business.

In *CIR v Pick n Pay Employee Share Purchase Trust* (1992), a distinction was drawn between the carrying on of a business and the purpose of a profit-making scheme. From this case it could be argued that a business may generate an income or a loss which is of a capital and not of an income nature. It is only if the business was conducted as part of a profit-making scheme that the income/loss would be of an income nature and thus taxable. It seems possible to have a 'business' that is not 'carrying on a trade'.

There is no need for a number of continued transactions before an activity will be regarded as a business. In *CIR v Stott* (1928) at 262 it was held that even a single transaction may indicate the doing of business of buying and selling. In *CIR v Lydenburg Platinum Ltd.* (1929) at 145-146 it was averred that continuity is a necessary element in the carrying on of a business in the case of an individual. In *CIR v Pick n Pay Employee Share Purchase Trust* (1992) it was accepted that a series of transactions is characteristic of the carrying on of a business. Section 20A (7) determines that all farming activities carried on by a person shall be deemed to constitute a single trade for the purposes of section 20A. In the case of a farmer, there may be a wide variety of transactions. It is important to define the profit motive ((ITC 1529 (1992); (ITC 1185 (1972))). Once satisfied that a trade was carried out, an assessed loss is recognised and may be ring-fenced. As Lester (2006) pointed out, the highest hurdle is to prove that a trade was conducted (section 11(a)) and the expenditure was laid out for the purpose of the trade (section 23(g)). To avoid ring-fencing, one must satisfy SARS that a genuine

business venture exists (Lester, 2006). Thus a profit motive was already accepted by both parties (SARS and the taxpayer) when the possible ring-fencing of assessed losses was to be considered. There is no doubt that there is a profit motive; it should be decided *how certain* this profit will be (reasonable prospect) and *when* this profit will be generated (reasonable period).

The only guidance in the application of the 'business' criteria is stated in the *SARS Guide*, which advises that a general impression of the activities should indicate whether they would normally be regarded as a 'business' in ordinary commercial life (SARS, 2010:19). It was found that the inclusion of the phrase 'trade that constitutes a business' is unclear.

4 TAXABLE INCOME AND PROFIT

A subsequent issue to be considered is the comparison between taxable income and profit of farmers. A comparison between 'taxable income' and 'profit' is performed to determine the influence it will have on the outcome of the 'facts and circumstances test' as per note 3 of the flowchart (see Figure 1). This comparison is made through a review of existing literature and a hypothetical case scenario. The intention with section 20A of the Act as per the *Explanatory Memorandum* is that a legitimate trade should not be ring-fenced and that the losses from hobby-like or artificially labelled trades should be ring-fenced (National Treasury, 2003:25, 28).

To promote farming operations, various tax concessions have been introduced in the Act over the years. The taxable income of farmers is determined by section 26(1) and in the manner set out in the First Schedule. The accounting treatment of the same transactions is also analysed to determine its effect on the calculation of profit.

According to one of the tax concessions under Paragraph 5 of the First Schedule of the Act, farmers must account for livestock at the end of the year at standard value. This value is a nominal value, which is a relatively low value compared to the market value (Croome, 2013:444). The deduction in respect of the purchase price of the livestock together with the nominal opening value is limited to the farming income for that year (Paragraph 8 of the First Schedule). Paragraph 2 of the First Schedule indicates that a farmer must only account for closing stock of produce held and not disposed of. For income tax purposes no value is to be placed on growing crops; for example, wheat that has not been reaped yet (Smit, 2015:656)

Consumable stores are dealt with differently. In terms of section 22 of the Act, farmers are excluded from the trading stock provision, the definition of which includes consumable stores and provisions. As opposed to other trades, a farmer does not have to account for consumable stores; e.g. a farmer may buy fertiliser, seed, fuel, or animal feed one day before the tax year end and does not have to take into account any closing stock for the income tax calculation but may deduct the full amount for tax purposes (Smit, 2015:656). In terms of section 12B of the Act, a farmer can claim a deduction on farming equipment of 50% in year one and 30% and 20% in the next two years.

Capital improvements and developments are another one of the most valuable tax benefits available only to farmers which is the right to claim an outright tax deduction in terms of Paragraph 12 of the First Schedule for capital expenditure, such as, amongst others, buildings used in connection with farming activities, dams, irrigation systems, and fences (Williams, 2009a:3) but a loss cannot be created by the deduction of such expenses and in *CIR v D & N Promotions (Pty) Ltd. (1993)* at 414, regarding farmers' entitlement to deduct capital expenditure from farming income, it was stated by Levinsohn J that it might seem as if the intention of tax legislation is to place farmers in a privileged position.

The tax concessions that are applicable to farmers may potentially result in an accounting or business profit to change to a useful tax loss (Kotzé, 2010). Farming operations may be used as a tax-saving measure if assessed losses may be claimed against taxable income (Arendse, 2005:12). One school of thought may be that the escape clause for farmers can be applied if the taxpayer is able to satisfy SARS that the farming business has a reasonable prospect of making a profit (Arendse, 2005). However, the wording used in section 20A (3) clearly states that there must be a reasonable prospect of making a taxable income. The financial and economic viability of a business is, amongst others, measured by its profit. To escape ring-fencing, a farmer must prove that the farming activities are profitable, or that there is a reasonable prospect that they will become profitable.

The International Accounting Standards (IAS) prescribes the accounting treatment of transactions. The general meaning of accounting profit refers to the profit as determined in terms of IAS 1, Par. 7: 'Profit or loss is the total of income less expenses, excluding the components of other comprehensive income' (IAS, 2014).

When it comes to livestock and growing crops International Accounting Standard 41 *Agriculture* (IAS 41) prescribes the accounting treatment related to agricultural activity and shall be applied to account for biological assets. Paragraph 5 of IAS 41 defines a biological asset as a living animal or plant and is measured at fair value less cost to sell (Paragraph 12 of IAS 41). IFRS 13's (IASB, 2011) *Fair Value Measurement* specifies the meaning of fair value as the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date.

For accounting purposes, according to IAS 2, the consumable stock must be accounted for at the lowest of cost or net realisable value and in terms of depreciation farming equipment will be classified as depreciable assets and in terms of IAS 16 it may be written off for accounting purposes over the useful life of the asset.

When it comes to capital and development expenditure these items would, for accounting purposes, most probably be capitalised as prescribed in IAS 40's Investment Assets. Capital expenditure such as fences, dams, farm buildings and fixed irrigation systems will be treated as assets for accounting purposes, and will have no influence on the calculation of the accounting profit.

5 CASE SCENARIOS

5.1 Case scenario: Legitimate bona fide farmer

This section aims to perform a high-level comparison between the tax treatments of certain transactions from farming operations versus the accounting treatment of similar transactions using a basic hypothetical case scenario. The aim of this comparison is to gain insight into the possible differences between the calculation of the taxable profit from farming operations as presented in Table 1 and the calculation of accounting profit from farming operations as presented in Table 2 to determine the sway on the decision to ring-fence a farmer or not. The timeline of the case scenario covers a period of 16 years and includes examples of typical life events and simulated numerical data along the timeline.

In this case scenario, Mr X, a higher-income individual who is an executive director of multiple companies, has the means to finance the start-up of a part-time farming operation. From the onset, the farmer experiences setbacks which have a particular effect on his operation. The farmer's long-term goal is to build up a flock of sheep of 2 000 to ensure economic viability on a full-time basis. He only sells sheep, estimated at

R400 000 per annum, that are not fit to build up the flock of sheep. As he reached a particular goal, he received notice that the rental agreement for the farm had been cancelled. He consequently has to sell all the livestock. However, he still had the intention to become a bona fide farmer. He bought agricultural land at the end of year six for growing crops. The farmer only sells limited number of game during the next seven years because he wants to build up his game stock. From the growing crops and few game sales the farmer generate a potential gross income of R3 million per annum. He already incurred expenses in year six to buy, amongst others, seed and fertiliser. Estimated running expenses were incurred throughout all the years of farming operations. The farmer drew up a proper business plan to ensure that his farming business was economically viable and to minimise possible tax implications. He incurred tax losses for the first seven years and, according to his business plan, he projected a reasonable prospect to derive a taxable income from year eight. He then decided to purchase game, seeing that it was a potentially prosperous business. He invested substantial amounts in the game business through capital investments. Section 20A (7) determines that in the case of farming operations, all the different activities carried on by a person shall be deemed to constitute a single trade. Thus, although the agricultural operations generated taxable income and the game activity generated tax losses, it would be deemed as one single trade and it was submitted that these activities would be considered as a whole to apply potential ring-fencing of the assessed losses and possible gains.

For income tax purposes, the closing livestock will be valued according to the First Schedule of the Act, Paragraph 5, at a nominal value of, for example, R6 a sheep (Government Notice, 1976). The estimated market value at which he bought and sell sheep throughout the six year period is R1 000 per sheep. He bought livestock in year 1 of R1 000 000 and game in subsequent years. The closing and opening value of livestock for income tax purposes will be at standard value and for accounting purposes it will be at market value. The standard value for game to be accounted for is R Nil for tax purposes (SARS Interpretation Note, 69:4.3.2),

R540 000 of the R1 600 000 capital expenditure incurred in year eight is not deductible as the deduction is limited to the taxable income and therefore the taxable income for year eight is R Nil. The excess capital expenditure of year eight is carried over and deductible in year nine.

	Yr 1	Yr2-3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10	Yr 11-13	Yr 14	Yr 15	Yr 16
	R'000	R'000	R'000	R'000	R'000	R'000	R'000	R'000	R'000	R'000	R'000	R'000	R'000
Gross farming income	0	400	400	400	1 600	1 400	3 000	3 000	3 000	3 000	3 000	3 000	3 000
Closing stock													
Livestock - Standard Value (par 5)	6	7	10	11	6	0	0	0	0	0	0	0	0
retrunzer and Pesticides													
Animal Feed													
Standing Crops													
Total farming income	6	407	410	411	1 606	1 400	3 000	3 000	3 000	3 000	3 000	3 000	3 000
Livestock - Limitation (par 8)													
Opening livestock	-6	-407	-200	-10	-11	-6	0	0	-3 000	-3 000	0	-1 000	-1 000
Purchases	1 000	0							12 000			1 000	1 000
Brought forward	0	994	192	0	0	0	0	0	0	9 000	0	0	0
Carried forward	994	593	0	0	0	0	0	0	9 000	6 000	0	0	0
Expenses	-1 000	-1 000	-1 000	-1 000	-1 200	-1 100	-1 200	-2 000	-1 800	-1 800	-1 800	-1 800	-2 300
Wear and Tear						-400	-740	-460	-200				
Irrigation system, stores, dam and fences					-395		-1 600				-1 500		
Limited to farming income (par 12(3))							540	-540			300	-200	
Taxable profit/-loss	-1 000	-1 000	-790	-599	0	-106	0	0	-2 000	-1 800	0	0	-300
Tax savings at 41% (2016 tax rates)	410	410	324	246	0	43	0	0	820	738	0	0	123

TABLE 1: Case scenario – Calculation of taxable income from farming operations

Source: Author's own example (*Par. – refers to the paragraph of the First Schedule to the Income Tax Act)

Table 2 illustrates the calculation of an accounting profit of Mr X if applying accounting standards to the same case scenario. Apart from the possible sale of game the issue of capital equipment is also crucial. According to IAS 16, the purchase of the farming equipment of R800 000 and R1 000 000 in year seven and eight respectively prescribe that the equipment be depreciated on a systematic basis over their useful life. For the purpose of this case scenario, the equipment is depreciated over a five-year period. To calculate the taxable income from farming operations a deduction of 50% of the R800 000 which is R400 000 is allowable whilst only R160 000 will be deducted for to calculate profit.

The capital and development expenditure will be regarded as investment assets according to IAS 40 and for the purpose of this example, no write-off is done for

accounting purposes. If looked at differently, one can fit the same scenario to a different analysis, viz. the calculation of an accounting profit.

	Yr 1	Yr 2-5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10	Yr 11	Yr 12-14	Yr 15	Yr 16
	R'000	R'000	R'000	R'000	R'000	R'000	R'000	R'000	R'000	R'000	R'000
Sales	0	400	1 600	1 400	3 000	3 000	3 000	3 000	3 000	3 000	3 000
Nett Fertilizer and Pesticides - cost price - IAS2			200								
Net Animal Feed - cost price - IAS2	200	0	-200								
Net standing crops - fair value -IAS 41			0	1 300							
	200	400	1 600	2 700	3 000	3 000	3 000	3 000	3 000	3 000	3 000
<u>Cost of sales - livestock (biological assets)</u>	0	200	-400	-1 400	0	0	0	400	400	0	100
Opening stock	0	1 000	1 800	1 400	0	0	0	12 000	12 400	13 200	14 200
Purchases	1 000	0					12 000			1 000	1 000
Closing stock - fair value - IAS 41	1 000	1 200	1 400	0	0	0	12 000	12 400	12 800	14 200	15 300
Expenses	-1 000	-1 000	-1 200	-1 100	-1 200	-2 000	-1 800	-1 800	-1 800	-1 800	-2 300
Depreciation				-160	-360	-360	-360	-360	-200		
Irrigation system, stores, dam and fences											
Net profit/ -loss	-800	-400	0	40	1 440	640	840	1 240	1 400	1 200	800

TABLE 2: Case scenario – Calculation of accounting profit

Source: Author’s own example

The case scenario example in Table 1 shows that no taxable income was derived in any one of the 16 years. The same data, if applied to accounting principles in Table 2, reveal a net accounting profit in 10 of the 16 years. It is evident that the application of accounting principles versus tax treatment may have a major impact on the end result in terms of profitability measurement. The case scenario example illustrates that the beneficial tax concessions available to farmers may result in a substantial difference in the taxable profit (see Table 1) versus the accounting profit (see Table 2) from farming operations. It thus emerges that the wrong person can be ring-fenced, thus negating the original intention which was to ring-fence higher-income individuals who do not have a genuine legitimate farming business but a hobby-like or artificially labelled trade (National Treasury, 2003). However, the wording used in the Act states that there must be a reasonable prospect to generate a taxable income in a reasonable period of time. As the ‘taxable income’ and ‘profit’ do not have the same outcome the law must be applied as is. The legitimate farmer can be ring-fenced from year 1 as he could

potentially not prove that there was a reasonable prospect to generate taxable income in a reasonable period.

5.2 Reasonability test

When will there be a reasonable prospect to derive taxable income in a reasonable period? In this section, this 'reasonability' test will be analysed through a review of various literature sources, and a further hypothetical case scenario.

A high-income individual was carrying on more than one trade and incurred a tax loss from part-time farming operations and is subject to possible ring-fencing. Section 20A(3) determines that a farmer may escape ring-fencing if he or she can prove that there is a reasonable prospect to generate taxable income in a reasonable period from the farming activities, taking into account, amongst others, the six objective factors listed earlier. Determining whether a trade is being carried on can become problematic in some instances (SARS, 2010:4). The application of a subjective test with reference to the facts and circumstances and the intention of the taxpayer place SARS in a difficult position, since it is an onerous task to determine whether a loss should be allowed or not (SARS, 2010:3). In the *SARS Guide* the difficult position SARS found itself in after the judgement hand-down in the Smith case (*CSARS v Smith*, 2002) was explained. This seemed to be the last straw in terms of the abuse of the beneficial tax treatment of farmers. In this case, a medical doctor, a weekend farmer, claimed farming losses for 13 consecutive years against his income from his medical practice. The 'facts and circumstances' test in terms of section 11(a), read with section 23(g), was applied and the judge relied on a 'subjective' test and ruled in favour of the taxpayer. Section 20A, Ring-fencing of assessed losses, was introduced the next year with a more stringent 'facts and circumstances' test as a means to uncover these artificially labelled trades (National Treasury, 2003:25).

For the remainder of this section, the word 'profit' will be used instead of 'taxable income' as there may be a material difference between the terms.

The 'reasonability test' may be applied by all suspect trades for a six-out-of-ten-year period. Part-time farmers are excluded from the six-out-of-ten-year requirement because, as given in the commentary (National Treasury, 2003:29), 'many forms of legitimate farming entail long-term losses before the expectation of profit can be realised'. The test laid down in section 20A(3) should be applied to ring-fenced

assessed losses of farmers due to the fact that the six-out-of-ten-year requirement is applicable to all other suspect trades but the Act in section 20A(4) specifically states that it is not applicable to farmers.

A further problematic term is the term 'reasonable prospect'. To escape ring-fencing, the part-time farmer must prove that there will be a reasonable prospect to derive taxable income in a reasonable period, but there is no definition for the term 'reasonable prospect to generate taxable income' in the Act.

It was found that objective tests consider the past facts and circumstances and do not give consideration to the intention of the taxpayer (SARS, 2010:18). The term 'reasonable expectation' has been considered by South African courts on a few occasions when determining whether a loss suffered by letting immovable property is an allowable deduction in terms of section 11(a). In ITC 561(1944), ITC 1292 ((41 SATC 163)) and ITC 1367 (45 SATC 39) it was considered whether there was a reasonable expectation of realising a profit (Steenkamp, 2010:73).

If a farmer did not generate any profit, for example from maize production for five years, he may decide to not continue with growing maize but to change to a potentially more profitable farming activity like growing vegetables or game farming. To complicate matters further, it is stated in section 20A(7) of the Act that, contrary to other trades where losses can only be set-off against income from only the same trade, that multiple farming activities are deemed to constitute a single trade. Mitchell (2004) pointed out that the unified treatment of all farming activities is appropriate because farming typically entails multiple, diverse activities. It may be that more than one activity should be considered simultaneously to determine the reasonable prospect and reasonable period in which profit should be generated.

There may of course be all kinds of risks in farming which prevent it from generating a taxable income. In a study by the Organization for Economic Cooperation and Development (OECD) (2009:16), the exposure of the agriculture sector to risk was analysed. Some of the risks more specific to agriculture are ecological risks (climate change, natural resources such as water); production risks (unpredictable weather conditions, diseases, and pests); market risks (uncertainty around the output and input price variability); and regulatory or institutional risks (tax provisions, agriculture policies and food safety and environmental regulations).

The objective factors in section 20A(3)(a) – (f) to be considered in determining whether there is a reasonable prospect of deriving profit within a reasonable period are analysed in the search for clarity of the meaning of reasonable prospect and reasonable period.

5.3 Reasonable prospect and reasonable period

When it comes to the proportion of gross income derived from the trade to the amount of allowable deductions, it is unclear what the results of this test will be. A livestock or game farmer, for example, may decide not to sell his game but hold them back for breeding or to increase his herd. SARS issues no guidelines to determine what percentage would be acceptable and no other guidelines could be found either.

The level of activities carried out and the amount spent in respect of advertising, promotion, or selling is crucial. Most farmers are price-takers – meaning that they are dependent on international and national trends and markets. In terms of the commercial manner of trade, the following issues should be considered, viz. the number of full-time employees, the commercial setting of the premises, the extent of equipment used exclusively in that trade and the time that the person spends at the premises conducting that business. This factor is unclear because the *SARS Guide* (SARS, 2010:16) specifically indicates that a bona fide farming activity will not cease to be bona fide merely because the taxpayer conducts the activity on a part-time basis.

There is no definition of ‘commercial manner’ in the Act. Case law or ordinary meaning should therefore be considered. The *SARS Guide* (SARS, 2010:21) lists the following factors that should be considered as an indication of the commercial nature of a trade:

The taxpayer has a business plan (covered by section 20A (3) (e), the main purpose is making a profit (section 11(a)) when determining whether a trade is carried on, the taxpayer seeks the best prices or commercial markets for services or products (section 20A(3)(b), the size and scale of the activity are sufficient for the specific trade and exceed any personal needs by far. If the scale of the activity is to only satisfy the taxpayer’s personal needs, the expenses/losses should have been disallowed under section 23(g), and the activity is organised and records of all transactions are kept. It is unclear how this requirement can contribute to the decision to ring-fence a tax loss. The taxpayer bears the onus of proof on a balance or a preponderance of probabilities (CIR v Middelmann (1991))) that a deduction or loss may be claimed. Finally, there must be a

repetition and regularity of activities. If transactions are irregular and isolated, it may be an indication that the trade is not carried on in a commercial manner, but in the case of farming activities, it may be more probable that transactions will be irregular and isolated. A central concern is the number of years with assessed losses, taking into account any unexpected events and the nature of the business involved. No indication of an acceptable number of years could be found as with the other trades where a six-out-of-ten-year period is specifically stated as the number of years with assessed losses where a taxpayer may escape ring-fencing. It is not clear to what extent the nature of the business would contribute towards escaping ring-fencing. An olive farm as an activity with a long start-up period was used as an example in the *Explanatory Memorandum* (National Treasury, 2003:29). On the same page it was explained that farming was excluded from the six-out-of-ten-year prohibition because many forms of legitimate farming entail long-term losses before the expectation of profit can be realised.

The importance of having a business plan to ensure that taxable income is derived may be a controversial issue as the DAFF's *Agriculture Business Plan Guidelines* explains that a business plan is a written document that consists of a plan of how a business owner intends to organise an entrepreneurial endeavour and implement activities necessary and sufficient for the venture to succeed (DAFF, 2011). Nowhere was it found that the objective of the plan is also to ensure that taxable income be derived. Tax may be a major part of the financial objectives and budgets as 41% (2016 year of assessment) of taxable income will be subject to tax in the case of higher-income individuals. Although tax may be part of the budget and cash flow projections, it is submitted that no business plan is prepared with the intention to ensure that there is a reasonable prospect that taxable income is derived in a reasonable period, especially in the case of farmers. In the case of farmers the difference between a taxable income and accounting profit may well be substantial.

This discussion will be incomplete without a consideration of the notion of reasonable prospect of profit within a reasonable period. The timing of the ring-fencing is not clear as the legislation refers to 'reasonable period', which in itself is uncertain and provides no clarity to taxpayers. Sub-section (d) in section 20A (3) may indicate that a reasonable period should be determined based on the number of years of assessment in which assessed losses were incurred in carrying on the trade in relation to the total

number of years that the taxpayer has conducted the specific trade, taking into account any unexpected events giving rise to any of the assessed losses and the nature of the business involved. The *SARS Guide* provides examples of unexpected events in cases of farming activities and refers to diseases, pests, plagues, floods, hailstorms, and any other unexpected event which substantially impedes the profitability of the farming activity (SARS, 2010:21). When a loss has been incurred for a number of years, the nature of the activity, for example olive farming, will also be taken into account (SARS, 2012:22).

6 The hobby-like part-time farmer

This discussion would be incomplete without providing a scenario for the hobby-like part-time farmer, who hovers on the borderline of this issue. Section 20A (3) introduced the 'reasonability test', which was not part of the Act before 1 March 2004. More or less the same facts and circumstances that were considered in the Smith case (ITC 1698 (2000); CSARS v Smith (2002)) will now be weighed against the new section to determine whether the outcome would have been different if the same case went on trial today.

For this case scenario, the facts and circumstances are only discussed briefly. The taxpayer in question is a medical practitioner earning a taxable income and being taxed at the highest marginal rate of tax, and can therefore be seen as a higher-income individual. He conducted farming operations on a part-time basis. He incurred losses in all 13 years under discussion below. Due to the collapse of the mohair industry his angora farming did not succeed, and he considered game farming. The other negative factors were labour challenges, theft, and predators. For the next six years he was now fully converted to game farming. He conducted research and considered that the venture had real prospects of economic viability. He bought small numbers of game and increased the number and different species of game on the farm. He expected a taxable income from hunting after eight to ten years after he developed the farm and built up game stock. As was testified in court, the reason for the slow development was, inter alia, that a kudu bull must be seven/eight years old before it is considered a trophy animal. Drought for three years in that area obliged him to buy feed for the animals. A total estimated market value of R351 000 was placed on these animals by SARS. It should be mentioned here that Erasmus J in ITC 1698 (2000) commented that it was highly questionable whether the game was at that time worth anything close to that

estimate. The taxpayer's appeal against the disallowance of the losses was allowed although there was little proof as to how and when the taxpayer would have turned his small farm in a remote hilly area into a profitable game farm. It was specifically held that the appellant failed to prove that there existed a reasonable prospect of the operation ultimately generating a profit. It seems, on a balance of probabilities, that the appellant was not a hobby-like farmer and he intended to farm for profit on the property as there was no evidence to the contrary (ITC 1698 (2000):173-174).

Coming to the last two years, almost three weeks after he sold his farm B, he bought a farm closer to his home that was well stocked with trophy animals. He spent a great deal on improvements and developments but then had to sell the farm. It was held that this activity was clearly a farming operation with the intention to generate a profit (ITC 1698 (2000):163). SARS disallowed the losses for the last four years based on the fact that there seemed to be no prospect to generate a profit. The Commissioner for Inland Revenue contended that the appellant had to show that, objectively considered, there existed at all relevant times a reasonable prospect of an ultimate profit for him from the farming operations (ITC 1698 (2000):162).

Although the Act as it was before 1 March 2004 did not mention anything about 'business' or 'reasonable prospect or period' to generate a profit, this was the argument of the Commissioner. The court did not agree with this view and indicated that a much broader view should be taken and concluded that the taxpayer must show that he possessed at the relevant time a genuine intention to carry on farming operations profitably.

The outcome of this case scenario before the introduction of section 20A of the Act was that 'reasonable prospect of profit' was nowhere in the Act itself as a requirement independent of the taxpayer's intention to make a profit. Section 20A of the Act was therefore introduced to include the requirement that there had to be a 'reasonable prospect to derive a profit' based on the objective facts on hand.

What would the outcome have been if this same case had been brought before the court after the introduction of section 20A? Would the outcome have been different? The objective facts at hand show that there was no taxable income for 13 years. There was a farm property, game stock, and an intention to generate profit. One of the main issues was the reasonable prospect to generate profit from the game farming. There

may be two views on this scenario - one view being that the taxpayer's expectation to generate a profit from this farming operation was unrealistic and unreasonable.

The farmer's view, on the other hand, would most probably have been that there was a realistic and reasonable prospect to generate profit from the game farm. A total value for the same game that was worth R351 000 in 2004 might be R1 266 760 if calculated at the average price for a common group type per animal in 2013(Oscar Content Management Systems, 2014). Looking back, it may seem as if there could have been a reasonable prospect to generate a profit from the farming operations. Unfortunately the privilege of hindsight is not available to a taxpayer or to SARS.

Should there be a retrial of the Smith case after the introduction of section 20A, it might well be with the information in hindsight that the court could have concluded that there was a reasonable prospect to generate profit and that the farming losses should not be ring-fenced. This scenario indicates that a 'hobby-like part-time farmer' may still potentially escape ring-fencing.

If the objective factors are measured against the hypothetical case scenario of the legitimate farmer it is evident that the farmer has a reasonable prospect to generate a profit as emerges from the calculation in Table 2 where there was an accounting loss in only 5 of the 16 years. However, Table 1 indicates a taxable loss for 16 consecutive years. With the privilege of hindsight and weighed against the objective facts it could be assumed that the legitimate farmer never had a reasonable prospect to generate taxable income in a reasonable period and the tax losses must be ring-fenced from year 1.

The intention of the legislature was very clear with the introduction of section 20A: 'Its aim is to prohibit higher income individuals from claiming hobby-like expenses and losses from artificially labelled trades against other income (usually salary or professional income) and thereby creating a considerable tax benefit' (National Treasury, 2003:25). The revenue authority was in a difficult position to address both hobby-like trades and artificially labelled trades. This study underlines the concern that the revenue authority may still be in a difficult position to evaluate the bona fides of a part-time farming activity and to determine the end of the escape clause. Legitimate part-time farmers may be disadvantaged because of the uncertainty in the application of this legislation.

To escape ring-fencing, a taxpayer must prove that the part-time farming activities constitute a business in respect of which there is a reasonable prospect of deriving taxable income within a reasonable period. The analysis of the term 'taxable income' instead of 'profit' if applied to a tax loss of a farmer shows that there may be a substantial difference between the taxable income and profit in the case of a farmer. It was noted that the use of the term 'taxable income' in section 20A (3) of the Act, if applied to a tax loss of a farmer, is not suitable. It was also found that the term 'taxable income' in relation to 'business' or 'business plan' is not a proper indication of financial and economic viability of bona fide farming.

Lastly, the analysis performed of the meaning of the words used in section 20A(3) of the Act such as 'business', 'reasonable prospect', and 'reasonable period' in relation to bona fide part-time farmers provides little clarity on the burden of proof expected of part-time farmers. It was further noted that section 20A(3) of the Act may put legitimate bona fide part-time farmers in an unfortunate position because, according to Bob Williams, a tax expert at the University of Natal, in *Business Day* the losses of genuine trades that ran for a number of years could also be ring-fenced (Temkin, 2004). Robert Gad, a tax partner at law firm Sonnenberg Hoffman Galombik also responded in the same newspaper that the possible ring-fencing provisions might discourage a legitimate start-up farming activity as a secondary investment (Temkin, 2004). It may also hinder further growth of the agricultural sector in South Africa through the loss of part-time farmers. Taxpayers and their tax practitioners need clarity and certainty in order to comply with tax legislation. It is a controversial issue that on the one hand, the tax legislation puts the farmer in a privileged position with the First Schedule, but on the other hand, the wording of the tax legislation may result in the ring-fencing of legitimate part-time farmers to their serious detriment. The uncertainty in the application and the wording used in the ring-fencing of farming losses may lead to non-compliance by otherwise law-abiding citizens (Smith, as explained by Soares 2007:640). Tax rules should be easy to understand. Complex tax rules make it easier for lawmakers to enact (and conceal) targeted tax breaks benefiting particular groups (ITEP, 2012).

The uncertainty in the application wording used in the ring-fencing of farming losses should be re-considered to provide clarity to bona fide part-time farmers on what is really expected of them with regard to the section 20A requirement that there must be a reasonable prospect to derive a taxable income within a reasonable period. The

advocates of tax reform should keep the principles of tax policy design in mind as they seek to improve their tax systems (ITEP, 2012) and deal with all taxpayers in a fair and even-handed manner.

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CHAPTER 3: CONCLUDING REMARKS

3.1 CONCLUSION

The intention of the legislator with the introduction of section 20A was to ring-fence the assessed losses of hobby-like or artificially labelled trades.

The first problem identified was that 'taxable income' in relation to 'business' or 'business plan' may not be a proper indication of financial and economic viability of bona fide farming activities. Profit would be indicative of the financial and economic viability of a business. A comparison and analysis of the difference between 'taxable income' and 'profit' from farming operations was done to investigate the possible impact it may have on the ring-fencing of part-time farmers' tax losses. To escape ring-fencing, a taxpayer must prove that the part-time farming activities constitute a business in respect of which there is a reasonable prospect of deriving taxable income within a reasonable period. No justification could be found for the use of the term 'taxable income' instead of 'profit' if applied to a tax loss of a farmer. It was also found from this study that there may be a substantial difference between profit from trade and taxable income from trade in the case of farmers, which may lead to the ring-fencing of bona fide legitimate part-time farming tax losses as opposed to the ring-fencing of hobby-like, artificially labelled trades.

The second problem identified was the application of the 'facts and circumstances test' per section 20A(3) when applied to the ring-fencing of part-time farming losses. To find clarity on the burden of proof placed on bona fide part-time farmers to escape ring-fencing, words such as 'business', 'business plan', 'commercial manner', 'reasonable prospect', and 'reasonable period' were analysed. It was found that higher income individuals with tax losses from part-time farming activities may experience a potential challenge to determine when and under which circumstances their part-time farming losses may be ring-fenced. As per the study by Adam Smith in his book, *The Wealth of Nations*, uncertainty and simplicity are principles in tax policy design that should not be compromised. The taxpayer should have a clear idea of the timing of, manner in which, and quantity of tax payable. Uncertainty may lead to non-compliant taxpayers. The problem to differentiate between hobby-like and legitimate bona fide trades that was

experienced by SARS in the first place and which resulted in the introduction of section 20A may still be a problem. It is a concern that there may still be an element of uncertainty experienced by higher income individuals with part-time farming activities to determine when and under what circumstances their part-time farming losses may be ring-fenced.

The beneficial tax treatment of farmers, especially for start-up farmers, is that the losses can be set off against the profits or the major trade or income source (Ger., 2004). Taxpayers and their advisors need to be certain of the application and interpretation of the facts and circumstances to ring-fence part-time farming losses. To apply this legislation to the facts and circumstances of each particular case, it is evident that the wording used is open to wide interpretation and it is possible to reach a subjective outcome which depends on the examiner instead of an objective outcome. Tax uncertainty may discourage potential part-time farmers who might have grown their farming operations into large businesses that could have contributed towards the food security and unemployment challenges experienced in this country.

It is a controversial issue that on the one hand the tax legislation puts the farmer in a privileged position with the First Schedule, but on the other hand the wording of the tax legislation may result in the ring-fencing of legitimate farmers with concomitant negative implications.

It was found there may be a risk that the farming tax losses of legitimate bona-fide farmers will be ring-fenced.

3.2 SUGGESTIONS FOR FURTHER RESEARCH

It is recommended that further research be considered to determine whether section 20A is potentially unconstitutional, whereby it discriminates against individual taxpayers in that a full-time farmer with a substantial amount of income, for example from interest, dividends, or distributions from a trust, is not listed as a suspect trade, whilst a part-time higher-income farmer with exactly the same farming tax loss may be ring-fenced. Furthermore, it may also be unconstitutional that a higher-income farmer may not set off part-time farming losses against other income, whilst an individual earning just below the maximum tax bracket may set off the part-time farming loss.

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