IN THE TAX COURT HELD AT MEGAWATT PARK

CASE NUMBER: 11773

Before **Gildenhuys J**
Accountant member: AC Geake
Commercial member: S Tucker
Heard on: 9 and 10 May 2007
Decided on: 5 October 2007

In case between:

C (PTY) LTD Appellant

and

THE COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE Respondent

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JUDGMENT

GILDENHUYS J

[1] The appellant in this matter is a company duly registered and incorporated in terms of the Companies Act no 61 of 1973. The appellant's primary business is the award of licences to the security industry for the use of a computer programme which it developed, known as the CT Programme.

[2] The case before the Court relates to the assessment of the appellant for income tax in its 2004 year of assessment, covering the period from 1 March 2003 to 28 February 2004.

[3] At the end of the appellant's 2003 tax year, there was an accumulated assessed loss of R 3 338 742.00. The loss was principally made up of development expenditure in respect of the CT Programme. In the 2004 tax year, further loss of R424 057.00 was incurred. The only income for that year was R12 302.00 in respect of interest plus small amounts of sundry income, all of which the appellant conceded, for purposes of adjudication of the issues before me, to have been unrelated to trading.

[4] The Commissioner disallowed the set-off of the loss carried forward by the appellant in terms of section 20(1) of the Income Tax Act No 58 of 1962, for the 2004 year of assessment.

[5] The issues before the Court turn mainly on the interpretation of subsections 20(1) and (2) of the Income Tax Act No 58 of 1962. The relevant subsections read as follows:

> "(1) For the purposes of determining the taxable income derived by any person from carrying on any trade, there shall be, subject to section 20A, be set off against the income so derived by such person-
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> (a) Any balance of assessed loss incurred by the taxpayer in any previous year which has been carried forward from the preceding year of assessment: Provided that-
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> (2) For the purposes of this section **"assessed loss"** means any amount by which the deductions admissible under sections 11 to 19, inclusive, exceeded the income in respect of which they are so admissible."

[6] The Commissioner submits that, aside from the requirement that the appellant must have carried on a trade during the 2004 tax year, it is also a requirement of section 20(1) that income must have been received by or accrued to the taxpayer from such trade. If no such income had been derived, it will not be possible to balance the assessed loss against income, as required under section 20(1). The appellant, on the other hand, contends that the receipt or accrual of income is not a prerequisite, and if it is, then the section is unconstitutional on grounds set out in its Statement of Grounds of Appeal. Those grounds are not relevant for purposes of this judgment.

[7] Several questions arise from the appeal. The parties agreed to separate one of them, *viz* whether the receipt or accrual of income is a pre-requisite for a set-off under section 20, for prior hearing and decision. I thereupon made the following order:

> "1. In terms of section 83 of the Income Tax Act read with Rule 20(1) of the Income Tax Rules and Rule 33(4) of the High Court Rules there is a question of law which it is convenient to decide before evidence is led and separately from any other question, including the constitutional enforceability of the section, namely:
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> > Whether or not income must have been received by or accrued to the taxpayer in the relevant year of assessment in order for the taxpayer to satisfy the requirements of Section 20(1) of the IT Act.
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> 2. The aforesaid issue will be determined before the determination of any other issue, all the other issues being stayed pending such determination.

> 3. Such determination shall be in the form of a declarator and limited to whether or not, on an interpretation of the section and the Act as it stands (and without considering the constitutional enforceability of such section), income must have been received by or accrued to the taxpayer in the relevant year of assessment in order to satisfy the requirements of Section 20(1) of the IT Act."

I will, for purposes of this judgment, assume that the other requirement for utilizing an assessed loss, namely that the taxpayer has carried on a trade during the year of assessment, has been fulfilled.

[8] The issue has been raised in several Appellate Division and Supreme Court of Appeal decisions, but not conclusively decided. In the seminal decision of *SA Bazaars (Pty) Ltd v Commissioner for Inland Revenue* 1952(4) SA 505 (A), the Court considered a predecessor of the present section 20(1) which was, although differently constructed, for all practical purposes identical. Centlivres CJ said (at 510F):

> "Under sub-sec (3) of sec 11 the balance of assessed loss incurred in any previous year can only be set off when it has been carried forward from the preceding year of assessment."

The learned Judge then continued and said (at 510H-511F):

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

during the year under consideration it was not competent for it to set-off in its income tax return for that year the balance of assessed loss incurred by it in previous years. It is not necessary for the purpose of this case to decide whether the appellant would have been entitled to set-off that balance in respect of the year ending on 30th June, 1944, if during that year it had carried on a trade but earned no income."

[9] Beyers JA explained the *SA Bazaars* case in *New Urban Properties Ltd v Secretary for Inland Revenue* 1966 (1) SA 217 (A) at 224 D-F in the following terms:

"…[Section 11(3)] envisages a continuity in setting off an assessed loss in every year succeeding the year in which it was originally incurred, so that in each succeeding year a balance can be struck to the satisfaction of the Secretary which can then be carried forward from year to year until it is exhausted; if, for any reason, the assessed loss cannot be so set off and balanced in any particular year, there is then no "balance of assessed loss" for that year which (viewed from that year of assessment) can be carried forward to the succeeding year, or (viewed from the succeeding year of assessment) there is no "balance of assessed loss which has been carried forward from the preceding year of assessment"; in other words, the essential continuity has been fatally interrupted."

[10] The application of section 20 was again discussed by the Appellate Division in the case of *Conshu (Pty) Ltd v Commissioner for Inland Revenue* 1994 (4) SA 603 (A). After analysing the section, Harms JA said (in a majority judgment at 613 C-E):

"It follows, in my view, from this analysis that the word 'income', as used in the introductory part of s 20(1), is not used in its defined sense (cf *Commissioner for*

> *Inland Revenue v Simpson* 1949 (4) SA 678 (A) at 692) but rather as the income taxable but for the set-off. This all simply means that a set-off in terms of s 20 can only arise if there would otherwise have been taxable income, i e pre-tax profit. I find it impossible to perceive how, in an assessment to tax, set-off of an assessed loss can operate in relation to, say, an individual item of income such as the recoupment on the sale of an asset."

This conclusion (which Mr Spilg, who appeared on behalf of the appellant, submitted was *obiter*) was described by Dr Hendrik Coetzee in an article "*Thoughts on Taxation: Assessed Losses – The Final Blow*" (Accountancy SA, Oct 1998, 19) as "far-reaching". The effect of it is that, should there be no "income" in a given tax year, there can be no set-off of an assessed loss brought forward to that tax year. This conclusion will also hold if the term "income" is given its defined meaning instead of "pre-tax profit".

[11] In *Robin Consolidated Industries Ltd v Commissioner for Inland Revenue* 1997 (3) SA 654 (SCA) at 665C, Schutz JA remarked that it appears from the *SA Bazaars* case that –

> "… set-off is admissible only (a) against income derived from trade; and (b) where the balance of assessed loss had been carried forward from the preceding year."

The effect of these propositions, as stated by Schultz JA at 665F, is that a balance can be carried forward from any year only if a balance has been struck in that year.

[12] The issue left open in the *SA Bazaars* case (*viz* whether set-off can take place in respect of a year during which the taxpayer carried on a trade but earned no trade income) arose again in the case of *Commissioner, South African Revenue Service v Megs Investments (Pty) Ltd and Another* 2005 (4) SA 328 (SCA). Jones AJA, who delivered the Court's judgment, emphasized (at 333I) that this issue was also left open by Schutz JA in the *Robin Consolidated Industries* case.

[13] The taxpayer in the *Megs Investments* case traded during the tax year in question. It sought to set off interest income earned during that tax year against the balance of assessed loss arising from trades which it carried on. Counsel conceded that to succeed, the taxpayer had to overcome the hurdle of showing a connection between the trades it carried on and the income it received. Jones AJA remarked (at 334F-H):

> "This concession is in effect a concession of the correctness of the argument by the Commissioner that the point left open in the *SA Bazaars* case - whether setoff can operate if a trade is carried on but no income is derived from it - should be answered in this case in favour of the Commissioner. I think that in the light of the wording of s 20(1) and the wording of s 11 *(a)* of the Act as it then read the concession may have been correctly made. I prefer, however, to say no more on the point. I must make it clear that no argument to the contrary has been placed before us, the point has not been given the consideration which contrary argument would require, and my decision is based on the concession."

[14] The issue whether set-off can take place in respect of a year during which the taxpayer carried on a trade but earned no income from the trade,

was also considered in various judgments of the South African Tax Court. In two cases, to which I shall refer, it was held that if in a particular year no income was earned, there is nothing against which a balance can be struck, and consequently no "balance of assessed loss" ensues.

[15] In *Income Tax Case No 664* (1948) 16 SATC 125, the President (Ingram KC) considered section 11(3) of the previous Income Tax Act No 31 of 1941 (the predecessor of section 20 of the present Act and of similar import) and said (at p126-127):

> "But it is to be noted that to allow the set-off [of any balance of assessed loss] to operate, the balance must be carried forward from *the* preceding year of assessment. The Act does not contemplate the set-off of a balance of assessed loss not so carried forward.
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> The position, therefore, that transpires is that as long as there is some amount of income in the next succeeding year, however small, there is still room for the set-off and accordingly again a fresh 'balance of assessed loss' arrived at to be carried forward.
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> The next question to be determined is what will be the position if there is no income in the next succeeding year. Here is important to note that the section operates by way of set-off, i.e., the apposition of one amount against the other. It does not envisage the addition of the 'balance of assessed loss' to a loss on the year's trading or its accumulation therewith.
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> It was argued on behalf of the appellant that once an assessed loss had been arrived at, then of its own motion it was entitled to carry it forward, and accordingly it became a 'balance' brought forward from year to year, notwithstanding that there had been no

income against which it could be set off. This, however, as indicated above, is not the correct meaning to be assigned to the terms 'balance' in the section.

Assessments are made on a yearly basis and if there be no income in any particular year, all that is revealed in such a case is a minus quantity not a balance. Hence one is thrown back to the original loss or balance of assessed loss, the set-off of which is negatived by the requirements, that it must have been carried forward from the preceding year of assessment"

[16] The issue arose again arose in the Orange Free State in *Income Tax Case* No 1679, 62SATC 294 (O). The President of the Court, Musi J, held as follows (at 300A-C):

"For set-off of the balance of assessed loss to be admissible two requirements must be met. (1) set off must be against income derived from trade (the trade requirement) and (2) the balance of the assessed loss must have been carried forward from the preceding year. The former presents no problem. Regarding the latter, the position was explained as follows in *New Urban Properties:* There must be continuity in setting-off an assessed loss. If the balance of assessed loss is carried forward from say the 1994 tax year in which it was originally determined, into the next tax year, being 1995, it must in the latter year be set off and balanced up against trade income derived in 1995 so that a new balance is struck that can then be carried forward to the 1996 tax year. If there is no income in the 1995 tax year, there is nothing against which to set off and balance up such balance and the essential continuity is interrupted. In other words, income in this chain of assessment is an essential link without which the chain is broken."

This judgment is also reported *s.v* E*tnique Travel CC v Commissioner South African Revenue Services* [1999] JOL 5412 (O).

[17] Mr Spilg referred me to *Income Tax Case* No 777, (1953) 19 SATC 320(T), a case in which a predecessor of the current section 20 was considered. He suggested in his Heads of Argument [par 47] that the Court in that case "expressly considered that it was unnecessary for there to have been income earned in the year for the assessed loss to be carried forward into the next tax year". I do not read case *ITC* 777 that way. The learned judge said the following (at p322):

> "It was not contended that the company was not entitled to set off its balance of assessed loss for the year ended 30th June, 1947, merely because it had no income in the year ended 30th June, 1948."

He did not decide on whether or not there had to be income against which a balance could be struck, but relied on there being no contention to the contrary.

[18] The issue was also the subject of several articles in law journals. In an article "Corporate Taxation and the Utilization of Assessed Losses in South Africa" (1998) 10 *SA Merc LJ* 193, Mr Vuyani R Ngalwana (from the Cape Bar) analysed section 20(1)(a) of the 1962 Act as follows (at p203):

> "The section clearly provides for the set-off, against the income, of any assessed loss or balance of assessed loss. The term 'set-off' envisages a pitting of two opposites against each other. Semantically, one cannot set off a positive figure against another in much the same way as one cannot set off one negative figure against another.

> One can perhaps add two positives together and two negatives together. The result of a set-off (really, a synonym for subtraction) ought to be a smaller number than the one with which one started, whether such result is a positive or negative figure. An arithmetical process which results in a larger number of the same kind as that with which one started (negative and negative, or positive and positive), therefore, is not set-off. A 'set-off' of one negative against another is effectively an addition, not a set-off. So bringing together one assessed loss with another, which results in a larger assessed loss, cannot be called set-off. Rather, it is an addition."

[19] Professor G J Swart, in an article "The Utilization of Assessed Losses by Companies – A Reappraisal after *Conshu (Pty) Ltd v Commissioner for Inland Revenue" (*1996) 8 *SA Merc LJ* 119, took a different view. He described the purpose of section 20(1) as follows (at p 127):

> "The object of s 20(1) is clearly to provide for the recovery, *in future tax years,* of expenditure and losses not recovered in full from income from trade during a tax year."

[20] Professor Swart points out (at p 130) that the derivation of income is not a requirement for allowing the deductions provided for in section 11 (a) – (x) of the 1962 Income Tax Act. Why then should it be a requirement for allowing the set-off of an assessed loss? He proceeded by giving the following hypothetical examples (at p 131):

> "(a) Rent-a-Box (Pty) Ltd carried on a manufacturing business until the 1994 tax year. The business was not successful and incurred substantial losses. The manufacturing business was therefore discontinued during the 1994 tax year, the name of the company changed and the factory sold, and the proceeds of the sale were used to

acquire a new office block as an income-earning investment. The company had an assessed loss of R 3 million at the end of 1994; it was carried over to 1995. Despite strenuous efforts during 1995 to let the property and the expenditure of considerable amount of money in its efforts to derive rental income, the company could not find any tenants for the property. As a result, it derived no income during 1995 but incurred deductible expenditure and losses of R 500 000 (for similar facts, see ITC 777 supra).

(b) Cromwalls Construction Ltd, a construction company, experienced a lean trading period during the 1994 tax year and incurred an assessed loss of R 1 million. It was carried forward to the 1995 tax year. During 1995 it secured a contract for a major construction project. As a result of the competitive situation in the construction industry, Cromwalls agreed to onerous payment terms: payment will not be made to Cromwalls until the completion of the project, which is expected only in two years' time, and the final contract price will be payable only after a certificate of completion has been issued by a consulting engineer. He is also empowered to adjust the final contract price in accordance with an agreed procedure and formula to provide for any defects in the construction work. The company's activities during 1995 were limited to this single project. It incurred deductible expenditure of R 8 million during the year. It was financed by means of bank loans and a loan of R 2 million from its client. No amount accrued to it under the contract during the year, so that Cromwalls earned no income during 1995.

The disallowance and resultant forfeiture of the assessed losses of R 3 million and R 1 million merely on the ground that Rent-a-Box and Cromwalls did not earn any income during 1995, would fly in the face of the principle that an expense or loss is not disqualified as a deduction merely by reason of its failure to produce income in the same or a future tax year."

[21] Prof Swart then concludes, based mainly on these examples, that the legislature could never have intended the derivation of income to be a prerequisite for the preservation of an assessed loss or balance of an

assessed loss carried forward by a company from a previous year.

[22] Giving the wording of section 20(1) its plain meaning, I cannot but conclude that a balance of assessed loss brought forward to any tax year cannot be set-off if there was no income during that tax year against which to set it off. As I have shown, this conclusion is supported by observations contained in the *Conshu* and *Meggs Investments* judgments. Although these observations did not constitute the *ratio decidendi* in any of them, they remain of significance. Furthermore, it was held in two Income Tax Cases (*Case No ITC* 664 and *Case No ITC* 1679, discussed above) that an assessed loss cannot be set off if there is no income against which a balance can be struck. The failure by the Commissioner for Inland Revenue in *Case No ITC* 777 to argue that the lack of income precludes the establishment of a balance of assessed loss, is no authority for the submission that a balance of assessed loss can be struck during a tax year where there was no income in that tax year.

[23] It is true that, because of the separation of a taxpayer's activities into discrete tax years, anomalies will arise. This was cogently illustrated by Prof Swart in his article (*supra*). However, similar anomalies arise in relation to the provision that if a company did not carry on any trade during a tax year, the balance of assessed loss incurred by it in previous years gets lost. The existence of anomalies is insufficient reason not to give effect to the wording of sec 20(1). As was said by Schultz JA in the *Robin Consolidated* case (*supra*, at 667D):

> "Then it is argued that we should construe the subsection so as to iron out the anomalies that may arise from the Act's artificial separation of a taxpayer's activities into discrete tax years. But the fact that this separation may work anomalously is not a reason for not giving effect to it, as is illustrated in Commissioner for Inland Revenue v Sunnyside Centre (Pty) Ltd 1997 (1) SA 68 (A) at 73D-E."

[24] I now turn to other considerations which bear on my reading of section 20(1). It is trite law that, unless there is a continuity of trading, no balance of assessed loss can be carried forward from one year to the next. If the essential continuity is interrupted, there can be no set-off and the balance of assessed loss is forfeited. If, despite the anomalies which must follow, the legislature intended in section 20(1) to require a continuity of trading, if would not be incongruous for the legislature to also require through section 20(1) that there must be a continuity of income.

[25] Section 20(2A) of the 1962 Act provides that, in the case of any taxpayer other than a company –

> "(a) …
>
> (b) the said taxpayer shall, subject to the provisos to subsection (1), not be prevented from carrying forward a balance of assessed loss merely by reason of the fact that he has not derived any income during any year of assessment."

The fact that section 20(2A)(b) specifically provides that a taxpayer other than a company shall not be prevented from carrying forward a balance of assessed loss merely because no income has been derived during the

particular tax year, is indicative of an intention on the part of the legislature that, in the case of a company, the derivation of income is a requirement for carrying forward a balance of assessed loss.

[26] The Commissioner for the South African Revenue Service released a Practice Note, no 33, entitled *Assessed Losses: Companies: the Trade and Income from Trade Requirements* on 4 July 2005. The Commissioner's view is set forth as follows:

> "The Commissioner is of the view that s 20 contains
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> - A trade requirement, and
> - An income from trade requirement.
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> Both these requirements must be satisfied before an assessed loss may be carried forward. The Commissioner does, however, accept that this may have some unintended results.
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> In dealing with the problem, the Commissioner will accept that as long as the company has proven that a trade has been carried on during the current year of assessment, it will be entitled to set off its balance of assessed loss from the preceding year, notwithstanding the fact that income may not have accrued from the carrying on of that trade. This concession is limited to situations when it is clear that a trade has been carried on."

[27] Mr Spilg submitted in his heads of argument that "the sentiments expressed in the last two sentences of the Practice Note are an acceptance of the law" set out in *Case No ITC* 777 (*supra*) and *Case No ITC* 1476 (1989 52 SATC 141). I have, when analysing *Case No ITC* 777, concluded that the

Court did not make a finding on whether or not "the income from trade requirement" is applicable. The Court did not put the "income from trade requirement" in force because it was not contended that the Court should do so. Although *Case No ITC* 1476 contains a detailed exposition of case no *ITC* 777, it deals only with the "trade requirement", not with the "income from trade requirement". But be that as it may, the Commissioner cannot (and clearly did not intend to) change the law by making concessions to address unintended results.

[28] For the reasons set out above, it is declared that income must have been receive by or accrued to the taxpayer in the relevant year of assessment in order for the taxpayer to satisfy the set-off requirements contained in section 20(1) of the Income Tax Act, 1962.

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ANTONIE GILDENHUYS
JUDGE OF THE TAX COURT