Given the poor economic climate that South Africa (and much of the world) has endured for the last six years, it is not surprising that many companies have assessed losses. It is often tempting for a group of companies to utilize assessed losses of a particular entity in the group by, for example, transferring certain business operations to such entity.

In this regard the provisions of section 103(2) of the Income Tax Act must be considered.

Section 103(2) is an anti-avoidance provision which essentially allows the Commissioner of the South African Revenue Service (‘the Commissioner’) to disallow the setting off of an assessed loss or balance of an assessed loss against the company’s income if certain requirements are met.

In this regard, section 103(2) provides that:

‘Whenever the Commissioner is satisfied that—

(a) any agreement affecting any company …; or
(b) any change in—

i. the shareholding in any company; or

ii. … as a direct or indirect result of which—

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TAX LAW

SECTION 103(2) OF THE INCOME TAX ACT – USE OF ASSESSED LOSSES
A income has been received by or has accrued to that company … during any year of assessment; or

B …has at any time been entered into or effected by any person solely or mainly for the purpose of utilizing any assessed loss, any balance of assessed loss, any capital loss or any assessed capital loss, as the case may be, incurred by the company …, in order to avoid liability on the part of that company … or any other person for the payment of any tax, duty or levy on income, or to reduce the amount thereof—

(aa) the set-off of any such assessed loss or balance of assessed loss against any such income shall be disallowed;

In light of the above, two requirements must be met in order for section 103(2)(b) to apply, i.e. the Commissioner must be satisfied that , inter alia,

- Any agreement has been entered into which directly or indirectly gave rise to income being received by such company ("the first requirement"); and

- That such agreement has been effected solely or mainly for the purpose of utilizing any assessed loss incurred by the company in order to avoid any tax liability, or to reduce any tax liability ("the second requirement").

It has been pointed out by Philip Haupt in Notes on South African Income Tax 2014, at page 656, that there is no abnormality requirement in section 103(2) and that if, for example, it could be shown that a company was acquired for good commercial reasons and that the set-off of income against the assessed loss was merely incidental to the main purpose then section 103(2) would not apply.

Juta’s Commentary on the Income Tax Act provides that there is no limitation on the meaning of an ‘indirect result’, and the chain of causation may therefore be long and involved, so long as not broken.

In the case of New Urban Properties Ltd vs. SIR 1966 (1) SA 215 (A), it was held that it will always be a question of fact whether a company has derived income ‘directly or indirectly’ as a result of the change of shareholding.

The second requirement

Section 103(2) can only apply if the relevant change in shareholding was entered into with the sole or main purpose of utilizing an assessed loss to reduce or avoid tax.

’Sole or main purpose’

The word ‘purpose’ is not defined in the Income Tax Act, but is generally defined to be ‘something set up as an object or end to be obtained’ (refer Merriam Webster Online Dictionary), ‘the reason for which something exists or is done, made, used, etc.’ and ‘an intended or desired result, end, aim, goal, practical result, effect’ (refer Dictionary.com).

The test as to ‘purpose’ is a subjective test and, although not decisive, the taxpayer’s ipse dixit as to his state of mind or the purpose of the transaction is the most important factor.

In ITC 1347 (1981) 44 SATC 33, a taxpayer acquired a company with an assessed loss. In considering the taxpayer’s ipse dixit, two of the factors considered by the court were that, although it was assumed that the company had an assessed loss, no specific enquiries were made by the taxpayer to determine the extent of such loss and nothing was paid for the acquisition of the assessed loss.

Furthermore, in ITC 1388 (1983) 46 SATC 126, a taxpayer acquired the shares in two separate entities and attempted to utilize their respective assessed losses. In allowing such utilization pertaining to one of the companies, a number of factors were taken into consideration. Although the accounting statements reflected that the company had an assessed loss, this loss had at no time been mentioned during the negotiations and played no part in the determination of the purchase price. Since sufficient commercial reasons were advanced for the transaction and the fact that the determination of the extent of the assessed loss was not one of the major considerations, it was found that the taxpayer could utilize such assessed losses
loss, since the main or sole purpose in entering into the transaction was not to acquire such loss. Section 103(2) was therefore not applicable.

Similarly, in ITC 983 (1961) 25 SATC 55, the court found that, where a clothing manufacturing company had acquired a subsidiary with a balance of assessed loss and had then introduced income into that subsidiary, the sole or main purpose of the acquisition was not the acquisition of the assessed loss but rather to enable the company to obtain a productive manufacturing unit that could go into immediate operation to supplement its own productive capacity. Section 103(2) was therefore not applicable.

In ITC 989 (1961) 25 SATC 122 the taxpayer company, had carried on business for a considerable period as a timber merchant and had incurred trading losses which resulted in an assessed loss. All the shares in the taxpayer company were then offered to and acquired by another company (i.e. the holding company) in the timber business. This holding company produced items made from wood such as doors which were marketed through a subsidiary company.

Prior to the acquisition of the shareholding of the taxpayer company, the holding company also utilized this subsidiary company to sell timber to builders, and tried to utilize it to sell timber to merchants also, but experienced difficulties in doing so because the practice of selling direct to builders led to the undercutting of merchants who consequently refused to buy from the subsidiary. After the acquisition, the holding company revised its selling arrangements and effected its sales of timber to builders through the taxpayer company. The timber was sold to it at the normal prices charged to merchants and was in turn resold by it to builders at retail prices.

In determining the liability for normal tax of the taxpayer company for the first year after the sale of its shares, the Commissioner applied s 90(1)(b) of the Income Tax Act 31 of 1941 (the equivalent of s 103(2)) and disallowed the set-off of the balance of its assessed loss against its income.

The court held that, on the facts, the taxpayer company had shown that neither its sole nor its main purpose was the avoidance of liability for tax. While there was some advantage derived by the holding company in purchasing the shares of the taxpayer company and thus acquiring the benefit of its assessed loss, the holding company was able to show that material benefits accrued to it, for example, benefits flowing from the separation of the wholesale and retail trades. Accordingly there appeared to be good reason to believe that the purchase of the shares would, in fact, have been a profitable and advantageous purchase even if there had been no assessed loss. Section 103(2) was therefore not applicable.

In light of the cases set out above, it is therefore a subjective and factual enquiry as to whether, for example, the acquisition of a business by an assessed loss company has been entered into solely or mainly for the purpose of utilizing its assessed loss.

In terms of section 103(4) of the Income Tax Act, the taxpayer bears the onus of proving or showing that the relevant change in shareholding was not entered into with the sole or main purpose of utilizing an assessed loss to reduce, postpone or avoid tax.

This is a subjective and factual test.

As set out in ITC 989 it should be ensured that there are sufficient business-related reasons for entering into the transaction, i.e. that these business reasons constitute the main reason for the transaction. It should also be ensured that, as a factual matter, the assessed loss company would, for example, acquire the business from the other entity even if it did not have an assessed loss.

The word ‘purpose’ is not defined in the Income Tax Act, but is generally defined to be ‘something set up as an object or end to be obtained’ (refer Merriam Webster Online Dictionary), “the reason for which something exists or is done, made, used, etc.” and “an intended or desired result, end, aim, goal, practical result, effect” (refer Dictionary.com).

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