

PART-TIME FARMERS' LOSSES ARE BEING RING FENCED

BY

DR PHILIP THEUNISSEN

Not all incomes are taxable. Some forms of income are usually always taxable while others are only taxable in specific cases. There are also permissible deductions that can be made, and some forms of income are tax-free. There's a basic formula according to which the taxpayer can determine his or her taxable income for a specific time period.

According to this formula, the permissible expenses are deducted from the total income earned for a specific time period. This brings the taxpayer first to his or her gross income, then to income and then to the taxable income or calculated loss. According to this basic definition, a person's total income was taxed, which implied that losses from one of his or her businesses can be offset against the profits of his or her other businesses. In this way, part-time farmers who continuously expanded their operations were able to build up a farming loss that could be deducted from their other forms of income. This gave way to many medical doctors, attorneys, accountants, marketing agents and other professionals using farming operations to create assessed losses.

By definition, costs and losses incurred for the generation of income for a given tax period are allowed, provided they were incurred by a South African citizen via a practice of a non-capital nature. The Receiver, however, finds it problematic that not all "activities" are approached with the right *bona fides*. For this reason, the most recent tax laws try and curb this particular tax benefit of professionals; such part-time activities are now classified as suspect activities. The result is that the losses incurred through these activities can only be offset against the profits from the same activities and not against the profits of other activities. The losses of the suspect activities are thus curbed and separately accumulated until these activities start showing profits. At this point, the loss can be applied against taxable income, but it may under no circumstances be deducted from the taxpayer's main practice.

General application

Several circumstances must be present before ring fencing can apply. Firstly, the taxpayer must be a natural person whose taxable income is subject to the maximum marginal rate before taking any assessed losses into account. If this is the case, then either:

- There must have been assessed losses from the secondary activities in at least three of the past five years, or
- The secondary activities must be one of a designated group, which for convenience may be described as "suspect activities" (see below).

If either of these conditions is present, then, unless there is a "reasonable prospect" (see below) of deriving taxable income within a reasonable period from the secondary trade, losses from it are ring-fenced and may only be set off against future income from that secondary trade.

This regulation will become effective when the 2004/2005 tax year commences, and losses before then will not be taken into account. If an activity has once been declared suspect, its status can also not be changed, and it will be considered as such for the remainder of the taxpayer's lifespan.

Despite the three-losses-in-five-years test there is a further category in which certain activities are declared suspect beforehand. Where these activities are concerned, taxpayers will find that they won't be able to apply losses as deductions against profits from other activities, and this is already so for the current tax year (2004/2005). These activities include the following:

- Sport;
- Trade in collectors' items;
- Leasing living units, except in cases where at least 80% of the unit is occupied by a person who is not a family member of the tax payer;
- Leasing of vehicles, aircraft and boats, except in cases where at least 80% of the asset is used by a person who is not a family member of the taxpayer;
- Showing of animals in competitions;
- Farming or breeding of animals other than on a full-time basis;
- Performing arts such as acting, singing, painting, photography, pottery etc;
- Gambling and betting.

The owners of racing horses are specifically excluded from these activities. The portfolio committee of finance was of the opinion that the racing-horse industry is almost exclusively run by part-time owners and that the contribution this practice makes to the general economy justifies that such activities should not be declared suspect.

Escape route

Despite the stipulations already discussed, there is an escape route tax payers can follow so that their secondary activities are not declared suspect. For this escape plan the taxpayer will have to provide proof that his or her secondary practice is legal and has a good chance to become profitable in future. The rule of thumb is that the secondary practice should rather display the characteristics of a "business" than a "hobby". There must then be fair expectations that the business will become profitable within a fair period of time, and the following facts and situations will be key:

- *The relationship of losses to income* – If the taxpayer has a small gross income but accompanying large losses, it points to a risk for the Receiver, and it will be declared suspect;
- *Advertising and marketing* – A typical business that shows losses at first will advertise and market with the aim to attract profits at a later stage. In comparison, a hobby is seldom advertised or marketed with the aim of building a client base;
- *Running of a business* – The characteristic of a business-oriented practice will be that the activities surrounding it will be indicative of a business, and the following factors will be taken into account:
 - The number of full-time employees;
 - The position of the business (business site versus a cottage in the garden);
 - The number and value of equipment used;
 - The amount of time the taxpayer spends with the business.
 - ♣ The ratio of the number of years showing losses versus the number of years showing profit;
 - ♣ The future business plan of the practice;
 - ♣ The availability of the business' assets for passing time or entertainment.

The escape route cannot be used in cases where the secondary practice has suffered six losses during the past 10 years. If this is the case, the secondary practice doesn't pass the test and will be classified as

suspect. The supporting argument is that a person who has the intention to run a profitable business will not persist if it is continuously showing a loss. In comparison, a person who practices a hobby will persist with it even against a loss. Losses that were incurred up until 29 February 2004 will not be brought into consideration for this aim.

Other stipulations

The yield recovered from the sale of assets from such suspect activities can also be applied against the losses of those activities. Thus, it does not only have to realise a current income.

With regards to full-time farming operations, the operation as a whole is seen as a practice, and the various branches aren't considered separately. Losses in the beef-cattle enterprise of the operation can, for instance, be offset against profits in the maize enterprise. The various departments or branches of such a farming operation are not seen as secondary activities for ring fencing.

Ring fencing is only applicable to natural persons that practice a secondary business. It doesn't apply to companies, closed corporations or trusts. The latter entities are still taxed as a whole, and losses from so-called suspect activities may still be offset against profits from primary activities.

The new laws about ring fencing a loss from suspect activities do not want to limit the *bona fide* businesses. The aim of ring fencing is to limit the application of losses derived from the practice of a hobby against the main income of professionals' primary income, especially those subject to the maximum marginal rate. This will have a real impact on the tax paid by many part-time farmers. It could hold tax benefits for the Receiver, but it could have a negative effect on the economic contribution of those part-time farmers.

BETHLEHEM

June 2004