Tax treatment of losses incurred during lockdown

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There is little doubt that the national lockdown in response to the COVID-19 health crisis has had a negative financial impact on individuals and business alike. In our Tax & Exchange Control Alert of 28 May 2020, we discussed some of the practical day-to-day tax consequences that the lockdown may have on businesses.

In this alert we take a look at the effect that the national lockdown may have on expenditure or losses incurred by individuals and businesses. We also the look at the tax consequences that may arise as a result of employers providing their employees with personal protective equipment. To this end we will consider two scenarios.

Scenario 1: Tax treatment of losses incurred during lockdown
In our first scenario we have a taxpayer trading in general goods or rendering services that were not classified as essential goods and services, under the regulations promulgated under the Disaster Management Act 57 of 2002, which applied from the commencement of the lockdown on 26 March until 31 May, when the lockdown moved to level 3. This means that the taxpayer had to close their doors to customers from 26 March 2020 to 1 June 2020 when level 3 was introduced. During this period, the taxpayer may have incurred expenditure and suffered losses they may wish to claim as a deduction.

In order to calculate the taxable income of a taxpayer, one

must deduct from the taxpayers income all amounts that are allowed as tax deductions in terms of the Income Tax Act 58 of 1962 (Act). In terms of section 11 of the Act, in determining the taxable income derived by any person carrying on any trade, there shall be allowed as deductions from the income of such person expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature.

In terms of section 11, the first step of the enquiry is to establish whether the taxpayer was trading for purposes of the Act. Carrying on a trade presupposes a system or plan which discloses a degree of continuity in the operation. The test to be applied to determine whether trading is being carried on is an objective test. This means that if objective factors indicate that the taxpayer is trading then the trade requirement is satisfied.

The difficulty that arises here is that the taxpayer would have closed down its business for the duration of the lockdown and the question then becomes whether the taxpayer ceased to be carrying on a trade during that period.

In order to determine whether the taxpayer was trading one has to consider whether there were objective factors that indicated that, despite the closing down of the business for a considerable period, the taxpayer nevertheless continued carrying on a trade. The phrase *carrying on a trade* is not defined in the Act thus one has to look to how it has been defined in case law.

In *SA Bazaars (Pty) Ltd v Commissioner of Inland Revenue* 18 SATC 240, the court considered whether a taxpayer who carried on a retail general dealers business continued to trade for purposes of the Act when it closed down its business. In this case, the taxpayer had closed down its business but had continued to maintain its bank account, hold general meetings and prepare its annual account which disclosed that its losses

had been carried forward year-on-year since closing down.

While the taxpayers conduct was aimed at keeping itself alive during the period that it was closed down, this did not mean that it was carrying on a trade. Specifically, the court held that:

the mere fact that it kept itself alive during that and subsequent periods does not mean that during those periods it was carrying on a trade. It is clear from the stated case that it closed down its business and as long as it kept its business closed it cannot be said to have been carrying on a trade, despite any intention it might have had to resume its trading activities at a future date.

In ITC 777 19 SATC 320, the taxpayer owned property which it had endeavoured to lease out without much hope of success. The question that arose there was whether the taxpayer was carrying on a trade. The argument raised by SARS was that a mere intention to let out the property was itself not sufficient to constitute carrying on a trade. According to SARS, there must have been some actual dealing and the fact that the property had not been leased meant a trade was not being carried on. The court reasoned that had the taxpayer been successful in letting out the property there would be no question that the rental would have been income derived from carrying on a trade. The court held that-

a mere intention to let property would not amount to the carrying on of a trade but I do not agree that to constitute carrying on trade there had to be an actual letting. It was the intention of the company if possible, to let the property and though its efforts to do so were not sustained or strenuous it did endeavour to let it to and through associated companies. It has been held that in many businesses long intervals of inactivity occur. . . As the company had endeavoured to let the property, I am of opinion that it did carry on trade

According to the court a long period of inactivity did not negate the carrying on of a trade.

In ITC 1476 52 SATC 141, the court had occasion to consider the objective factors which, if present, would indicate the carrying on of a trade. The court stated that *the appellant incurred no expense for office rent or salaries. There were no travelling or advertising expenses. This is all an indication of no activity at all*. The court concluded that the absence of these factors indicated that the taxpayer was totally inactive and thus not carrying on a trade.

In Commissioner for *South African Revenue Service v Smith* 2002 (6) 621 (SCA), the Supreme Court of Appeal had to consider whether a taxpayer was carrying on the trade of farming when the taxpayer had no reasonable prospects of turning a profit. The court held that to be considered to be carrying on a farming operation, the taxpayer was only required to show that he possessed a genuine intention to carry on farming operations profitably. All considerations that had a bearing on whether a trade is being carried on, including the consideration of a profit, must be taken into account to answer the question.

What emerges from the case law above is that it is not possible to lay down an exhaustive list of activities that must be present in order to determine what constitutes the carrying on of a trade. All factors that have a bearing on the enquiry will be considered. This means that each case will be determined on its own facts.

Returning to our scenario, the taxpayer would have to first prove an intention to carry on trade and secondly, demonstrate the objective factors against which the taxpayers intention can be tested. Factors such as paying salaries, incurring rental expense and advertising costs will have a bearing on the enquiry. We submit that these factors would, if present, demonstrate that despite having closed down its business for

the duration of the lockdown, the taxpayer was not completely inactive.

Although, each case will be determined on its own merits, the circumstances under which businesses would have closed down during the lockdown period are quite unique and may also have a bearing on the enquiry.

Scenario 2: the provision of personal protective equipment

In our second scenario, an employer has been operating during the lockdown and has provided its employees with personal protective equipment, such as masks and hand sanitizers to use whilst at work.

Ordinarily, where an employer provides assets to its employees, it is likely that the employees will also use these assets for their own private use. In the case of masks and sanitizers, employees can also wear these masks at work and at home. The issue that arises is whether the assets that the employer has provided to its employees constitute a taxable benefit in the hands of the employees.

In terms of the Act, the value of fringe benefits, referred to as taxable benefits, received by an employee from his or her employer must be included in the gross income of an employee. The value is the cash equivalent of the fringe benefit, as determined under the provisions of the Seventh Schedule to the Act.

In terms of paragraph 6 of the Seventh Schedule, a taxable benefit arises whenever an employee is granted the right to use any asset by his or her employer for his private or domestic use. Where an employee is granted the right to use the asset over its useful life or a major portion of its useful life, the value of the private or domestic use is equal to the cost of the asset to the employer.

However, in terms of paragraph 6(4)(a) where the private or

domestic use of an asset by the employee is incidental to the use of the asset for the purposes of the employers business, no value is placed on that asset. This means that a taxable benefit does not arise. The determination of whether an asset is used mainly for the business of the employer is determined on the facts of each case.

The nature of the asset and the various ways in which the employee uses the asset, amongst other things, will be relevant in determining whether the asset is used mainly for the business of the employer. There must be a close link between the grant of the right to use the asset and the employees responsibilities. In this enquiry, what will ordinarily be important are the terms under which the use of the asset is granted.

In our scenario, an argument may be made that the use of personal protective equipment like masks is mainly to enable the employee to perform his job and consequently no value will be placed on the private or domestic use. What is important to note is that only when almost the entire use of the asset is for purposes of the employers business will the private or domestic use of the asset by the employee be considered to be incidental.

In addition, the employer and and employee could also potentially rely on paragraph 10(2)(c) of the Seventh Schedule to the Act. It states that no value is placed on any service rendered by an employer to his employees at their work place for the better performance of their duties or as a benefit to be enjoyed by them at their place of work. This means that were an employer has rendered a service to its employees at the workplace for the better performance of their duties there is a taxable benefit, to the value of nil. As such, no tax is payable even though there is still a taxable benefit. The argument here could be that the provision of personal protective equipment is a service rendered by the employer to the employees in order to ensure that they can perform their

duties during the on-going health crisis.

Another consideration from the employers perspective is whether the expenditure incurred in order to provide employees with personal protective equipment may also be deductible in terms of section 11 of the Act. As noted above, section 11 of the Act provides for the deduction of expenditure and losses incurred in the production of income, provided the expenditure or loss is not of a capital nature.

The question that will arise in this scenario is whether the expenditure incurred to acquire personal protective equipment for employees can be considered to be expenditure incurred for the purposes of earning an income by the employer.

In *Port Elizabeth Electric Tramways Company Ltd v Commissioner for Inland Revenue* 8 SATC 13 the court considered this very question and held that in order to answer this question what must be determined is how closely linked the expenditure is to the business operation of the taxpayer. The Court held that *all expenses attached to the performance of a business operation bona fide performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are bona fide incurred for the more efficient performance of such operation provided they are so closely connected with it that they may be regarded as part of the cost of performing it*.

In this case, it is submitted that as the use of personal protective equipment is required in order for businesses to be open, one could argue that the expenditure in respect of the provision of personal protective equipment would be expenditure that is necessary for the performance of the employers business operations.

Comment

Individuals and business who incur expenditure or losses as a result of the COVID-19 pandemic, must ensure that they meet

the relevant requirements to claim such expenditure or loss incurred as a deduction for income tax purposes. If a taxpayer is uncertain whether an amount is deductible, they should obtain proper tax advice on the issue or consider applying to SARS for an advanced tax ruling, in particular if the expense in question is significant.