CAPITAL ALLOWANCES IN TERMS OF SOUTH AFRICAN TAX LAW

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DECLARATION

I declare that this dissertation is my own, unaided work. It is being submitted for the degree of Master of Commerce in the University of the Witwatersrand Johannesburg. It has not yet been submitted before for any degree or examination in any other University.

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ABSTRACT

As a general rule, expenditure of a capital nature does not rank for deduction in the determination of taxable income.

Section 11(a) of the Income Tax Act, 1962, as amended (the Act) provides:

"For the purpose of determining the taxable income derived by any person from carrying on any trade within the Republic, there shall be allowed as deductions from the income of such person so derived -

(a) expenditure and losses actually incurred in the Republic in the production of the income, provided such expenditure and losses are not of a capital nature".

The Act does, however, provide in specific cases for the deduction of capital expenditure.

To a large extent, therefore, this dissertation is concerned with the nature and the extent of the special capital allowances with emphasis on the approach by the Courts, and practice adopted by the Revenue Department. The distinction blurred, as it often is, between expenditure of a capital nature and revenue expenditure falls outside the scope of this study.

Part I covers the incentives which are available to specific classes of taxpayers. Certain taxpayers are allowed to deduct capital expenditure from their income in the determination of taxable income. To this extent these taxpayers are placed in a privileged position. Various expressions relating to these taxpayers are not defined in the Act. One such expression is a "process of manufacture". An analysis of the decided cases has

revealed twelve different factors which the courts have considered in the interpretation of the expression. One of the main difficulties with "process of manufacture" seems to be the point at which process of manufacture commences, especially in relation to miners and farmers. Should a wine farmer, for instance be classed as a farmer or an industrialist? If the making of wine is a process of manufacture then the farmer is also an industrialist who would qualify for other incentives not normally available to farmers. However, the Act is not clear on what constitutes "process of manufacture".

Part II covers capital allowances available under the Act for intellectual property. Intellectual property consists of patents, designs, trade marks and copyrights. The Act refers to such intellectual property "or any other property which in the opinion of the Commissioner is of a similar nature". A detailed examination of each branch of intellectual property is made to identify "similar property".

Part III covers the deduction of expenses incurred in respect of knowledge. Knowledge is dealt with under three headings - know-how, scientific research and post-graduate studies. The deduction of capital allowances in respect of scientific research relates to the field of natural or applied science.
The field of natural science is very wide and includes engineering, architecture and quantity surveying. It would therefore seem possible that the professions engaged in those fields, for instance, could benefit by the tax allowances available in respect of scientific research.

Parts IV to VIII covers capital allowances available to most, and not only specific classes of taxpayers . Allowances for wear and tear, scrapping, leasehold improvements, lease premiums and repairs are discussed. The main issue in respect of the wear and tear allowance is the judicial interpretation of the expression "machinery or plant". One problem is that wear and tear is not allowed "buildings or other structures or works of a permanent nature". This leads to the question of machinery or plant re "machinery or plant" or whether they manner as to loo : their identity to become "building". The court cases have laid down a number of tests in this regard, such as intention, and these are discussed and related to the judicial interpretation of "machinery or plant" under common law.

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<u>PART I</u>

South Africa is becoming more industrialised and technology is developing rapidly. More and better machines are needed in order to -

- meet the quality and quantity of products demanded by world markets; and to
- manufacture products timeously for export markets.

In an effort to meet these objectives and also to stimulate development growth, certain privileged classes of taxpayers are provided with tax concessions and incentives. These concessions and incentives take various forms but normally amount to accelerated wear and tear allowances. In addition, certain taxpayers qualify for investment allowances, which result in deductions from their income of amounts which exceed the actual cost of qualifying items. The privileged classes of taxpayers are -

- manufacturers;
- industrialists in regional development areas;
- hotelkeepers;
- taxpayers erecting residential units;
- shipbuilders and owners of ships;
- owners of aircraft;
- exporters carrying on a beneficiation process;
- miners;
- farmers;
- co-operatives; and
- owners of national keypoints.

It is important to note that where doubt arises as regards the interpretation of the Act in relation to the deduction of capital expenditure by a privileged class, the interpretation must be applied restrictively against the class privilege: "The general rule is that expenditure of a capital nature cannot be deducted for the purpose of de.ermining the taxable income of a taxpayer. See section 11(2)(a) of the Act. In para 17 of the Third Schedule an exception is made in the case of farmers who are allowed to deduct the capital expenditure therein specified. To this extent farmers are, as a class, placed in a favourable position but there is no justification in the paragraph for extending this exception. Craies on Statute Law, p 109 says: 'The Courts, in dealing with taxing Acts, will not presume in favour of any special priviledge of exemption from taxation. Said Lord Young in Hogg v Parochial Board of Auchtermuchty, 7 Rettie 986: "I think it proper to say that, in dubio, I should deem it the duty of the Court to reject any construction of a modern statute which implied the extension of a class privilege of exemption from taxation, provided the language reasonably admitted of another interpretation"'" [per Centlivres CJ held in Ernst v CIR [1954 (1) SA 318 (A), 19 SATC 1 at 8]. This approach was confirmed in Badenhorst & Others v CIR [1955(2) SA 207 (N), 20 SATC 39]; and Buglers Post (Pty) Ltd v SIR [1974 (3) SA 28 (A), 36 SATC 71].

Machinery or plant

Deductions may be claimed in the form of initial and investment allowances in respect of machinery or plant used directly in a process of manufacture (Sections 12(1) and 12(2)). Although these allowances are available to hotelkeepers, they are not available in respect of mining and farming operations. The words "machinery or plant" are not defined in the Act (see C.21.7 infra).

CHAPTER 1

MANUFACTURERS

In the determination of their taxable income, manufacturers are allowed to deduct from their income, two types of allowances. These are an initial and an investment allowance calculated by reference to the cost of the qualifying item. The conditions under which these allowances may be claimed and the rates of the allowances are different in relation to the type of asset which would qualify. The qualifying assets are machinery or plant and buildings. In the case of buildings an annual allowance instead of an initial allowance may be claimed by industrialists.

1.1 Machinery or plant - initial allowance

The initial allowance relating to machinery or plant was introduced into the Act in 1954 at a rate of 10% calculated on the cost of new or unused machinery or plant. The rate of the allowances was increased over the years to its present level of 25%. Originally the allowance was restricted to machinery or plant used in a process of manufacture. In 1961, however, the allowance was extended to machinery or plant used in a process, which in the Commisisoner's opinion was of a similar nature.

An important concession was made in 1966. The allowance could from then onwards also be claimed by a lessor on the condition that the lessee uses the machinery or plant for the lessee's trade and is used by the lessee directly in a process of manufacture carried on by him or in any other process carried on by him which in the opinion of the Commissioner is of a similar nature.

Another important concession was made in 1978. The term "new or unused machinery" was extended to include used machines.

The effect of the initial allowance is to accelerate the writing off for tax purposes of the cost of machinery or plant. Unlike the wear and tear allowance which is calculated on the value (C21.4 <u>infra</u>) after certain adjustments, the initial allowance is calculated on the cost price of machinery or plant. Any donated asset, for instance would therefore not qualify for the initial allowance. However, there could be an argument that the initial allowance may well be calculated on the value of machinery or plant (C4.31 <u>infra</u>).

<u>Example</u>

A taxpayer purchases a machine on 1 January 1983 at a cost of R20 000. The machine is brought into use in a process of manufacture on 1 February 1983. The Commissioner allows 10% wear and tear on a "straight-line basis" and the taxpayer's year end is on 28 February 1983. Calculate the initial allowance.

<u>Solution</u>

	R
Cost of machine	20 000
Initial allowance - 25%	5 000
	15 000
Wear and tear allowance (10% x 15 000) x 1/12	125
Tax value at 28 February 1983	14 875

The special features of the initial allowance, are as follows:

- The machinery or plant may be new or used (second hand) but must be used by the taxpayer for the purposes of his trade, and used by him directly in a process of manufacture carried on by him, or in any other process carried on by him which in the opinion of the Commissioner is of a similar nature.
- The allowance is available to a lessor if the machinery or plant are used by the lessee for the purposes of the lessee's trade, directly in a process of manufacture carried on by him or any other process carried on by him which in the opinion of the Commissioner is of a similar nature [Section 12(1)(b) and (d)]. Sections 12(1)(b) and (d) provides that the machinery or plant must be used by a lessee for the purposes of the lessee's trade. A sub-lessee would therefore not qualify. The only section which specifically mentions a sub tenant is section 13(1) which deals with the annual allowance on buildings. It is further provided in sections 12(1)(b) and (d) that the lessor would not qualify for the allowance if the lessee does not derive amounts constituting "income" for the purposes of the Act.
- The cost of new or unused machinery or plant for the purposes of calculating the intial allowance is deemed to be the cost which, in the opinion of the Commissioner, is the cash price under a transaction concluded at arms length plus the direct cost of installation [Section 12(3A)]. This cost must be reduced by any untaxed recoupment in respect of machinery or plant damaged or destroyed.
- The cost of "used machinery, plant, implements, utensils or articles", for the purposes of calculating the allowance is "deemed to be the actual cost thereof (as established to the satisfaction of the Commissioner) less the aggregate of the amounts allowed to be deducted in respect thereof under

section 11(e)". The reason why the term "machinery, plant, implements, utensils or articles" is used in section 12(4) instead of "machinery or plant", is that the section applies also to hotelkeepers. A deduction of untaxed recoupments is not made from the cost of used machinery or plant as the concession under section 8(4)(e) is available o. y in respect of new machinery or plant in relation to a process of manufacture or in any other process which in the opinion of the Commissioner is of a simila: nature.

- It should be noted that the term "cost" would include the cost of foundations and supporting structures [Section 11(e) (iiA)].
- The initial allowance is not available to a lessor unless the lease is for a period of at least five years, or such shorter period as the Commissioner may approve [Section 12(5)(a)]. Any allowances which have been granted are included in income should the lessor dispose of his interest or portion of his interest within this period [Section 12(5)(b)].
- The recoupment of the allowance is subject to tax [Section 8(4)].
- The initial allowance is not available in respect of mining and farming operations.

The following recommendations by the Standing Commission on Taxation Policy was accepted in 1983 by the Minister of Finance:

"i) The initial allowance, which is currently granted at the rate of 25 per cent, should be increased in so far as machinery and plant used in a process of manufacture are concerned as from 1 July 1985 to at least 55 per cent (ie the existing 25 per cent plus 30 per cent to compensate for the abolition of the investment allowance) but to not more than 100 per cent.

(ii) Depending on the percentage at which the enhanced allowance is to be set any balance of the cost of the asset be written off over a limited period in order to ensure that taxpayer will not be in a worse position than at present.

(iii) The figure of 55 per cent should not be regarded as sacrosanct and could be decreased in future years.

(iv) Adequate warning of a proposed change in the rate should .. given by the Minister.

(v) The initial allowance of 25% be retained for the time being in respect of machinery and plant used in a process similar to a process of manufacture and that the Commission examine at the earliest opportunity the desirability or otherwise of extending the enhanced allowance referred to in recommendation - (i) above to equipment used in such similar processes".

1.2 Investment allowances

The investment allowances were introduced into the Act in 1960 with the purpose of giving a further incentive to the manufacturing and hotel industries. The Minister of Finance, at the time of introduction pointed out that these allowances were not be to regarded as a permanent feature of our tax system. The investment allowances were therefore granted for a limited period, were abolished a few years later (except in certain cases), and were re-introduced in 1970. The latest expiry dates are 30 June 1985 and 30 June 1986 in respect of machinery or plant and buildings respectively.

What the Minister said in 1970:
"My next concession is specifically designed to encourage fixed investment in manufacturing industry, which, as I

explained earlier, has for some time been lower than I should like to see.

Honourable Members will recall that a system of investment allowances was introduced by my predecessor in the early 1960s when investment was extremely sluggish, and was abolished (except in certain special cases) a few years ago when conditions had changed and inflationary pressures were building up.

Although, as I have explained, the danger of excessive pressure of demand on our limited resources has by no means disappeared, I think that a temporary encouragement to investment in manufacturing industry is again justified. (per 1970 ITR at p151)

In addition to mere encouragement, the Minister in 1973 revealed another purpose for the investment allowance. (per 1983 ITR at p62).

"With a view to encouraging industrial investment and also to allow to some extent for rising prices and consequential increased replacement cost of industrial buildings and machinery, an increase in the investment allowance is, to my mind, justified".

What the Minister said in 1975:

"I come to some important concessions designed to encourage investment, which is so essential for our economic future.

There has been much discussion lately of the effects of inflation under traditional accounting methods on business profits and in particular on the ability of business to set aside sufficient funds to replace capital assets. It is argued that depreciation allowances based on historical costs are insufficient at a time of rapid inflation, to make adequate provision for such replacement and in effect result in the over-statement of business profits". (per 1975 ITR at p69)

In 1976 and 1977 the purposes of the allowances were seen to compensate for the effects of inflation on the value of productive assets, and in 1979 inflation and increased replacement costs were again linked together as justification for the investment allowances.

During 1980 the Minister added yet another purpose for the investment allowance:

"These allowances today fulfil a dual function: firstly, they reduce the effective rate of taxation payable by companies and, secondly they bring relief in cases where depreciation and the write-off assets (are) based on historical costs. The view is held in some quarters that these allowances, by encouraging investments, tend to increase industrial capacity, a development which should normally not be curbed but that it may in certain circumstances be advantageous to pay these allowances in cash especially in decentralised areas because of the more difficult location problems experienced there.

Others, again, express concern about the large amounts foregone in revenue, especially when the allowances are not limited to their original purpose, and feel that it would be better to provide the desired incentive in the form of an appropriation of expenditure.

It is also argued that the possible encouragement of capital-intensive industries in this way is not conductive to the provision of adequate employment opportunities and that a better balance should be sought between incentives for capital and labour-intensive enterprises, also in the mining and agricultural sectors.

The matter has many facets and I feel that we should be cautious before changing the status quo. 'Opinions have vested interests just as men have', said Samuel Butler, and he could be right. I have thus deemed it fit to direct the Standing Commissioner on Taxation to investigate this whole issue and to submit recommendations to me". (per 1980 ITR at p76)

Considering the various statements by the Minister, the question arises as to whether these allowances have become a permanent feature of our tax law. The answer was given in 1981.

What the Minister said in 1981:
"The machinery investment allowance, which is granted to manufacturers in terms of the Income Tax Act has been in operation for many years. It is, however, not a permanent feature of tax law, but has been renewed from time to time for the purpose of encouraging continuing investment in modern industrial machinery and plant. In recent years the allowance has also served as a buffer against the steadily rising replacement costs of new equipment". (per 1981 ITR at p5).

The investment allowances are in addition to the initial and wear and tear allowances. They have the effect of allowing a manufacturer or a hotelkeeper to claim as a deduction an amount which is in excess of the cost of a qualifying asset.

Initially the investment allowances were meant for owners of assets only. In 1962 and 1966 the building and machinery or plant investment allowances respectively, were extended to the effect that lessees would as from those dates also qualify for the allowances.

The extension of the dates to which the investment allowances are claimable by taxpayers has become a regular feature since they were introduced into the Act. In a speech delivered on 13 November 1980 the Minister referred to an investigation into the desirability or otherwise of incentive allowances which was being carried out by the Standing Commission on Taxation Policy. The Commission recommended that:

"The investment allowance on machinery and plant, which is due to expire on 30 June 1985, should not be extended for a further period but should be abolished". (per Report By The Standing Commission 1983 at p19).

The Minister of Finance accepted this recommendation in 1983.

1.3 Machinery or plant - investment allowance

The special features of the investment allowance, the rate of which is at present 30% of the cost of new machinery or plant, are as follows:

- The machinery or plant must be new or unused [Section 12(2)].
- The machinery or plant must be used by the taxpayer for the purposes of his trade directly in a process of manufacture carried on by him [Section 12(2)]. Prior to 1 July 1979 processes similar to a process of manufacture also qualified.
- The allowance is available to a lessor if the machinery or plant are used by the lessee for the purposes of his trade directly in a process of manufacture carried on by him. It is specifically provided that the allowance is not available if the lessee does not in carrying on his trade, derive income as defined in the Act. In other words, if the lessee is, say, a pension fund which is exempt from tax, the allowance would not be available [Section 12(2)(d)].

- The allowance is calculated on the cost, which is deemed to be the cost which in the opinion of the Commissioner is the cash price, under a transaction concluded at arm's length, plus the direct cost of installation [Section 12(3A)]. The term "cost" includes the cost of foundations and supporting structures [Section 11(e)(iiA)].
- The allowance is not available to a lessor unless the lease is for a period of at least five years, or such shorter period as the Commissioner may approve [Section 12(5)].
- The recoupment of the investment allowance is subject to tax only in the instance where a lessor has within five years disposed of the whole or portion of his interest or his right to receive rent under the lease [Section 12(5)(b)].
- The allowance may be increased by the Minister of Finance if such machinery or plant are brought into use in an economic development area [Section 12(2A)].
- The investment allowance is not available in respect of mining or farming operations.

1.4 Buildings

Deductions may be claimed in the form of annual and investment allowances in respect of buildings used in a process of manufacture [Sections 13(1), 13(5)]. The allowances are not available in respect of mining or farming operations. The word "building" is not defined in the Act (C21.6 *infra*).

1.5 Building annual allowance

The annual allowance of 2% on the cost of new factory buildings was introduced into the Act in 1959. Initially the allowance was only available on new buildings, but has subsequently been extended to include improvements to existing buildings. The allowance is available on a "straight-line" basis and is not reduced proportionally if not used as specified for the full year of assessment.

Example

A factory is erected by a taxpayer and is occupied on 27 February 1983 for the purposes of a process of manufacture. The taxpayer's year end is 28 February 1983 and the cost of the building was R200 000.

Solution

	R
Allowance at 28 February 1983	
Annual allowance of 2%	4 000
Investment allowance - 20% (Cl.6 *infra*)	40 000
	44 000

It is interesting to note that the annual allowance is specifically available to a lessor even if the occupier of the premises is a sub-tenant. Section 13(1) uses the phrase "tenant or subtenant" and not "lessee" as in the case of section 12(1) and 12(2) which deal with capital allowances in respect of machinery or plant.

The special features of the annual allowance which has remained unchanged at 2% [Section 13(1)] per annum of the cost of buildings are:

- The allowance is available to a taxpayer who incurs the cost of the building or improvements. In other words, a non-owner of the assets concerned such as a lessee will also qualify for the allowance.

- The buildings must be used during the year of assessment by the taxpayer in the course of his trade, or by his tenant or subtenant, wholly or mainly for the purposes of carrying on therein any process of manufacture or any other process which in the opinion of the Commissioner is of a similar nature [Section 13(1)(b)].
- A taxpayer who purchases a building will be allowed the annual allowance only if the seller was entitled to the allowance and the building was wholly or mainly used during the year of assessment by the taxpayer, his tenant or subtenant for the purpose of carrying on therein a process of manufacture or any other process which in the opinion of the Commissioner is of a similar nature [Section 13(1)(d)].
- Improvements to buildings will qualify for the allowance. The buildings must be used during the year of assessment by the taxpayer, his tenant or subtenant in the manner outlined above [Section 13(1)(f)].
- Buildings or improvements thereto to the extent to which an allowance has been granted in terms of section 11(g) ("leasehold improvements" Chapter 23), are specifically excluded for the purpose of the annual allowance. The aggregate of the annual and leasehold improvements allowances are limited to the cost of the buildings or improvements thereto [Section 13(2)]. The reference to cost of the buildings or improvements is the cost after the deduction of untaxed recoupments under section 8(4)(e).

Example

A taxpayer carries on a process of manufacture, and:

a) in terms of an obligation under a lease for twenty years erects a factory at a cost of R200 000; or

b) erects a factory on his own property at a cost of R200 000.

Two years subsequent to occupying the factory, it was destroyed by fire. An insurance claim of R200 000 was received and the taxpayer replaces the factory in the same year at a cost of R250 000.

Solution (a)

Should the taxpayer claim an allowance under section 11(g), he would not be allowed a deduction under section 13(1) viz the annual allowance.

	R
Cost of improvements	200 000
Allowances under section 11(g) for	
2 years, ie 2 x R10 000	20 000
Tax value at date of fire	180 000
Insurance receipt	200 000
Recoupment of section 11(g) allowances	20 000

The taxpayer has an option to set off this recoupment "against so much of the cost to him of such further building purchased or erected by him as remains after the deduction of any portion of such cost in respect of which an allowance has been granted to the taxpayer under section 11(g), whether in the current or any previous year of assessment". [Section 13(3). See below for conditions].

Should such an election be made:

	R
Cost of replacement building	250 000
Less: Recoupment	20 000
	230 000
Less: Aggregate allowances under section 11(g) (will be spread over 18 years but is limited to the amount stipulated in the lease)	200 000
Portion of cost subject to annual allowance of 2%)	30 000

Solution (b)

Cost of factory	200 000
Annual allowance - 2% for 2 years	8 000
Tax value at date of fire	192 000

The receipt of R200 000 from the insurance company will render R8 000 subject to inclusion into income of the taxpayer as a recoupment [section 8(4)(a)]. The recoupment of the investment allowance is exempt from tax. In terms of section 13(3) the recoupment of the annual allowance can at the option of the taxpayer be set off against the cost of a replacement and not be included in the taxpayer's income in the year of recoupment. There are however, certain conditions -

- the taxpayer must notify the Commissioner in writing of the exercise of the option when submittng his return of income for the year during which the recoupment occurred; and

- another qualifying building must be purchased or erected within twelve months or such further period as the Commissioner may allow from the date on which the event giving rise to the recovery or recoupment occurred.

	R
Cost of replacement building	250 000
Less untaxed recoupment	8 000
Amount subject to annual allowance to be claimed at the rate of 2% p.a.	242 000

- Any untaxed recoupment in terms of section 8(4)(e) must be deducted from the cost of the building or improvements thereto replacing those which have been damaged or destroyed, for the purposes of calculating the annual allowance [Section 13(3)].
- A regular feature of this allowance is that the buildings must be used during the year of assessment by the taxpayer, his tenant or subtenant in the manner outlined above. It follows therefore that a lessee will qualify for the allowance if he has incurred the cost irrespective of the period of the lease. In other words if the lessee is still in occupation after the expiry of the lease he would still qualify for the allowance. Should the lessee cease occupation, the allowance will likewise cease. The lessee could under the latter circumstances qualify for a scrapping allowance.
- The 1983 Report By The Standing Commission of Enquiry recommended (at p20) as regards factory buildings that "where the erection of such buildings is commenced after 30 June 1985 a building initial allowance equal to 20 per cent of the cost to the taxpayer of the building be granted in the year in which the building is brought into use". This incentive is to substitute the present annual and investment allowances on the cost of industrial buildings.

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- The 1983 Report By The Standing Commission of Enquiry recommended (at p20) as regards factory buildings that "where the erection of such buildings is commenced after 30 June 1985 a building initial allowance equal to 20 per cent of the cost to the taxpayer of the building be granted in the year in which the building is brought into use". This incentive is to substitute the present annual and investment allowances on the cost of industrial buildings.