

CAPITAL ALLOWANCES IN TERMS OF SOUTH AFRICAN
TAX LAW

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A dissertation Submitted to the Faculty of Commerce
University of the Witwatersrand, Johannesburg
for the Degree of Master of Commerce

June 1984

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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22 June 1984

CONTENTS

	Page
ABSTRACT	xvi
TABLE OF CASES	
Supreme Court and others	xix
Special court for hearing income tax appeals	xxx

PART I

<u>PRIVILEGED CLASSES OF TAXPAYERS</u>	1
Chapter 1 MANUFACTURERS	
Machinery or plant - initial allowance	3
Investment allowance	7
Machinery or plant - investment allowance	11
Buildings	12
Building annual allowance	12
Building investment allowance	18
Chapter 2 INDUSTRIALISTS IN REGIONAL DEVELOPMENT AREAS	21
Regional development incentives	25
Development regions	31
The incentives	33
Incentives in Metropolitan areas	33
Who qualifies for incentive allowances	33
Capital allowances	35
Rail rebate on outgoing goods	35
Rail Rebate on incoming goods	35
Road transportation - own vehicles	36
Rebate on private road transportation	36
Rebate on harbour services	36
Electricity subsidy	36

	Page
Subsidy on housing for key personnel	37
Training rebate in cash	37
Special tender preferences	38
Labour incentive	38
Interest subsidy	38
Rental subsidy	39
Relocation costs	39
 Chapter 3	
HOTELKEEPERS	41
The nature of an hotel	42
Hotel equipment - initial allowance	46
Hotel equipment - investment allowance	47
Hotel buildings	48
 Chapter 4	
PROCESS OF MANUFACTURE	53
Meaning of "process of manufacture"	53
Manufacture v alterations	55
Manufacture v assembly	56
Manufacture v preparation	57
Manufacture v repair	58
Use of labour and machines with skill and experience	59
Change in Utility	60
Process as one in a series	62
Difference in nature of product	64
Change in immovable property	66
Volume of production	67
Process of manufacture - summary of judicial interpretation	69
Commencement of the process	69
Directly in a process of manufacture	74
New machinery	76

	Page
Qualification - who must carry on process	79
Cost of buildings or improvements	80
Pre-production interest	84
Trade and income from trade	86
Location of trade	88
Interpretation	89
Privileged classes of taxpayers	91
Undistributed profits tax	91
Recoupment - UPT	94
Recoupment of initial allowance	96
Recoupment of investment allowance	97
Scrapping allowance	97
Tax implications of leasing instead of purchasing	98
The element of time - illustration	99
The availability of a tax base	102
Cost of machinery or plant	106
Departmental practice	110
Practical application	110
 Chapter 5 TAXPAYERS ERECTING RESIDENTIAL UNITS	 119
Nature of a residential unit	120
Locality of residential unit	122
Capital allowances	122
Residential building annual and initial allowances	123
Recoupment	123
Scrapping	126
 Chapter 6 SHIPBUILDERS AND OWNERS OF SHIPS	 127
The nature and meaning of a "ship"	127
The nature and meaning of a "ship" under English law	131

	Page
Nature and meaning of "ship" - conclusion	138
Ship and its appurtenances	139
Movable property	141
Machinery or plant	141
Capital allowances	142
Annual allowance	142
Special initial allowance	144
Allowance in respect of future repairs	146
Adjustable cost	147
Recoupment of allowance	147
Scrapping allowance	149
Subsidiary companies	157
 Chapter 7 OWNERS OF AIRCRAFT	 160
Brief history of flight	160
Nature of an aircraft	161
Capital allowances	162
Annual allowance	162
Initial allowance	163
Adjustable cost	165
Recoupment	174
Scrapping allowance	177
 Chapter 8 EXPORTERS CARRYING ON A BENEFICIATION PROCESS	 178
The nature of the beneficiation allowance	180
Beneficiation process v process of manufacture	184
The amount of the beneficiation allowance	185
Recoupment of the beneficiation allowance	185
Scrapping allowance	186
Machinery or plant	186

	Page
Chapter 9 MINERS	187
The meaning of "mining operations"	188
Mining operations v process of manufacture	191
Mining v processing - common law	193
Mining v processing - foreign countries	195
Summary of decisions under common law and in foreign cases	199
Mining operations - uranium and natural oil	199
Mining operations v process of manufacture - conclusion	203
"Minerals" - under common law	204
"Minerals" - under tax law	205
"Minerals" under foreign tax law	207
"Minerals" - conclusion	209
Capital expenditure incurred by a miner	209
The nature of capital expenditure	214
Capital expenditure - multiple mining operations	218
Capital expenditure - locality of assets created	219
Special capital allowance	221
Recoupment of capital allowances	224
Prospecting expenditure	227
Capital expenditure on change of ownership	229
Chapter 10 FARMERS	234
Farming operations	234
Summary of judicial interpretations - "farming operations"	240
Income derived from farming operations	241
Speculation in livestock	244
Horse racing	245

	Page
Donation and inheritance	246
Fructus	247
Summary of South African interpretations - "derived from farming operations"	249
Farming operations v process of manufacture	249
Summary of judicial decisions	254
Capital expenditure	254
Expenditure must be incurred by the farmer	264
Expenditure incurred "in respect of"	266
Buildings used in connection with farming operations	269
In connection with farming activities	276
Other buildings	279
Machinery, implements, utensils and articles	279
Recoupment of capital expenditure	283
Plantation farmers - capital expenditure	290
Plantation farmers - recoupment of capital allowances	291
 Chapter 11 CO-OPERATIVES	292
Co-operatives v companies	293
Types of co-operatives	295
Primary agricultural co-operatives	296
Primary special farmers' co-operatives	297
Primary trading co-operatives	298
Central and federal agricultural co-operatives	298
Central and federal special farmers' co-operatives	299
Central and federal trading co-operatives	299
Membership	300
Capital allowances	300

	Page
Storage building	302
Agricultural products	303
Primary process	305
Structures of a permanent nature	309
Annual allowance	310
Investment allowance	314
Cost of building	315
Machinery initial allowance	316
Machinery investment allowance	317
Cost of machinery or plant	319
Loan repayment allowance	320
Recoupment	326
Scrapping	327
Amalgamations of co-operatives	327
Location of qualifying assets	331
Machinery or plant	332
 Chapter 12 OWNERS OF NATIONAL KEY POINTS	 334
Expenditure incurred	335
"Place or area"	336
"Directly"	337
The owner of a national key point	340
Recoupment of security expenses	341
 INTELLECTUAL PROPERTY	
 Chapter 13 PATENTS	 345
Brief history	345
Nature of patents	346
Inventive steps	349
"Capable of being used"	349
Categories of excluded matter	350
Assignment	351

PART II

Chapter 14	DESIGNS	352
	Nature of a design	352
	Duration of design protection	354
Chapter 15	TRADE MARKS	355
	Brief history	355
	The nature of trade marks	358
	Validity of a trade mark	360
	Distinctiveness of a trade mark	362
	Duration or "life" of a trade mark	363
	Registered users of trade marks (Section 48 of the Trade Marks Act)	363
	Assignment of a trade mark (Section 49 of the Trade Marks Act)	365
	Deemed trade mark	366
	Defensive trade marks (Section 53 of the Trade Marks Act)	367
Chapter 16	COPYRIGHTS	368
	Brief history	368
	Works eligible for copyright	370
	Copyright of computer programs	372
	Nature of copyright	373
	Duration of copyright protection	374
Chapter 17	SIMILAR PROPERTY AND OTHER PROVISIONS	377
	Similar property	377
	Acquisition of intellectual property	380
	Royalty payment	381
	Lump sum payment	381
	Capital payment	381
	Character of outright assignment	381

	Page
Premium or consideration in the nature of a premium	383
Capital allowance - outright purchase	384
The amount of the allowance	385
Exporters	387

PART III

KNOWLEDGE

Chapter 18	"KNOW-HOW"	391
	Nature of "know-how"	391
	Secret processes	395
	Secret processes and "similar property"	395
	Premium or consideration in the nature of a premium	397
	Imparting knowledge	398
	Directly or indirectly connected	399
	Active and passive elements	400
	Amount of the allowance in respect of premiums	400
	Acquisition of "know-how"	401
	"Connected with"	402
	Used in the production of income	403
	Amount of the allowance	403
	Recoupment of allowances	404
	Scrapping allowance	406
	Relief to lessors	406
Chapter 19	SCIENTIFIC RESEARCH	407
	Nature of scientific research	407
	Scientific activities	408
	Research and development	408

	Page
Distinction between development and implementation	411
Research - related scientific activities	412
Non-research related scientific activities	413
Research fields	414
Capital allowances	414
Expenditure of a capital nature	419
Certificates by the Council for Scientific and Industrial Research (CSIR)	424
Recoupment of scientific research expenditure	424
Recoupment	426
Scrapping allowance	427
Conclusion	427
 Chapter 20 POST-GRADUATE STUDIES	430
Expenditure incurred	435
Travelling	434
Living and subsistence	435
Departmental practice	435
1983 Amendment	439
 PART IV	
 Chapter 21 WEAR AND TEAR	442
Commissioner's discretion	443
Basis used in the calculation of wear and tear	445
Value of any machinery, implements, utensils and articles	447
Machinery, implements, utensils and articles	452
Buildings	455
Plant or machinery	456
Structures	467

	Page
Articles	468
Movables attached to immovables	469
Weirs	473
Railway lines	473
Other structures	475
Carports	477
Subject matter attached or affixed to buildings or structures of a permanent nature	478
Improvements	486
Used by the taxpayer for the purposes of his trade	487
"By reason of wear and tear"	488
"During the year of assessment"	491
Recoupment of wear and tear	492
How recoupments take place	493
Date on which recoupment takes place	494
Amount of recoupment	495
Privileged classes of taxpayers	497
Capital nature of recoupment	500
"Lock stock and barrel" transactions	502
Incidence of inflation	502
Departmental practice	504

PART V

Chapter 22	SCRAPPING	506
	Special features	506
	The meaning of "scrapping"	510
	Physical deterioration - during the course of carrying on a trade	512
	Decision to scrap and cessation of use	516
	Owner of assets	518
	For the purposes of trade	518
	During the year of assessment	519

PART VI

Chapter 23	LEASEHOLD IMPROVEMENTS	522
	Limitations	523
	Leveraged leasing	527
	Lease agreement	529
	Period of lease	530
	The amount of the allowance	530
	Obligation	533
	Implied obligation	534
	Variations to lease agreements	536
	Proportionment	537
	The tax treatment of the lessor	538
	Relief granted to the lessor	540
	Recoupment	543
	Scrapping allowance	547

PART VII

Chapter 24	REPAIRS	551
	Meaning of "repairs"	551
	Actually incurred	553
	Occupied for the purposes of trade	554
	In respect of which income is receivable	554
	Beetles	555
	For the purpose of trade	556
	Repairs v reconstruction and improvements	557
	Intention	570
	Notional cost of repairs	571
	Conclusion	573

PART VIII

Chapter 25	LEASE PREMIUMS	576
	Meaning of "lease premiums"	576
	The tax treatment of the lessor	579
	Relief granted to lessor	580
	Recoupment	580
	Tax exempt entities	580
Annexure A	Industrial development points	583
Annexure B	Minimum requirements for hotels	589
Annexure C	Minimum differential grading requirements for hotels	601
Annexure D	Hotel grading factors and points	613
Annexure E	Research fields	630
Annexure F	Departmental practice - wear and tear	659
	BIBLIOGRAPHY	668
	INDEX	673

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 lose 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.

The author wishes to express his thanks to the following persons for their advice, encouragement and assistance towards the preparation of this dissertation:

- . The Department of Inland Revenue for permission to make use of the A F Corbett Library.
- . Professor E B Broomberg for his advice and encouragement and many valuable suggestions.
- . The partners of Alex. Aiken & Carter for their assistance in the production of the manuscript, and the permission to make use of their word processor and stationery.
- . A L H Mayne for his proof-reading of the manuscript.
- . Miss G Smith for her patient and painstaking typing and retyping of the manuscript.
- . Cynthia, my wife, for her extreme patience and tolerance.

TABLE OF CASES

SUPREME COURT AND OTHER	Page
A v Cot 1954(1) SA 38(SR), 19 SATC 29	533
African Detinning Works (Pty) Ltd, SIR v, 1982(1) SA 797(AD), 42 SATC 134	486
African Products Manufacturing Co Ltd, CIR v, 1944 TPD 248, 13 SATC 164	558 569
Afrikaanse Verbond Begrafnis Onderneming Beperk v CIR 1950 (3) SA 209 (A), 16 SATC 401	252 260
Ambleside Tobacco Grading Company (Pvt) Ltd v Abrahamson No 1959 (1) SA 295 (R)	236 251
Anglo American Corporation of SA Ltd v COT (1) SA 973 (RAD), 37 SATC 45	260
B v COT 19 SATC 353	572 573
Bacher Aron & Co (Rhodesia) Ltd, Minister of Finance v, 1956(1) SA 63 (SR), 20 SATC 321	53 55 56
Badenhorst & Others v CIR 1955 (.) SA 207 (N), 20 SATC 39	2 291
Barclay, Curle & Co Ltd, CIR v, (1969) IWL 675, 45 TC 221	81 461
Barron and Others v Sachar 1947 (2) SA 1049	243
Bells Trust v CIR 1948 (3) SA 480 (A), 15 SATC 255	275
Bellville-Inry Edms Bpk v Continental China (Pty) Ltd 1976 (3) SA 583 (C)	182
Beneke & Another, R v, 1957(1) SA 594, 21 SATC 183	59 251
Benson v Yard Arm Club Ltd (1979) STC 266, (1979) 2 All ER 336	463
Berg, Rex v, 6 SATC 320	488
Berold, Rex v, 1943 CPD 344	253
Blom and Another, Rex v, 1951 (1) SA 708(T)	194
Blumberg & Sulski v Brown & Freitas 1922 TPD 130	242

TABLE OF CASES

SUPREME COURT AND OTHER (Cont)	Page
Boksburg Brick and Fire Clay Co Ltd v CIR 1941	
TPD 232 12 SATC 225,	189 190 191 206
Booyesen's Estates, COT v 1918 AD 576, 32 SATC 10	430
Broken Hill (Proprietary) Limited v FCT 1969	
1 ATR 40	82 197 230 454 464
Brown v Burnley Football and Athletic Co Ltd (1980)	
STC 424	463
Bryant v Minister of Labour and Minister of Justice 1943	
TPD 205	217 250
Buglers Post (Pty) Ltd v SIR 1974 (3) SA 28 (A),	
36 SATC 71	2 234 268
Butcher Bros (Pty) Ltd, CIR v, 1945 AD 301,	
13 SATC 21	538 576 578
C v COT 1981 (2) SA 298(ZA), 43 SATC 9	469 485
Cadac Engineering Works (Pty) Ltd, SIR v, 1965 (2) SA	
511 A, 27 SATC 61	420
Caladonian Railway Co v Banks 1880, 18 SLR 85, 1 TC 487	489
Californian Copper Syndicate v Inland Revenue 1904,	
41 SCLR 691	246
Caltex (Africa) Ltd v Director of Valuations 1961 (1)	
SA 525 (C)	288
Cape Brandy Syndicate 1921 1 KB 64	89 90
Cape Explosives Works v South African Oil and Fat	
Industries Ltd 1921 CPD 244	272
Cape Lime Company Ltd, SIR v, 1967 (4) SA 226(A)	
29 SATC 131	70 72 192

TABLE OF CASES

SUPREME COURT AND OTHER (Cont)	Page
Cape Truck Co, Commissioner of Customs v, 15 SATC 474	459
Carfax Waste Paper Co Ltd v Minister of Labour (1968)	
1 All ER 1041	63 308
Carlis v Oldfield, 4 HC 385	141
Carltonville Motors (Pty) Ltd, CIR v, 1964(3) SA 581 AD,	
26 SATC 195	535
Gate v Devon and Exeter Constitutional Newspaper Co (1889)	
40 Ch D 500	374
Champions Ltd v van Staden Bros and Another,	
1929 CPD 330	287 471
Charkay Properties (Pty) Ltd, SIR v, 1976 (4) SA	
872 (AD), 38 SATC 159	468 477 483 387
City Deep Limited, CIR v, 1924 AD 298, 1 SATC 18	377 395 433
Clayton v COT 1923, SR 105	553
Cole Bros Ltd v Phillips (1980) STC 518	464
Coltman v Chamberlain (1890) 25 QB 328	140
Consolidated Citrus Estates Ltd, SIR v, 1976 (4)	
SA 500, 38 SATC 126	339
Cook v Beach Station Caravans (1974) STC 402 (1974) 3 All	
ER 159	463
Corelli v Gray 1912 29 TLR 570 1913, 30 TLR 116	373
Crown Mines Ltd, CIR v, 1923 AD 121	267
CTC Bazaars (SA) Ltd, Rex v, 1943 CPD 334	253
Daphne v Shaw (1927) 11 TC 256	460 461
D'Arcy v Allen 11 Co (Rep 846)	
Dawson v Counsel! (H M Inspector of Taxes) 1922 TC 149	245
Delfos, CIR v, 1933 AD 242	89
Dibowitz v CIR 1952 (1) SA 55 (AD)	90
Die Olifantsrivierse Ko-operatiewe Wynkelders Bpk,	
SBI v 1976(3) SA 261 (AD), 38 SATC 79	87

TABLE OF CASES

SUPREME COURT AND OTHER (Cont)	Page
Dixon v Fitch's Garage Ltd (1975) STC 480, (1975) 3 All ER 455	463
Dryburgh v The Lord Advocate 1926 Scots Law Times, p99	217
Dun & Bradstreet (Pty) Ltd v SA Merchants Combined Credit Bureau (Cape) (Pty) Ltd 1968 (1) SALR 209	396
du Preez v Steenkamp 1926 TPD 362	242
E S & A Robinson (Rhodesia) (Pvt) Ltd v Macintyre No 1962(2) SA 638, 24 SATC 767	59
Earl of Derby v Aylmer 6 TC 665	457
Eaton Hall (Pty) Limited, SIR v, 1975 (4) SA 954(AD), 37 SATC 343	83 84 338
Eaton v Registrar of Deeds 1890 7 SC 249	342 451
Edwards v Barberton Mines 1961 (1) SA 187(T)	288 471
EJ Bowman (London) Ltd and Others, T Oertli AG v, (1957) RPC 388	358
Ernst v CIR 1954 (1) SA 318 (A), 19 SATC 1	2 265 267 271 272
Evans Medical Supplies Ltd v Moriarty (H.M. Inspector of Taxes) 37 TC 540	392 396
Ex Parte Beal 1867 3 QB 387	374
Ex Parte Erasmus 1968 (4) SA 788 (T)	205
Ex Parte Ferguson and Hutchinson (1870) 6 QB 280	137
Falcon Investments Ltd v Birnam (Suburban) (Pty) Ltd 1973 (4) SA 384 (A)	182 204 205 207
Fisher's Executrix, Union Government v, 1921 TPD 328	342
Francis Day and Hunter v Bron (Trading as Delmar Publishing CO) 1963 2 All ER 16 24	373 374
Franz Hanfstaengl v H R Baines & Co Ltd and E J Mansfield 1895 AC 20	374

TABLE OF CASES

SUPREME COURT AND OTHER (Cont)	Page
Gale v Laurie and Others 5 B & C 156	139
Gault v Behrmann 1936 TPD 38	287 471
George Forest Timber Co Ltd, CIR v, 1924 AD 516, 1 SATC 20	209 342 415
Giesken and Giesken, Rex v, 1947 (4) SA 561 (AD)	235 251
Glen Anil Development Corporation Limited v SIR 1975(4) SA 715 (AD), 37 SATC 319	90
Gordon's Hotel Ltd, LCC v, 114 LT 1126	276
Gray No v Assistant Master & Another 1979(3) SA 427, (High Court of Zimbabwe), 41 SATC 117	66
Great Western Railway v Carpalla United China Clay Company 1909 1 Ch 218	207
Grootvlei Proprietary Mines Ltd v CIR 1952 (4) SA 440 (A), 18 SATC 231	224 225
Guardian Assurance Holdings (SA) Ltd, SIR v, 1976 (4) SA 522 (A), 38 SATC 111	433
Guernsey & Foreign Investment Trust Ltd v CIR 1938 CPD 158, 9 SATC 390	188
H v COT 1981 (2) SA (ZA), 43 SATC 22	238
Hampton v Forte Autogrille Ltd (1980) STC 80	463
Handley Page v Butterworth 19 TC 328	392
Hanfstaengl v Newnes 1894 3 Ch 109	374
Hastings v Cogavin 1904 2 Ir R 529	267
Hatrick & Co Ltd v The King 128 LT 430	276
Hayne and Co v Kaffiar'an Steam Mill Co Ltd 1914 AD 363	229 282 335
Henderson, FCT v 1969 1 ATR 133	189
Herbert Morris Ltd v Saxelby 1916 1 AC 688	392
Hersamer (Pty) Ltd, SIR v, 1967(3) SA 177(AD), 29 SATC 53	53 55 61 62 63 68

TABLE OF CASES

SUPREME COURT AND OTHER (Cont)	Page
Highland Railway Co v Balderston 1889, 16 R 950, 2 TC 425	555
Hobday v Nicol 1944(1) AER 302	467
Hogg v Parochial Board of Auchtermuchty 7 Rettie 986	2 271
ICI Australia Ltd, COT v, 1972 3 ATR 321	198
Imperial Chemical Industries of Australia and New Zealand v FCT 1 ATR 450	466
J Lyons and Co Ltd v Attorney General (1944) Ch 281	460
Jarrold v John Good & Sons Ltd (1963) 1 All ER 141, 40 TC 681 CA	463
Jones & Co v CIR 1926 CPD 1, 2 SATC 7	188
Joseph Crisfield & Sons Ltd Appn (1909) 26 RPC 837	362
Kantor v Macintyre No & Another 1958(1) SA 45 (FC), 21 SATC 407	54 59 66 251
Kerguelen Sealing and Whaling Co Ltd v CIR 1939 AD 487, 10 SATC 363	272
Knight v COT (Ratcliffe and McGrath Income Tax Decisions 1928 - 30 p 330)	245
Kramer, Rex v, 1929 TPD 173	253
KWV v Industrial Council for the Building Industry & Others 1949 (2) SA 614 (AD)	236 250 253 303 467
Koffyfontein Estates Ltd v COT 1917 TPD 250	473
La Sueur, CIR v, 1960 (2) SA 709 (AD), 23 SATC 261	279 333 455 478 481 486
Lewis v Fothergill 5 Ch 106	194
Lombard, R v, 1948 (2) SA 31	128 235
Lurcott v Wakely and Wheeler 1911 1 KB 903	551 561 563
Macdonald Ltd v Radin NO 1915 AD 467	287 470 474 479
MacGregor TM RPC 36	364
Maden & Ireland Ltd, Hinton (HM Inspector of Taxes) v, (1959) 3 All ER 356	458 460

TABLE OF CASES

SUPREME COURT AND OTHER (Cont)	Page
Margrett v Lowestoft Water and Gas Co (1935) 19 TC 481	567
Mashaoane v Mashaoane 1962 (1) SA 628 (D & CLD)	336
Masonite Africa Ltd v Estcort Municipality 1955 (3) SA 88	302 455
McNicol v Pinch 1906 2KB 352	56
McVeigh v Arthur Sanderson & Sons Ltd (1969) 1 WLR 1143, 45 TC 273	461
Melluish v LCC 111 LT 539	276
Merchant's Marine Insurance Co Ltd v North of England Protecting & Indemnity Association (1926) 25 Lloyd LR 446	133 136
Millin v CIR 1928 AD 207, 3 SATC 170	430
Modderfontein Deep Levels Ltd & Another v Feinstein 1920 TPD 283	87
Mooi v SIR 1972 (1) SA 675 (A), 34 SATC 1	421 579
Moorreesburg Produce Co Ltd v CIR 1945, CPD 289, 13 SATC 245	493
Moreton Central Sugar Mill Co Ltd v FCT Commissioner of Taxation 1967 10 AITR 420 73 464	
Morris Motors v Lilley 9, 3 All ER 737	77
Mount Isa Mines v FCT 1955, 6 AITR 346	227
Munby v Furlong (1976) STC 72, 50 TC 491	461
Murchison Exploration and Mining Co Ltd v CIR (TPD) June 1938, 10 SATC 143	190
Murray v Imperial Chemical Industries Limited 1967 2 All ER 980	381
Musker v English Electric Co 41 TC 556	393
Mutual Life Insurance Co of New York v Ingle 1910 TPD 540	189
Myerson, CIR v, 1947 (2) SA 1243 (AD), 14 SATC 300	576
Natal Estates v SIR 1975 (4) SA 177 (A), 37 SATC 175	266

TABLE OF CASES

SUPREME COURT AND OTHER (Cont)	Page
New South Wales Associated Blue Metal Quarries Ltd v FCT 1955 6 AITR 239	207
New State Areas Ltd v CIR 1945 AD 610, 14 SATC 155	415 421
Newcastle Collieries v Borough of Newcastle, 1916 AD 561	332 473
Nicholson v Chapman (1793) 2 Hy B1 254	132
Niko, CIR v, 1940 AD 416, 11 SATC 124	502
Nihovo, R v, 1921 AD 485	70
Northern Office Micro Computers (Pty) Ltd and Others v Rosenstein 1981 (4) SA 123 (C)	372
Nourse Mines Ltd, Union Government v, 1912 TPD 24	193 215 216
Nyasaland Quarries and Mining Co, COT v, February 1961, 24 SATC 579	189 208
Olivier v Haarhof TS 1906	471
Oosterhuizen v Oosthuizen 1903 TS 688	241 242
Overseas Trust Corporation Limited v CIR 1926 AD 444, 2 SATC 71	246
Palabora Mining Company Ltd v SIR 1973 (3) SA 819 (A) 35 SATC 159	220 420
Partington v The Attorney-General 21 LT 370	89
Pearl Assurance Co Ltd v O'Callaghan (1943) 1 All ER 624, 25 TC 211 CA	464
Polpen Shipping Co Ltd v Commercial Union Assurance Co Ltd (1942) 1 KB 162	135
Port Alfred Landing and Shipping Co v Bonnievale 3 EDC 146	141
Porterville Ko-op Landbou Maatskappy Bpk, Rex v, 1952) SA 44 (C)	236 251
Powell v The Birmingham Vinegar Brewery CO Ltd (1897) 14 RPC 720	358
Prance v LCC 122 LT 820	276

TABLE OF CASES

SUPREME COURT AND OTHER (Cont)	Page
Princess Estate and Gold Mining Co v Registrar of Mining Titles 1911 TPD 1066	332
Processing Enterprises (Pvt) Ltd, COT v, 1975 (2) SA 2. (RAD) 37 SATC 109	55 62 65 306
Professional Suites Ltd v COT (High Court of Northern Rhodesia (December 1960), 24 SATC 573	536 537
Purefoy Engineering Co Ltd v Sykes Boxall & Co Ltd (1955) 72 RPC (CA) 89	373 374
Pyott Limited v CIR, 1945 AD 128, 13 SATC 121	451
Queen Slide Fasteners of SA (Pty) Ltd v Commissioner of Customs 1953(3) SA 195 (W), 19 SATC 73	53 56
Rabinowitz & Another v de Beers Consolidated Mines Ltd 1958 (3) SA 619 (AD)	268
Rand Refinery Ltd v Town Council of Germiston 1929 WLD 63	193
Raphaely, R v, 1957 (3) SA 41	465
Real Estate Land Company v United States 309 US 13, 160 ALR 1248	511
Rees v Melville (1914) 1911-1016 Mac CC 168	373
Rees v Robbins 1914 Times 6 February and 4 July	373
Reinhardt v Ricker and David 1905 TS 179	342
Reliant Tool Co, Lord Advocate v, 1968 1 All ER 162	63
Rex Tearoom Cinema v CIR 1946 TPD 338, 14 SATC 76	534 535
Rhodesian Railways Limited and Others v COT 1925 AD 438, 1 SATC 133	473 474 571
Ridgeway Hotel Ltd, COT v (Federal Supreme Court) (November 1961), 24 SATC 616	531 537
Rolls-Royce Ltd v Jeffrey (1962) 1 WLR 425	393 394 401
Rose & Company v Campbell (1968) All ER 405	459
S v Clearwater Tea Manufacturers (Pvt) Ltd 1975 (3) SA 65(AD), 37 SATC 279	65 250
Sacks v CIR 1946 AD 31, 13 SATC 343	421

TABLE OF CASES

SUPREME COURT AND OTHER (Cont)	Page
Safranmark (Pty) Ltd, SIR v, 1982(1) SA 113(AD), 43 SATC 235	53 67
Salmon & Woods, Ex Parte Gould 2 Mor Bkey Cas 137	140
Samuel McCausland Ltd v Ministry of Commerce (1956) NI 36	307 309
Schofield v R and H Hale Ltd 1975 STC 353	303 463
Schoombie, R v, 1945 AD 541	70
Seligan, Rex v, 1926 TPD 27	253
Sharpe, R v, 1903 TS 871	70
Sidersky, R v, 1928 TPD 109	217 253
South Metropolitan Gas Company v Dodd, 13 TC 211	510
South Wales Aluminium Co Ltd v Assessment Committee for the Neath Assessment Area (1943 (2) AER 587	467
St John's School (Mountford and Knibbs) v Ward (1975) STC 7 CA	463
Standard Vacuum Refining Co v Durban City Council 1961 (2) SA 669 (A)	201 288 471
Stott, CIR v, 1928 AD 252, 3 SATC 253	246
Sub Nigel Ltd v CIR 1948 (4) SA 580 (A) 15 SATC 381	213 451
Swaziland Ranches Ltd, COT v, (Swaziland Court of Appeal, July 1978, 1978, 40 SATC 232	277 278 310
TA v COT 1960 (4) SA 917 (High Court of Zimbabwe) 24 SATC 47	57 306
The Gas Float Whitton, No 2 1896 P42	131
The Mayor of Southport v Morris (1893) 1 QB 359	136
Theatre Investments (Pty) Ltd v Butcher Brothers Ltd 1978 (3) SA 682 (AD)	201 332 333 471
Torf's Est. v Minister of Finance 1948 (2) SALR 283, 293 NPD	342

TABLE OF CASES

SUPREME COURT AND OTHER (Cont)	Page
Trego v Hunt (1896) AC 7	392
Turnbull v CIR 1953 (2) SA 573 (A), 18 SATC 336	383 398 422 576
United Aircraft Corporation, FCT v, 68 CLR 525	396
Vacu-lug (Pvt) Ltd v COT 1963 (2) SA 694 (SR) 25 SATC 201	382
Van Wezel v Van Wezel's Trustees 1924 AD 409	287 332 469 471
Victoria Falls and Transvaal Power Co Ltd, Commissioner of Customs v, 6 SATC 131	459
Wangaratta Woollen Mills Ltd v FCT (1969), 1 ATR 329	63 308 454
Watson v RCA Victor Co Incorporated (1934) 50 Lloyd LR 77	134
Western Clock Co v Oris Watch Co Ltd (1931) Ex CR 64	362
Whitwick Colliery Co Ltd, Boyce (Inspector of Taxes) v, 1934 All ER 706	220
Wolf, CIR v, 1928 AD 177, 3 SATC 153	224
Yarmouth v France (1887) 19 QBD 647	458 460 466
Yorkshire Copper Works' Appn (1954) 71 RPC 150	362
Zaaiplaats Tin Mining Co Ltd v Union Government 1944 TPD 42	182 183

XXX

TABLE OF CASES

SPECIAL COURT FOR HEARING INCOME TAX APPEALS	Page
ITC 12, 1 SATC 117	529
ITC 50, 2 SATC 123	489
ITC 91, 3 SATC 235	491
ITC 122, 4 SATC 115	553
ITC 135, 4 SATC 201	430
ITC 141, 4 SATC 218	560
ITC 146, 4 SATC 278	490 573
ITC 150, 4 SATC 294	489
ITC 152, 4 SATC 299	430
ITC 162, 5 SATC 76	555
ITC 163, 5 SATC 77	567
ITC 164, 5 SATC 79	445 490
ITC 166, 5 SATC 85	241 242
ITC 180, 5 SATC 256	469
ITC 200, 5 SATC 389	512 514
ITC 203, 6 SATC 34	568
ITC 205, 6 SATC 42	518
ITC 208, 6 SATC 55	237 240
ITC 212, 6 SATC 63	469
ITC 213, 6 SATC 66	443
ITC 215, 6 SATC 133	489 492
ITC 225, 6 SATC 158	476
ITC 238, 6 SATC 353	571
ITC 240, 6 SATC 363	444 488
ITC 243, 6 SATC 370	554
ITC 247, 6 SATC 379	491
ITC 251, 7 SATC 47	444 476
ITC 261, 7 SATC 139	270 271
ITC 271, 7 SATC 170	473
ITC 280, 7 SATC 251	264

TABLE OF CASES

SPECIAL COURT FOR HEARING INCOME TAX APPEALS (Cont)	Page
ITC 295, 7 SATC 350	443 488 492
ITC 311, 8 SATC 152	492 502
ITC 322, 8 SATC 243	518
ITC 358, 9 SATC 179	519
ITC 361, 9 SATC 189	559 569
ITC 370, 9 SATC 313	475
ITC 410, 10 SATC 232	478
ITC 442, 11 SATC 78	572
ITC 450, 11 SATC 101	264
ITC 456, 11 SATC 171	530
ITC 458, 11 SATC 178	246
ITC 460, 11 SATC 186	444 502
ITC 469, 11 SATC 261	475
ITC 481, 11 SATC 345	553
ITC 491, 12 SATC 77	567
ITC 512, 12 SATC 246	86
ITC 519, 12 SATC 271	530
ITC 520, 12 SATC 404	558 559
ITC 559, 13 SATC 308	500
ITC 561, 13 SATC 313	554
ITC 565, 13 SATC 330	502
ITC 568, 13 SATC 443	444
ITC 577, 13 SATC 486	444
ITC 586, 14 SATC 123	235 244
ITC 589, 14 SATC 132	456
ITC 605, 14 SATC 361	554
ITC 615, 14 SATC 399	86
ITC 617, 14 SATC 474	551 558 564 570
ITC 623, 14 SATC 510	443
ITC 626, 14 SATC 530	564

TABLE OF CASES

SPECIAL COURT FOR HEARING INCOME TAX APPEALS (Cont)	Page
ITC 295, 7 SATC 350	443 488 492
ITC 311, 8 SATC 152	492 502
ITC 322, 8 SATC 243	518
ITC 358, 9 SATC 179	519
ITC 361, 9 SATC 189	559 569
ITC 370, 9 SATC 313	475
ITC 410, 10 SATC 232	478
ITC 442, 11 SATC 78	572
ITC 450, 11 SATC 101	264
ITC 456, 11 SATC 171	530
ITC 458, 11 SATC 178	246
ITC 460, 11 SATC 186	444 502
ITC 469, 11 SATC 261	475
ITC 481, 11 SATC 345	553
ITC 491, 12 SATC 77	567
ITC 512, 12 SATC 246	86
ITC 519, 12 SATC 271	530
ITC 520, 12 SATC 404	558 559
ITC 559, 13 SATC 308	500
ITC 561, 13 SATC 313	554
ITC 565, 13 SATC 330	502
ITC 568, 13 SATC 443	444
ITC 577, 13 SATC 486	444
ITC 586, 14 SATC 123	235 244
ITC 589, 14 SATC 132	456
ITC 605, 14 SATC 361	554
ITC 615, 14 SATC 399	86
ITC 617, 14 SATC 474	551 558 564 570
ITC 623, 14 SATC 510	443
ITC 626, 14 SATC 530	564

TABLE OF CASES

SPECIAL COURT FOR HEARING INCOME TAX APPEALS (Cont)	Page		
ITC 631, 15 SATC 100	516	517	520
ITC 637, 15 SATC 126		565	573
ITC 639, 15 SATC 226	245	246	247
ITC 641, 15 SATC 233	246	443	450 457
ITC 643, 15 SATC 243			556
ITC 651, 15 SATC 369			562
ITC 657, 15 SATC 495	511	513	514 516
ITC 663, 16 SATC 121			445
ITC 665, 16 SATC 127			556
ITC 666, 16 SATC 130			419
ITC 672, 16 SATC 227			76
ITC 681, 16 SATC 357			500
ITC 685, 16 SATC 372			534
ITC 693, 16 SATC 510		469	490
ITC 699, 17 SATC 99			501
ITC 709, 17 SATC 227		562	573
ITC 720, 17 SATC 474			430
ITC 722, 17 SATC 490			476
ITC 732, 18 SATC 108			242
ITC 740, 18 SATC 219			247
ITC 741, 18 SATC 222			270
ITC 754, 18 SATC 424		513	514 515
ITC 767, 19 SATC 206			539
ITC 769, 19 SATC 214	452	457	509 514
ITC 770, 19 SATC 216			86
ITC 773, 19 SATC 308			478
ITC 774, 19 SATC 311		94	106 452
ITC 780, 19 SATC 328			450
ITC 782, 19 SATC 410			246
ITC 785, 19 SATC 419			530
ITC 795, 20 SATC 107			514

TABLE OF CASES

SPECIAL COURT FOR HEARING INCOME TAX APPEALS (Cont)	Page
ITC 800, 20 SATC 226	434
ITC 811, 20 SATC 465	422 447
ITC 821, 21 SATC 75	553
ITC 838, 21 SATC 419	447
ITC 840, 21 SATC 424	488
ITC 844, 22 SATC 70	559
ITC 849, 22 SATC 83	556
ITC 852, 22 SATC 187	511 515
ITC 853, 22 SATC 191	267 268
ITC 855, 22 SATC 195	436 474 561 566 569
ITC 859, 22 SATC 292	267
ITC 865, 22 SATC 393	573
ITC 866, 22 SATC 397	480 481
ITC 885, 23 SATC 336	276 278 310
ITC 898, 23 SATC 491	532
ITC 900, 23 SATC 501	515
ITC 905, 24 SATC 87	474 509
ITC 906, 24 SATC 90	563
ITC 915, 24 SATC 219	568
ITC 923, 24 SATC 246	268 282 291 336
ITC 925, 24 SATC 252	563
ITC 937, 24 SATC 274	237
ITC 940, 24 SATC 380	533
ITC 955, 24 SATC 331	515 516
ITC 957, 24 SATC 637	86
ITC 964, 24 SATC 709	533 534
ITC 971, 24 SATC 791	537
ITC 997, 25 SATC 177	63
ITC 1006, 25 SATC 248	54 60 62
ITC 1007, 25 SATC 251	456 486
ITC 1011, 25 SATC 283	476

TABLE OF CASES

SPECIAL COURT FOR HEARING INCOME TAX APPEALS (Cont)	Page
ITC 1031, 26 SATC 63	516
ITC 1034, 26 SATC 78	535
ITC 1036, 26 SATC 84	531
ITC 1047, 26 SATC 223	476.
ITC 1052, 26 SATC 253	63
ITC 1061, 26 SATC 317	54 73 74 337
ITC 1066, 27 SATC 114	389 436
ITC 1097, 27 SATC 290	265
ITC 1101, 29 SATC 23	54 66
ITC 1110, 29 SATC 169	214
ITC 1114, 30 SATC 14	72 76 78
ITC 1135, 31 SATC 228	235 239 240
ITC 1137, 32 SATC 1	80 82
ITC 1145, 33 SATC 26	389 430
ITC 1149, 33 SATC 98	279 481 482
ITC 1159, 33 SATC 190	517
ITC 1177, 34 SATC 147	240
ITC 1186, 35 SATC 129	536
ITC 1188, 35 SATC 150	522
ITC 1190, 35 SATC 188	391
ITC 1213, 36 SATC 113	566
ITC 1228, 37 SATC 64	62
ITC 1234, 37 SATC 188	458
ITC 1245, 38 SATC 13	517 520
ITC 1246, 38 SATC 21	58
ITC 1247, 38 SATC 27	66 68 73 94
ITC 1248, 38 SATC 35	482
ITC 1249, 38 SATC 74	195 196 208 253
ITC 1257, 39 SATC 55	422
ITC 1258, 39 SATC 8	235
ITC 1258, 39 SATC 58	239

TABLE OF CASES

SPECIAL COURT FOR HEARING INCOME TAX APPEALS (Cont)			Page
ITC	1263, 39 SATC 120		570
ITC	1264, 39 SATC 133		560
ITC	1266, 39 SATC 142	76 79	192
ITC	1285, 41 SATC 73		246
ITC	1286, 41 SATC 98		456
ITC	1297, 42 SATC 36	72 76	
ITC	1313, 42 SATC 197		477
ITC	1319, 42 SATC 263	235	237
ITC	1323, 42 SATC 287		485
ITC	1324, 42 SATC 288		238
ITC	1339, 43 SATC 178		196

PART I

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 determining 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 privilege 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 [1953(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 infra) 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 infra).

Example

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.

Solution

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

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 initial 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 only 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 similar 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 be 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 conducive 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 <u>infra</u>)	<u>40 000</u>
	<u>44 000</u>

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	<u>20 000</u>
Tax value at date of fire	180 000
Insurance receipt	<u>200 000</u>
Recoupment of section 11(g) allowances	<u>20 000</u>

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

Solution (h)

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

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 submitting 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
<u>Less</u> untaxed recoupment	<u>8 000</u>
Amount subject to annual allowance to be claimed at the rate of 2% p.a.	<u>242 000</u>

- 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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Name of thesis Capital allowances in terms of South African Tax law 1984

PUBLISHER:

University of the Witwatersrand, Johannesburg

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