elsewhere in the form of large blocks of lime stone which had to be broken up by heavy-duty crushers or even blasting before being fed into different crushers for further fragmentation. The fact that its raw material is available in the form of a mass of natural deposits on its land cannot, in my opinion, really affect the nature of the operations carried on at the quarry".

Smit AJA the concurring judge said at 142: "Raw material, in this case, the lime stone, is necessary for the process of manufacturing hydrated lime, but I do not think that it can be said that the process of manufacture already begins when the raw material is extracted from the rock. This operation is too remote to form part of the process. One must distinguish between the acts performed in acquiring the raw material for the process of manufacture and those which commence the process. But the breaking down of the lime stone on the floor of the quarry is different". And at 144: "But if I am wrong in the view that the process already commences with the blasting of the lime stone on the floor of the quarry then I would say the process starts at the latest with the feeding of the crushers. Before rock is fed into the crushers the whole process is at a standstill. The feeding of these crushers is therefore an integral part of the process and the machinery or plant used for this purpose must be considered as machinery or plant used directly in the process of manufacture". It was further held that once the process of manufacture has commenced, the movement of material from one piece of plant to the next one is an integral part of the process of manufacture, and any plant or machinery used to effect such movement is used directly in such process of manufacture.

In ITC 1297 (42 SATC 36) the court had to decide whether the transporting of pipes from the place where they were manufactured to the site where the pipe line was laid forms part of the process of constructing the pipe line. Schock J held at 38: "As stated by Smit AJA in the case of SIR v Cape Lime Company Limited 1967(4) SA at 236E. 'One must distinguish between the act performed in acquiring the raw material for the process of manufacture and those which commence the process'. The transport of the pipes from the factory to the site was, in my judgement, clearly an act performed in acquiring the pipes for the construction of the pipeline and in no way part of the construction of the pipeline".

The court in ITC 1114 (30 SATC 14) had to decide whether the process of manufacture starts where a pipeline was used for pumping butadiene from the wharf to storage tanks. The president of the court used the following example at 21:

"One may refer by way of analogy, to a vast, lengthy conveyor belt or assembly line in a large factory. The raw material placed on the line may move forward through several preliminary stages without undergoing any change until it reaches a point along the moving line where the transformation which is the object of the enterprise begins to take shape. It could hardly be said that only that portion of the plant (in the assembly line or conveyor belt) which lies beyond the point where the transformation of the material begins, is plant used in the process and that the preceding portion of the line is merely used for transporting or conveying raw material to the crucial point. The line is one integrated plant or piece of machinery and functions as such. When the butadiene enters the pipe line, this is, in effect, the throwing of the switch which sets the unit working".

In ITC 1247 (C4.10 *supra*) the court had to decide where the process commences in relation to the moulding of concrete into shapes necessary for use in the construction of curbs, drainage canals,manhole cov[illegible] and saddles supporting underground pipes. It was n[illegible] that the availability of the several ingredients necessary for the mixing operations was of importance. On the facts of the case the court viewed that the process commences with the selection of the necessary materials and therefore included the transportation of such material to the plant where the mixing ocurred. (C4.4 *supra* for dictum of Corbett J in ITC 1061).

The Australian High Court is *Moreton Central Sugar Mill Co Ltd v FCT* (1967, 10 AITR 420) had to decide whether production of sugar commences at the cane fields or at the mill. Kitto J expressed himself as follows:
"It is true, as high authority lays down that in order to derive a product from raw materials you must 'first catch your hare'. But hunting, even by the cook, is no part of the operations by means of which jugged hare is derived from hare. To go and get your raw materials is one thing; to derive the desired end product from them is another. Accordingly, in my opinion, it is only after the sugar cane has been brought to the mill that the appellant can be said to commence the operations by which it derives sugar from the cane".

It would appear from the above decisions that raw material intended for the use in a process must be available before the process can commence. The activity of fetching the raw material to the site where the process of manufacaure is to take place does therefore not appear to form part of the process of manufacture.

4.14 Directly in a process of manufacture

The taxpayer in ITC 1061 (26 SATC 317) carried on the business of road construction. Road construction was accepted as a process similar to a process of manufacture. A van was purchased and used to transport -

- personnel to and from the site;
- materials required at the site; and
- filling material required at the site.

The court had to decide whether the van was used directly in the process which was similar to a process of manufacture. Corbett J said at 318-319: "The sections in question speak of plant or machinery used by the taxpayer 'directly' in a process of manufacture or other process considered by the Secretary to be of a similar nature. The use of the word 'directly' in these sections indicates that the legislature intended a distinction to be drawn between plant or machinery directly used in a process of manufacture, and plant or machinery which is only indirectly so used. Full effect must be given to this intention. The word 'directly' in this sense , is defined by the Shorter Oxford English Dictionary to mean - 'Without the intervention of a medium; immediately; by a direct process of mode'. The same dictionary defines the adjective 'direct', in a cognate sense, as meaning - 'Without intervening agency; immediate'. Sections 12(1) and 12(2), therefore, have reference to plant or machinery used directly, ie, without the intervention of some other medium or agency in the process of manfacture." The court listed the essential actions or operations which constitute roadmaking as -

- preparation of the site of the road including the pegging thereof;
- the cleaning of vegetation and physical obstructions;
- the smoothing out and the levelling of the ground;

- the excavation of certain sections and the filling of others;
- the construction of bridges and culverts over which the road is to pass;
- compacting and processing of the road foundation and other layers, including surfacing; and
- the construction of ancillary works, such as curbs and channels.

Referring to the above activities Corbett J was of the following opinion at 320: "Plant which is directly i.e. without the intervention of another medium or agency engaged in the carrying out of one or other of these basic operations is, in my view, being used directly in the process of road construction". Other operations necessary for road construction in as far as they do not relate directly to the process of construction was held to be ancillary thereto. As regards the purposes for which the motor van was used it was held at 320: "It seems to me that for the most part of these actions are to be classified as ancillary operations and are not part of the process of road construction itself. (I say 'for the most part' because the movement of material excavated from the site or of filling material required on the site is clearly a road-making operation). It follows that the plant which is used for such transportation, ie, other than the movement of excavated or filling material, is not being used directly in the process of road construction". On the facts of the case the court held that the use of the motor van directly in the process was neither its sole use nor its dominant use and accordingly it could not be shown that the motor van was used directly in the process of road construction.

Whether plant or machinery are used in a process of manufacture would depend on their relationship with the process. The court in ITC 1266 (39 SATC 142) held that the word "directly" refers to and qualifies the relationship between the use of the machinery and the process of manufacture. The question as to where the process commences will in most cases decide the relationship between the plant or machinery and the process of manufacture. A pipeline which was used for pumping butadiene from the wharf to storage tanks was held to be used directly in a process of manufacture (ITC 1114 and ITC 1297, C4.13 *supra*).

In order to decide whether an item of plant or machinery is used directly in a process of manufacture, one has first to identify the essential activities or actions which would constitute the process of manufacture. Having identified the essential activities it remains to decide whether the item of plant or machinery relates to any of those essential activities. Should it relate to an essential activity, the item of plant or machinery could be said to be used directly in the process of manufacture.

4.15 New machinery

For the purposes of the investment allowance, plant or machinery used directly in a process of manufacture must be new to qualify for the allowance. In ITC 672 (16 SATC 227) the taxpayer manufactured canned goods and purchased new machinery. The machinery, after the use of three months was sold to a subsidiary company, who then claimed the investment allowance. The taxpayer subsidiary company contended "new" to mean new to the taxpayer and by illustration quoted: "I buy a new house, or I acquire a new wife". It was held that "new" means new in the sense of not having been used before by the particular taxpayer and in the sense of not having been acquired from somebody else and so second hand.

The English courts in Morris Motors v Lilley, (1959, 3 All ER 737), had to decide when a motor car was new. The facts were briefly as follows: An authorised dealer of Morris Motors Limited sold a Morris Minor to L, who took delivery after having registered the vehicle in his name. On the same day the defendant in the case purchased the vehicle from L and as a result of advertising sold the vehicle as new. The plaintiff sought to restrain the defendant who was not an authorised dealer to advertise and sell its motor vehicles as new. In granting the interdict Wynn-Parry J said: "I was invited to say that the mere fact that by process of calculation the car had only been driven approximately one hundred and thirty miles between leaving the factory at Cowley and its delivery to Mr Berryman did not rob it of the characteristic of being a new car. It seems to me that that is a wholly unsafe test to make. It is perfectly clear from the plaintiffs' documents that they regard and hold out to their distributors and to the public that a car ceases to be a new car once it is sold retail. That appears to me to be the only safe course to take. Once a car becomes the subject-matter of a sale of purchase, once it is registered with the local county council, once the number plates have been affixed and it has been driven out of the distributors or the dealer's premises, that car, in my judgement, ceases to be a new car".

The Australian Income Tax Act, unlike the South African Income Tax Act, defines "new" as meaning not having previously been either used by any person or not having been previously acquired or held by any person for use by that person. An Australian wholesale merchant interpose between the Australian manufacturer of the equipment and the Australian user, would not cause the equipment to fall outside the category of "new". If an Australian manufacturer purchased the equipment for use but before using it sold it to a second Australian manufacturer, then the equipment would not be new in the hands of the second manufacturer. The restriction of the allowance to new plant in Australia therefore ensures that the investment allowance is available only once in relation to any one item of plant, no matter how frequently that plant changes hands.

In ITC 1114 (30 SATC 14) the court had to decide whether reconstructed tanks were "new or unused". The facts were briefly as follows: The tanks concerned were found unsuitable for the purposes for which the appellant required to use them, and they were accordingly altered to suit the taxpayer's purpose. The alteration involved the dismantling of all fittings from the tanks and the building of a new basis. The tanks, stripped of their previous fittings were cut up and moved to the new bases which had been constructed. After the tanks had been rewelded and installed on their new bases, they were fitted with new equipment and had to be connected by means of new pipe lines to the pump house. The tanks themselves were not new or unused tanks; before being cut up and re-erected on new sites, they had been in use previously. The court held that the tanks, after being cut up, rewelded, recalibrated and re-erected on new bases, became "new immovable objects". They were not simply old or used tanks employed for a new use. They assumed a new identity as tanks. The court was of the opinion that the material of which the tanks consisted were old and used, but after demolition and reconstruction, in which the old material together with new fittings were used to forge a different entity, newly located on different bases and sites, the resultant products were new tanks.

The expression "new" in relation to machinery used directly in a process of manufacture is not defined in the Act. It appears that the term "new" could be construed as meaning not having been used before. An item would become second hand if it had previously been owned, worn or used by another. Whether an item would retain its character as "new" if it was previously owned by another who neither used it nor acquired it with the intention of use has not yet been decided by our courts.

4.16 Qualification - who must carry on process

In ITC 1266 (39 SATC 142) a taxpayer leased new machinery to a cartage contractor who transported material for persons engaged in processes of manufacture or processes which are of a similar nature. The sole issue was whether, to entitle a taxpayer to qualify for the capital allowances, the lessee himself must be the manufacturer as distinct from merely working under contract for a third party who is a manufacturer. The court held that the wording of section 12 were wide enough to cover the situation where the lessee of the machinery uses it in a process of manufacture carried on by somebody else. The court held at 145: "The purpose of the machinery investment allowance is presumably to encourage investment in plant and machinery which is used for manufacture and similar activities. It would not be inconsistent with this purpose if the allowance is granted to all persons who make such an investment, even if the process of manufacture for which the plant or machinery is used is not their own. I do not therefore see any reason for departing from the literal meaning of the subsection". Shortly after the court delivered its judgement in favour of the taxpayer the law was changed.

With effect from the commencement of years of assessment ending on or after 1 January 1978 the investment allowance and the initial allowance are allowed only where the machinery or plant are used by the taxpayer directly in a process of manufacture or similar process carried on by him or used by his lessee directly in a process of manufacture or similar process carried on by him (lessee).

4.17 Cost of buildings or improvements

The allowances under section 13 are based on the cost to the taxpayer of a building or improvements. The cost of buildings or improvements is, unlike the cost of machinery or plant, not defined in the Act. It was held in ITC 1137 (32 SATC 1) that the cost of excavations is not part of the cost of the building. The court referred to the definition of "erect" in the Oxford English Dictionary and Websters and came to the conclusion that the underlying concept in all the definitions is the raising up of whatever is being erected. It was held that while the digging of trenches to house the foundations is a necessary preliminary to the raising of the foundation themselves, it could not be said to be the commencement of the erection of the building. Excavation was held to be preparatory to but not part of the process of erection.

Our superior courts have not yet been called upon to decide whether the cost of excavations must be regarded as part of the cost of a building. In an English case

(CIR v Barclay, Curle & Co Ltd, 45 TC 221) which concerned the definition of "plant" it was held that the cost of excavations formed part of the cost of plant. The facts were briefly: The taxpayer company, which carried on the trade of shipbuilders, repairers, and engineers constructed and equipped a dry-dock. The dock acted like a hydraulic chamber in which a volume of water variable at will could be used to lower a ship, so that it could be exposed for inspection and repair, and to raise it again to tidal level, so that it could sail away. The work involved the excavation of some 200 000 tons of earth and rock at a cost of £186 928 to form a rectangular basin, which then had to be lined throughout with about 100 000 tons of concrete at a cost of £500 380. A dock-gate, pumps, valves piping and electrical machinery were installed in the chamber and these were an integral part of the dock as a functioning entity. The dock was subject to wear and tear and was considered, if properly maintained to last some 80 to 100 years. The Court of Cession (Scotland) unanimously decided that the cost of excavations and concrete was part of the cost of the construction of the dock. The Home of Lords, on appeal agreed with the decision by a majority of 3 to 2. Per Lord Reid: "So the question is whether, if the dock is plant, the cost of making room for it is expenditure on the provision of the plant for the purposes of the trade of the dock-owner. In my view this can include more than the cost of the plant itself, because plant cannot be said to have been provided for the purposes of the trade until it is installed: until then it is of no use for the purposes of the trade. This plant, the dock, could not even be made until the necessary excavating had been done. All the Commissioners say in refusing this part of the claim is that this expenditure was too remote from the provision of the dry dock. There, I think, they misdirected themselves. If the cost of the provision of plant can include more than the cost of the plant itself, I do not see how expenditure which must be incurred before the plant can be provided can be too remote".

The decision in this case throws doubt on the correctness of the decision in ITC 1137 (supra) that -

- the digging of trenches to take foundations was preparatory to, but not part of, the process of erection of a building; and
- the date when the erection of a building commenced must be taken as the date when the laying of foundations started and not when the excavations for such foundations began.

It is implicit in the English decision that the cost of excavations is part of the cost of a building for the purposes of the capital allowances.

In an Australian case of Broken Hill Pty Co Ltd v Federal Commissioner of Taxation [(1968) 10 AITR 481] the court had to decide whether the demolition expenses of an existing building form part of the cost of the new building erected in its place due to the fact that such an expense is of a capital nature. Kitto J, referring to this type of expense said at 500: "It stands in clear contrast with expenditure on excavations for the foundations of a new structure. No doubt that expenditure is part of the cost of the new structure, but the reason is that the excavations do not bring about any general advantage for the land: on the contrary, the only purpose they serve is peculiar to the new structure. Even in the common case where a site on which plant is to be erected has first to be cleared of trees, I should think that the correct view would be that the clearing is an improvement to the land rather than part of the installation of the plant, for its effect is upon the general usefulness of the land, and, accordingly, its cost is part of the cost of the improved land and not part of the cost of the plant".

In SIR v Eaton Hall (Pty) Ltd [(1975(4) SA 953(AD), 37 SATC 343] a new wing to a building was erected at a cost which included an amount of interest. The court had to decide whether the word "cost" should include such interest. It was held that the interest paid merely represented part of the cost of financing the cost of the building and as such was not directly or closely connected to the price or consideration paid for the erection of the new wing. Relief has been given to taxpayers in 1981 by the introduction of the new section 11(bA). As a result of this decision taxpayers took the route of forming another company to erect the building. This new company would be a construction company which would raise its own finance and charge the taxpayer in respect of the construction an amount which would include interest charges. These schemes are known as turn-key projects which are accepted by the Commissioner in practice, thereby effectively circumventing the Eaton Hall judgement.

Example

A taxpayer wishes to erect a building at an estimated cost of R10 million. The construction will take two years and the estimated interest charge would amount to, say, R2 million.

Should the taxpayer itself construct the building, the cost of the building for the purposes of section 13, would be R10 million (based on the Eaton Hall judgement)

The taxpayer, on the other hand, could create a new company to erect the building. This new company could then raise its own finance and enter into a contract with the taxpayer for the erection of the building at a contract price of R12 million. The cost to the taxpayer under these circumstances would be R12 million and not R10 million.

Pre-production interest is now available as a deduction in the year during which the buildings or improvements are brought into use for the purposes of the taxpayer's trade.

4.18 Pre-production interest

One of the few instances where accounting principles coincided with tax principles concerned the treatment of interest which was incurred prior to production. This was the case until the introduction of section 11(bA) into the Act with effect from the commencement of years of assessment ending on or after 1 January 1982.

Pre-production interest is an expense of a capital nature and as such is not deductible from income under section 11(a). Furthermore, the Appellate Division in SIR v Eaton Hall (Pty) Limited [1975 (4) SA 953 AD, 37 SATC 343] held that interest paid on money borrowed to finance the cost of erection of a building did not form part of its cost for the purposes of the capital allowances under section 13. One, therefore, had the situation, prior to 1 January 1982, that pre-production interest in relation to buildings were not deductible at all in the determination of taxable income. This appeared to have also been the position in relation to plant or machinery.

Section 11(bA) permits the deduction of interest, including related finance charges, which is not otherwise allowable as a deduction under the Act. The expression "related finance charges" is not defined in the Act. Silke on South African Income Tax (10th edition), referring to related finance charges, says on page 588 that it " ... could possibly refer to raising fees and 'guarantee' or 'surety' fees. It is submitted that it does not include finance charges under a suspensive sale, although the point may be worth testing". Meyerowitz and Spiro in Income Tax in South Africa say on page 280: "The deduction applies in respect of 'interest (including related finance charges'. It would seem that because of the word 'related' the finance charges must be of a nature or kind akin to interest, for example, the finance charges added to the cash price of machinery when it is bought on hire purhcase or under a suspensive sale. It is, we understand, the departmental view that any item which is treated as a finance charge in terms of the Limitation and Disclosure of Finance Charges Act should be treated as a related finance charge, including raising fees."

In order to qualify as a deduction under section 11(bA) the interest must be actually incurred by the taxpayer on any loan, advance or credit utilised by him for the acquisition, installation, erection or construction of any -

- machinery;
- plant;
- building; or
- improvements to a building

to be used by him for the purposes of his trade.

The expression "trade" is very widely defined in section 1 of the Act. Therefore, pre-production interest incurred in the financing of the acquisition of all types of business assets may give rise to the deduction. Such assets will include blocks of offices and apartments used by the taxpayer for the purposes of trade.

4.19 Trade and income from trade

The definition of "trade" is very wide, and includes every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent, design, trade mark, copyright, or any other property which in the opinion of the Commissioner is of a similar nature (definition of "trade" in S1 of the Act).

Certain activities which may produce income will fall outside this definition, for example, interest accumulation and investment of savings and dividends. The accumulation and investment of savings which resulted in interest income was held in ITC 512 (12 SATC 246) not to constitute the carrying on of a trade. The business of investment in shares, however, was viewed by the court in ITC 770 (19 SATC 216) as being a "trade". Investment activities on a large scale and which is not incidental appears to qualify as a "trade". Incidental loans to shareholders by a company which did not carry on the business of money-lending was held not to be a "trade" in ITC 957 (24 SATC 637). The letting of property is specifically included in the definition as being a "trade". This was confirmed in ITC 615 (14 SATC 399). The intention to make a profit is not a prerequisite of the carrying on of a "trade". In

Modderfontein Deep Levels Ltd & Another v Feinstein (1920 TPD 288) it was held that the acquisition of certain articles with the intention of reselling (without making a profit) to its employees still constituted carrying on a trade or business. The making of profit is not the essence of trading.

In SBI v Die Olifantsrivierse Ko-operatiewe Wynkelders Bpk [1976 (3) SA 261 (AD), 38 SATC 79] a co-operative society derived income in the form of interest on certain investments. The taxpayer claimed the 2% annual allowance on the cost of buildings erected. The claim was resisted on the grounds that under section 13(1)(a) a deduction is claimable only against income from trade as a wine producer and that since such last-mentioned income is exempt from tax, there exists no amount from which the deduction claimed could be made. Section 13(1) provides that "... there shall be allowed to be deducted from the income of the taxpayer an allowance equal to two per cent ....". It was held that the use of the word "income" in section 13(1) excluded any indication that it should be limited to income from a particular trade.

It could be that the same principle would apply also to various other allowances and deductions if the word "income" has the same meaning for the purposes of these allowances and deductions as it has in section 13(1). For example, the following deductions are not restricted to income derived from a trade and may thus be deducted against non-trading income such as interest: the exporters allowances, the capital allowances granted to hotelkeepers on their qualifying buildings and hotel equipment, certain allowances granted to indsutrialists in economic development areas, the investment and initial allowances permitted for manufacturing machinery or plant, and the special allowances permitted to the owners of ships and aircraft.

On the other hand, deductions permitted under section 11 are restricted to income derived from trade. Other classes of taxpayers who cannot deduct certain capital allowances against all their income are those who carry on mining and farming operations. These capital allowances can be deducted only from the income derived from mining and farming operations.

4.20 Location of trade

Where must the trade be located in order to qualify the taxpayer for the capital allowances under the Act?

The various capital expenditure which may be deducted by a taxpayer under section 11 are restricted to :"any trade within the Republic". The wear and tear allowance for instance is granted in respect of machinery, implements, utensils and articles used by the taxpayer for the purposes of his trade. Where such a trade is carried on in Bophuthatswana for example the taxpayer does not qualify for a deduction of wear and tear from his South African income.

Section 12 does not appear to restrict the locality of the trade carried on by the taxpayer. The machinery initial and investment allowances are available in respect of machinery or plant used by the taxpayer "for the purposes of his trade" or by the lessee "for the purposes of the lessee's trade". Unlike section 11, the words "within the Republic" are not used.

As regards the capital allowances in relation to industrial buildings are concerned, section 13 does not indicate where these buildings must be located. The section merely refers to buildings which were wholly or mainly used by the taxpayer during the year of assessment for the purposes of carrying on therein in the course of his trade (other than mining or farming) any process of manufacture. What is the position then of a South African taxpayer with an industrial building in say, Bophuthatswana? Would he qualify for the capital allowances to be deducted from his other South African income in respect of a building used by him in say Bophuthatswana in a process of manufacture?

The capital allowances in the form of concessions and incentives were made available to privileged classes of taxpayers with the intention of stimulating development growth in South Africa. There are therefore two aspects to consider in arriving at a solution to the problem of locality. Firstly one has to consider the fiscal interpretation of the "purpose of trade", and secondly one must consider this interpretation in relation to privileged classes of taxpayers.

4.21 Interpretation

The familiar passages in Partington v The Attorney General (21 LT 370 at 375) in the judgement of Lord Cairns; and the equally familiar passage enunciated by Rowlatt J in the Cape Brandy Syndicate case [(1921) 1 KB 64 at 71], leave one with the impression that a literal approach must be followed rather than an approach to ascertain and apply the Legislature's intention. However, in CIR v Delfos (1933 AD 242 at 254), Wessels CJ said, after referring to the rule stated by Lord Cairns in Partington v The Attorney-General case supra that: "I do not understand this to mean that in no case in a taxing Act are we to give to a section a narrower or wider meaning than its apparent meaning, for in all cases of interpretation we must take the whole statute into consideration and so arrive at the true intention of the Legislature".

In Glen Anil Development Corporation Limited v SIR [1975(4) SA 715 (AD)], Botha JA, after discussing the foregoing decisions, said at 727: "However, that may be, it is clear from the remarks of Wessels CJ in the Delfos case ... that even in the interpretion of fiscal legislation the true intention of the Legislature is of a paramount importance, and, I should say, decisive."

It is also worth bearing in mind that in discussing this approach in the Glen Anil case (supra) the learned Judge of Appeal also drew attention to the qualification stated by Centlives CJ in Dibowitz v CIR 1952 (1) SA 55 (AD) of the rule spelled out by Rowlatt J in the Cape Brandy Syndicate case. At page 61 of the Dibowitz judgement (supra), the former Chief Justice said: "When that citation was made (ie by Rowlatt J) it was assumed that that rule should be qualified by saying that even in taxing statutes something may have to be implied by necessity".

The intention of the legislator was to stimulate growth and encourage investment in South Africa and not foreign countries. It could therefore well be that South African taxpayers will not qualify for the machinery or building capital allowances in respect of processes of manufacture or industrial buildings in foreign countries.

4.22 Privileged classes of taxpayers

When 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. (See Part I). It is therefore possible that the reference to "trade" in sections 12 and 13 could be interpreted as "trade within the Republic".

4.23 Undistributed profits tax

In determining the distributable income of a company for the purpose of undistributed profits tax, one of the amounts which are deductible from "total net profits" in the determination of the distributable income is the cost price of new or unused machinery or plant. The following are the conditions of this concession -

- the company must have concluded a contract in the year of assessment or a previous year of asessment for the acquisition of new or unused machinery;
- such machinery or plant must or will, to the satisfaction of the Commissioner, within a period of three years after the end of the current year of assessment, be brought into use by the company for the purposes of its trade in the Republic; and
- the new or unused machinery must be or will be used by the company for the purpose of its trade in the Republic and will be used by it directly in a process of manufacture.

The company may, at its own election, deduct in each year the portion of the cost actually paid in that year, or deduct the total cost in the year in which the machinery or plant are first brought into use as above.

Prior to 1973 this election by the taxpayer used to be critical in relation to the company's distributable profit. If the deduction of the cost (the whole or the portion which the company could elect) was more than necessary to reduce the distributable income to nil, the taxpayer in fact lost the benefit of the excess. The benefit was also lost where even without considering any cost in respect of the new or unused machinery or plant, there was no distributable income.

Relief was given to companies in 1973 by an amendment of section 49. The effect of the amendment was that an allowance in respect of the cost of machinery or plant used or to be used by the company for the purpose of its trade in the Republic directly in a process of manufacture, is limited. The allowance is limited to so much of the cost as is sufficient to reduce the distributable income of the company to an amount equal tothe dividends distributed by it during the specified period, in other words, to reduce the amount subject to undistributed profits tax to nil. The amount of cost not so applied is carried forward to the next year of assessment for deduction in a similar manner provided that during such year the company has continued to carry on trade for the purposes of which the machinery or plant is to be or is brought into use.

<u>Example</u>

A company purchases new plant for its process of manufacture at a cost of R300 000. Its distributable income before taking into account the new machinery allowance in terms of section 49 is:

Year 1	R30 000
2	180 000
3	450 000

Dividends declared during the respective periods amounted to:

Year 1	NIL
2	60 000
3	180 000

Solution

		R
Year 1 - Distributable income		30 000
Less new machinery allowance		30 000
Subject to UPT		NIL
Balance of cost of machinery		
R300 000 - R30 000 = R270 000.		

	R	R
Year 2 - Distributable income		180 000
Less Dividends	60 000	
New machinery allowance	120 000	180 000
Subject to UPT		NIL
Balance of cost of machinery		
R270 000 - 120 000 = R150 000		
Year 3 - Distributable income		450 000
Less dividends	180 000	
New machinery allowance	150 000	330 000
Subject to UPT		120 000

It should be noted that this concession is available only to owners and not to lessors of machinery or plant. This could be an added factor in deciding whether to lease or whether to purchase machinery or plant for a process of manufacture.

The cost price of machinery or plant for the purpose of the initial and investment allowances is defined in section 12(3A). It is submitted that this definition does not apply to the cost price of machinery or plant for the purpose of section 49. Where machinery or plant is purchased under a suspensive sale agreement, finance charges will be classified as part of the capital cost of the asset. (ITC 774, 19 SATC 311)

In ITC 1247 (38 SATC 27) the taxpayer claimed a deduction under para (iii) of the definition of "distributable income" contained in section 49 of the Act, in respect of new or unused machinery or plant. The taxpayer was engaged in the construction of roads which process was held to be of a similar nature to a process of manufacture. The court emphasised that para (iii) of the definition of section 49 differs in scope from section 12(1) of the Act. In terms of section 12(1) deductions are allowed in respect of new and unused machinery not only if it is used directly in the process of manufacture but also if it is used directly in the process which in the opinion of the Commissioner is of a similar nature to a process of manufacture. Widening the scope of section 12(1) by extending the right of deduction to a process similar to a process of manufacture was effected by Act 80 of 1961 which did not provide for like extension in regard to undistributed profits tax. The words added to section 12(1) show very clearly that the legislature recognised a distinction between processes of manufacture and processes which were similar thereto.

4.24 Recoupment - UPT

All amounts deducted in respect of new or unused machinery in the determination of the company's distributable income, whether in the current or any previous year of assessment, which have been recovered or recouped are to be included in the company's "net profits" in the year during which such recovery or recoupment took place (section 49 - definition of "distributable income").

Since the recoupment of costs relate to the determination of the distributable income and not to the determination of "net profits" what is the position where instead "net profits" there is a "deficit" as defined in section 49?

"Distributable income" according to the definition in section 49 is the sum of the total net profits and the amounts recovered or recouped on the cost of new or unused machinery or plant previously deducted. If the total "net profits" can be a deficit it would appear that the sum of the two amounts will be the recouped costs less the deficit of net profits. The phrase "total net profits" is defined as the total net profits, excluding assessed losses, less any deficit incurred by the company which has been brought forward from the preceding year of assessment. "Deficit" in turn is defined as the amount by which the sum of the deductions admissible in the determination of total net profits exceeds the sum of the amounts from which they are deductible. The effect of these provisions is that a "deficit" may in any year reduce the "total net profits" to nil, but cannot create a negative quantity of "total net profits". Any "deficit" in excess of "total net profits" is carried forward to the next year of assessment. Consequently a company can have a "distributable income" as a result of a recovery or recoupment of new machinery or plant, even if there is a "deficit" to be carried forward to a subsequent year of assessment.

Section 50 sets out a series of exemptions from undistributed profits tax. The section does not state that the provisions relating to undistributed profits tax do not apply. "Distributable income" has therefore to be determined each year although the company is exempt from tax. A historical "deficit" relating to the time when the company was not subject to undistributed profits tax is only required to be determined when the company is subject to the tax ie not exempt. As a "deficit" comes into the computation of "total net profits" and the latter is the foundation for determining distributable income, it follows that until a company is subject to undistributable profits tax, the provisions relating to "total net profits" and "distributable income" do not apply. Consequently it could mean that any recovery or recoupment of costs of ew or unused machinery or plant acquired at the time a company was exempt from the tax will not add to its "distributable 'ncome".

4.25 Recoupment of initial allowance

Section 8(4)(a) provides that an initial allowance which has been allowed in a current or any previous year of assessment which has been recovered or recouped, is to be included in the income in the year of assessment during which the recovery or recoupment takes place.

Should the initial allowance be recouped as a result of damage or destruction of machinery or nlant which was used by the manufacture directly in a process of manufacture, or directly in any other process which in the opinion of the Commissioner is of a similar nature, the recoupment shall under certain circumstances not be included in income [section 8(4)(e)].

The aspect of recoupment has been fully dealt with in relation to wear and tear in C21.20 infra. The provisions of the Act discussed in that paragraph apply equally to the recoupment of the initial allowance.

4.26 Recoupment of investment allowance

The recovery or recoupment of the machinery and building investment allowances are not normally subject to tax. These allowances are specifically excluded in section 8(4)(a) which provides that allowances, granted under sections 11 to 20, which are recovered or recouped must be included in the taxpayer's income during the year in which such recovery or recoupment takes place.

Should the lessor dispose of his interest or his right to receive rent under a lease, or a portion of such interest or right, the machinery investment allowance which had been allowed previously will, however, be added to the income of the lessor. A similar penalty has not been imposed on lessors in respect of the building investment allowance.

4.27 Scrapping allowance

The scrapping allowance granted under section 11(o) may be claimed in respect of machinery or plant which have been scrapped by a manufacturer. The scrapping allowance, as applied to buildings used in a process of manufacture or in any process which in the Commissioner's discretion is of a similar nature, is however subject to certain restrictions.

4.28 <u>Tax implications of leasing instead of purchasing</u>

The tax implications of leasing machinery or plant instead of purchasing machinery or plant for a process of manufacture could have a considerable bearing on the taxpayer's ultimate decision whether to employ the method or not. In deciding whether to lease or purchase various factors have to be taken into consideration. These include -

- the element of time;
- the availability of tax base;
- current lending interest rates;
- rate of tax;
- period of lease;
- terms of lease;
- residual value at end of lease; and
- future relationship with asset which was leased.

These factors in relation to tax allowances only, can best be illustrated by an example. The terms of a contract of lease are of importance in relation to tax consequences. The terms and conditions of the contracts upon which the parties may agree are varied. The tax consequences can therefore only be discussed in relation to the facts in each case. It is necessary to assume certain terms and the reader must bear in mind that the illustration applies only in relation to those of similar terms.

The capital allowances available to a taxpayer will play an important role in deciding whether to purchase or lease an asset. For the purposes of this thesis it will suffice to mention that in comparing tax benefits under each route one must not lose sight of the element of time. The effectives of tax allowances should be measured by recognising the factor of time. It therefore becomes necessary to prepare discounted cash flows for each route.

4.29 The element of time - illustration

A taxpayer company purchases a machine to be used directly in a process of manufacture. The cash price of the machine amounts to R100 000 and is used by the company on the first day of the first tax year. The company has an option to either -

a) purchase the machine with own funds;
b) purchase the machine on suspensive sale conditions; or
c) lease the machine.

Assume finance charges at the rate of 15% for five years in the case of a suspensive sale agreement payable in equal monthly instalments; and in the case of a lease five instalments of R48 333 each at the end of each year. The Commissioner would allow a wear and tear allowance of 20% on a straight line method.

a) Purchase with own funds

		PV @ 15%
	R	R
Aggregate tax allowances:		
Investment allowance - 30% of R100 000	30 000	
Initial allowance - 25% of R100 000	25 000	
Wear and tear- 75% of R100 000	75 000	
	130 000	

	R	PV @ 15% R
Present value of net cash requirement:		
Cash outlay at beginning of year		100 000
Less: cash saved as a result of above tax allowances -		
46,2% x R30 000		(13 860)
Discounted over 1 year @ 15%		(12 052)
46,2% x R25 000		(11 550)
Discounted over 1 year @ 15%		(10 043)
46,2% of the present value of R15 000 for five years, discounted over 1 year @ 15%	23 230	(20 200
Present value of net cash requirement	54 675	57 705

b) <u>Purchase under suspensive sale condition</u>

	R	PV @ 15% R
Aggregate tax allowance:		
Investment allowance - 30% x R100 000	30 000	
Initial allowance - 25% x R100 000	25 000	
Wear and tear [100 000 - 25 000 (initial)] + 45 000	120 000	
	175 000	

	R	PV @ 15% R
Present value of net cash requirement:		
Cash outlay over period of three years	145 000	
Present value of thirty six instalments of R4 028		116 197
Less cash saved as a result of above tax allowances -		
46,2% of 30 000, discounted over 1 year @ 15%		(12 052)
46,2% of 25 000, discounted over 1 year @ 15%		(10 043)
46,2% of (present value of R24 000 for five years @ 15%)- discounted over 1 year @ 15%		(32 321)
Present value of net cash requirement		61 781

	R	PV @ 15% R
c) Lease		
Aggregate tax allowance	145 000	
Present value of net cash requirement		
Present value of three annual instalments of R48 333 at the end of each of three years, discounted over 1 year @ 15%		95 961
Less cash saved as a result of above tax allowances -		
46,2% of (present value of R48 333 over three years @ 15% discounted over 1 year @ 15%		(44 334)
Present value of net cash requirement		51 627

In making a decision whether to buy or to lease machinery or plant, the element of time cannot be ignored and is an important economic factor. The above example indicates the taxpayer would require the least cash if he decides to lease the machine.

Note: In practice, the lease payments as regards to amount and intervals of payment, may well result in an entirely different answer. The purpose of the above example is to stress the importance of time in relation to available tax allowances.

4.30 The availability of tax base

Should a taxpayer have an assessed loss or an insufficient tax base, there can be no tax savings. The tax savings are then deferred to later years and the taxpayer will not obtain an immediate cash flow advantage.

Originally the initial and investment allowances were available only to owners of machinery or plant. These allowances were made available to lessors of machinery or plant from 1966. It is therefore possible for a lessee to trade off his capital allowances to a lessor in return for a low down-payment and minimum interest on the outstanding balance.

Lessor taxpayers were quick to spot deficiencies in the legislation and devised various schemes to take advantage of the tax law as it then stood. As a result of these schemes the following restrictions were placed on the extension of the concession to lessors.

1. The investment allowance was withdrawn in 1978 where the lessee of hired machinery was not a taxpayer as defined in the Act.

What the Minister said in 1978: "I am sure that you will, on reflection agree that it is wrong to hand out hidden subsidies by means of concessions in the Income Tax Act. Where both the lessor and lessee are taxpaying bodies the tax effect of the granting of initial, investment and wear and tear allowances is the same whether granted to an owner/manufacturer or to a combination of lessor/lessee - but where the lessee is a non-taxpayer the allowances constitute a tax give-away without a concomitant return on the second leg".

2. The period of the lease for the purposes of the initial and investment allowances was restricted in 1981 to "at least 5 years or in the case of machinery or plant which in the opinion of the Commissioner has a shorter useful life, such period as the Commissioner may approve" [section 12(5)(a)].

   The practice of lessors to purchase machinery on a long term basis and leasing it to a lessee on a short term lease and thereby getting the allowances front end, gave rise to this amendment.

3. The lessors however saw another loophole and simply sold the machinery or plant to the lessee in year two, i.e. after having claimed the initial and investment allowances. As a result, section 12(5)(b) was introduced in 1982:

   "Where a lessor under a lease of machinery or plant concluded on or after the said date has, within a period of 5 years or within any applicable shorter period mentioned in paragraph (a), reckoned from the commencement of the period for which the machinery or plant is let under such lease, or has within that period and on or after the date of commencement of the Income Tax Act, 1982, disposed of a portion of such interest or right, there shall be included in his income for the year of assessment during which the disposal is made a sum equal to the aggregate of any machinery initial allowance and any machinery investment allowance granted to him in respect of the said machinery or plant, less such amount as the Commissioner may allow in respect of the expired portion of the lease or any portion of such interest or right which has not been disposed of by the lessor, if the Commissioner is satisfied that the circumstances warrant such allowance". This allowance became effective as from the commencement of years of assessment ended on or after 23 June 1982.

This amendment may create practical difficulties. Consider the case where a taxpayer purchases a machine on credit and on-leases it to a manufacturer. As security the financial institutions may require the lessor to pledge his rights under the lease. In this case the lessor has in effect disposed of his interest and rights under the lease and the capital allowances will be added back to his income. The question is whether a pledge insecuritatem debiti will be a disposal of an interest in a lease or a right to receive rentals. The Commissioner's practice is not to treat a pledge or rights under a lease in this light as long as the lessee continues to account to the lessor in respect of rentals in terms of the lease.

In recent years taxpayers with large tax bases have utilised these tax bases to their financial advantage. These tax bases are exploited by means of participation in leverage leases. The lessee, on the other hand elects to use lease financing as it cannot benefit immediately from the tax allowances associated with the acquisition of machinery or plant.

Leveraged le ing is a form of leasing where the lessor provi'es only a percentage (normally 20% to 40%) of the capi al needed to finance an asset. The rest of the capital is borrowed from institutional investors against the security of the rentals and is without recourse to the lessor.

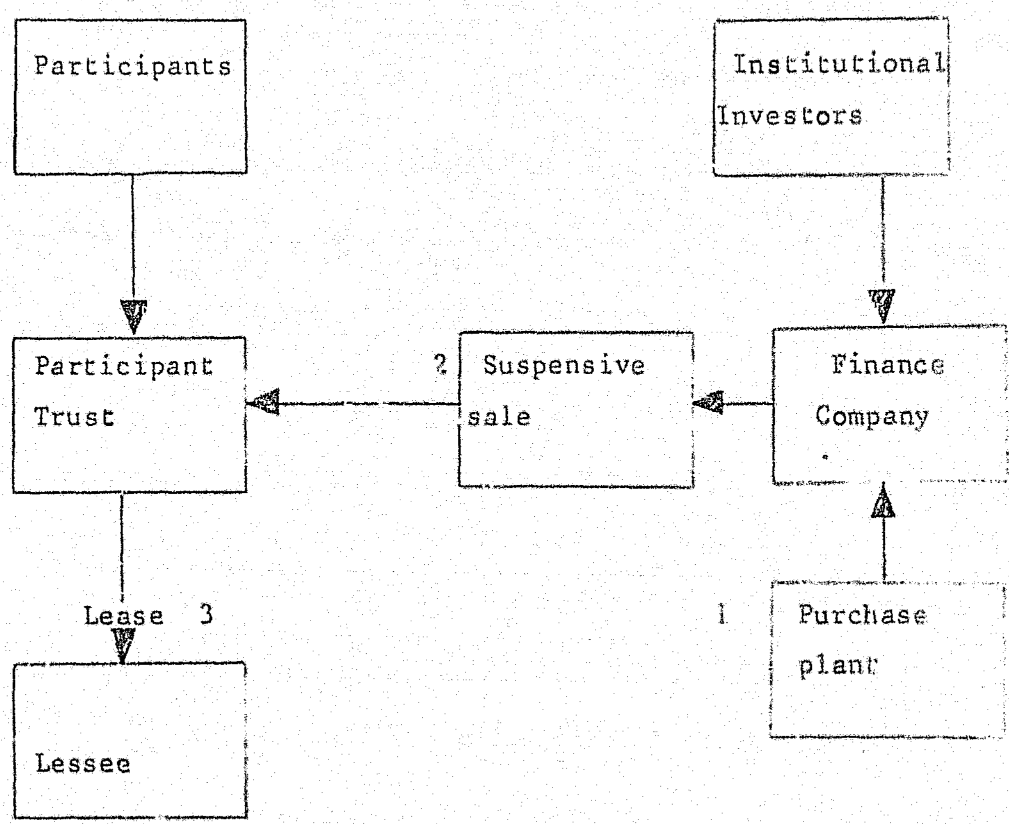
The following is a typical example:

A leverage lease is entered into between the equipment user as lessee and a partnership (participant trust) to be formed, as lessor.

The participant trust will consist of one or more corporate entities, and will acquire the equipment from a finance company under a suspensive sale contract. The finance company will have acquired the new and unused equipment from the supplier of the equipment. The finance company will fund this acquisition by an advance payment from the participant trust in terms of the suspensive sale agreement and from contributions from institutional investors (the leverage in the transaction). These investors as loan contributors to the finance company receive income and principal from the repayment stream under the suspensive sale. This return cash flow is covered by lease rentals and is equal to rentals.

The suspenive sale is without recourse to the general credit of partners in the partnership (beneficiaries of the participant trust).

A conceptual diagram of the transaction is as follows:



1, 2, and 3 = Sequence of principal transactions

4.31 Cost of machinery or plant

Until the introduction into the Act of a definition of cost in relation to machinery or plant in 1981, the practice of the Commissioner was to regard finance charges as part of the cost of those machinery or plant. This practice was based on a decision of the special court in ITC 774 (19 SATC 311) during 1953. The facts of the case were briefly as follows: A taxpayer manufacturer purchased a motor vehicle under a hire purchase agreement for a total consideration of £973 inclusive of £31 which was described in the agreement as "finance service charges". The taxpayer's claim to deduct the finance charges from his income in the determination of his taxable income was successfully resisted by the Commissioner. The court held that the true nature of the contract was the sale of the motor vehicle on credit and that the finance charges was part of the expenditure necessary for the purposes of acquiring a capital asset.

Originally the initial and investment allowances were granted only to the owner of industrial assets. In 1962 and 1966, however, these allowances were made available to lessors of buildings and machinery or plant respectively. In an effort to benefit by this latter concession in favour of lessors, certain undesirable practices appeared in leasing agreements. In a somewhat simplified way, this is what happened: Assume that X for financial reasons decides to hire machinery for his manufacturing process. Y is lessor and claims in the first year of the plant's operation the initial (25%) and the investment allowances (30%). In addition the lessor also claims, say, 20% (five years) of 75% in respect of wear and tear allowance. In order to take advantage of the maximum allowances the cost of Y is inflated by his purchasing the machinery on a suspensive sale basis. In other words Y bases his claims in respect of the capital allowances on the cash price to him together with the finance charges over the period of payment under the suspensive sale agreement. The longer this perod is the greater the total cost will be which results in larger capital allowances during the first year. This scheme enables Y to reduce his taxable income considerably in the first year. This in turn results in tax savings with a positive cash flow for Y. The cost price of machinery or plant was for the purpose of the capital allowances inflated by the addition of finance charges. Those who devised this type of scheme ensured that the period of the lease was lengthy. The "cost" after the addition of finance charges was as a resisted by the Commissioner. The court held that the true nature of the contract was the sale of the motor vehicle on credit and that the finance charges was part of the expenditure necessary for the purposes of acquiring a capital asset.

Originally the initial and investment allowances were granted only to the owner of industrial assets. In 1962 and 1966, however, these allowances were made available to lessors of buildings and machinery or plant respectively. In an effort to benefit by this latter concession in favour of lessors, certain undesirable practices appeared in leasing agreements. In a somewhat simplified way, this is what happened: Assume that X for financial reasons decides to hire machinery for his manufacturing process. Y is lessor and claims in the first year of the plant's operation the initial (25%) and the investment allowances (30%). In addition the lessor also claims, say, 20% (five years) of 75% in respect of wear and tear allowance. In order to take advantage of the maximum allowances the cost of Y is inflated by his purchasing the machinery on a suspensive sale basis. In other words Y bases his claims in respect of the capital allowances on the cash price to him together with the finance charges over the period of payment under the suspensive sale agreement. The longer this perod is the greater the total cost will be which results in larger capital allowances during the first year. This scheme enables Y to reduce his taxable income considerably in the first year. This in turn results in tax savings with a positive cash flow for Y. The cost price of machinery or plant was for the purpose of the capital allowances inflated by the addition of finance charges. Those who devised this type of scheme ensured that the period of the lease was lengthy. The "cost" after the addition of finance charges was as a result several times the cash value. If for example the cost was inflated to say 300 as against a cash price of 100, the capital allowances would be three times greater to the lessor taxpayer. Everybody with the exception of the Fiscus was happy with the arrangement. The manufacturer gets paid for the machinery (normally in full by a financial institution in return for a cession of rentals owing by the lessee to the lessor); the lessee obtains the machinery at a lower cost; and the lessor has a positive cash flow. The effect of the scheme is a loss of revenue to the Fiscus in regard to the investment allowance if the true cost of the plant should be regarded as the cash price only.

What the Minister said in 1981: "I feel constrained, however, to sound a note of warning in regard to certain undesirable practices which have appeared in leasing agreements whereby the cost of the asset is artificially increased in order to allow the lessee to reap the benefit of bigger investment allowances on the inflated cost. Certain proposals will also be made to Parliament in this regard".

The Fiscus has put an end to this device by introducing into section 12 a new subsection 3(A). It provides that in regard to machinery or plant brought into use on or after 24 August 1981 (save for the exception mentioned below), the cost is deemed to be that which in the opinion of the Commissioner a person would at the time, if he acquired the machinery or plant under a cash transaction at arm's length, have incurred in respect of the direct cost of the acquisition plus the direct cost of installation or erection.

Consider the case, however, where a new item of plant has, for instance, been donated to a manufacturer. Would such plant qualify for the initial and investment allowances although the user manufacturer had not incurred any actual cost in its acquisition?

Section 12(3A) provides that the cost, for the purposes of the initial and investment allowances "shall .... . deemed to be the cost which, ... a person would, ... have incurred in respect of the direct cost of the acquisition of such machinery or plant, ..." The wording of the section seem to suggest that it could be construed that plant which has been donated would qualify for the allowance.

If the machinery or plant is brought into use after 24 August 1981, but the equipment was delivered to the purchaser under an agreement concluded not later than that date in terms of which the purchaser was obliged to take delivery at a price fixed or determinable under the agreement without any adjustment for taxation under the Act, then the deeming provision does not apply to determine the cost. If the agreement contains a provision (as some agreements have) that the price is to alter should the purchaser not be entitled to the allowances for tax, then the agreement will not protect him from the application of the deeming provision.

Section 12(3A) applies to both the initial and investment allowances. In addition to the direct cost of machinery or plant as defined above, the following will also qualify as part of the cost of machinery or plant -

- direct cost of installation or erection thereof (section 12(3A)); and

- the cost of a foundation or supporting structure [section 11(e) deemed the cost of these to be part of the cost of machinery or plant "for the purposes of this Act"].

4.32 Departmental practice

Taxpayers in some instances purchase plant or machinery in foreign currencies. The cost thereof for the purpose of S12 will be determined in the same manner as outlined in C21.4 *infra*.

4.33 Practical application

It is quite legal for a taxpayer to arrange his affairs in such a manner so as to pay the minimum amount of tax. Inspired by their dislike of paying tax, certain taxpayers wanting to improve land have made use of institutions, which are themselves exempt from tax.

The provisions of sections 11(g) and 13 of the Act are best illustrated by a hypothetical case. For purposes of illustration, let us assume a taxpayer manufacturer is desirous of erecting a factory for his manufacturing process. The land would cost him R1 million and the factory building R5 million. The following are some of the options open to him -

- a separate company specifically floated for this purpose could be the owner of the land;
- the taxpayer manufacturer could himself acquire the land; and
- the land could be subject to joint ownership, i.e. partnership.

Separate company specifically floated

The shares in the company could be held by the taxpayer manufacturer (subsidiary company).

If a subsidiary company buys the land and effects the improvements, it will be allowed to claim the annual and investment allowances under section 13. The advantages would be -

- there would be a saving in transfer duty in future should the property be sold (the shares would be sold instead of the property); and
- limited liability.

The big disadvantage of this arrangement would be that the subsidiary's only income would be rental. There may therefore be an insufficient tax base to benefit from the capital allowances in the first year.

An alternative is for the subsidiary to buy the land and to lease it back to the holding company. The lessee holding company could improve the land in terms of an obligation to do so or could effect the improvements voluntarily. Should the improvements be effected in terms of an obligation, the subsidiary company would be taxed on the amount of the improvements. The whole amount would be taxable in the year during which the right accrues (in practice when the building is completed). No relief would be granted under section 11(h) as the lessee and lessor are related. The lessee would be able to claim the cost of the improvements over the period of the lease (C23.12 infra).

Should the improvements be effected voluntarily, the tax position would change. The lessee would not be entitled to the section 11(g) allowances but could claim the capital allowances under section 13. To qualify for the deduction under this section, the lessee would have to have a right to occupation of at least 1C years. In addition, the lessee could claim an allowance in respect of pre-production interest under section 11(bA). There would be a disadvantage on the sale of the building should the subsidiary as owner sell the building. The purchaser would not be able to claim the annual allowance of 2%. The reason is that the subsidiary as owner was not itself entitled to the annual allowance prior to sale. In law a non-owner can sell an asset which does not belong to him, if he can guarantee free occupation. The taxpayer manufacturer as lessee could therefore sell the building, but whether such a transaction would be recognised in tax law is uncertain.

Acquisition of land by the manufacturer

Should the manufacturer buy the land and effect the improvements, the capital allowances under section 13 could be claimed.

Joint ownership

The ownership of the land and the manufacturing process for that matter could be shared jointly by different taxpayers. The only tax effect is that each member would be entitled to a proportionate share of the relevant allowances.

Illustration

It is quite common in South Africa for one company in a group to be the owner of the property in the group. The following is an example of such an instance.

1. Ajax is the holding company of Bromax, and carries on a process of manufacture. Both companies are for all purposes private companies.

2. The property with the factory thereon is registered in the name of Bromax and is let to Ajax.
3. Ajax has a taxable income of R1 million per annum.

4. The following details are available as regards Bromax:
   - The cost of the property is reflected as R363 000 in the financial statements.
   - To date the company has been allowed an amount of R44 000 in respect of the annual building allowance.
   - The property is held for 13 years,
   - The only income of the company consists of R44 000 per annum, a return of 12,12% on the cost of the property. This percentage return on cost is considered reasonable.
5. Due to increased demand for its product, Ajax is contemplating improving the industrial capacity of the factory.
6. It is estimated that the improvements will cost R1 350 000, and the objective is to obtain the maximum benefit from the available tax allowances.

Suggested solution

The first step would be to consider the allowances which are available to the group.

Building Investment Allowance [Section 13(5), (6), (6A)]

- The allowance at present is 20% on the cost to the taxpayer of any building erected or any improvements effected to any building used for manufacturing purposes.
- Improvements must be effected for the purpose of increasing or improving the industrial capacity of the building.

- The cost of excavations is not part of the cost of the building.
- The allowance is available to a lessee who erects a building or effects improvements provided the lessee has the right to occupation for at least 10 years.

Building Annual Allowance [Section 13(1) to (4)]

- The allowance at present is 2% on the cost to the taxpayer of any building erected or purchased (if the seller was entitled to the allowance) or of any improvements effected to any building used for manufacturing purposes.
- Improvements must be effected for the purpose of increasing or improving the industrial capacity of the building.
- The cost of excavations is not part of the cost of the building. It is submitted that the cost of transfer duty is linked closely enough to justify its inclusion in cost.
- The allowance is subject to recoupment under section 8(4). Any building or improvements thereto qualifying for the allowance would also qualify for the scrapping allowance under section 11(o), but only after 10 years.
- Whenever a qualifying building is purchased there will have to be a reasonable apportionment between the cost of the building and the land.

Improvements by Bromax

This would be the most uncomplicated approach. The company would be entitled to the following allowances:

- The cost of excavations is not part of the cost of the building.
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- The cost of excavations is not part of the cost of the building. It is submitted that the cost of transfer duty is linked closely enough to justify its inclusion in cost.
- The allowance is subject to recoupment under section 8(4). Any building or improvements thereto qualifying for the allowance would also qualify for the scrapping allowance under section 11(o), but only after 10 years.
- Whenever a qualifying building is purchased there will have to be a reasonable apportionment between the cost of the building and the land.

Improvements by Bromax

This would be the most uncomplicated approach. The company would be entitled to the following allowances:

	Allowance	PV @ 15%
	R	R
Cost of improvements R1 350 000		
20% Investment Allowance	270 000	270 000
2% Annual Allowance (50 years) 27 000		179 834
		449 834

	PV @ 15%
	R

The company's rental income is R54 000 per annum. On the estimated building cost of R1 350 000 the company could at the same rate earn R162 000 per annum. (The interest factor on the cost of the building is ignored).

The allowances could therefore be utilised within two years, as follows:-

Allowances - year 1	297 000
Less available income	162 000
Carried forward	135 000
Allowance - year 2	27 000
	162 000
Less available income	162 000

The present values @ 15% would then be:

Investment Allowance - year 1	135 000
- year 2	
(R135 000 deferred 1 year)	117 391
Annual Allowance (50 years)	179 834
	432 225

It is considered that a lease agreement at a market value rental could not invite any action under section 103 of the Act.

Improvements by Ajax

In terms of section 11(g), Ajax could claim an allowance in respect of any obligatory improvements effected under its lease with Bromax. In terms of paragraph (h) of the defintion of "gross income" Bromax would be taxed immediately on the value of the improvements whereas Ajax's allowance in respect of such value would be spread over the initial period of the lease. Unfortunately the discounting allowance provided for in section 11(h) to a lessor is not available in a group relationship situation.

If the lease agreement between the companies provides for a lease period of ten years, with or without further renewal options, the group allowance would be as follows:

	Allowance	PV @ 15%
	R	R
Value of improvements		
(Bromax) (R1 350 000		(1 350 000)
Annual write off (Ajax) (R135 000		
for 10 years)		135 000
	677 534	
Investment Allowance (Ajax)	270 000	270 000
		(402 466)

Without the relief provided for by section 11(h) this approach would not be feasable.

If Ajax effected the improvements without any obligation to do so it would be entitled to the same investment and annual allowance as Bromax (as above). Ajax, however, has sufficient profits to benefit by the allowances in one year. The group would be better off to the extent of R17 609 (R449 834 less R432 225).

As far as the risk of effecting improvements on another's property is concerned: if the lease were terminated, say after 10 years and Bromax or the property were sold Ajax would have to endeavour recouping (tax free) the balance of its improvements of R1 080 000 (R1 350 000 less R270 000). At worst it could claim a scrapping allowance in respect thereof. Alternatively, and subject to the possibility of an attack under section 103, Ajax could suffer the scrapping loss whilst the group could possibly achieve an increased capital profit on the sale of the company or the property, preferably the latter!

Purchase of the property by Ajax, prior to improvements

The first requirement would be to apportion the cost between the land and buildings. In regard to this aspect, full consideration should be given to the implications of section 103.

An arm's length transaction would normally indictate that the sale of a property take place at market value. What would the position be if such a sale resulted in greater tax benefits. The Commissioner could successfully contend that three of the four requiremnts of section 103 were present, which would leave the problem of normality. It could probably be successfully argued that any transaction whereby a wholly-owned subsidiary sold anything to its holding company at anything but book value to the group, could be considered abnormal. This aspect of "normality" has not yet been decided by our courts.

Assuming that R300 000 of the purchase price of R363 000 is allocated to the building, the allowances available to the group would be as follows:

	Allowance	PV @ 15%
	R	R
Recoupment (Bomax)	(44 000)	(44 000)
Annual allowance - 2% x 300 000		
for 50 years	6 000	
		39 963
		4 037
Add loss of allowances now available to		
Bomax - (2% x R300 000 for +/- 40 years)		39 963
Loss of group allowances		(43 887)
Add transfer duty - 5% x R363 000		(18 150)
Total loss to group		(62 037)

Conclusion

In order to maximise the benefit from available tax allowances, Ajax shou'd effect the improvements, without any obligation in terms of a lease.

CHAPTER 5

TAXPAYERS ERECTING RESIDENTIAL UNITS

The provision of adequate and sufficient housing has been a problem which the South African Government had to deal with over the years. The problem was addressed by -

- the allocation of substantial public funds for the provision of housing; and
- the encouragement of employers by means of tax concessions to assist in either acquiring their own homes or in obtaining rental accommodation.

The problem has not yet been solved as the demand for housing far exceeds the supply thereof.

What the Minister of Finance said in his 1982 budget speech:

"The private sector will be called upon to make a much more substantial contribution towards solving this problem, but in the meantime I feel it appropriate for Government to offer further tax concessions specifically to encourage the construction of new rental accommodation, at present at a premium throughout the country.

Various schemes and suggestions have been researched, but most were found to be either impracticable, too open to abuse, or even in conflict with sound taxation principles.

I am prepared, nevertheless, to offer the following concessions to investors who plan on erecting housing accommodation for rent: the annual depreciation allowance of 2 per cent at present applicable to new industrial buildings will be extended to include all new housing projects which offer not less than 5 family housing units for rent. This will apply to all qualifying housing projects the erection of which commences on or after 1 April 1982.

In addition I wish to propose that an initial allowance of 10 per cent of the cost of the project be allowed as a deduction from income in the year in which the project is completed and the accommodation is first let to tenants.

If the developer of the housing project should dispose of such property either by means of an outright sale of the whole project or through sectional title selling of individual units, or in any other way, the allowances previously granted will be recouped and included in his taxable income. Details of the allowances will be contained in the Income Tax Bill which will be presented to Parliament later in the session.

I am confident that these concessions will stimulate the provision of rental accommodation for the benefit of those dependent on rental units for accommodation, and will assist investors materially with their cash flow problems and return on investment".

5.1 Nature of a residential unit

The expression "residential unit" is defined in section 13 ter(1) of the Act nd "means any self-contained residential accommodation consisting of more than one room (but excluding any hostel, hotel or similar accommodation), the erection of which was commenced by the taxpayer on or after 1 April 1982 and which was erected under a housing project of the taxpayer -

(a) in order to be let to a tenant for the purpose of deriving a profit for the taxpayer; or

(b) in order to be occupied by a <u>bona fide</u> full-time employee of the taxpayer".

A certain amount of group relief was given by an amendment to section 13 <u>ter</u> in 1983. Section 13 <u>ter</u> (11) was introduced into the Act. Where a company is mainly engaged in the provision of housing facilities for the employees of its sole or principal shareholder or for the employees of any wholly owned subsidiary of its sole or principal shareholder, all the employees of such shareholder or subsidiaries shall be deemed to be its employees.

The expression "housing projects" is also defined in section 13(1) as meaning "any project for the erection of a building or buildings in the Republic consisting of or including at least five residential units".

Specifically excluded from the expression "residential units" are: "any hostel, hotel or similar accommodation". Hostels and hotels both provide accommodation in rooms which are normally not self-contained. It is submitted that the following would be "similar accommodation" -

- boarding houses; and
- clubs which provide accommodation.

The word "residential", being an adjective of description, is defined in Funk and Wagnalls New Practical Standard Dictionary as "pertaining to, fitted for, or resulting from residence". The definition of "resident" in the same dictionary is "one who resides or dwells in a place". "Reside" is also defined as: "To make an abode for a considerable time; live; dwell". It is therefore submitted that residential units which are erected for temporary accommodation would not qualify for the allowances under section 13 <u>ter</u>.

5.2 Locality of residential unit

The only restriction as to locality is that the residential unit must be erected in the Republic. Units in the independent States would therefore not qualify.

The units need not be erected wholly on property belonging to the taxpayer. This is confirmed by section 13 ter(4) which states that the allowances will not be available "in respect of any portion of the cost of any residential unit on any premises not owned by the taxpayer unless the taxpayer, at the date on which the erection of such residential unit is commenced, is entitled to the occupation of such premises for a period ending not less than ten years after such date".

A housing project could therefore consist of, say, two residential units erected on property owned by the taxpayer and three residential units erected on leased property. The taxpayer, in order to qualify for the allowances, must, however, have the right of occupation for at least ten years in respect of the three units. Should the right of occupation be less than ten years, the taxpayer in the above example would only qualify for two-fifths of the allowances under section 13 ter. It should be noted that the residential units must, however, be occupied as contemplated in the definition of "residential unit" above.

5.3 Capital allowance

The cost of a permanent structure in the form of a residential unit would be in the nature of a capital expenditure. Such cost could therefore not have been allowed as a deduction in the determination of taxable income, had it not been for section 13 ter of the Act.

The allowance consists of an annual allowance and an initial allowance.

5.4 Residential building annual and initial allowances

The other special feature of the allowances are:

- The amount of the annual and initial allowances are equal to two per cent and ten per cent respectively of the cost to the taxpayer of any residential unit.
- The residential unit must have been erected by the taxpayer under a housing project, for the cost to qualify.
- The allowances are available in the year of assessment during which the residential unit is for the first time let or occupied as contemplated in the definition of "residential unit" above. It is specifically provided that at least five residential units must have been let or occupied before the taxpayer will qualify for the allowances. In other words the allowances will be made for the first succeeding year of assessment in which at least five residential units have been let or occupied.
- The aggregate of the annual allowance and the initial allowance is restricted to cost or if calculated on a portion of cost, such portion.
- The allowances are not available in respect of any portion of the cost of a residential unit which have been allowed as a deduction under any other provision of the Act.

5.5 Recoupment

Section 13 ter (7)(a) provides for the inclusion of a portion of the initial allowance in the year during which the residential unit is so used or dealt with so that it ceases to be occupied as contemplated in the definition of "residential unit". The amount to be included would be the amount of the initial allowance which has been granted previously less one-tenth of such amount for each completed period of one year, but not exceeding ten years. The ten year period is calculated from the date on which such residential unit was first occupied as contemplated until the date on which the residential unit was used or dealt with as aforesaid. It is specifically provided [section 13 ter (8)] that the provisions of sections 8(4)(a) and 11(o) shall not apply to any amount included in income under this subsection.

Example

A erects five residential units all of which are completed during the first year. The aggregate cost amounted to R500 000 and the units are all occupied by bona fide employees in the first year. During the fifth year one unit became vacant and remained vacant until the end of the year of assessment. The vacant unit was sold for R120 000 during year six as no tenant could be obtained.

Solution

	R	R
Cost of housing project		500 000
Initial allowance year 1		
10% of R500 000	50 000	
Annual allowance - year 1 to		
year 4 - (2% x 500 000) x 4	40 000	90 000
Tax value at end year 4		410 000

To be added to income in year 5:

		R
Initial allowance:		
The initial allowance granted in respect of one unit amounted to R10 000. Add to income:- R10 000 less ($\frac{1}{10} \times \frac{10\ 000}{1}$ times completed year ie 4)		6 000
Annual allowance:-		
Nothing is included in income but the allowance is not granted in year 5		NIL
Total to be added to income of A at end of year 5		6 000

	R	R
Year 6:		
Cost of one unit sold in year 6		100 000
Less allowances in previous years:		
Initial allowance - 10%	10 000	
Less added to income in year 5	6 000	
	4 000	
Annual allowance - 2% x 100000 x 4 years	8 000	12 000
Tax value		88 000
Selling price		120 000
Surplus		32 000

The surplus consists of:	
Recoupment under S8(4)(a)	12 000
Capital profit	20 000
	32 000

An amount of R12 000 must therefore be added to income in year 6.

The question which arises is whether the taxpayer in the above example would be allowed the annual allowance during year 5 onwards in respect of the remaining units. There appears to be no restriction in section 13 ter of a deduction of the annual allowance in respect of the remaining four units under these circumstances. Should the unit be scrapped in year 6 for no consideration, an amount of R88 00, being the tax value, would qualify for a scrapping allowance.

The taxpayer is therefore penalised in the year during which any residential unit ceases to be occupied as contemplated. In the above example the unit was sold in year six. Let us assume A was unsuccessful in selling the unit and decided to let the property in year six. It would appear from the wording of the section that the portion of the initial allowance which was added to income in year five, cannot be re-instated in year six. The annual allowance, on the other hand, can be continued in year six if the unit is again occupied as contemplated.

5.6 Scrapping

The scrapping allowance under section 11(o) would apply to residential units.