Deductions, recoupments, losses through scrapping, secondary trades, and corporate restructuring

A review of recent tax legislation

New or amended deduction provisions

The 2005 amendments to the Income Tax Act 58 of 1962 include several provisions relating to the deduction of expenditure. Two of these are incentives, one to encourage taxpayers to undertake research and development, and the other to engage in urban renewal projects. The other two amend and to some extent improve existing provisions.

Research and development

Sections 11(f) and (g) of the Act, which provide for deductions in respect of expenditure on scientific research, are no longer available for years of assessment commencing on or after 1 January 2004. These two provisions were deficient in several respects, and it was not always easy to obtain the benefits they purported to offer. Not least of these deficiencies was the fact that taxpayers could suffer penalties for completing research too quickly. Also, the CSIR had to approve much of such expenditure before it could be claimed.

A new section 11B has been introduced to replace section 11(f) and (g). The new provisions are considerably simpler and less restrictive than the previous ones and are welcome. They aim to encourage the development of intellectual property in South Africa, and should be viewed in tandem with the repeal of section 11(gA) and (gB) and the introduction of section 11(gC) relating to intellectual property. I shall discuss them below.

Once the following criteria are met, the costs are deductible in the year in which they are incurred:

- In order for the costs of research and development (‘R&D’) to be deductible, an appreciable element of innovation is essential. The activity must actually or potentially result in an identifiable intangible asset ‘as contemplated under generally accepted
accounting practice’. If this statement is intended to refer to the appropriate South African Institute of Chartered Accountants statement on GAAP, then AC 129 defines ‘intangible asset’ as ‘an identifiable non-monetary asset without physical substance held for use in the production or supply of goods or services, for rental to others, or for administrative purposes’.

- For the purposes of the section, the R&D may not be related to the social sciences, arts, humanities, or management, or to market research, sales, or marketing promotion. The section is also limited in that the asset contemplated may not be a trade mark.

- The expenditure may be undertaken by the taxpayer or by an unconnected third party on behalf of the taxpayer, provided that in the latter case full ownership and control over the results of the R&D remain with the taxpayer.

- In addition, the costs of registration, re-registration, or renewal of legal protection are also deductible in the year in which they are incurred.

The costs of capital assets, including buildings, used in R&D may be written off over four years, 40 per cent being deductible in the year of first use and twenty per cent per year thereafter. But there is a difference between the treatment of buildings and of other capital assets. If a building is used partly for R&D and partly for other purposes, the allowance is based on an apportionment of the cost based on use. In the case of other assets such as machinery and plant, by contrast, no allowance is permitted if it is used for any purpose other than research and development. In many cases, of course, such dual use machinery would be subject to the allowances for manufacturing machinery provided for under section 12C. In fact, the taxpayer may choose to claim allowances under another section of the Act in respect of any asset in preference to the provisions of section 11B, provided the assets qualify under those sections, of course.

Urban development zones

A new section 13quat provides incentives for urban renewal and development. The aim is to encourage schemes to renew blighted urban areas and revive central business districts. An interesting provision is the requirement that both the private sector and the relevant municipality must be involved in the renewal process of the area concerned. This could take the form of a public-private partnership (‘PPP’) or similar agreement dedicated to the same end, but it is clear that there can be no such project without the commitment of the municipality to a large-scale renewal of an area. It must be shown that the area was formerly a significant source of property rates or assessed property values, and that these are undergoing a sustained decline.

The provisions of the section are therefore aimed at specific demarcated areas and entitle the taxpayer to claim allowances of

- in the case of any new building, twenty per cent of the cost in the year in which a certificate of occupancy has been issued and the building brought into use for the purposes of trade, and five per cent per year for the next sixteen years; and

- in the case of improvements where the existing structural or exterior framework is preserved, twenty per cent of the cost per year in the year of first use and each of the next four years.

There is thus a significant incentive to regain the outward appearance and atmosphere of such areas rather than to rebuild and modernize them completely.

Two measures apply to prevent abuse of the concessions:

- the allowances are not available where the taxpayer has at any time in the past either ceased to use the building solely for the purposes of trade, or has owned and disposed of the building; and
the section will apply only to projects in respect of which the contracts were signed by all parties after the date that the Bill was tabled, which appears to have been 18 November 2003. There is no provision for retrospective relief for projects already under way. Perhaps it goes without saying that the renewal or refurbishment of individual apartments or offices or even whole floors will not qualify for the allowances.

As I mentioned above, the section requires public and private participation and serious and continuing commitment by the municipality. So it is clear that access to the provisions of the section depends upon the existence of a specific municipal improvement programme involving the private sector. It is not open to an entrepreneur who arbitrarily acquires a ramshackle building and improves it, however praiseworthy and useful such an investment might be.

**Intellectual property**

Consequent upon the new provisions relating to the costs of R&D discussed above, the current provisions for deduction of the costs of intellectual property under section 11(gA) and (gB) are not available for years of assessment commencing on or after 1 January 2004. A new section 11(gC) replaces them. No longer will taxpayers be allowed to deduct costs incurred in devising, developing, or creating inventions, designs, copyright, or similar property, but only the costs of acquiring such assets. But the cost of acquiring trade marks may not be deducted. The amount deductible, commencing in the year that the taxpayer brings the property into use for the first time, is the same as it was under the previous provisions:

- ten per cent per year in respect of designs,
- and
- five per cent for other categories of intellectual property.

If the cost does not exceed R5 000, the full amount is deductible in the year of first use. The limitation in the previous sections relating to transactions between connected persons remains — the basis of the deduction is the lesser of the cost to the seller or the market value.

So section 11(gC) applies to the costs of acquiring intellectual property, whereas section 11B deals with the deductibility of research and development expenditure. So expenses incurred in devising, developing, or creating intellectual property are not lost. But the provisions for their deduction have been shifted to section 11B.

**Expenditure and losses incurred prior to commencement of trade**

There has always been a problem with expenditure incurred in establishing a business before trade commences. Because it has not, strictly speaking, been incurred in the course of trade or in the production of income, such expenditure has not qualified for deduction. The only exception has been in respect of pre-production interest incurred in respect of loans obtained in order to finance the erection or installation of machinery, plant, building pipelines, or similar assets. This category of interest is deductible as soon as trade commences.

A new section 11A seeks to eliminate this unfortunate shortcoming in the Act by providing that any expenses that would otherwise have been deductible under sections 11 (the general deduction formula) or 11B (R&D) qualify for deduction once the business commences trading. Such deductions are ring-fenced to the trade concerned and may not be set off against any other income of the taxpayer.

**Recoupment of allowances**

Included in the recent amendments are significant changes to the treatment of the effects of disposing of assets. These encompass recoupments of allowances previously claimed, capital gains, and losses occasioned by scrapping.

The Eighth Schedule to the Act provides in paragraphs 65 and 66 that a taxpayer may spread or roll over the gain from the disposal of an asset
in certain circumstances. As I shall show below, where the asset is a depreciable asset, the gain is spread over the tax life of the replacement asset. The intention is to prevent a tax leakage either where there is an involuntary disposal of an asset by means of expropriation, loss, or destruction and the asset will be replaced and brought into use within three years, or where an asset is disposed of in the normal course, any gain may also be spread or rolled over, provided it is replaced and brought into use within one year.

By contrast, until the amendments to the Act by the Revenue Laws Amendment Act 45 of 2003, very limited concessions applied to the recoupment of wear and tear and similar allowances when an asset was sold. Under normal circumstances, any recoupment of allowances previously claimed were taxable in terms of section 8(4)(a). Only if a damaged or destroyed (not merely sold or scrapped) asset had been used in a process of manufacture or similar process, or was of a specialized nature such as a ship, aircraft, or pipeline, was the taxpayer able to roll the recoupment of allowances on any such asset over to the replacement asset, and then only if the replacement was brought into use within three years and used for at least five years (or less if it was scrapped or disposed of in the normal course of business).

| Tax incentives are to encourage taxpayers to undertake research and development, and engage in urban renewal projects |

The concession has now been extended to a wider range of assets, but not buildings, by the introduction of several additions to section 8(4) and by a revision of paragraphs 65 and 66.

A simple example will illustrate the interaction of section 8(4) and paragraphs 65 and 66. Assume these facts:

- Base cost of asset disposed of: 100
- Wear and tear/capital allowances: 40
- Tax value on disposal: 60
- Compensation received from insurer: 150
- Total gain/recoupment: 90

This amount is made up of a taxable recoupment of 40 in terms of section 8(4)(a) and a capital gain of 50 to which paragraphs 65 or 66 may be applied if the required conditions are met.

**Paragraph 65**

This paragraph is available where there has been an involuntary disposal of an asset and the owner receives compensation at least equal to the base cost. In the case of a depreciable asset, the tax on the gain may, at the instance of the taxpayer, be deferred and accounted for over the period during which tax allowances on the replacement asset are permitted. If the replacement asset is disposed of before that period is over, the balance of the deferred gain accrues on the disposal. In the case of other assets, the gain is deferred until disposal of the replacement asset. In order for this concession to be available, four requirements must be met:

- the full proceeds must be invested in the replacement asset or assets;
- the asset or assets must be either immovable property in South Africa, or, if movable assets, those of a resident, or the South African permanent establishment of a non-resident;
- the contract for the replacement asset must be concluded within twelve months (or eighteen months with the permission of SARS); and
- the replacement asset must be brought into use within three years.

Where the asset is replaced by more than one asset, the deferred gain must be apportioned to each asset according to its cost.

Where the replacement asset is a depreciable asset, the deferred gain is brought to account in each year of use on the same basis that allowances are claimed. In other words, the gain is taxed in proportion to the allowances. If the asset is disposed of before this process is complete,
the outstanding balance of the deferred gain becomes taxable immediately.

Where any of the four conditions are not met within the prescribed period, the gain is deemed to have accrued at the end of the period. Interest at the prescribed rate is calculated on the gain from the time it actually accrued, and this is treated as a capital gain.

Where the replacement asset is a personal use asset, these provisions do not apply unless the asset disposed of was also a personal use asset.

Paragraph 66

This paragraph is available in respect of any asset in respect of which allowances can be claimed; in other words, depreciable assets. When such an asset is disposed of and a capital gain results, the taxpayer may elect that the gain be taxed in proportion to the allowances that can be claimed in respect of the replacement asset, which must also be available for allowances. The detailed provisions are the same as those in paragraph 65.

To sum up the difference between paragraphs 65 and 66: paragraph 65 applies to any asset provided it has been involuntarily disposed of; paragraph 66 applies only to assets in respect of which allowances can be claimed (depreciable assets) but the disposal may be voluntary.

Cessation of use in trade

Where a replacement asset ceases to be used in the taxpayer’s trade, any disregarded capital gain is immediately recognized.

Section 8(4)(e)-(cE)

The general provision governing deferrals is that the recoupment provisions of section 8(4)(a) will not apply where the taxpayer has elected that paragraph 65 or 66 will apply to a disposal. The effect of this is that the taxpayer may not simultaneously elect to apply section 8(4)(e) to defer the recoupments of allowances but elect not to defer the capital gains. Conversely, if the taxpayer elects to apply paragraphs 65 or 66, the deferral of the recoupments must follow.

Where more than one asset replaces the asset disposed of, the recoupment must be allocated between the replacement assets in proportion to the proceeds spent on each (s 8(4)(eA)).

Where the replacement asset is a depreciable asset, the recouped amount must be taken into account over the life of the replacement asset proportionate to the amount of the allowance that can be claimed each year in respect of that asset (s 8(4)(eB)).

Where the replacement asset is disposed of before the deferred amount has been fully taken into account, the outstanding portion is deemed to have been recouped in that year (s 8(4)(eC)).

Section 8(4)(eD) provides similarly in respect of the unclaimed portion of the amount where the replacement asset ceases to be used for the purpose that qualified it for the election under paragraph 66 — the purposes of the trade or manufacturing activity of the taxpayer.

Where the taxpayer fails to conclude a contract for or bring into use a replacement asset within the period provided in paragraphs 65 (three years) and 66 (one year), not only is the amount immediately taxable but deemed interest on the amount is calculated at the prescribed rate, and this is treated as a recoupment as well (s 8(4)(eE)).

Losses through scrapping

The current provisions relating to losses through scrapping are less than satisfactory. They are restrictive in their application and have been rendered confusing and awkward to follow, as recent amendments and additions to section 11(o) have turned the section into something of a hotchpotch. To make matters worse, judicial decisions created uncertainty as to the very meaning of the term ‘scrapping’.

The section has been extensively rewritten,
and now applies to depreciable assets (those that qualify for the wear and tear, farming, or manufacturing allowances, as well as ships and aircraft) that have an expected life for tax purposes of less than ten years. The significance of the ten-year limit is that certain assets may, in terms of SARS Practice Note 19, be written off only over periods exceeding ten years. So section 11(6) would not apply to such assets. Examples are fishing vessels, lifts, paintings, pleasure craft, portable safes, and water purification plants.

The allowance is the amount by which the cost to the taxpayer of the asset exceeds the sum of the proceeds from disposal (by whatever means) and any allowances previously claimed. For this purpose cost is the actual cost, plus any costs incurred in relocating the asset, less any recoupments brought forward from the disposal of another asset and set off against the cost of the asset. Cost is the arm’s length cash cost of the asset.

A new section 76A has been introduced into the Act, but it has not yet come into operation. The President will bring it into operation by promulgation in the Gazette at a date to be determined. Its provisions are part of the current attack on structured finance transactions and are intended to give SARS an early warning of the existence of such schemes.

Two classes of reportable arrangement are defined:

- The first class is one that includes the three provisions set out below:
  - the calculation of interest, finance costs, fees, and other expenses depends wholly or partly on the tax treatment of the arrangement;
  - provision for the variation of such expenses should the actual tax treatment differ from the anticipated treatment, or should SARS challenge the treatment; and
  - the potential amount of such a variation exceeds R5 million.
- The second class is any arrangement that has certain characteristics, identified by the Minister by notice in the Gazette, that are likely to lead to an undue tax benefit. There is as yet no indication of what these characteristics will be, but the principle of tax-driven schemes as opposed to commercially justifiable arrangements is likely to be a determining factor.

A tax benefit is any reduction or postponement of a liability for any tax, duty, levy, charge, or other amount administered by SARS.

In addition to the fact that the Minister is enabled to identify certain arrangements as being tainted in respect of the section, he may also identify others that, despite being arrangements, are not likely to lead to an undue tax benefit. This provision was absent from the first draft of the Bill, and its inclusion is welcome because it provides a simple means of keeping innocent but otherwise vulnerable arrangements from being unwittingly subject to the section.

Any arrangement identified by the Minister under either of his options must be incorporated into the Act within twelve months. Presumably this will lead to the introduction of another Schedule to the Act.

The section applies to both companies and trusts, and requires every such entity that derives a tax benefit to report this fact to SARS within 60 days after the date on which any amount is first received or accrues, or is paid or incurred, in the terms set out below:

- a description of all the steps and key features of the arrangement;
- a list of all the parties to it;
- copies of all the signed documents; and
- any financial model of the arrangement, including any spreadsheet or computer model of the implementation of the arrangement.

If the taxpayer fails to report as required, it will be deemed to have entered into the arrangement by abnormal means or to have created abnormal rights or obligations as contemplated in section 105(1), the general anti-avoidance provision of the Act. Willful or reckless failure to report as required will render the taxpayer liable to pay the amount of the benefit in addition to the tax chargeable. In other words, the taxpayer will be unable to claim any tax benefits under the arrangement.
The final version of section 76A differs markedly from the first draft, no doubt as a result of vigorous lobbying by banks and other users of such arrangements. It will be interesting to see whether any further changes occur before the section comes into operation.

**Secondary trades and ring-fencing of assessed losses**

The long-anticipated legislation limiting the ability of taxpayers to set off losses from a secondary trade against other income has been introduced by the new section 20A in the Act. Whereas most commentators expected the provisions to have dire consequences for taxpayers, they are not as far-reaching as expected. Moreover, as I shall explain below, their main impact will be directly felt only several years hence, even though the section itself came into operation on 1 March 2004.

**General application**

Several circumstances must be present before the section can apply:

- the taxpayer must be a natural person whose taxable income is subject to the maximum marginal rate before taking any assessed losses into account.
- If this is the case, then either:
  - there must have been assessed losses from the secondary trade in at least three of the past five years, or
  - the secondary trade must be one of a designated group which for convenience may be described as ‘suspect trades’ (see below).

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

The suspect trades referred to above consists of the activities set out below (these examples are taken from the Explanatory Memorandum issued by SARS):

- any sport practised by the taxpayer or any relative (this includes, for example, any form of sport, hunting, yachting or boat racing, horse-racing, water skiing, and scuba diving);
- dealing in collectibles by the taxpayer or any relative (collectibles include cars, stamps, coins, antiques, militaria, art, and wine);
- rental of residential accommodation, unless at least 80 per cent of the residential accommodation is used for at least half of the year of assessment by persons who are not relatives. Residential accommodation is intended to include the rental of holiday homes, bed and breakfast establishments, guesthouses, and dwelling houses. For example, townhouses and guesthouses subject to a long-term lease of at least one year would fall outside the suspect list because the taxpayer (or relative) cannot obtain access for private use. By contrast, the bed and breakfast leasing of a few rooms within the taxpayer’s main home would fall under the suspect list. Holiday homes used by the taxpayer and not by non-relatives for at least half of the year of assessment would be suspect;
- rental of transportation assets, unless at least 80 per cent of those assets are used for at least half of the year of assessment by persons who are not relatives. This applies to, for example, aircraft, cars, and boats;
- animal showing by the taxpayer or any relative. The showing of animals in competitions includes, for example, the showing of horses, dogs, and cats;
- part-time farming or animal breeding carried on by the taxpayer. This is probably the activity that, above all the others, is the target of the section. Farming or animal breeding by the taxpayer other than on a full-time basis, such as weekend or casual farming, is suspect. One notable activity within this suspect class would be game farming;
- performing or creative arts carried on by the taxpayer or any relative. Such activities include, for example, acting, singing, film making, photography, writing, pottery, and carpentry. Mere passive investment in these activities would not generally fall within the suspect class. For example, investment in commercial film making will not be suspect if the taxpayer...
(or relative) has no real involvement with the making of the film, whereas the making of home movies may suggest a hobby-like element;
• gambling or betting practised by the taxpayer or any relative. This activity includes trying one's luck at a casino on a regular basis, card playing, lottery purchases, and sports betting.

In this context the term 'relative' is limited to a spouse, parent, child, stepchild, brother, sister, grandchild or grandparent, which is more limited than the definition for general purposes of the Act.

Corporate restructuring rules

Several provisions of Part III of the Act have been amended by the 2003 Amendment Act. The corporate restructuring rules are complex and situations inevitably arise where the rules cannot be easily applied or where there are unintended and unwelcome consequences. Refinements to the rules are likely to continue for at least the next few years until they stabilize into a generally acceptable structure. I shall discuss the amendments below.

Application now elective rather than mandatory

Of the six kinds of transaction contemplated in Part III, the application of these rules was elective for company formations, intra-group transactions and liquidations, but mandatory for share-for-share transactions, amalgamations, and unbundlings. This has been amended so that the parties in the latter category may elect that the rules do not apply to them. So there is still a distinction between the two categories:
• for the first group, the rules will not apply unless the parties elect that they will;
• for the second group, the rules will apply unless the parties elect that they will not.

In the case of unbundlings, however, there is a further restriction in that the election option, which is found in section 46(8), applies only where the unbundled company, both before and after the unbundling, is a controlled group company in relation to the transferee shareholder, and both the unbundled and unbundling companies are unlisted.

The eighteen-month rule and trading stock

The eighteen-month rule, in terms of which assets must be held for that period after a rollover, has proved to be unreasonable in certain respects:
• Where the asset is trading stock and of a type in which the transferee company regularly and continuously trades, it was unrealistic to expect the transferee not to treat it in the same way as any other such item of stock. The rule has been amended by the introduction in section 41 of a definition of trading stock for the purpose of Part III only, which ensures that trading stock transferred where these conditions apply may be sold immediately.
• The eighteen-month rule does not apply to assets disposed of involuntarily as contemplated in paragraph of the Eighth Schedule to the Act — by expropriation, loss, or destruction within eighteen months after a transaction. But paragraph 65 does not apply to financial instruments. In terms of the amendments to Part III, financial instruments that undergo involuntary disposals contemplated under paragraph 65 are now exempt from the eighteen-month rule.

Unbundling transactions

The requirement that the shares involved in an unbundling transaction must have been held for eighteen months before the transaction has been deleted by means of a complete revision of the definition of 'unbundling transaction'. The provisions of the new definition provide that
• the unbundled company must be a resident, while the unbundling company need only be a resident if it is listed;
• the concessions apply to so many of the equity shares of the unbundled company as are held by the unbundling company and are disposed of (in other words, there may be a partial unbundling);
the disposal must be in proportion to the effective interests of the respective shareholders;

• where the unbundling company is listed, and the shares of the unbundled company will be listed within twelve months, the shares must be distributed to the shareholders of the unbundling company;

• where the unbundling company is unlisted, the shares must be disposed of to companies within the group;

• the provisions will apply where the distribution takes place pursuant to an order in terms of the Competition Act 89 of 1998. Moreover, in such a case the minimum shareholding requirement set out below does not apply;

• before the disposal, the unbundling company must hold, if the unbundled company is listed, more than 25 per cent of the equity where no other shareholder holds an equal or greater amount and 35 per cent in any other case; and where the unbundled company is unlisted, more than 50 per cent of the equity.

Financial instrument holding companies

The definitions of domestic and foreign investment holding companies have been aligned as far as practically possible.

If a company is a financial instrument holding company, domestic or foreign, there are limitations on its ability to participate in the corporate restructuring rules, with the result that such instruments may generally not be transferred between taxpayers without attracting tax consequences. Certain financial instruments are disregarded for this purpose, and may thus enjoy the benefits of Part III:

• instruments that are debts that arose in the course of taxable trading transactions;
• inter-group loans and advances; and
• instruments that are transferred to or from certain regulated financial institutions such as banks, insurance companies, and collective investment schemes.

The limitations have been further relaxed in three respects and restricted in another:

• A financial instrument holding company is one where more than half of its assets, measured by both cost and market value, consists of financial instruments. This measure has been relaxed in respect of the cost ratio in that up to two-thirds of the assets by cost, instead of half, may be financial instruments. The 50:50 provision as to cost remains. This concession has been backdated to 6 November 2002, when the definition was introduced into the Act.

• The list of financial instruments to be disregarded has been extended in one respect. At present, if the controlling company is a resident, only resident controlled regulated financial institutions are disregarded. Alternatively, all the participants must be non-residents. This restriction has been relaxed so that the exclusion applies to controlled group companies that meet either of the exclusions, domestic or foreign.

• Holdings of cash or cash equivalents will not be taken into account as financial instruments in intra-group transfers or liquidations distributions. In sections 45(6) and 47(6) the Act describes this category as ‘any financial instrument the market value of which is equal to its base cost’. The reason for this concession is the recognition that members of a group are economically the same as divisions of the same company.

• The restriction relates to intra-group loans and advances. In order to be disregarded, such instruments must be between a company and any of its controlled group companies or between controlled group companies in relation to that company.

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