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Fixed Assets: Pitfalls and opportunities

20 April 2022

PRESENTED BY

Kreston South Africa
Johan Heydenrych: Director Tax Services
Marina Pretorius: Associate Director: Tax Services

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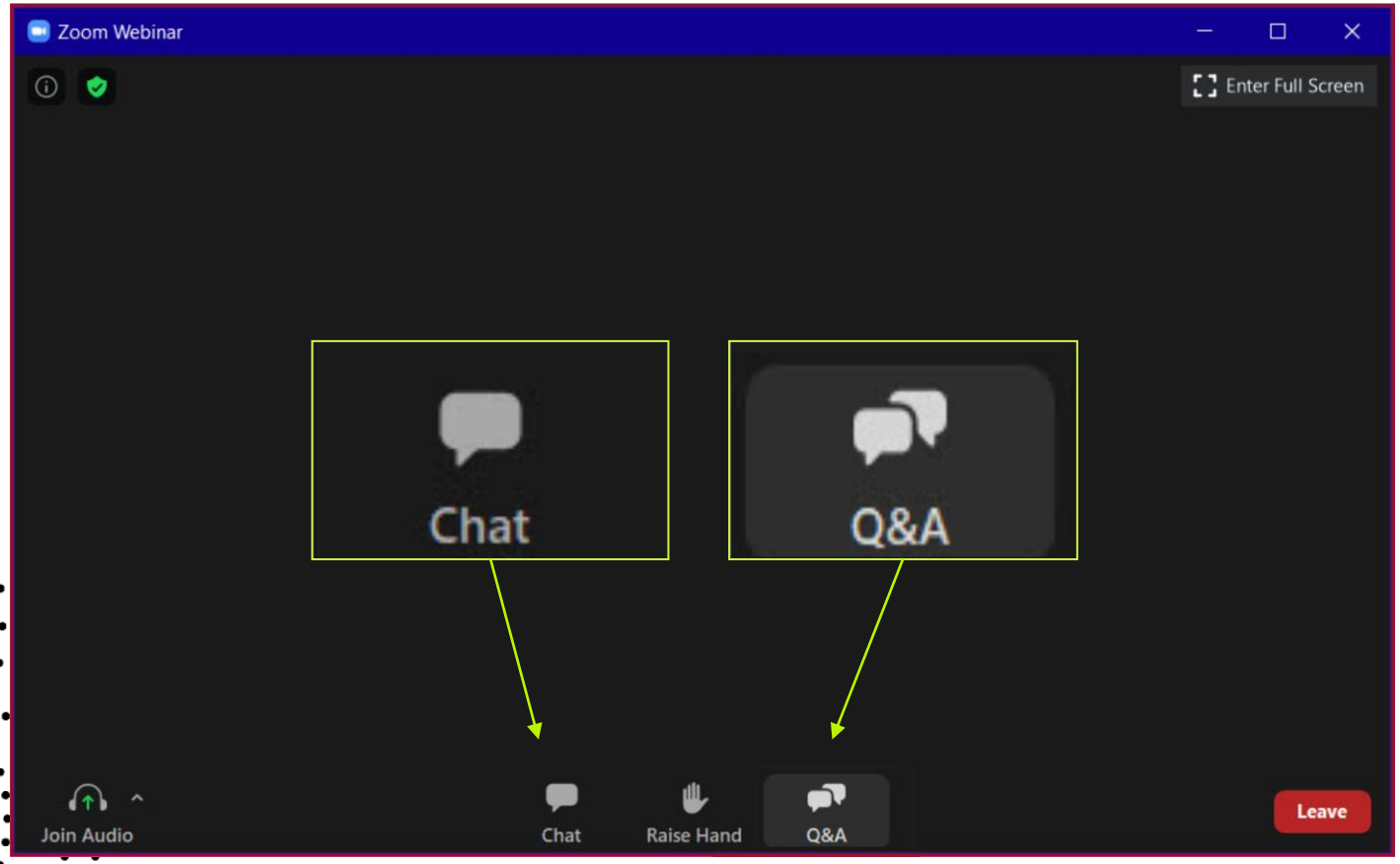

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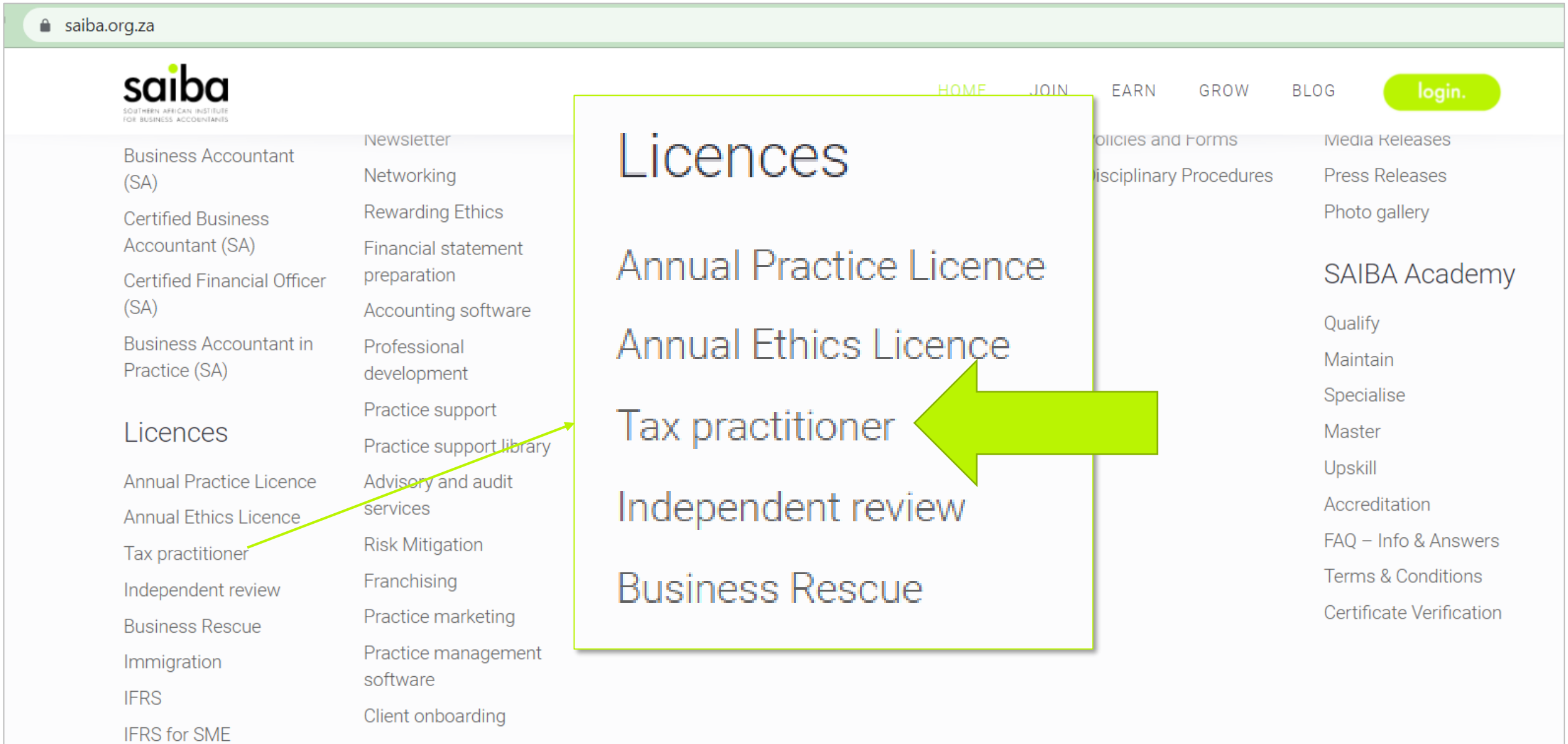

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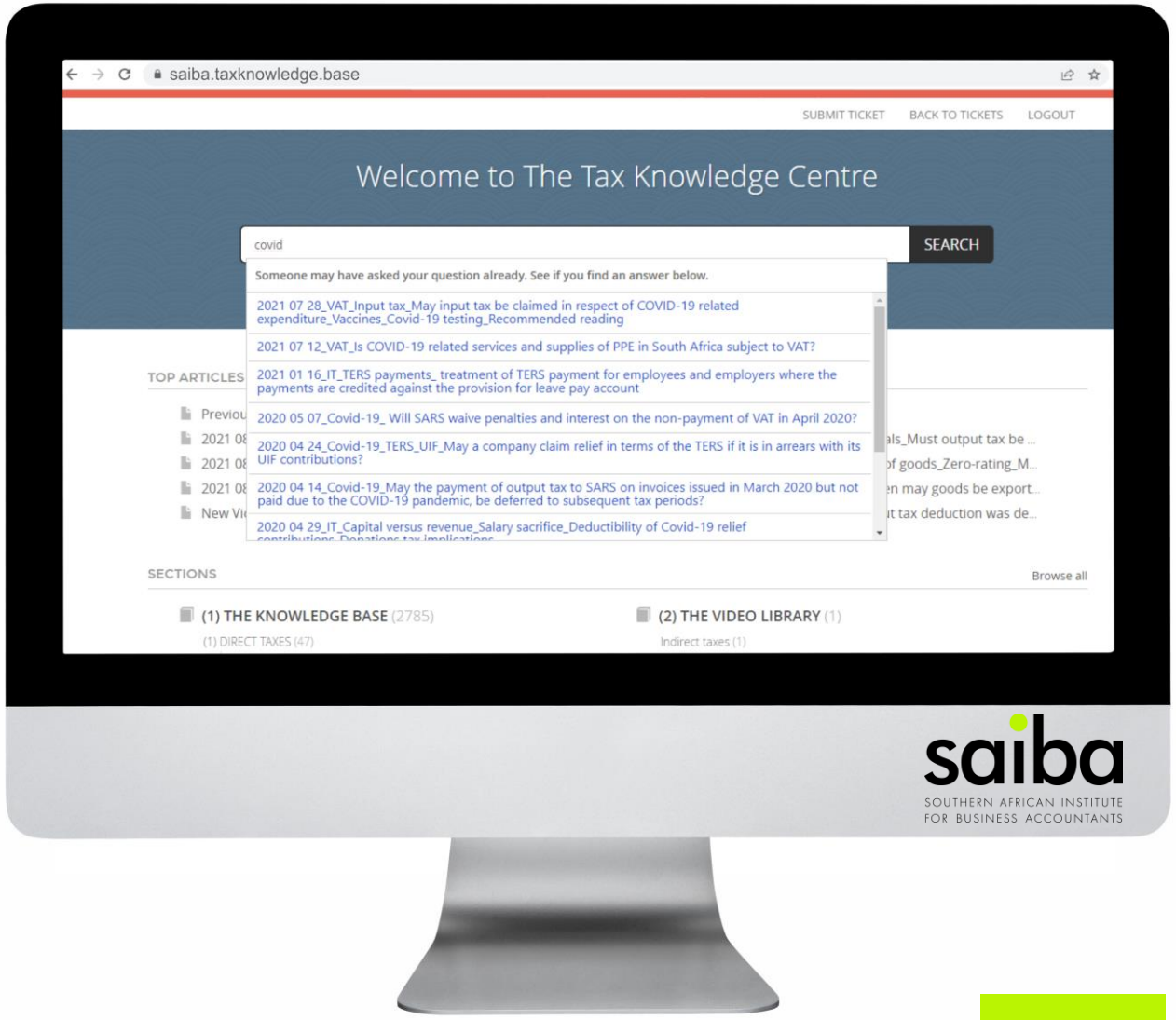

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ABOUT THE PRESENTER

Johan Heydenrych
Kreston South Africa

Johan is a Chartered Accountant who specialised in taxation since 1991. He holds the following qualifications:

- B. Com (Accounting) (Cum Laude)
- B. Com (Accounting) (Hons) (Cum Laude) (Award: "Best student in Audit 700")
- Certificate in the Theory of Accounting
- M. Com (Taxation) (Cum Laude) (Award: "Best M. Com (Tax) student")
- Chartered Accountant (Specialising in Taxation)
- Member of SAICA
- Registered Tax Practitioner

Johan was a tax partner at KPMG from 1997 to 2020 and is currently a partner in the Kreston SA network specialising in taxation.
He provides a wide range of tax services to various clients across industries. These include but are not limited to the following:

- Advice on Tax Risk Management and Tax Governance.
- Tax compliance services including but not limited to ITR 14 and IT 14SD
- Dealing with tax disputes including representing clients at Alternative Dispute Resolution (ADR) hearings.
- Submission of documentation and revised returns under the Voluntary Disclosure Programme.
- Issuing of tax technical opinions on Income Tax, VAT and PAYE. This include preparing briefs to Senior Counsel and submissions of requests for Binding Opinions from SARS.
- Audit support services that includes Normal Tax and Deferred Tax disclosure and disclosure of uncertain tax positions.
- Assistance with implementation of tax reporting for new accounting standards such as IFRIC 23, IFRS 9, IFRS 15 and IFRS 16.
- Facilitation of tax diagnostic sessions with existing and prospective clients.
- Advice on mergers, acquisitions and reorganizations.
- Tax due diligences
- Advice on tax implications of recapitalization transactions, debt restructures, liquidations and deregistration's

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ABOUT THE PRESENTERS

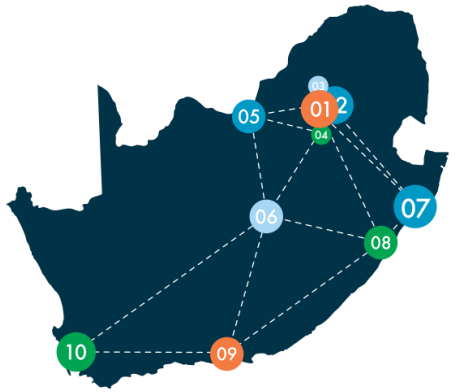
Marina Pretorius

Kreston South Africa

- Marina joined the Kreston Pretoria team on 1 March 2021 after specialising in tax at KPMG for the last 13 years. She is an experienced tax advisor who holds an H. Dip(Tax) Degree. She completed her articles at Deloitte where she also passed the CA(SA) qualifying examination.
- She worked in the UK on large listed clients for 2 years and joined KPMG tax department in 2007.
- As Associate Director and head of KPMG's Global Compliance Managed Services business unit, she is very experienced in tax and accounting reporting requirements for large multi-nationals.
- This includes ITR 14 disclosures required for multi-nationals as well as submissions of CbC Reports, Master Files and Local Files.

Education and Qualifications

- B. Com (Accounting)
- B. Com (Accounting) (Hons)
- Certificate in the Theory of Accounting
- Passed qualifying CA(SA) exam.
- H.Dip (Tax)
- Registered Tax Practitioner



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TAX HAPPY HOUR INDEX

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1.

Accounting vs Tax treatment of fixed assets

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Cost price of an asset

IAS 16	Principles
Par 7	The cost of an item of property, plant and equipment shall be recognised as an asset if, and only if: (a) it is probable that future economic benefits associated with the item will flow to the entity; and (b) the cost of the item can be measured reliably
Par 16	The cost of an item of property, plant and equipment comprises: (a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates. (b) any costs **directly attributable to bringing the asset** to the location and condition necessary for it to be capable of operating in the manner intended by management. (c) the initial estimate of the costs of dismantling and removing the item and **restoring** the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

Generally same for tax

Generally same for tax

Restoration costs not part of costs of asset. Some concerns about tax deductibility when actually incurred. Probably capital?

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Cost price of an asset

Principles

Examples of **directly attributable costs**

(a) Employee cost from individuals that are directly involved in the construction or acquisition of an asset

(b) Professional fees

Generally not part of the cost of the asset. It may or may not be deductible in terms of S11(a).

Capitalised interest

- The cost incurred in financing expenditures for an asset that are being constructed is part of the asset's historical acquisition cost.
- Interest cost can be regarded as a direct cost can be assigned to the acquired asset.

Need to be separately evaluated. E.g. Architects fee may be capitalised but cost to rezone land may simply be capital expense

Claimable in terms of section 24J. If pre-trade, may only be claimed once trade begins ito section 11A

Restoration- or dismantling provision

- Capitalise against asset and account for provision.
- Depreciate over useful life of asset
- Assess the fair value of provision on yearly basis.

Restoration costs not part of costs of asset. Some concerns about tax deductibility when actually incurred. Probably capital?

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Rules governing depreciation, impairment, useful lives and residual value

IAS 16	Principles
Par 30	After recognition as an asset, an item of property, plant and equipment shall be carried at its cost less any accumulated depreciation and any accumulated impairment losses
Par 48	The depreciation charge for each period shall be recognised in profit or loss Depreciation of asset begins when the asset is available for its intended use.
Par 7	Useful life is: (a) the period over which an asset is expected to be available for use by an entity; or (b) the number of production or similar units expected to be obtained from the asset by an entity
Par 6	The residual value of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life

Tax depreciation may be different and should be dealt with in terms of each relevant section

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Change in estimate vs error

	Principles
IAS 8	*Reassessment of Useful life or residual value:* - Treated as change in accounting estimate (prospectively)
	No or inadequate yearly assessment: *- Treated as prior period error (retrospectively)*

Be careful if prior year numbers are restated. The tax should not be impacted, but unwinding the accounting adjustment may be tricky.

2.

General Deduction Formula

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General Deduction Formula (S11(a))

- Carrying on a trade
- Expenditure and losses
- Actually incurred
- During the year of assessment
- In the production of income
- Not of a capital nature

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General deduction formula:

Not of a capital nature

- Expense to acquire/create an income producing asset or expense to work the asset
- Each item considered on merits of own case

Some guidelines

- Enduring benefit?
- Add to "income earning structure"
- Once off expense from which future benefits will flow

3.

Section 11 (e)

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Section 11(e) Wear and Tear Allowance

Allowance on assets not of permanent nature over useful life of the asset.	Apportioned	Not available on section 12C assets.	Interpretation Note 47
Value of asset vs cost.	Often confused with assets of permanent nature.	<R7 000 Rule (Not applied to lessor of assets)	Shade netting, fences, roads, security, signage.

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Case deals with Understatement penalties charged by SARS when a Section 11(e) catch-up claim was made

REPUBLIC OF SOUTH AFRICA

IN THE TAX COURT OF SOUTH AFRICA

GAUTENG DIVISION, PRETORIA

CASE NO: 24674

DATE: 25 November 2020

(1) REPORTABLE: YES/**NO**
(2) OF INTEREST TO OTHER JUDGES: YES/**NO**
(3) REVISED.

25 November 2020
Date

SIGNATURE

Before the Honourable Justice P.M. Mabuse
Ms Anna Teichert, Commercial Member
Ms Natasha Singh, Accountant Member

In the matter between:

CBA (PTY) LTD APPELLANT

and

COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE RESPONDENT

Understatement Percentage Penalty Table

1	2	3	4	5	6
Item	*Behaviour*	*Standard case*	*If obstructive, or if it is a 'repeat case'*	*Voluntary disclosure after notification of audit or criminal investigation*	*Voluntary disclosure before notification of audit or criminal investigation*
(i)	'Substantial understatement'	10%	20%	5%	0%
(ii)	Reasonable care not taken in completing return	25%	50%	15%	0%
(iii)	No reasonable grounds for 'tax position' taken	50%	75%	25%	0%
(iv)	'Impermissible avoidance arrangement'	75%	100%	35%	0%
(v)	Gross negligence	100%	125%	50%	5%
(vi)	Intentional tax evasion	150%	200%	75%	10%

ORDINARY NEGLIGENCE

Negligence would include the failure to take reasonable care in completing returns or the lack of reasonable grounds for the assumption of a particular tax position.

(Guide to understatement Penalties (Issue 2))

Note: Impermissible avoidance arrangements falls short of "gross negligence" but will arguably also be "negligence".

Transnet Limited t/a Portnet v Owners of the N B Stella Tingas and Another 2003(2) SA 473 SCA

- *"It follows I think that to qualify as gross negligent the conduct in question, ... must involve a departure from the standard of the reasonable person to such an extent that it may properly be categorised as extreme.*
- *It must demonstrate where this is found to be conscious risk-taking, a complete obtuseness of mind or where there is no conscious risk taking a total failure to take care. If something less were required the distinction between ordinary and gross negligence would lose its validity."*

The facts

[1] This is an appeal by CBA (Pty) Ltd ("the taxpayer"), against the decision of the Commissioner for the South African Revenue Service (SARS) to impose under statement penalties ("usp") at the rate of 15% on the grounds of "no reasonable grounds for tax position taken". For purposes of convenience, the taxpayer will be referred to as the appellant.

[5] The taxpayer submitted to SARS an Income Tax Return for audit in 2017. This tax return was submitted in respect of the 2016 tax year. SARS completed the tax type for the said tax period 2016 and, based on the audit findings, made the following adjustment:

Summary and Explanation for the Proposed Adjustment

Tax Period:	2016
Provisions of Income Tax Act (ITA):	Section 11(e)
Brief Description of the Adjustment:	Wear and Tear
Adjustment Amount:	R17,564,368.00
Tax Amount:	R4,918,023.00

Appears to be a typo... rate should be 50%

The facts

[6] In the 2016 year of assessment tax return, the taxpayer had claimed "wear and tear" allowance of R54,305,235.00. Included in this allowance was an amount of R17,564,367.99 described by the taxpayer as "wear and tear catch-up" which was due to an error in the 2015 year's calculation of the "wear and tear' allowance. According to SARS the aforegoing description was according to emails sent to Ms Edith Mantloane by Ms LM on 16 April 2017. The taxpayer agreed with the proposed adjustment in its letter dated 30 June 2017 which was the taxpayer's response to SARS's Letter of the Audit Findings.

[8] The Commissioner contends that tax is an annual event and therefore expenses and/or allowance must be claimed in the year during which such expenses or assets are first incurred. The amount of the allowance must be determined on the basis of the period of use listed for the purpose of section 11(*e*) allowance issued by the Commissioner, or a shorter period of use approved by the Commissioner from the date the asset was brought into use. Therefore, the appellant may not in law, claim in the 2016 year of tax assessment, the "catch-up wear and tear" expenses that it was supposed to have claimed or that it incurred in the 2015 tax year of assessment. It was for that reason that the amount of "catch-up wear and tear' allowance of R17,564,368.00 was not allowed.

Taxpayer claimed "catch-up" claim

SARS argues that tax is annual event

The facts

[11] Relying on the law, SARS demonstrated how the understatement penalty was imposed. That was done as follows:

Description:	Tax amount
"Catch-up wear and tear":	R4,418 ,023.04
Applicable behaviour:	No reasonable grounds for tax position taken
Applicable conduct:	Standard
Usp percentage:	50%
USP Amount:	R2,459,011.00

[10] Then the taxpayer indicated that it was objecting against the penalties levied in terms of section 223 of the TAA. The taxpayer states that, because of the adjustment, the taxpayer had an original assessed loss of R37,635,914.00. After the adjustment, the assessed loss to be carried forward was R20,071,546.00. The taxpayer then contends that there had been no loss to the *fiscus* that resulted from the identified error.

USP is payable even though it only affects assessed losses and is timing in nature only

The facts

The appellant agrees with SARS's findings with regards to the over-claiming of the allowances. It contends that the over-claim of wear-and-tear resulted an error in the preparation of the financial and the registers.

Was this the right approach? Would the outcome have been different if SARS was challenged on this point?

NB – This case does not deal with the question whether or not catch-up claims are available. It deals with whether or SARS could levy USP

The appellants argument

[17] The taxpayer objected to the understatement penalty imposed of R2,459,011.00 on the grounds that there is no understatement by the taxpayer in respect of the 2016 year of assessment under this ground of assessment. Under this ground of objection, the taxpayer contended that reading section 222 and section 221 together the understatement cannot be levied unless there is prejudice to SARS or *fiscus*. Harm would be caused to SARS if SARS consented to the erroneous refund and subsequently made payment of that refund to the taxpayer, in other words, to the appellant. In other words, if SARS would be out of pocket in the amount of incorrect sum. There is therefore no loss of the *fiscus*.

The Taxpayer argued that there was no "prejudice" to SARS due to the assessed loss

[18] SARS disallowed the objection and furnished written reasons for the disallowance. SARS pointed out that following the finalisation of an audit, when the catch up wear-and- tear allowance of R17,564,368.00 was disallowed (and the appellant agreed that this wear-and-tear should not have been claimed in the 2016 year of assessment), an understatement penalty of R2,459,011.52 was imposed. The understatement penalty was imposed because it was found that there was no bona fide inadvertent error; that there was an understatement and prejudice to SARS and *fiscus*. The applicable behaviour was determined to be "no reasonable grounds for the tax position taken" and the conduct was determined to be "standard". A penalty was determined at 50% of the tax of R17,564,368.00.

The Law: Section 11(e)

11. General deductions allowed in determination of taxable income.—For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived—

(e) save as provided in paragraph 12 (2) of the First Schedule, such sum as the Commissioner may think just and reasonable as representing the amount by which the value of any machinery, plant, implements, utensils and articles (other than machinery, plant, implements, utensils and articles in respect of which a deduction may be granted under section 12B, 12C, 12DA, 12E (1), 12U or 37B) owned by the taxpayer or acquired by the taxpayer as purchaser in terms of an agreement contemplated in paragraph (a) of the definition of "instalment credit agreement" in section 1 of the Value-Added Tax Act and used by the taxpayer for the purpose of his or her trade has been diminished by reason of wear and tear or depreciation during the year of assessment

The Law: Section 11(e)

4.1.5 Use requirement

The allowance is deductible only to the extent that the qualifying asset is *used* by a taxpayer for purposes of his or her trade. The asset will be written off over its useful life.

IN 47 determines the "USEFUL LIFE" of the asset. If a catch-up claim is required in order to be in line with the useful life as determined by SARS, has there been truly non-compliance with SARS practice?

(a) Qualifying assets for which write-off periods have been listed in the Annexure

The **Annexure** contains a schedule of write-off periods that are acceptable to the Commissioner for assets that are written off on the straight-line method. These write-off periods are acceptable for assets that are used for purposes of trade, including a trade of leasing, and apply to any asset brought into use on or after 24 March 2020. The assets listed in the **Annexure** are of general application and not intended for specific industries.

Annexure– Schedule of write-off periods acceptable to SARS

Asset	Proposed write-off period (in years)

The Law: Section 11(e)

- The question is then whether or not whether there was any "understatement" for purposes of the understatement penalty regime. The term "understatement" is defined in section 221 as follows:
- *'understatement' means any prejudice to SARS or the fiscus as a result of—*

  (a) failure to submit a return required under a tax Act or by the Commissioner;

  (b) an omission from a return;

  (c) an incorrect statement in a return;

  (d) if no return is required, the failure to pay the correct amount of 'tax';

  (e) an 'impermissible avoidance arrangement'.
- The taxpayer clearly does not have the authority to determine the period over which a section 11(e) allowance may be claimed. This is the sole responsibility of SARS.
- The ITR 14 therefore merely represent a request by the taxpayer for SARS to exercise their discretion in a particular manner. Nothing precludes SARS under a specific set of circumstances to allow a catch-up claim for section 11(e) claims.

Some personal notes….

The court case does not deal with 11(e) catch-up claims

The Taxpayer should not have conceded that it was not entitled to a catch-up claim. Given strong substantiation that an asset must be written off over its useful life, SARS may have been convinced to exercise their discretion favourably.

I suspect that the Taxpayer conceded on the disallowance of the catch-up claim since it was in a tax loss situation and the difference is temporary only. I still maintain that there was no prejudice to SARS. The fact that the taxpayer claimed allowances over the expected life of the asset but claims less in the beginning years and more in the latter years is to the advantage of SARS and not to the prejudice of SARS

Some personal notes….

Be careful to concede too easily on the subject matter in dispute – even if it will only create a temporary adjustment

Be careful to make full disclosure in the ITR 14 for any discretionary allowances. This includes section 11(e) and Section 22 stock obsolescence. If the amounts are large, obtain a Binding Private Ruling. If relatively small, disclose separately under "other" with full description.

Some personal notes….

SARS is not the Taxpayer's friend…. This is an unfortunate reality created by SARS and not by the Taxpayer. One must anticipate a confrontational relationship with SARS. The 50% penalty charged by SARS for an issue where the allowance is subject to SARS discretion, the taxpayer was in an assessed loss, and the amounts will in any event qualify for deductions in future years, seems overly punitive and unfair.

> At some point, at some level, someone must look at the trees and see the forest…I am saying that a step back for a balanced look by a CRA official exercising a good dose of commercial common sense should not have resulted in relentless pursuit of a half-million dollar penalty. Yes, the Act stipulates taxpayers are to be penalized for remitting late, but do not bite the hand that feeds you when the hand tries so diligently to ensure you get every mouthful.
>
> The Honorable Campbell J. Miller
> *Home Depot of Canada Inc. v. R.*, 2009 TCC 281

Counter Tax Lawyers

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Fences

- Interpretation Note 47: *Set out below are assets which have been held by the courts to comprise buildings or other structures or works of a permanent nature: Fencing (ITC 225 (1931) 6 SATC 158 (U).)*

- Relevant extract from Interpretation Note 45 (dealing with security expenditure) reads as follows: *"Security expenditure comprising a structure or work of a permanent nature will not qualify for the wear-and-tear or depreciation allowance under section 11(e). Examples of such structures include walls or electric fences around the perimeter of business premises. See, for example, ITC 773 in which the cost of erecting a partition in leased premises to protect trading stock was held to be a structure of a permanent nature, and ITC 225 in which the court held that the cost of erecting fencing was a work of a permanent nature.*

- It follows from the above that the tax treatment of fencing is not clear.

    - According to SARS, section 11(e) Is not available since fencing is of a "permanent nature". The court case dates back to 1931, and does not necessarily take into account modern technologies such as "clear-view" fencing.

    - Section 13(1) and Section 13quin is not available for perimeter fencing since they are not buildings. However, fencing inside a building that is integrated into the building structure may potentially qualify for a section 13quin or 13(1) deduction.

    - There may be instances where the fence is part of the process of manufacture and may qualify for a section 12C allowance. This will be the case where a fence is an integral part of the plant and machinery erected for personal safety of operators.

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Air Conditioning

- The ducts forms part of the building whilst the cooling towers, condensing sets and air handling units are considered moveable and may be claimed in terms of section 11(e).
- Since the section 11(e) periods are 15 or 20 years, generally taxpayers follows conservative views and claim over 20 years.

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Security

- Expenses on security may prove to be problematical and comprehensive detail must be obtained from Procurement.
    - Cameras, fingerprint readers, card readers, boom gates, software etc may be regarded as movable assets giving rise to Section 11(e) allowances.
    - Turnstiles, internal security doors etc may be part of the building and may give rise to a Section 13(1) or 13quin deduction.
- Physical security that is not part of the building may however not qualify for any capital allowances. Apart from “fences” that are discussed separately, this may include turnstiles and gates.

4.

Section 12C

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Allowance is based on cost

4-year write off

- New or unused plant or machinery
- Process of manufacture or similar process
- 40/20/20/20 (No R7 000 Rule)
- Not apportioned for part of the year

5-year write off

- All other circumstances
- 20/20/20/20/20 (No R7 000 Rule)
- Not apportioned for part of year

Wef from 1/1/2016 also applies to Supplier Tooling

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Process of manufacture
Is the product produced essentially different from the materials or components which went into its making
What is the "degree" of the change to the "ingredients" used to make the final product
Is the end product different in nature?
Is the end product different in utility?
Is the end product different in value?
Did the ingredients "cease to exist"?
Did the ingredients "cease to retain its individual qualities"?
Was the end product created from a "process"?
Was a different "compound substance" created with a "special quality"?
Is a "standardised product" created on "large scale" through a "continuous process" using specialised equipment in an organised manner?

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Process of manufacture

Important to determine where the process starts and where it finishes

- Cape Lime (railway line between two sites held to be part of the same process of manufacture)
- Stellenbosch Farmers Winery – Tankers used to transport wine from farms is part of the process of manufacture
- National Co-operative Dairies - the cooling of the milk in tanks installed in the farmers' dairy was merely to preserve it by inhibiting bacterial growth and was not part of the process of manufacture.

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Some practical issues

There is no choice – if Section12C is applicable, you cannot choose to apply Section 11(e) since it is more conservative – Tax is an annual event

It is not only the nature of an asset that is relevant – it is also the location e.g. forklift in factory may qualify for 12C but forklift in warehouse may qualify for 11(e)

Underclaim of S11(e) can be corrected in future years but not for section 12C

The R7 000 rule applies to section 11(e) but not to section 12C

5.

Repairs and Maintenance (S11(d))

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Specific accounting rules governing repairs and maintenance

- Repairs and maintenance are expenses a business incurs to restore an asset to its previous operating condition or to keep an asset in its current operating condition.
- An entity shall capitalise the cost of repairs and maintenance when they
  - extend the life of an asset,
  - increase the functionality or
  - improves the outcome of the asset

Section 11(d)

11. General deductions allowed in determination of taxable income.—For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived—

- expenditure
- actually incurred
- during the year of assessment
- on repairs of
    - property
        - occupied for the purpose of trade or
        - in respect of which income is receivable,
- and sums expended for the repair of
    - machinery, implements, utensils and other articles
        - employed by the taxpayer for the purposes of his trade;

The first category mentioned above refers to repairs effected to immovable property and the second category to repairs pertaining to movable property.

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Was there deterioration of the property because of use?

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Was there deterioration of the property because of use?

No

Expense is capital in nature – not deductible in terms of section 11(a) or 11(d). Consider potential claim under section 12C, 11(e), 13(1) or 13 quin.

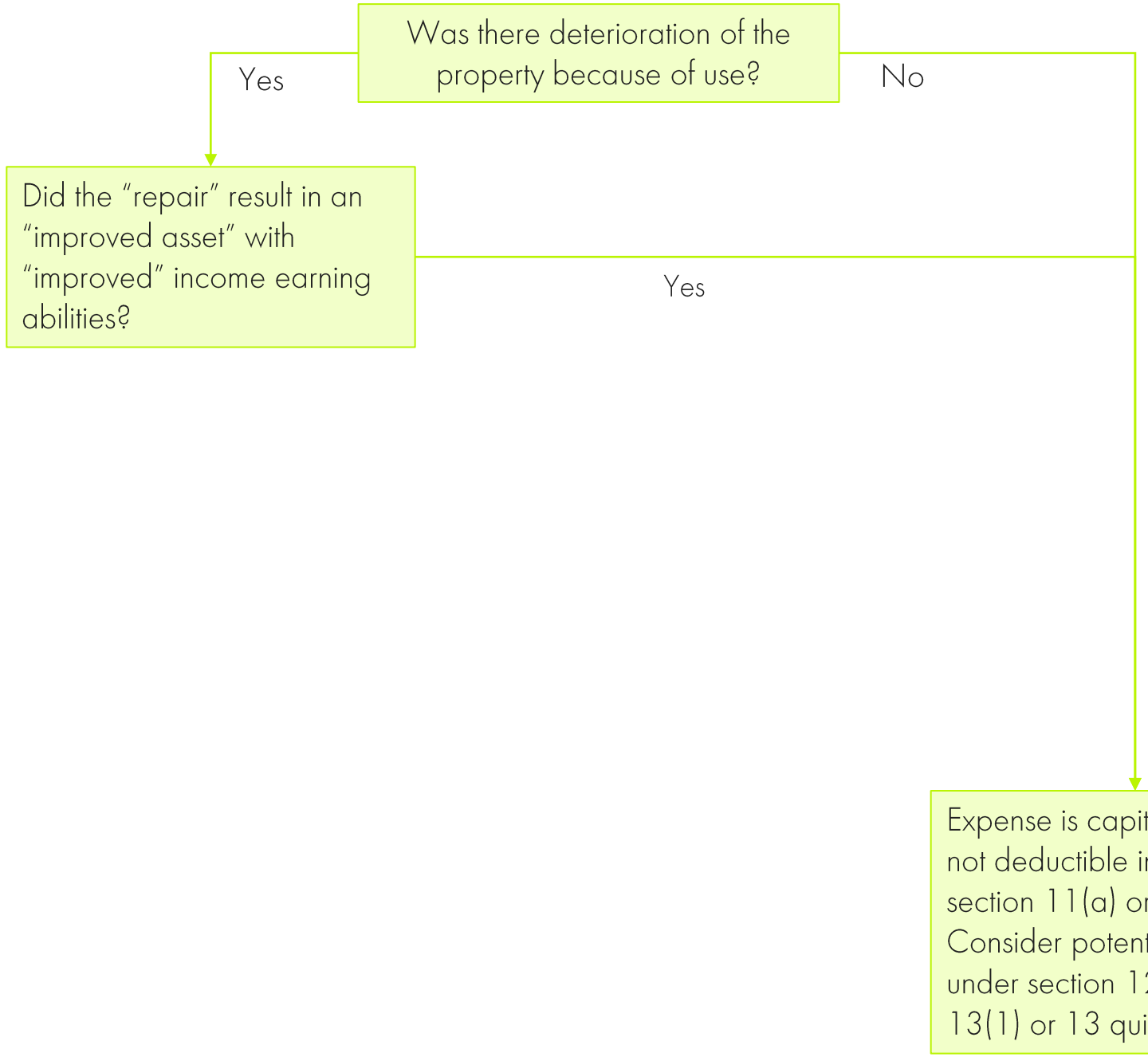
Was there deterioration of the property because of use?

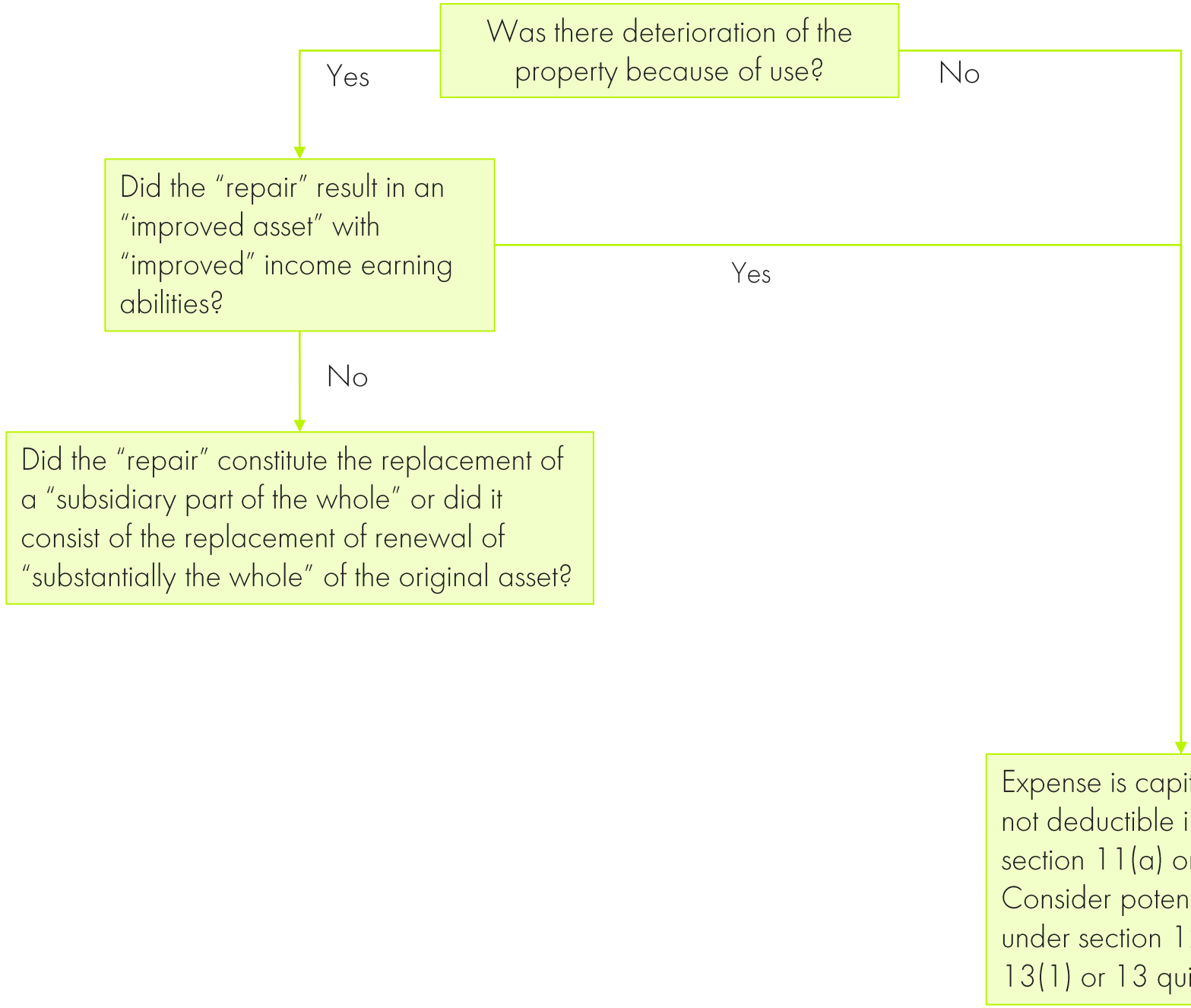
Yes

Did the "repair" result in an "improved asset" with "improved" income earning abilities?

No

Expense is capital in nature – not deductible in terms of section 11(a) or 11(d). Consider potential claim under section 12C, 11(e), 13(1) or 13 quin.


Was there deterioration of the property because of use?
Yes
No
Did the "repair" result in an "improved asset" with "improved" income earning abilities?
Yes
Expense is capital in nature – not deductible in terms of section 11(a) or 11(d). Consider potential claim under section 12C, 11(e), 13(1) or 13 quin.


Was there deterioration of the property because of use?
Yes
No
Did the "repair" result in an "improved asset" with "improved" income earning abilities?
Yes
No
Did the "repair" constitute the replacement of a "subsidiary part of the whole" or did it consist of the replacement of renewal of "substantially the whole" of the original asset?
Expense is capital in nature – not deductible in terms of section 11(a) or 11(d). Consider potential claim under section 12C, 11(e), 13(1) or 13 quin.

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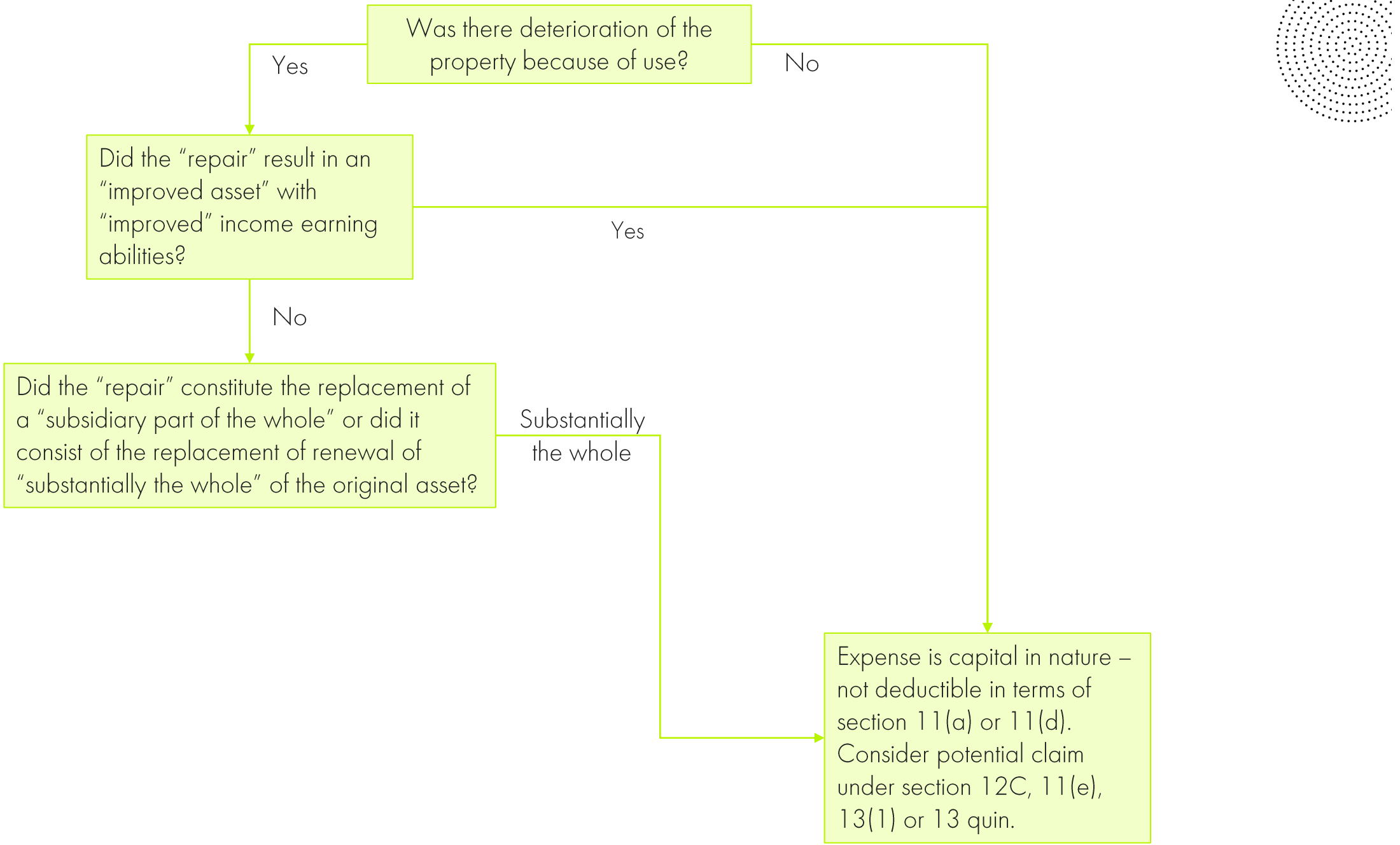

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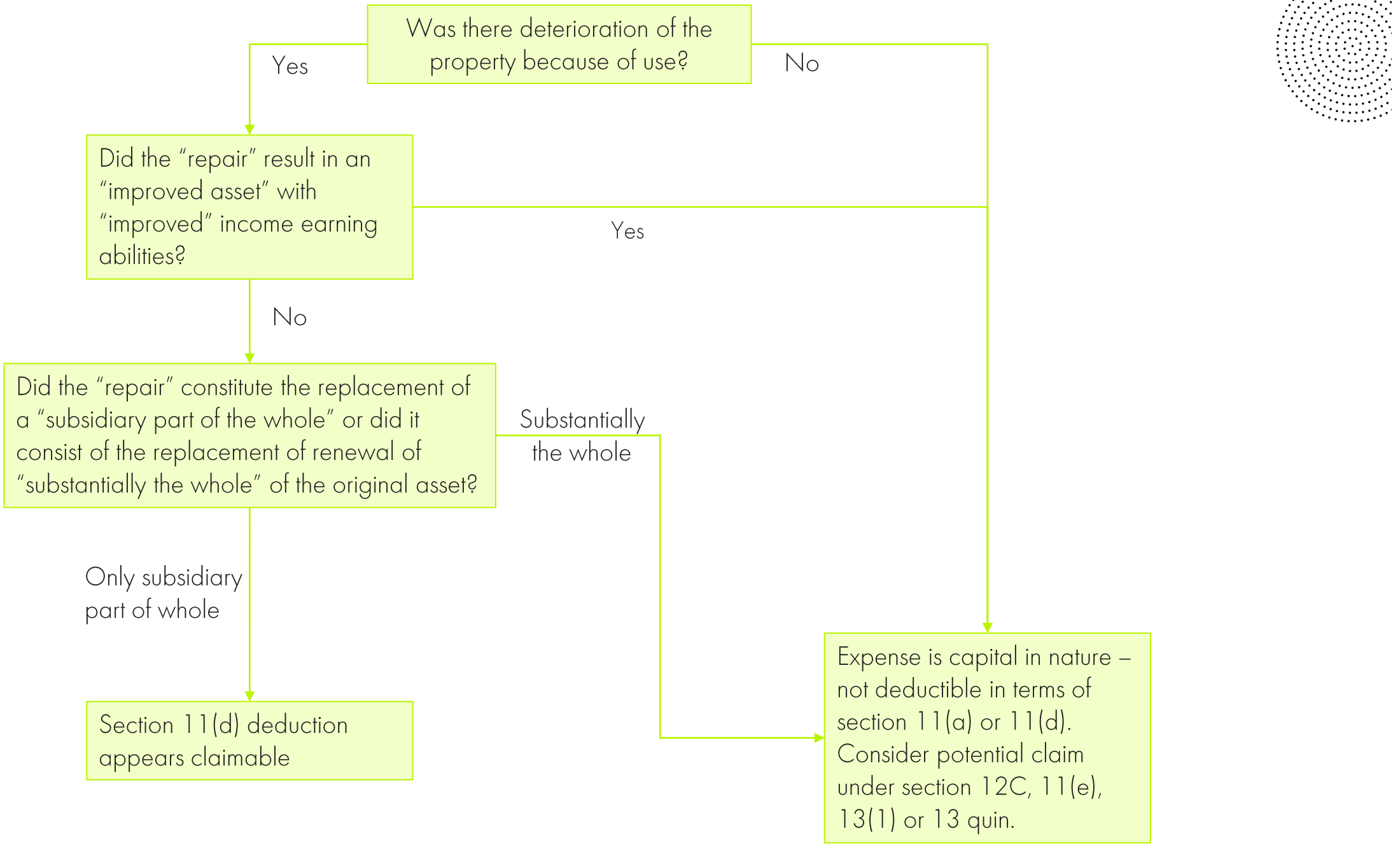

6.

Building allowance

Section 13quin

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Sect 13quin Allowance

5% allowance available to the owner of the building where construction, erection or installation commenced on or after 1 April 2007 and it was contracted for on or after that date.

Interaction between 11(e) and 13quin complicated.

Must own the land

Available on all buildings – not only where used in process of manufacture

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Commonly found errors

- Section 13quin not available if taxpayer does not own the building or deemed to own the building per Section 12N
- Section 13quin not available on the following:
  - Landscaping
  - Access Roads
  - Open parking
  - Storm Water management (e.g. catch-up dam)
  - Fences
- Need to distinguish between assets qualifying for 11(e) and 13 quin e.g. Generators, Cooling Towers, Water Tanks, Elevators, signage
- VAT may not be claimed on canteen and canteen equipment

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Professional fees

- S13(1) and S13quin (and other similar sections) allows allowances to be claimed on the direct cost of acquisition or erection of the building.
- The cost of a feasibility study where cost is incurred to establish whether or not the project should be embarked on is not a direct cost of acquisition and/or erection and should not form part of the cost of the buildings.
- The cost of architects, land survey, and project management to the extent that it relates to the building itself (and not to e.g. access roads, open parking etc) can arguably be included in the cost of the building.
- Environmental impact studies, cost of rezoning and building plan approval fees are not clear and each of these types of costs should be investigated carefully to ensure compliance with the tax laws.
- Cost of landscaping may not be included in the cost of the building.
- Whilst many of these costs may not qualify for purposes of sections 13(1) or 13quin, they may potentially be taken into account as base cost for CGT purposes. Each cost must be evaluated based on its own merits.

7.

Leasehold improvements

Section 11(g) and par (h) of Gross Income Definition

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Section 11(g)

11. General deductions allowed in determination of taxable income.—
For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived—

(*g*) an allowance in respect of any expenditure actually incurred by the taxpayer, in pursuance of an obligation to effect improvements on land or to buildings, incurred under an agreement whereby the right of use or occupation of the land or buildings is granted by any other person, where the land or buildings are used or occupied for the production of income or income is derived therefrom: Provided that—

(vi) the provisions of this paragraph shall not apply in relation to any such expenditure incurred if the value of such improvements or the amount to be expended on such improvements, as contemplated in paragraph (*h*) of the definition of "gross income" in section 1, does not for the purposes of this Act constitute income of the person to whom the right to have such improvements effected has accrued;

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Par (h) of Gross Income Definition

(*h*) in the case of any person to whom, in terms of any agreement relating to the grant to any other person of the right of use or occupation of land or buildings, or by virtue of the cession of any rights under any such agreement, there has accrued in any such year or period the right to have improvements effected on the land or to the buildings by any other person—

(i) the amount stipulated in the agreement as the value of the improvements or as the amount to be expended on the improvements; or

(ii) if no amount is so stipulated, an amount representing the fair and reasonable value of the improvements

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Test for accession

1

The nature and purpose of the attached thing: This test entails that there has to be a rationale or reason for the thing to be attached to the immovable. This is largely a matter of recognising the obvious destination of certain things. E.g., chimney-pots, guttering, plumbing components, electrical fittings and the like made for a building, or to be permanently affixed to a building, lose their independent identity as the purpose for which they are affixed is to become a permanent part of the immovable.

2

The manner and degree of its attachment: This test entails that there has to be an enquiry as to the extent that the thing has become a part of the immovable. The fundamental issue is that of permanence and finality of the attachment. E.g., something which cannot be removed without damage to itself, or the immovable is more likely to be regarded as having become immovable by accession.

3

The intention with which the attachment was made: In this test the court has to determine the intention of the owner of the thing at the time when the attachment was made to the immovable. E.g., whether the intention was that the attachment should be permanent or temporary.

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Commonly found errors

For accounting purposes, items are loosely classified as "leasehold improvements" when for tax purposes, the cost may be claimable in terms of sections 11(a),11(e), 11(d), 12C or may even be a notional amount (e.g. notional interest)

The fact that the lessee is "entitled" to effect leasehold improvements does not mean that the lessee is "obligated" to effect leasehold improvements

At the end of the lease period – a capital loss arise – but consider potential connected party rules?

8.

Disposal of assets

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Accounting: Asset disposal

General rule

- Proceeds – net book value at date of disposal;

Assets withdrawn from use and scrap sales

- Disposed and recognise loss when assets withdrawn from use
- Account for proceeds on the sale of scrap

Time of disposal - immovable property

- Generally when registered in the deeds office

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Disposal of assets and other recoupments

- General recoupments (s8(4)(a))
- Deferred recoupments (s8(4)(e))
- Donations, dividends and disposals to connected persons (s8(4)(k))
- Alienation, loss or destruction allowance (s11(o))

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Depreciable asset allowance - section 11(o)

- Applies to alienation, loss or destruction of an asset
- No allowance on land and buildings
- Applies to
    - Machinery, plant etc that qualified for an 11(e), 12C, 12B, 12E, 14 or 14bis allowance AND
    - The expected useful life (for tax purposes) did NOT exceed 10 years as determined on date of original acquisition.
- Does not apply when dispose to connected parties.
- Does not apply when withdrawn from use or never been used.
- At election of taxpayer
    - The allowance is the amount by which the cost of the assets exceeds the sum of allowances claimed and the proceeds on disposal.

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General recoupment provision (Section 8(4)(a))

- Included in taxpayer's income
- All of the following deducted amounts/allowances that have been recovered or recouped during the current year of assessment
  - Section 11 -20
  - Section 24D, 24F, 24G, 24I, 24J, 27(2)(b) and (d),
  - Not recouped
    - Section 11(k), (p), (q), 11quin, 12(2), 12A(3), 13(5), 13bis(7), 15(a) or 15A.
- Recoupment normally by way of sale, bad debts recovered, insurance receipts etc.

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Donation/transfer recoupment: Section 8(4)(k)

- Where any person has
  - Donated any asset
  - Transferred in whatever manner or form any asset to a shareholder of that company, OR
  - Disposed of any asset to a person who is a connected person
- In respect of which a deduction or allowance has been granted to such person
  - Such person shall be deemed to have recovered or recouped an amount equal to the market value of such asset as at the date of donation, transfer or disposal

9.

Asset Finance

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Accounting vs Tax

Tax implications in the hands of the Financier/lessor

Summary of tax implications on a variety of asset finance options

Type of arrangement	Practical arrangement	Ownership of asset	Accounting	Income Tax	VAT
Term loan agreement	Financier does not acquire and sell the asset. Financier simply provides a vanilla loan to the customer which the customer then uses for purposes of acquiring a asset from a dealer.	Ownership is obtained by the customer directly from the dealer. Financier never acquires ownership. The Financier loan is totally unsecured and Financier has no right to repossess the asset in the case of default.	Debt receivable. Recognise interest on yield to maturity basis. Transaction charges ito NCA are recognised as income. IFRS 9 impairment of loans.	Tax on interest accrued in terms of S24J of the ITA. Accounting and tax is generally the same. Section 11(jA) may be claimed on IFRS 9 impairments. Claim section 11(i) bad debt when debt is irrecoverable.	VAT is charged on transactional costs as allowed by NCA. No VAT on loan account. Since the debt is unsecured, there should be no VAT on repossessions. No need for amendment of existing VAT Ruling on apportionment.
Instalment sale agreement	Asset is acquired by Financier from seller and immediately on-sold to the customer for the same price on a back-to-back basis. Certain transaction related costs may be charged to the consumer provided the NCA is complied with.	Ownership passes to the customer upon delivery of asset. Even though ownership passes to the recipient, the asset serves contractually as security to the debt. The security is however not exceptionally strong since the ownership and possession is acquired by the customer.	Debt receivable. Recognise interest on yield to maturity basis. Transaction charges ito NCA is recognised as income. IFRS 9 impairment of loans.	Tax on interest accrued in terms of S24J of the ITA. Accounting and tax is generally the same. Section 11(jA) may be claimed on IFRS 9 impairments. Claim section 11(i) bad debt when debt is irrecoverable.	VAT is claimed on purchase of asset and output VAT paid on the sale of asset. SARS however does not allow the Bank to include the output VAT on sale to be included in the denominator for purposes of calculating the VAT apportionment ratio. As such, it has no impact on the VAT apportionment ratio of the Bank. Financier will need to amend the VAT Ruling application to include these transactions. The transactional charges attracting VAT may be included in the denominator as taxable supplies. VAT on repossessions is complex, but simplistically speaking a notional input VAT is claimed on the outstanding cash value of the loan. Output VAT is then payable when the asset so repossessed is sold in the market. The ruling application for VAT apportionment must address sale of repossessed assets.

Summary of tax implications on a variety of asset finance options

Type of arrangement	Practical arrangement	Ownership of asset	Accounting	Income Tax	VAT
Operating lease arrangement	The asset is acquired from the dealer. The asset is leased to the customer at an agreed monthly rate. There is no residual value stipulated in the rental agreement and the rental payments are not necessarily designed to cover the full cost of the asset.	Ownership is retained by the Bank.	The asset is reflected as "leased assets" under PPE on the balance sheet. It is generally depreciated over the useful life that is generally linked to the rental period. The gross rental income is reflected in the Income Statement. Profit/loss is recognised when the asset is sold.	Section 11(e) deduction is claimed on the cost of the asset over the longer of IN 47 period or the lease period. There is no residual value stipulated in the contract meaning that any anticipated residual value is also claimed ito S11(e). Financier must include gross rental income and transactional fees received in its taxable income. The section 11(e) deductions are limited to taxable income from leasing ito section 23A of the Income Tax Act. Further research is required re doubtful debt allowances (S11(jA)) due to recent law amendments. Section 11(i) is available on outstanding rental written off as irrecoverable.	VAT is payable on the monthly rental income. Input VAT is claimed on the acquisition cost of the asset. Output VAT is again paid on the sale of the asset when sold. The current VAT apportionment ratio ruling from SARS needs to be amended to deal with these type of transactions. The operating lease model holds VAT apportionment ratio benefits to Financier Bank since it will increase the ratio available for the bank as a whole.
Finance lease agreement	The asset is acquired from the dealer. The asset is leased to the customer at an agreed monthly rate. There is a residual value stipulated in the rental agreement and the rental payments and the residual value are designed to cover the full cost of the asset together with interest as stipulated in the agreement. Risk and rewards of ownership is transferred to the lessee, but not full ownership.	Ownership is retained by the Bank. The customer may acquire ownership at the end of the lease period upon payment of the residual value as stipulated in the lease agreement.	Even though ownership is retained by the Bank, from an accounting perspective, the transaction is treated exactly the same as an instalment credit agreement. i.e. a Debtor is reflected and the gross rentals received are recognised as a repayment of capital and interest. This is due to the fact that the accounting recognition is based on "substance over form". IFRS 9 is applied on loan impairments.	From an Income Tax perspective, the legal form of the transaction prevails. The tax treatment is therefore the same as an operating lease as follows: Section 11(e) deduction is claimed on the cost of the asset over the longer of IN 47 period or the lease period. There is no residual value stipulated in the contract meaning that any anticipated residual value is also claimed ito S11(e). Financier must include gross rental income and transactional fees received in its taxable income. The section 11(e) deductions are limited to taxable income from leasing ito section 23A of the Income Tax Act. Further research is required re doubtful debt allowances (S11(jA)) due to recent law amendments. Section 11(i) is available on outstanding rental written off as irrecoverable. The disconnect between the accounting and tax treatment will result in a complex deferred tax computation.	The VAT Act deems the supply of an "instalment credit agreement" to be a taxable supply meaning that for VAT purposes, output VAT is payable when the asset is supplied to the customer even though ownership does not pass to the customer at that point in time. The VAT treatment is therefore aligned to the accounting treatment. NB - One needs to ensure that the agreement falls within the definition of an instalment credit agreement. VAT is claimed on purchase of asset and output VAT paid on the supply of asset under an instalment credit agreement. The value is the cash value of the transaction. SARS however does not allow the Bank to include the output VAT on supply to be included in the denominator for purposes of calculating the VAT apportionment ratio. As such, it has no impact on the VAT apportionment ratio of the Bank. Financier will need to amend the VAT Ruling application to include these transactions. The transactional charges attracting VAT may be included in the denominator as taxable supplies. VAT on repossessions is complex, but simplistically speaking a notional input VAT is claimed on the outstanding cash value of the loan. Output VAT is then payable when the asset so repossessed is sold in the market. The ruling application for VAT apportionment must address sale of repossessed assets.

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Accounting vs Tax

Tax implications in the hands of the customer/lessee

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The lessee

- A finance lease is reflected as an asset on the balance sheet with a corresponding liability.
  - From a tax perspective, there is no asset
    - Add back
      - depreciation and
      - interest
    - Deduct actual lease payments made

    BUT – be careful for section 23C – Reduce the monthly lease payments by the VAT component if VAT was claimed upfront and the lease payment effectively includes a VAT component. Note that the VAT is often paid separately by the lessee to the lessor and VAT is then not financed.
- IFRS 16 adjustment is made on a similar basis
  - However be careful how initial recognition of "Right of use asset" and "Right of use obligation" was made.

10.

Sale of business

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Extracts from IN 94

4. Purchase price allocation

A business as a whole is not recognised as a single asset for income tax purposes. The business consists of a collection of assets (and possibly liabilities) and the total purchase price must be allocated to the individual assets (and possibly liabilities) which form the subject matter of the sale.[10] An allocation of the purchase price to individual assets is required regardless of whether the sale agreement reflects the purchase price as comprising a lump sum net amount or as an itemised list of assets less liabilities and contingent liabilities.

A purchase price allocation is required irrespective of whether the purchase price exceeds or is less than the book values recorded in the seller's accounting records.

SARS will generally apply the purchase price allocation specified in an agreement of sale to both the seller and purchaser. SARS may apply a different allocation if there is evidence to the effect that the specified allocation does not represent the actual facts and the true intention of the parties. For example, such a misallocation would arise if the seller has a significant assessed loss and the parties to the transaction agree to allocate the full purchase price to trading stock such that it is significantly overvalued and allocate a nil value to the fixed assets which have significant value. In ITC 1235[11] the parties allocated R1 to a plantation. The court held that the agreement was fictitious and not a real agreement and accepted the Commissioner's valuation.

SARS may review the purchase price allocation adopted by the taxpayer when an agreement of sale does not specify a purchase price allocation and request support for the allocation adopted. The seller and the purchaser are required to adopt the same purchase price allocation.

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Position of seller

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Sale of business example – sells business for R10m (i.e. @NBV)

	Dr/(Cr)	Sale journals	Dr/(Cr)
Share Capital	-1 000 000		
Retained earnings	-9 000 000		
Loan account buyer			
Fixed assets Cost	15 000 000		
Accumulated depreciation	-5 000 000		
Debtors	10 000 000		
Bank	1 000 000		
Provision for leave pay and bonus	-2 500 000		
Warranty provision	-1 000 000		
Trade creditors	-4 000 000		
Long term loan	-3 500 000		
	0		

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Sale of business journal entries

	Dr/(Cr)	Sale journals	Dr/(Cr)
Share Capital	-1 000 000		-1 000 000
Retained earnings	-9 000 000		-9 000 000
Loan account buyer		10 000 000	10 000 000
Fixed assets Cost	15 000 000	-15 000 000	0
Accumulated depreciation	-5 000 000	5 000 000	0
Debtors	10 000 000	-10 000 000	0
Bank	1 000 000	-1 000 000	0
Provision for leave pay and bonus	-2 500 000	2 500 000	0
Warranty provision	-1 000 000	1 000 000	0
Trade creditors	-4 000 000	4 000 000	0
Long term loan	-3 500 000	3 500 000	0
	0	0	0

The seller sells assets of R21m and receives compensation as follows:

- Loan account of R10m
- Cession of obligation to make payment for actual liabilities of R7.5m
- Assumption of contingent liabilities of R3.5m by buyer

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Sale of business journal entries

	Dr/(Cr)	Sale journals	Dr/(Cr)
Share Capital	-1 000 000		-1 000 000
Retained earnings	-9 000 000		-9 000 000
Loan account buyer		10 000 000	10 000 000
Fixed assets Cost	15 000 000	-15 000 000	0
Accumulated depreciation	-5 000 000	5 000 000	0
Debtors	10 000 000	-10 000 000	0
Bank	1 000 000	-1 000 000	0
Provision for leave pay and bonus	-2 500 000	2 500 000	0
Warranty provision	-1 000 000	1 000 000	0
Trade creditors	-4 000 000	4 000 000	0
Long term loan	-3 500 000	3 500 000	0
	0	0	0

- What is Tax value
- Section 8(4)(a) recoupment
- S11(o) deduction (No S11(o) if sold to connected party
- CGT if sold at more than original cost

Per Ackermans Case - add back ito taxable income R3.5million

IN94: *If a purchaser assumes a free-standing contingent liability as settlement or part settlement of a purchase price of an asset, the seller will not have incurred any expenditure on assumption of the free-standing contingent liability by the purchaser.*

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Position of purchaser

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Purchase of business journals

	Dr/(Cr)	Journals	Dr/(Cr)
Share Capital	-1 000		-1 000
Retained earnings			0
Loan account liability		-10 000 000	-10 000 000
Fixed assets Cost (2nd hand)		10 000 000	10 000 000
Accumulated depreciation		0	0
Debtors		10 000 000	10 000 000
Bank	1 000	1 000 000	1 001 000
Provision for leave pay and bonus		-2 500 000	-2 500 000
Warranty provision		-1 000 000	-1 000 000
Trade creditors		-4 000 000	-4 000 000
Long term loan		-3 500 000	-3 500 000
	0	0	0

The buyer acquires assets of R21m and settles the purchase price by

- Loan account of R10m
- Assuming fixed obligation for actual liabilities of R7.5m
- Assuming contingent liabilities of R3.5m

IN 94 – Position of buyer

From the purchaser's perspective, the assumption of the free-standing contingent liability is a means of settling or partly settling the purchase price payable for the assets acquired and as such is directly related to the acquisition of the assets. Accordingly, when determining the purchaser's entitlement to a tax deduction or allowance for the amount of the free-standing contingent liability assumed as at the date of sale, it is necessary to look at the particular asset acquired and the applicable deduction provision. Typical sections which may apply include section 11(a) and (e), and sections 12C and 13.

It becomes necessary to consider whether the purchaser is entitled to a deduction if and when the free-standing contingent liability becomes unconditional and as a consequence the purchaser incurs expenditure.

The expenditure has arisen as a direct result of the purchaser's assumption of the free-standing contingent liability which was assumed as a means of settling the purchase price payable for the assets acquired. It was an undertaking between the purchaser and the seller. Accordingly, in determining the capital or revenue nature of the expense, the nature of the particular asset acquired must be ascertained.

Under the above example, the expenditure is of a capital nature because it was incurred as a result of the acquisition of fixed assets which are part of the purchaser's income-producing structure. The expenditure creates an enduring benefit since the assets will be used over an extended period and the purchase is a "once-and-for-all" non-recurring expense. Although payments of remuneration are often of a revenue nature, this is not inevitably the case and it is important to consider the primary purpose of the particular salary and wage expenditure since it could be of a capital nature. In the example above, the purchaser's purpose and intention was related to the acquisition of fixed assets and not to the rewarding of services rendered and the expenditure is therefore of a capital nature. (Emphasis added)

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Consequences

Without careful planning, NEITHER the seller not the buyer will enjoy a tax deduction for contingent liabilities transferred as part of the sale of a business as a going concern

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But what if corporate rules are used?

However, to the extent that the relief in sections 42 to 47 applies to the assets acquired, the expenditure that is incurred by the transferee when the free-standing contingent liability materialises must be evaluated within the context of the nature of the going concern business as carried on by the transferor before the transfer and by the transferee after the transfer. In making such an evaluation no regard must be had to the fact that the assumption of the contingent liabilities by the transferee was part of the consideration for the acquisition of the assets. The circumstances under which the free-standing contingent liability arose in the hands of the transferor as well as the transferee must therefore be taken into account in determining the deductibility of the expenditure.

For example, assume the transferor raised a bonus provision for employee services rendered in the earning of taxable sales income and that had it materialised the expenditure incurred would have been of a revenue nature. After the acquisition of the business the transferee carries on the going concern in the same manner as the transferor and settles the bonus provision when it becomes unconditional. The expenditure incurred by the transferee would be of a revenue nature assuming no additional facts emerge to impact the transaction.

Impact if corporate rules are applied:

- Still no deduction for seller per Ackermans Case (contrary to accounting)
- Potential double deduction for buyer per IN 94

Definitions S41 of the Income Tax Act:

"debt" includes any contingent liability

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25 May 2022
Wednesday

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