The tax benefits available to investors in immovable property in South Africa

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ABSTRACT

The object of this thesis is to provide guidelines relating to the tax benefits that are available to investors in immovable property in South Africa. This was done by analysing the various sections of the Income Tax Act, as well as case law and South African Revenue Service guidelines that interpret these sections, which provide for expenditure which may be deducted by taxpayers from their income when conducting the trade of letting immovable property in order to reduce their overall tax liability. The thesis also includes a chapter dealing with the four different types of vehicles that taxpayers may use when investing in property. It was found that there are significant tax benefits available to investors in immovable property through the general deductions provided in terms of section 11(a) of the Act, as well as the specific deductions that the legislature has promulgated for investors in immovable property. It was also found that each of the four vehicles has its own advantages and that a taxpayer's personal circumstances will dictate which of the vehicles will best suit his or her needs.

KEY WORDS

Income Tax benefits

Immovable Property

General Deduction Formula

Specific Deductions

Investment vehicles

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CHAPTER 1 – Introduction

1.1 Context

When the world-wide recession started around 2008 the legislature made the decision to attempt to help people to have access to a reasonably priced rental market; this was done through the Revenue Laws Amendment Act[1] (the Amendment Act). The Amendment Act implemented provisions through the addition of certain sections to the Income Tax Act[2] (the Act). The primary amendment was to section 13*ter* of the Act, which was replaced with section 13*sex*; this change was effective from the 21st of October 2008. Other changes were made by the legislature in earlier years. These were the introduction of section 13*quin* that relates to deductions allowable in respect of commercial buildings as well as section 13*quat* which deals with commercial and residential property in urban development zones.

From a survey of the literature it appears that there are very few academic works published on these relatively new sections of the Act, or any case law interpreting them; an analysis of these provisions will therefore depend on the researcher's own interpretation, certain publications by tax authors,[3] the National Treasury[4] and the South African Revenue Services (SARS)[5] which attempt to shed light on the exact meaning of these provisions and their practical implications.

These changes and additions to the Act are in addition to the provisions which were already present which allow individuals carrying on the trade of investing in fixed property, including those who are in salaried employment, deductions from their income in order to reduce their overall tax liability; something which may have been beyond their means were it not

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[1] No. 60 of 2008.
[2] No. 58 of 1962.
[3] A De Koker and R Williams *SILKE on South African Income Tax* Memorial Ed (2015).
[4] South African Revenue Service *Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008* (2008) http://www.sars.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-2008-01%20%20Explanatory%20Memorandum%20Revenue%20Laws%20Amendment%20Bill%202008.pdf (accessed 12 July 2015).

[5] South African Revenue Service *Legal and Policy Income Tax: Guide to Building Allowances* (2014)

http://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-IT-G18%20-%20Guide%20to%20Building%20Allowances%20-%20External%20Guide.pdf (accessed 15 July 2015).

for these provisions. These existing provisions are found in the "general deduction formula", comprising the preamble to section 11, section 11(a) and section 23(g) of the Act. The general deduction formula provides for elements that must be present in order for the claim for a deduction to succeed: the expenditure (or loss) sought to be deducted must be incurred in carrying on a trade (as defined), in the production of income and not of a capital nature.

The general deduction formula has been dealt with extensively by our courts; the interpretation of these provisions will, therefore, be considered in light of the various judgments made on the subject. The general deduction formula is a key aspect of the Act; its provisions relate not only to deductions available to property investors, but cover a wide range of deductions which are available to taxpayers in general in South Africa. However, this thesis will only consider the general deduction formula in relation to its applicability to deductions allowable to property investors.

The Act therefore provides for different mechanisms which property investors may use to reduce their tax liability. As will be expanded upon in the thesis, the new provisions are geared towards a more aggressive property investor, whereas the general deduction formula can be used by individuals seeking to begin investing in property with one property. The thesis will also provide an analysis of the various vehicles which a potential property investor may use to begin investing and the advantages and disadvantages of doing so. The vehicles which will be discussed include:

1. investing in personal capacity (or as a partner in a partnership);
2. investing through a company; and
3. investing through a trust.

While the possible tax implications of investing as an individual are relatively well understood, there are certain tax provisions which relate solely to individuals which need to be considered in depth. One particular aspect is the "ring-fencing" of assessed losses in terms of section 20A of the Act, which only applies to individuals. The South African Revenue Service (SARS) released a comprehensive guide on the ring fencing of assessed losses;[6] this guide analyses section 20A of the Act and explains in detail its meaning and applicability to individuals conducting a trade (such as the renting out of immovable property). While the SARS guide deals with various trades, the income from which is ring-fenced, this thesis will only discuss the ring-fencing of rental income received by individuals who have purchased a property with the goal of benefiting from the receipt of rental income. This aspect of property investment is very important and individuals need be aware of this provision when considering the viability of investing in property. An understanding can assist in a challenge to SARS in the event that a SARS assessment ring-fences taxpayers rental income in situations where such ring-fencing is not warranted. The incorrect ring-fencing of income can play an important role in the deductions which individuals will be able to claim against their income.

Individuals forming partnerships in order to invest in property are also discussed. Partners in a partnership are taxed on income received in their individual capacity; partnerships are not a separate legal entity. Partnerships allow entrepreneurs to combine their skills, capital and labour in order to invest together without the formalities required for a company.

The tax consequences of utilising a company to invest in property are relatively well understood. However, an analysis of the tax implications of using a company in order to invest will be duly considered.

The final vehicle that will be dealt with is trusts. Trusts are instruments which are not widely understood. This thesis will, therefore, begin its analysis on the use of trusts in investing in property by explaining their nature and structure. Once the working of trusts has been discussed and the number of different ways in which a well-informed investor can set up a trust considered, the advantages and disadvantages of using a trust as a mechanism to invest in property will be scrutinised. The Real Estate Investment Trust (REIT), a specific type of property investment company, will also be discussed.

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[6] South African Revenue Service *Guide on the Ring-Fencing of Assessed Losses Arising from Certain Trades Conducted by Individuals* (2010) http://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-IT-G04%20-%20Guide%20on%20Ring%20Fencing%20of%20Assessed%20Losses%20Arising%20from%20Trades%20Conducted%20by%20Individuals%20-%20External%20Guide.pdf (accessed 5 July 2015).

There does not appear to be a complete and comprehensive guide detailing the available tax benefits to investors in immovable property in South Africa. This is one of the gaps in current academic knowledge which this thesis intends to address in order to make available the knowledge needed to make an informed decision as to whether investing in property is a sound financial decision.

The challenge will be to consolidate the different bodies of knowledge (including statutes, case law, government publications, professional journals and academic research) into one piece of work which will provide for a clear understanding of how the legislature, with the aid of the court's interpretation, has promulgated law with the aim of encouraging people to invest in immovable property.

1.2 Goals of the research

The aim of this work, therefore, is to set out a comprehensive guide relating to investing in property in South Africa and the possible tax benefits which are available. This will demonstrate to potential investors the affordability of an investment in property by allowing them to anticipate the deductions from their income that will be available. The other major aspect to this work will be to provide guidance on whether it is worthwhile for an individual taxpayer to set up a separate entity in which to invest as opposed to investing in an individual capacity.

While a general recommendation will be made as to the best vehicle, various factors will affect a person's decision and what works best for one might not work best for another. It is the aim of this work to provide the requisite information necessary to enable an informed decision to be made as to which vehicle would best suit the needs of various taxpayers.

1.3 Research methodology

The basis of the thesis is the interpretation of statutes. When courts interpret statutes, there are certain guidelines which they are obliged to follow; guidelines which have been set down by the highest courts in the country. Due to the principle of *stare decisis*, the lower courts, when dealing with an interpretation issue, must follow the principles set out by the highest courts in the land (being the Supreme Court of Appeal and the Constitutional Court).

Sections of the Act which have already been interpreted by the judiciary (as will be dealt with in the body of this work) will have been interpreted on the basis of these principles; the analysis of the newer aspects of the law, which have yet to be interpreted, will be done on the same basis as would be done by the courts. The research for this thesis can be carried out objectively irrespective of whom is carrying out the research, as it is simply necessary to follow the rules for the interpretation of statutes as set out by the courts.

With regard to methodology, a doctrinal research method will be applied. This method is governed by the process of identifying, analysing, organising and synthesising statutes, judicial decisions and academic commentary thereon.[7] This form of research is based on readings and conducting a deep analysis of scholarly works and case law; the research is based on traditional legal sources.

There are no ethical considerations which need to be taken into account in relation to the data. All the data upon which this work relies are freely available in the public domain.

<u>Limitations of scope</u>

This thesis has two limitations:

- the first is that it deals only with investments by natural persons in their personal capacity or as a member of a partnership; the tax consequences for companies, trusts and other types of organization of investments in property are not discussed;
- the thesis does not deal with the consequences of the sale of the investment property – the potential recoupment of property allowances or the capital gains tax consequences.

[7] M McKerchar *Philosophical Paradigms, Inquiry Strategies and Knowledge Claims: Applying the Principles of Research Design and Conduct to Taxation* (2008) 6 eJournal of Tax 1 at 5 -22.

1.4 Overview of the chapters

Chapter 1

Chapter 1 is the introductory chapter setting out the content of the thesis as well as the research methodology that will be used.

Chapter 2

Chapter 2 will discuss the general deduction formula and the tax benefits available to investors in terms of section 11 of the Act; other deductions that are available to taxpayers in terms of other sections of the Act are also discussed. The interpretation principles which the courts must follow will also be discussed in this chapter.

Chapter 3

Chapter 3 will deal with the specific deductions for investors in immovable property that are present in the Act, concentrating on section 13*sex*. Section 13*quin* and 13*quat* are also discussed. It will also deal briefly with the section which has been replaced by section 13*sex.*

Chapter 4

Chapter 4 will be a comparison of the various vehicles which a potential investor may choose to utilise when investing in property. This chapter will also include a discussion on Real Estate Investment Trusts.

Chapter 5

Chapter 5 will be the concluding chapter summing up the contents of the thesis.

CHAPTER 2 – Deductions available against rental income

2.1 Introduction

This chapter will start by briefly explaining the principles relating to the interpretation of statues and contracts. This discussion is included at this point as, when reading case law, it is important that the reader understands the reasoning behind the court's method of interpretation. These principles also relate to the interpretation in general, such as the interpretation of contracts, something which a taxpayer who lets immovable property will have to deal with on a regular basis. It is therefore essential that the South African principles of interpretation are dealt with at this early point of the thesis, so that they may be applies in later chapters. This chapter then continues by dealing with the concept of "gross income" and the type of receipts which taxpayers who let property will need to include in their "gross income" so as to ensure compliance with the Act. The main aim of this chapter is to set out and deal with the general deduction formula contained in the preamble to section 11 and section 11(a) of the Act and detail how it provides tax benefits to taxpayers who purchase immovable property with the intention of letting it out for rental income.

The general deduction formula is an integral aspect of the tax benefits which are available to investors in immovable property as it allows taxpayers to deduct certain expenditure in arriving at their income, which they incur as a result of carrying on a trade of letting property. The requirements of the general deduction formula are stringent and it is imperative that a full analysis of the case law which deals with these aspects of the general deduction formula be set out. While SARS has set out a list of deductions which are available to property investors specifically, it is important to understand why SARS has set out certain expenses but not others. An understanding of the general deduction formula will also allow taxpayers to deduct other expenses which are not listed by SARS, as they will be able to motivate why the expense should be deductible.

A key aspect of the general deduction formula is that the taxpayer is required to be carrying on a trade from which income is earned. As such, case law has been set out detailing what the courts envisage when determining whether the taxpayer is carrying out the trade of letting property; this is a requirement which unwary taxpayers may easily fall foul of.

This chapter also sets out the specific deductions, such as legal expenses, repairs and bad and doubtful debts, which are contained in the Act and which allow the taxpayer to make deductions which would not necessarily be allowable in terms of the general deduction formula.

The deduction of expenses is an important means by which taxpayers may reduce their income tax liability; a proper understanding of the principles relating to the general deduction formula (as well as an understanding of the specific deductions) will allow the taxpayer to utilise the deduction provisions in the Act to the fullest extent possible. This chapter is an integral aspect of the tax benefits which are available to an investor in immovable property.

<u>2.2 Principles relating to the Interpretation of Statutes</u>

Where a taxpayer claims the deduction of an expense and SARS contests this, the matter may end up in the courts. It is therefore important to understand the principles of interpretation which our courts are bound to adhere to. These have been succinctly set out in the new *locus classicus* case of *Natal Joint Municipal Pension Fund v Endumeni Municipality.*[8] This is the latest judgment in the Supreme Court of Appeal dealing with the general interpretation principles which must be followed by all other courts in South Africa.

The following was held in this case:

> "The present state of the law can be expressed as follows: Interpretation is the process of attributing meaning to the words used in a document, be it legislation, some other statutory instrument, or contract, having regard to the context provided by reading the particular provision or provisions in the light of the document as a whole and the circumstances attendant upon its coming into existence. Whatever the nature of the document, consideration must be given to the language used in the light of the ordinary rules of grammar and syntax; the context in which the provision appears; the apparent purpose to which it is directed and the material known to those responsible for its production."[9]

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[8] 2012 (4) SA 593 (SCA).
[9] 2012 (4) SA 593 (SCA) 603 and 604.

It was held further that the process of interpretation is an objective one; that a sensible meaning is to be preferred to one that leads to non-sensible or non-businesslike results.[10] However, the judgment warns other judges to be careful not to substitute what they regard as sensible for the words actually used; to do so with regard to statutory interpretation would be to cross the divide between interpretation and legislation. To do so in a contractual context is to make a contract for the parties other than the one which they in fact made.[11]

> "The 'inevitable point of departure is the language of the provision itself', read in context and having regard to the purpose of the provision and the background to the preparation and production of the document."[12]

As this is the law pronounced by the Supreme Court of Appeal, it is these principles that all courts must apply when interpreting not only statutes, but also contractual provisions. When making sense of provisions of a statute or contractual provisions which have yet to be interpreted by the courts (such as section 13*sex* which is discussed in Chapter 3) these principles set out above must be applied; to do otherwise would result in an incorrect interpretation as to the meaning of the provisions in question (leading to an incorrect application of the law in practice). Disputes relating to contracts entered into between lessors and lessees of property will be subject to the same principles of interpretation.

2.3 Gross Income

At this point it is essential to define what is meant by the term "income" so as to gain a proper understanding as to which income taxpayers receive need be included in their taxable income. The starting point of this enquiry is to set out the definition of "gross income".

In relation to a resident of South Africa, section 1 of the Act defines "gross income" as:

> "'Gross income', in relation to any year of period of assessment, means –

[10] 2012 (4) SA 593 (SCA) 604.
[11] 2012 (4) SA 593 (SCA) 608.
[12] 2012 (4) SA 593 (SCA) 604.

(i) In the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident;

excluding receipts or accruals of a capital nature."

This thesis does not intend to go into detail about the nuances of the term "gross income", but suffice it to state that rental income which a taxpayer receives as a result of the letting of immovable property must be included in a taxpayer's "gross income"; this will result in the taxpayer being liable for taxation thereon.

> "In many instances very little difficulty is encountered in deciding the nature of income. For example, a salary or interest income or rental income is clearly income of a revenue nature."[13]

This can be concluded from findings of the court in the case of *WJ Fourie Beleggings BK v Commissioner, SARS.*[14] In this case the taxpayer received a lump sum payment (as compensation) from a third party which had unilaterally terminated a contractual agreement. In terms of the agreement between the parties, the taxpayer was to receive regular payments from a third party for the provision of accommodation and meals for the people whom the third party was tasked with taking care of. The Commissioner contested the taxpayer's claim that the amount was of a capital nature.

Leach AJA stated:

> "Accordingly, if a receipt or accrual was not of a capital nature, it must have been of an income or revenue nature."[15]

The court then had to determine whether the payment made to the taxpayer was a capital or revenue receipt. In this regard the court dealt with a number of earlier decided judgments in which the contracts in question created income earning opportunities for the taxpayer. The court held that the contracts in these cases were a means used to produce income and, as such, were part of the taxpayer's income-producing structure.[16] The court distinguished between these types of contracts and the contract in the current scenario on

[13] P Haupt *Notes on South African Income Tax* 33 ed (2014) 42.
[14] 2009 (5) SA 238 (SCA).
[15] 2009 (5) SA 238 (SCA) 241.
[16] 2009 (5) SA 238 (SCA) 245.

the basis that this contract did not operate as a means by which the taxpayer generated business or obtained opportunities to earn income.[17] The court held that the contract between the taxpayer and the third party was concluded as part of its business of providing accommodation. It was not part of the taxpayer's income-producing structure, but a product of the taxpayer's income-earning activities.[18]

As such the court held that the amount paid to the taxpayer on termination of the contract is not in the nature of capital and must, by definition, be regarded as part of the taxpayer's gross income.[19]

It is submitted, therefore, that rental monies which a taxpayer receives are revenue in nature (as they cannot be said to be capital). A rental contract for immovable property is similar to the contract as a result of which the taxpayer, *in WJ Fourie*, was receiving income from a third party for use of the taxpayer's premises. The rental contract does not operate as the means by which the taxpayer generates business nor does it form part of the taxpayer's income-producing structure. This has been confirmed by SARS who state that the rental income which a taxpayer receives must be added to their other taxable income.[20]

> "A payment for the use of property is referred to as 'rental'. The receipt of rental is a revenue receipt as it arises out of giving someone the use of a capital asset*."*[21]

There are, however, certain receipts which relate to the renting of immovable property in respect of which it is not clear whether they are to be included in a taxpayer's "gross income". The first is a deposit received by the taxpayer from the tenant (as is usual practice when a new tenant is moving into the premises).

These legal principles were dealt with in the case of *Greases (SA) Ltd v CIR.*[22] In this case the taxpayer company sold drums of grease to the public. The company required the customer to pay a deposit for the drums themselves and claimed that the drums remained in their

[17]2009 (5) SA 238 (SCA) 245.
[18]2009 (5) SA 238 (SCA) 245.
[19]2009 (5) SA 238 (SCA) 246.
[20] South African Revenue Service *Tax on Rental Income* (2015) http://www.sars.gov.za/TaxTypes/PIT/Pages/Tax-on-rental-income.aspx (accessed 16 September 2015).
[21]Haupt *Notes* 70.
[22]1951 (3) SA 518 (A), 17 SATC 358.

ownership. The taxpayer used these deposits in its ordinary business and did not deposit them into a trust account. These amounts were included by the Commissioner in the taxpayer's gross income; the taxpayer objected, stating that the deposits should not have been included. The court held that the dominating fact in this case was that the taxpayer received the deposit amounts for its own benefit and that it used these amounts in its day to day business operations; the monies were not deposited into a trust account.[23]

This case confirmed the principle that for an amount paid as a deposit to be excluded from a taxpayer's "gross income", it must be held in trust so that the taxpayer may not use it.[24] This is line with SARS' policy on deposits, that they must be kept in a separate trust account and refunded to the tenant on vacation of premises. If this is done, the deposit will not be included in the taxpayer's income.[25]

When the deposit (or part of the deposit) that has been included in "gross income" is refunded to a tenant, the refund will qualify as a deduction in terms of section 11(a) of the Act.

2.3.1 Special Inclusions in Gross Income

The definition of "gross income" includes certain receipts which must be included in a taxpayer's taxable income, irrespective of their possible capital nature. The inclusions which are relevant to the taxpayer who rents out immovable property are:

i. A lease premium; and
ii. Leasehold improvements.

2.3.2 Lease Premiums

Paragraph (g) of the definition of "gross income" states that any amount received or accrued from another person as a premium or like consideration for the use of occupation or the right of use of occupation of land or buildings forms part of the taxpayer's "gross income".

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[23] 1951 (3) SA 518 (A), 17 SATC 358 523.
[24] RC Williams *Income Tax in South Africa: Cases & Materials* 3 ed (2009) 128.
[25] South African Revenue Service *Rental Income*.

The concept of a "lease premium" was dealt with in *CIR v Butcher Brothers (Pty) Ltd.*[26] Feetham JA held that a "premium" is a cash consideration passing from lessee to lessor in addition to rent.[27] The court also held that payments for rates and taxes or maintenance of buildings do not constitute a lease premium.[28] As such, monies which a taxpayer receives from the tenant, which do not constitute rent money (and are not rates, taxes or maintenance), would fall under the definition of a premium and must be included in a taxpayer's "gross income".

It is submitted that section (g) of the definition of "gross income" contemplates two types of payments which a lessee may make to a lessor. The first one is the lessee paying an amount to the lessor for the right to enter into an agreement to rent the property and the second is an upfront lump sum payment in advance for the entire rental period (which is paid instead of monthly rental payments).[29] It is submitted that both these types of payments would fall within the bounds of paragraph (g) of the definition of "gross income" and therefore be specifically included in a taxpayer's taxable income.[30]

2.3.3 Leasehold Improvements

Paragraph (h) of the definition of "gross income" states that the following amounts must be included in a taxpayer's "gross income":

"(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."

[26]1945 AD 301, 13 SATC 21.
[27]1945 AD 301, 13 SATC 21 317.
[28]1945 AD 301, 13 SATC 21 318.
[29]Haupt *Notes* 70.
[30]Haupt *Notes* 72.

While the term is not specifically referred to, this paragraph deals with what are commonly known as "leasehold improvements".

> "A leasehold improvement is an improvement which a lessee makes to a property which he has leased from a lessor. The property does not belong to the lessee, but as he has the use of it he is willing to spend money on improving it, e.g. by erecting a building on it or adding to the building already on the property."[31]

The lessor is only obliged to add the value of the improvements to his "gross income" if the lease stipulates that the lessee must make improvements.[32] This type of receipt therefore needs to be included in the taxpayer's "gross income". This was confirmed in *ITC 1611.*[33] The court held that an improvement made to the taxpayer's land was not the taxable event; the accrual of the right to the taxpayer to have land improved is what the court termed a "taxable right".[34] The court went further to state that the taxpayer had the right to compel the tenant to procure the erection of a building on its property and that as such this right fell within the ambit of paragraph (h) of the definition of "gross income" (which meant the value of the building had to be included in the taxpayer's "gross income").[35]

The value of the leasehold improvements included in "gross income" in terms of paragraph (h) (discussed above) is reduced in terms of an allowance provided in section 11(h). This sub-section provides for a deduction from the value of the leasehold improvement and is in the form of a discounting factor based on the term of the lease and a present value factor, applied to the value included in gross income.

[31] Haupt *Notes* 72.
[32] Haupt *Notes* 72.
[33] (1995) 59 SAC 126 (T).
[34] (1995) 59 SAC 126 (T) 141.
[35] (1995) 59 SAC 126 (T) 152.

2.4 The General Deduction Formula

The preamble section 11 and section 11(a), read with section 23(g) (known collectively as the general deduction formula), allows taxpayers to deduct from their income certain expenditure which they have incurred. This will result in the taxpayer being liable for a reduced amount of tax on their total taxable income (provided that the taxpayer does not have an assessed loss which is ring-fenced).

The preamble to section 11 and section 11(a) of the Act read as follows:

> "11. General deductions allowed in determination of taxable income – For the purposes 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 –
>
> (a) expenditure and losses actually incurred in the production of income, provided such expenditure and losses are not of a capital nature."

Section 23(g) of the Act reads as follows:

> "23. Deductions not allowed in determination of taxable income – No deductions shall in any case be made in respect of the following matters, namely –
>
> (g) any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade."

What is evident from the plain reading of these sections is that section 11(a) provides positively for what may be deducted and section 23(g) is a general prohibition section which provides negatively for what may not be deducted.

The pertinent points of section 11 to which taxpayers must adhere to if they want to qualify for a section 11(a) deduction are as follows:

1. the taxpayer must be carrying on a trade;
2. the income must have been derived from such trade;

3. the taxpayer must have incurred expenditure or losses;
4. which were actually incurred;
5. in the production of income; and
6. which were not of a capital nature.

Each of these points must be considered in detail in order to determine whether taxpayers who purchase a property and let it will be able to deduct expenditure and losses incurred from their taxable income in order to reduce their tax liability.

<u>2.4.1 Carrying on a trade</u>

Section 1 of the Act defines a "trade" as follows:

> "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 as defined in the Patents Act or any design as defined in the Designs Act or any trade mark as defined in the Trade Marks Act or any copyright as defined in the Copyright Act or any other property which is of a similar nature."

It is therefore evident from the plain reading of the definition of "trade" as contained in the Act, that the letting of immovable property is indeed a trade in terms of the provisions of the Act.

At first reading it may seem that because a taxpayer is letting out property that a trade is automatically being carried on; it is not however so straight forward. There may be instances where the taxpayer is letting out property, but the courts do not consider that a trade is being carried on. A case which dealt with such a situation is *ITC 1653.*[36] In this case the taxpayer purchased a residential property as a long term investment and let it out for rental income. The resulting loss on the property was claimed as a deduction by the taxpayer. The Commissioner disallowed the deduction because, as it stated, the taxpayer

[36](1998) 61 SATC 120 (Z).

had purchased the property as a long term investment and that there was no hope of profit being realised on the income from rent.[37]

The court then dealt with other cases which have had similar facts. One of the cases dealt with is *ITC 1292.*[38] In this case the taxpayer purchased a vacation residence which he used himself, but also occasionally let out to others so as to reduce the cost of having a holiday home.

Myburgh J stated that:

> "If the possibility to earn a profit is excluded by the evidence, as is the position in the present case, then such expenses are not deductible. The test is the real hope to make a profit. Such hope must not be based on fanciful expectations but on reasonable possibility."[39]

As such, there was no prospect of the taxpayer making a profit and the court found that the expenses were not deductible.[40] It is submitted that after the amendment to section 23(g), this will no longer be a correct application of the law, as will be explained below.

Another case referred to in *ITC 1653* is *ITC 1371.*[41] In this case the taxpayer let property for which he received rental income. The court held that the definition of "trade" in the Act does not include the requirement that a profit be made before a deduction can be claimed. It was also stated that a trade will normally be conducted with a view to making a profit, but that this is not a requirement. All that is required is that a trade be engaged in with the purpose of producing income.[42] However, the court in *ITC 1385*[43] makes the point that where a taxpayer purchases a property with mixed intentions (e.g. for partial use as a vacation home and partly to rent out for income) it may be inferred that the taxpayer does not have a profit-making motive. In such a scenario, while it is not clear whether a trade is being carried on, the expenditure must be regarded as being partly laid out for the purpose of protecting the taxpayer's vacation home. The expenses were not laid out wholly or

[37] (1998) 61 SATC 120 (Z) 123.
[38] (1979) 41 SATC 163.
[39] ITC 192 (1979) 41 SATC 163 165-166.
[40] (1979) 41 SATC 163 166.
[41] (1983) 45 SATC 169.
[42] (1983) 45 SATC 169 176 and 177.
[43] (1984) 46 SATC 111.

exclusively for the purposes of trade (which was previously a requirement of section 23(g) of the Act); in the light of this the expenditure could not be deducted.[44]

It is submitted that such a scenario must now be dealt with in terms of section 23(g) which has been amended since this judgment was handed down(the requirements of which have been set out above). Any deductions which the taxpayer makes are now limited to the extent to which they are not laid out for purposes of trade.

The court in *ITC 1653*[45] agreed with what was held in *ITC 1371;* where a taxpayer is engaged in a trade of leasing, all that need be established is that the trade was engaged in, carried on or followed for the purpose of producing income. It is submitted that this is a correct interpretation of the definition of "trade" as the legislature could have included in the preamble to section 11 that the taxpayer must have a profit-making motive before he or she can be said to carrying on a trade; this is not specifically stated and therefore cannot be implied (in terms of the principles of statutory interpretation as set out later in this chapter).

If a taxpayer purchases a property with the intention of letting it out as well as using it as a holiday home the court will need to look at the facts of each case in order to determine to what extent the expenses were incurred for the purposes of trade. The court may need to look at what exactly the expenditure sought to achieve (i.e. whether the expenditure was incurred in order to earn income from letting the property or whether the expenditure was incurred for reasons relating to the use of the property as a holiday home) and possibly the period of time for which the taxpayer lets the property as opposed to the period during which it is used for private purposes. The court may apply the provisions of section 23(g) to restrict the deduction of expenses which were not expended for purposes of trade.

Another consideration for the taxpayer who incurs an assessed loss on the carrying on of a trade of letting property is whether that loss will be ring-fenced (so that this loss may not be set off against the taxpayer's other income). This aspect will be dealt with in depth in Chapter 4 of this thesis.

[44](1984) 46 SATC 111 115.
[45](1998) 61 SATC 120 (Z) 127.

2.4.2 Expenditure and Losses

The next point that needs to be considered is whether the taxpayer has incurred expenditure or a loss in the process of letting the property. The first aspect which needs to be considered is the difference between expenditure and losses. In the Appellate Division (now the Supreme Court of Appeal) case of *Joffe & Co (Pty) Ltd v Commissioner for Inland Revenue,*[46] the court held that it was not clear whether the term "loss" meant anything different than expenditure; possibly losses were expenditure of an involuntary nature.[47]

> "In any event, whether or not there is a difference between expenditure and losses does not appear to be a problem of any significance."[48]

What is evident is that the taxpayer, in the process of letting property, must have incurred expenditure or suffered losses in order to qualify for a deduction. Assuming that the taxpayer does incur expenses in the carrying on of the trade of letting, such as letting agent fees or interest paid on a mortgage bond, the next stage of the enquiry must be addressed.

2.4.3 Actually Incurred

The next stage of the enquiry is whether the expenditure has actually been incurred by the taxpayer. This phrase was dealt with in numerous cases, with the *locus classicus* case being *Port Elizabeth Electric Tramway Co v CIR.*[49] In that case Watermeyer AJP held the following:

> "Taking these in turn, the words of the statute are 'actually incurred' not 'necessarily incurred'. The use of the word 'actually' as contrasted with the word 'necessarily' may widen the field of deductible expenditure. For instance, one man may conduct his business inefficiently or extravagantly, actually incurring expenses which another man does not incur; such expenses therefore are not 'necessary', but they are actually incurred and therefore deductible. But

[46] 1946 AD 157.
[47] 1946 AD 157 166.
[48] Haupt *Notes* 114.
[49] 1936 CPD 241.

> expenses 'actually incurred' cannot mean 'actually paid'. So long as the liability to pay them actually has been incurred they may be deductible. For instance, a trader may at the end of the income tax year own money for stocks purchased in the course of the year or for services rendered to him. He has not paid such liabilities but they are deductible."[50]

This was reiterated again in subsequent cases. It is not necessary that the taxpayer has physically paid the expense as long as the liability has been incurred (the money is owed), an expenditure has arisen which may be claimed.[51] In the case of *Caltex Oil (SA) Ltd v SIR*[52] the court stated that the phrase "actually incurred" means all expenditure for which the liability has been incurred during the year of assessment, whether or not this liability has been discharged.

In the case of taxpayers letting property, an example may be the fees or commission paid to a letting agent who manages the collection of rent on behalf of the taxpayer. If this service was rendered during the year of assessment, but the taxpayer only pays the agent after the year of assessment, the taxpayer would be able to deduct these expenses in the current year of assessment as the liability to pay arose when the services were rendered.

In determining whether an expense has actually been incurred the circumstances of each expense must be considered. Another case which must be considered in relation the phrase "actually incurred" is *CIR v Golden Dumps.*[53] In this case the court had to decide whether an expense had been "actually incurred". The court approved what was held in *PE Electric Tramways* that "actually incurred" does not mean expenditure actually paid during the year of assessment, but all expenditure for which the liability has been incurred during the year of assessment; whether or not this liability has been discharged.[54] Nicholas AJA stated that if an expense is contingent in the legal sense, then the expenditure is incurred in the year of assessment in which the condition on which it depends is fulfilled.[55]

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[50] 1936 CPD 241 244.
[51] Haupt *Notes* 115.
[52] 1975 (1) SA 665 (A).
[53] 1993 (4) SA 110 (A).
[54] 1993 (4) SA 110 (A) 116.
[55] 1993 (4) SA 110 (A) 118.

In the case of *Edgars Stores Ltd v CIR,*[56] Corbett JA stated the following:

> "Thus it is clear that only expenditure (otherwise qualifying for deduction) in respect of which the taxpayer has incurred an obligation during the year of assessment in question may be deducted in terms of s 11(a) from income returned for that year. The obligation may be unconditional *ab initio* or, though initially conditional, may become unconditional by fulfilment of the condition during the year of assessment; in either case the relative expenditure is deductible in that year. But if the obligation is initially incurred as a conditional one during a particular year of assessment and the condition is fulfilled only in the following year of assessment, it is deductible only in the latter year of assessment."[57]

It is evident from these cases that expenditure need not be necessarily incurred and will only be "actually incurred" if the liability to pay is incurred during that particular year of assessment.

<u>2.4.4 In the year of assessment</u>

While this requirement is not specifically dealt with in section 11(a) the courts have held that the expenditure which a taxpayer wishes to deduct must have been incurred in the year in which it was claimed.[58] In the case of *Concentra (Pty) Ltd v CIR*[59] the taxpayer company attempted to deduct certain expenditure for the 1940 tax year, but which was incurred during the period 1937 to 1940. The Commissioner disallowed the deduction of the expenses incurred prior to the 1940 tax year. The Special Tax Court upheld the Commissioner's disallowance on the basis that the term "income" meant income earned during the year of assessment. The court held that "*the basis of the income tax law is the assessment of the yearly income; the amounts earned and expenses incurred."*[60] The court

[56] 1988 (3) SA 876 (A).
[57] 1988 (3) SA 876 (A) 889.
[58] Haupt *Notes* 117.
[59] 1942 CPD 509.
[60] 1942 CPD 509 513.

went on to state that the expenditure and losses referred to in the relevant section of the Act are expenditure and losses incurred in the year of assessment.[61]

The above-mentioned case of *CIR v Golden Dumps* dealt with the concept of the expenditure having to be incurred in the year of assessment. The court held that as the taxpayer's liability to pay the expenditure was only threatened, and that the possibility of them having to make the payment would only become apparent in a number of years' time when the Appellate Division gave its judgment, that the expenditure had not been incurred in the year of assessment (meaning it was not deductible at that stage).[62] The deduction would only be allowed in the year in which the Appellate Division held the taxpayer to be liable.

In *Caltex Oil (SA) Ltd v SIR,*[63] Botha JA stated the following:

> "It is only at the end of the year of assessment that it is possible, and then it is imperative, to determine the amounts received or accrued on the one hand and the expenditure actually incurred on the other during the year of assessment."[64]

As such, while section 11(a) does not specifically mention this requirement, the Appellate Division has interpreted the law in such a way so as to ensure that this is a prerequisite which the taxpayer needs to meet when attempting to deduct expenditure.

Section 23H of the Act provides that a deduction in terms of section 11(a) will be prohibited in situations where an expense is incurred in a certain tax year, but the benefits of such expenditure are not enjoyed in full in that year. Section 23H(1)(a) and (b) read as follows:

> "(1) Where any person has during any year of assessment actually incurred an expenditure (other than expenditure incurred in respect of the acquisition of any trading stock)-
>
> (a) which is allowable as a deduction in terms of the provisions of section 11 (a), (c), (d), or (w), or section 11A; and

[61] 1942 CPD 509 513 513.
[62] 1993 (4) SA 110 (A) 119.
[63] 1975 (1) SA 665 (A).
[64] 1975 (1) SA 665 (A) 674.

(b) the amount of the expenditure in respect of which a deduction shall be allowable in terms of such section in the said year and any subsequent year of assessment, shall be limited to, in the case of expenditure incurred in respect of –

(i) goods or services, all of which will not be supplied or rendered to such person during such year of assessment; or

(ii) any other benefit, the period to which the expenditure relates extends beyond such year of assessment...”

A practical example of the effects of this section is as follows. A person may incur an otherwise deductible expense in year one in respect of goods and services to be received in year two and the deduction will be deferred, unless the provisos to section 23H(1) apply. These read as follows:

“Provided that the provisions of this section shall not apply-

(aa) where all the goods or services are to be supplied or rendered within six months after the end of the year of assessment during which the expenditure was incurred, or such person will have the full enjoyment of such benefit in respect of which the expenditure was incurred within such period, unless the expenditure is allowable as a deduction in terms of section 11D (1); or

(bb) where the aggregate of all amounts of expenditure incurred by such person, which would otherwise be limited by this section, does not exceed R100 000; or

(cc) to any expenditure to which the provisions of section 24K or 24L apply; or

(dd) to any expenditure actually paid in respect of any unconditional liability to pay an amount imposed by legislation.”

> "The effect of the section is to defer the deduction of certain expenditure where all or portion of the goods, services, or benefits flowing from the expenditure will only be enjoyed after the year end."[65]

The pre-payment, for example, of the cost to repair the leased property or the municipal charges for water and electricity by the lessor of the property may fall to be dealt with in terms of this section.

2.4.5 In the production of income

The next factor, whether the expenditure has been incurred "in the production of income", is one which needs careful consideration and there is a body of case law which has dealt with this specific requirement of section 11(a); the implications of the term "in the production of income" are not clear from the plain reading of the sub-section.

The *locus classicus* decision is *Port Elizabeth Electric Tramway Co v CIR.*[66] In this case the taxpayer company carried on business as a tramway company. A vehicle of the company was involved in an accident (which an employee was driving) and the expenditure which the company incurred as a consequence of this accident was called into question (as to whether it was incurred in the production of income). The expenditure in this regard comprised of compensation paid to the family of the employee involved in the accident (as the employee had subsequently died) and the legal costs incurred as a consequence of having to defend the claim instituted by the employee (before he died) in terms of the Workman's Compensation Act. The court held that income is produced by the performance of a series of acts and the resultant expenditure is deductible provided that it is so closely linked to such acts as to be regarded as part of the cost of performing them.[67]

The court held further that the two relevant questions are:[68]

(a) Whether the act to which the expenditure is attached is performed in the production of income;
(b) Whether the expenditure is linked to it closely enough.

[65] Haupt *Notes* 132.
[66] 1936 CPD 241.
[67] 1936 CPD 241 245.
[68] 1936 CPD 241 245.

In this regard the purpose of the act entailing expenditure must be considered. If the purpose of the act is to earn income then expenditure attendant upon the act is deductible.

With regard to the second leg of the enquiry, the court stated the following:

> "The other question is what attendant expenses can be deducted? How closely must they be linked to the business operation? Here, in my opinion, all expenses attached to the performance of a business operation *bona fide* performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are *bona fide* incurred for the more efficient performance of such operation provided they are so closely connected with it that they may be regard as part of the cost of performing it."[69]

The court held that the employment of drivers is necessary in the business of the tramway company and that this employment carries with it as a necessary consequence a potential liability to pay compensation if such drivers are injured in the course of their employment. There is always a risk that a driver in the employ of the taxpayer will get injured; the potential liability is constantly present and is inseparable from the employment of drivers (meaning that the risk is inseparable from the carrying on of the business). The amounts paid by the taxpayer to the employee's family were, therefore, held to be deductible.[70]

These principles have been repeated on numerous occasions by our courts, including the Appellate Division (though slightly differently worded). A case in point is *CIR v Standard Bank of SA Ltd;*[71] in this case the following was stated:

> "Generally, in deciding whether money outlayed by a taxpayer constitute [sic] expenditure incurred in the production of the income (in terms of the general deduction formula) important and sometimes overriding factors are the purpose of the expenditure and what the expenditure actually effects; and in this regard

[69] 1936 CPD 241 246.
[70] 1936 CPD 241 247.
[71] 1985 (4) SA 485 (A).

> the closeness of the connection between the expenditure and the income-earning operations must be assessed."[72]

It is therefore clear that when deciding whether expenditure incurred by the taxpayer was incurred in the production of income, the principles laid down by the court in *Port Elizabeth Electric Tramway Co* must be the basis of arriving at the decision.

Taxpayers who let immovable property may find themselves in a situation where a tenant sues for an event which happens at the leased premises, for example a wall collapsing. If such an occurrence were to take place and the tenant was successful in obtaining a damages payment from the taxpayer, the taxpayer would want to deduct this expenditure from his or her taxable income (in terms of the general deduction formula). A case which can be considered in this light is *ITC 1837.*[73] In this case a taxpayer was ordered by the court to pay damages to a third party in light of a defamatory statement made by the taxpayer within the normal operations of his trade. The question which the court had to decide was whether these damages were deductible in terms of section 11(a).

The court held that these damages would be deductible if their payment constitutes an expenditure or loss actually incurred in the production of income and referred with approval to the case of *Port Elizabeth Electric Tramways* where it was held that expenses attached to the performance of the business operations, *bona fide* performed for the purpose of earning income are deductible even if attached to the performance of business operations by chance.[74] In *ITC 1837,* it was held that the taxpayer's obligations to pay damages were akin to a fortuitous expenditure arising from mischance or misfortune; as such the damages paid were deductible in terms of section 11(a).[75]

If a taxpayer found himself or herself in a situation where he or she was being sued by a tenant for an unfortunate event which occurred beyond his or her control, such as a wall (which had been properly maintained) falling on the tenant, then the taxpayer would be able to deduct such a damages expenditure if he or she could show that these expenses were incurred in the production of income on the basis of the law as set out above

[72] 1985 (4) SA 485 (A) 500.
[73] 71 SATC 177 2009 (CTC).
[74] 71 SATC 177 2009 (CTC) 184.
[75] 71 SATC 177 2009 (CTC) 185.

(presuming that the other requirements of the general deduction formula have been complied with).

In addressing the aim of this thesis, which is demonstrate the possible tax benefits that are available to investors in property, this chapter, will determine whether ordinary expenses incurred by the taxpayer (who lets property as a trade), such as:

1. rates and taxes;
2. body corporate levies;
3. interest on a mortgage bond (in terms of section 24J);
4. letting agent's fees;
5. water and electricity; and
6. repairs to the property (in terms of section 11(d)).

are deductible in the normal course of events.

When making this determination it would be necessary to consider the principles laid out in *Port Elizabeth Electric Tramways Co* in order to decide whether an expense will be deductible.

Another aspect that needs to be considered is expenditure incurred in the production of income in future years.

> "It should be noted that the term, 'In the production of income' does not mean that the expenditure may only be deducted once the income has been produced. As long as the purpose of the expense is to enable the taxpayer to earn income, the income may be earned in a later year. The expenditure is still deductible in the earlier year".[76]

In *Sub-Nigel Ltd v CIR,*[77] Centlivres JA stated that:

> "It seems to me clear on the authorities that the Court is not concerned whether a particular item of expenditure produced any part of the income: what it is

[76]Haupt *Notes* 120.
[77]1948 (4) SA 580 (A).

> concerned with is whether that item of expenditure was incurred for the purpose of earning income."[78]

Conversely, if expenditure is incurred after the income is earned, the taxpayer will have difficulty proving to the South African Revenue Service (SARS) that the expense was instrumental in producing the income.[79]

2.4.6 Of a capital nature

The final factor which needs to be considered in terms of section 11(a) is whether the expenditure incurred by the taxpayer was capital in nature; if this is the case, the expenditure cannot be deducted. The Act does not define the term "of a capital nature"; case law must be examined in order to gain a proper understanding as to what exactly the meaning of capital expenditure is. The pivotal case in this regard is *New State Areas Ltd v CIR.*[80] In this case the taxpayer was a gold mining company that had to install, in order to conduct its business, internal and external sewers on its land. The internal sewers became the property of the company upon completion, but the external sewers remained the property of the local government (even though the company had paid for their construction by borrowing money from the local town council). The issue which the court had to decide was whether the instalments paid to the council (the re-payment of the money borrowed for the purpose of building the sewers) was capital in nature. It was held that the internal sewers formed part of the equipment of the mine and became the property of the company upon completion.[81] It was held further therefore that even though the payments to the council were recurrent in nature they were indeed capital expenditure.[82]

The external sewers were, however, different. They never became property of the taxpayer and as such the taxpayer acquired no asset as a result of the payments to the local council (in re-payment of the loan). The court held that the payments were revenue in nature.[83]

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[78] 1948 (4) SA 580 (A) 592.
[79] Haupt *Notes* 120.
[80] 1946 AD 610.
[81] 1946 AD 610 627.
[82] 1946 AD 610 627.
[83] 1946 AD 610 627.

The principles upon which the court came to this conclusion are of the utmost importance as they have been used subsequently by our courts in determining whether expenditure is capital in nature or not.

The court stated that the acquisition of the means of production (e.g. property, plants, tools) which a taxpayer uses in the performance of the income producing operations and the expansion thereof are capital in nature. On the other hand, expenditure attendant on the performance of business operations is revenue in nature.[84] The court also held that both of these types of expenses can be incurred in the production of income.[85] The court held that merely because an asset is paid for by means of instalments or recurring payments does not automatically mean that it is revenue.[86] The court held that the deciding factor will always be as follows: if the expenditure can be regarded as being part of the cost of performing the income-earning operations of the business then it is revenue in nature and will be deductible; if, on the other hand, the expenditure is geared towards establishing, improving or adding to the income-earning plant or machinery of the business then it is capital in nature and not deductible.[87] In essence, then, the decision hinges on whether the expenditure was made to acquire or create and income-producing asset or whether it was incurred in working the income-producing asset. In most cases the acquisition or creation of a tangible asset, such as machinery, will result in the expenditure being capital in nature.

Another case which is of relevance is *CIR v George Forest Timber Co.*[88] In this case it was held that expenditure incurred in creating or acquiring an income producing concern (source of profit) must be capital. On the other hand, money spent working the source of profit must be revenue.[89]

An example of a capital asset would be a building which is purchased for the purpose of producing rental income. It must also be borne in mind that the payment for the use of an

[84]1946 AD 610 620.
[85]1946 AD 610 620.
[86]1946 AD 610 627.
[87]1946 AD 610 627.
[88]1924 AD 516, 1 SATC 20.
[89]1924 AD 516, 1 SATC 20 526.

asset, such as rent for a building, is of a revenue nature; the fact that the building is a capital asset does not affect the revenue nature of the rental payment.[90]

There are two relevant tax court cases which deal with capital expenses incurred by a landlord taxpayer. In *ITC 819 (1955),*[91] the taxpayer paid an amount of money to the tenant so that the tenant would vacate the premises (prior to the contract ending). The court, in this matter, held that this was a capital expense as it was not a consideration in the nature of rent passing from lessee to lessor.[92]

The court took a different approach in *ITC 1267 (1977);*[93] in this case the taxpayer paid compensation to a tenant for agreeing to an early cancellation of the contract (so that the taxpayer could lease the premises at a higher rate to a third party). The issue which the court had to decide was whether this amount was deductible in terms of section 11(a). The Commissioner argued that the amount was not deductible as it was a capital expenditure which was incurred for the purpose of acquiring an enduring benefit. The court held that the expense was revenue in nature as no new asset had been created, the income-producing structure of the taxpayer was not affected, no existing asset had been improved on nor was any long term advantage created for the taxpayer.[94]

It is submitted that the approach taken in *ITC 1267* is the correct approach as a payment made by a taxpayer that does not create a long-term advantage or enduring benefit is revenue in nature.[95]

All the requirements of the preamble to section 11 and section 11(a) have now been discussed and a determination of whether or not expenditure incurred by a taxpayer will meet all the requirements of this section can be made for a particular scenario.

At this stage it would be pertinent to consider the capital gains tax implications of expenses which are deemed to be capital in nature, such as improvements to a taxpayer's premises. The basic capital gains tax calculation needs to be considered at this stage in order to gain

[90] Haupt *Notes* 122.
[91] 21 SATC 71 (C).
[92] 21 SATC 71 (C) 72.
[93] 39 SATC 146 (T).
[94] 39 SATC 146 (T) 149 and 151.
[95] Haupt *Notes* 137.

an understanding of how the capital gains liability will be affected. This calculation is as follows:

- Proceeds from the sale of a capital asset;
- Less: Base cost of asset;
- Equals the capital gain.[96]

The base cost of an asset is dealt with in terms of Part V of the Eighth Schedule to the Act. In terms of the preamble to paragraph 20 and paragraph 20(a) read with 20(e), the base cost of an asset is the cost of acquisition or creation of that asset, plus the expenditure incurred in effecting an improvement or enhancement of that asset. As such, the cost of the asset and any improvements which taxpayers make to their tenanted premises will form the basis of or add to the base cost of the property, which, upon sale of the asset will result in the taxpayer having a reduced capital gains tax burden.

2.4.7 To the extent incurred in carrying on a trade

If it can be said that the expenditure meets the requirements of the preamble to section 11 and section 11(a), then section 23(g), the general prohibition section, becomes relevant in order to determine whether an expense will be deductible.

Section 23(g) prohibits the deduction of:

a) any monies claimed as a deduction;
b) to the extent to which;
c) the monies are not laid out or expended for the purpose of trade.

In terms of the decision in *Ticktin Timber CC v CIR,*[97] the purpose for which the expenditure is incurred is the decisive consideration in the application of section 23(g). In *CIR v Sunnyside Centre*[98] the court dealt with the fact that the legislature had changed the ambit of section 23(g). The section previously prevented the deduction of any expenses which were not wholly or exclusively laid out or expended for the purposes of trade; it has since been changed to prevent the deduction of monies expended, to the extent to which such monies

[96]Haupt *Notes* 669.
[97]1999 (4) SA 939 (SCA).
[98]1997 (1) SA 68 (A).

were not laid out for the purposes of trade. The effect of this appears to be that monies which have been expended for a dual purpose may now be apportioned so that the portion laid out for the purposes of trade may be deducted.[99]

A practical example of the implications of section 11(a) read with section 23(g) is as follows. A sole proprietor goes on an overseas trip for two weeks, during which time he conducts business. The first week is spent doing business, while the second week is taken as a holiday. The costs related to the business trip will be tax deductible as they are incurred for the purposes of trade and in the course of the trade from which he earns income. The week spent on holiday will, however, not be tax deductible; the provisions of section 23(g) will prevent this deduction. Half of the expense of his airfare will be tax deductible (as he spent half of the trip on business) and half the expense of his hotel will be deductible.[100]

The section 23(g) requirement is something which must be determined on a case to case basis considering the facts of each case.

If a taxpayer is able to show that the expenditure that has been incurred complies with all the requirements of the preamble to section 11 and section 11(a) and does not fall foul of section 23(g), then the taxpayer will be able to deduct this expense from income (resulting in a reduced taxable income and consequent tax liability).

2.5 Specific Deductions

2.5.1 Section 11 (c) – Legal Expenses

The Act provides for specific deductions (other than those allowed in terms of the general deduction formula). One of these sections is section 11(c) which deals with the deduction of legal expenses.

The section provides for a deduction of the following legal costs:

1. legal practitioner fees;
2. expenses related to procuring expert advice;
3. court fees;

[99] 1997 (1) SA 68 (A) 73.
[100] Haupt *Notes* 109.

4. taxing fees and witness fees and expenses;
5. sheriff fees; and
6. other necessary litigation fees.

If any of these expenses are to qualify for a deduction in terms of section 11(c), they must be (amongst other things):

1. actually be incurred;
2. in respect of any action, claim or dispute or action at law;
3. incurred in the course of, or by reason of, ordinary operations in carrying on trade; and
4. not be of a capital nature.

Legal expenses were not allowed as a deduction in the *Port Elizabeth Electric Tramways* case.[101] The details of this case were set out above, but it must be noted that the court did not allow the legal costs incurred by the taxpayer as the costs were expended in order to resist a demand for compensation. The costs were not incurred as a result of an action which was entered into for the purpose of earning income (the deduction did not comply with the section 11(a) requirement that the expenses be incurred in the production of income), but were incurred in an attempt to avoid having to pay compensation to an employee's family members. Section 11(c) was, however, introduced subsequent to the judgment being handed down in this case. While a superficial reading of the section appears to make it seem it easier to claim legal expenses, this is not necessarily always the case (particularly where the taxpayer is defending a matter which has been brought against him).

Section 11(c)(iii) states that the amount of expenses deductible will be limited to so much thereof as "is not incurred in respect of any claim made by the taxpayer for the payment to him of any amount which does not or would not constitute income of the taxpayer." It is evident that an amount received by a taxpayer from an action which he has instituted must be an amount which, if successful, would form part of his "gross income" and therefore his "income" ("gross income", less any exempt income). Therefore, if the taxpayer institutes a claim against a third party, then the costs incurred as a result thereof will only be deductible if the taxpayer is granted an award which would result in this amount being included in the

[101] 1936 CPD 241.

taxpayer's "gross income". If a taxpayer instituted action against a tenant for non-payment of rent and was successful in receiving the money from the tenant (as a result of the legal action), it is clear that the legal expenses incurred in such an action would be deductible under this section (as the rental income would be included in the taxpayer's income).

Section 11(c)(ii) states that if a claim is made against a taxpayer for payment of damages and the nature of the claim would not rank for a deduction in terms of section 11(a), then the legal expenses incurred as a result of such claim may not be deducted. In other words, the claim must relate to an incident which occurred in the course of the production of income, or put more succinctly by Van Reenen J in *ITC 1837:*

> "although rather confusingly formulated in a double negative form its tenor is that any legal expenses incurred by a taxpayer in respect of a claim for damages or compensation will be deductible under s 11(c) only to the extent that such damages or compensation are deductible from the income derived by him in terms of the provisions of sub-s 11(a) of the Act."[102]

In this case the taxpayer was sued for defamation due to a statement which he made whilst performing his job. In the resultant trial it was found that the taxpayer had uttered a defamatory statement and the court ordered the taxpayer to pay damages in the amount of R35 000.00 to the Plaintiff. Associated with the damages payment, the taxpayer incurred legal costs of R451 952.32; the taxpayer attempted to deduct the legal costs in terms of section 11(c) of The Act.

The court held that the taxpayer's employment as Premier of a province constituted a trade in terms of section 1 of the Act. The question therefore which the court had to decide was whether the legal expenses were incurred in respect of an action at law which arose in the course of or by reason of the ordinary operations undertaken by him in the carrying on of his trade.[103]

Van Reenen J stated the following:

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[102] 71 SATC 177 (2009) (CTC) 184.
[103] 71 SATC 177 (2009) (CTC) 182.

> "The prevailing view of authors on the subject appears to be that legal expenses are so deductible if the existence of a causal connection between the ordinary operation undertaken by a taxpayer in the carrying on of his trade, on the one hand, and the claim, dispute or action in respect of which such expenses have been incurred, on the other hand, has been established."[104]

The court held that the legal expenses which the taxpayer incurred were sufficiently closely linked to the taxpayer's ordinary trading operations so as to warrant the conclusion that they arose by reason of such operation which ensured that they could be deducted in terms of section 11(c).[105] It must be kept in mind that the principles set out in this case are only relevant to instances where the taxpayer is defending an action brought against him; as stated above, different principles apply when the taxpayer has himself brought the action.

The legal costs incurred by the taxpayer must also not be capital in nature. An example of legal expenses which have been held to be capital in nature is that of *Secretary for Inland Revenue v Cadac Engineering Works.*[106] In this case the taxpayer brought an application to interdict another company from manufacturing goods in competition with it. This taxpayer's application was dismissed with costs. The taxpayer attempted to deduct the costs incurred as a result of their dismissed application. Ogilvie-Thompson JA referred to and approved a statement made by the court in *New State Areas* to the effect that expenditure will be capital in nature if it is incurred for the purpose of acquiring a capital asset.[107]

The court held that the legal costs in this matter were incurred in order to attempt to eliminate a competitor.[108] It was submitted by the taxpayer that the expenditure had not added any asset to the taxpayer's income-earning structure. Ogilvie-Thompson JA stated that:

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[104] 71 SATC 177 (2009) (CTC) 182.
[105] 71 SATC 177 (2009) (CTC) 183.
[106] 1965 (2) SA 511 (A).
[107] 1965 (2) SA 511 (A) 519.
[108] 1965 (2) SA 511 (A) 517.

> "In my judgment, the mere circumstance that a payment has neither created a new asset nor made any addition to an existing asset is not necessarily conclusive in favour of such payment being a revenue expense."[109]

The court held that the taxpayer's income-earning structure comprehended, *inter alia*, its goodwill. The taxpayer's expenditure was aimed at eliminating a competitor, which it was held, was to protect and expand the taxpayer's market and goodwill.[110] "In short, the expenditure was incurred in order the better to exploit the taxpayer's existing capital assets..."[111] The expenditure was, therefore, held to be more closely related to the taxpayer's income earning-structure than its income-earning operations. The expenditure was held to be capital in nature.[112]

For the taxpayer renting out property, it is quite likely that certain legal expenses will be incurred which will be a deductible expense under section 11(c). These could include legal expenses related to an action which is instituted by the taxpayer against a tenant for arrear rental payments. However, if the tenant had to institute eviction proceedings it is unlikely that the costs would be deductible as a successful eviction case would not result in the taxpayer receiving income, but rather the tenant vacating the premises. An expense such as the drafting of a rental contract would not be deductible in terms of section 11(c) in that the costs would not have been incurred in respect of any action, claim or dispute at law. This expense would have to be considered for deduction in terms of section 11(a). If, however, there was a dispute which arose as a result of the interpretation of the rental contract (which was instituted by the taxpayer and could result in the receipt of income if successful), then this is an expense which would probably be deductible in terms of section 11(c).

2.5.2 Section 11(d) - Repairs

> "The cost of repairing an asset does not qualify as a deduction in terms of section 11(a), because it is of a capital nature."[113]

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[109] 1965 (2) SA 511 (A) 522.
[110] 1965 (2) SA 511 (A) 523.
[111] 1965 (2) SA 511 (A) 523.
[112] 1965 (2) SA 511 (A) 523.
[113] Haupt *Notes* 167.

Section 11(d) of the Act allows for a specific deduction for repairs provided that the following requirements are met:

(a) expenditure must actually be incurred;
(b) during the year the year of assessment;
(c) on the repair of property occupied for the purpose of trade or in respect of which income is receivable; or
(d) for the purpose of repairing machinery, implements utensils and other articles used by the taxpayer for the purposes of his trade; or
(e) for beetle treatment of the timber of the property mentioned above.

A case which illustrates section 11(d) is *ITC 1457 (1989).*[114] In this case the taxpayer converted a portion of flats which he owned into offices which could be used by medical practitioners. This process entailed the complete renovation of the first floor of the building. The crucial aspect which the taxpayer had to prove to the court was that the work done on the building was repairs and not improvements. Melamet J approved a statement made which set out the distinction between a repair and an improvement (which would not be a deductible expense).[115] It was held that the pivotal aspect of determining whether a repair has been effected is whether something which was not previously there was added to the asset (which would indicate an improvement) or whether the asset was merely restored to its previous state (in which case it is a repair and hence deductible in terms of section 11(d)).[116] It was held further that it does not matter whether new materials were used in the work done, but whether the building deteriorated and is being restored (repair) or just that the taxpayer has added to it (improvement).[117]

Another case which must be considered in this regard is *CIR v African Products Manufacturing Company Ltd.*[118] In this case the taxpayer needed to repair the roof of its building; it decided to put an entire new roof over their kilns. The court mentioned a number of cases which had dealt with similar issues and came to the conclusion that

[114] 51 SATC 131 (T).
[115] 51 SATC 131 (T) 136.
[116] 51 SATC 131 (T) 136.
[117] 51 SATC 131 (T) 136.
[118] 1944 TPD 248.

the erection of the roof with concrete over the kilns is not a reconstruction of substantially the whole of the factory or even of that portion containing the kilns.[119]

Barry JP stated the following:

> "The company was restoring the roof to its original condition and the fact that it used other material than that originally used was not for the purpose of improvement but for the purpose of restoring the roof to the condition in which it was originally."[120]

The taxpayer was allowed to deduct the costs of the repairs to the roof in terms of section 12(2)(c) (the forerunner of section 11(d)).

The taxpayer must therefore keep close track of any work done on premises let in carrying on a trade. In the event that SARS disputes a deduction which the taxpayer claims, the court will need to look to the facts of the particular circumstances (taking the law into account as set out above) in order to determine whether the work done constitutes repairs (which are an allowable deduction) or improvements (which are not deductible).

2.5.3 Section 11(i) Bad Debts

In terms of section 11(i) of the Act the taxpayer may deduct a debt which:

i. is due to the taxpayer;
ii. which has become bad during the year of assessment; and
iii. provided such amounts have been included in the taxpayer's income in the current or previous year of assessment.

The third requirement effectively means that the supply of goods or services which gave rise to the debt gave rise to "gross income".[121] An example of a bad debt which would not be able to be written off is where a company grants a loan to an employee who never repays it

[119] 1944 TPD 248 252.
[120] 1944 TPD 248 252.
[121] Haupt *Notes* 150.

and cannot be located to recover it. This loan would not have been included in the taxpayer company's "gross income" and cannot therefore be claimed as a deduction.[122]

> "SARS will only treat a debt as bad if the taxpayer can show that it has ceased active recovery collection or handed the debt over to an attorney or debt collector, and has written the debt off in its books."[123]

A case which must be considered when dealing with this section of the Act is *CIR v People's Stores (Walvis Bay) (Pty) Ltd;*[124] in this case Hefer JA held that the word "due" referred to in section 11(i) and (j) does not mean "due and payable". Rather, the legislature intended in these sections that the term "due" was intended to mean "owing" and no more.[125]

The taxpayer must be aware that if a debt is written off and handed to an attorney for collection, in the event that the attorney successfully recovers the debt, the amount which has been recovered must be included in the taxpayer's "gross income" in terms of section 8(4)(a) of the Act.

2.5.4 Section 11(j) Doubtful Debts

Section 11(j) of the Act reads as follows:

> "An allowance as may be made each year by the Commissioner in respect of so much of any debt due to the taxpayer as the Commissioner considers to be doubtful, if that debt would have been allowed as a deduction under any other provisions of this Part had that debt become bad: Provided that such allowance shall be included in the income of the taxpayer in the following year of assessment."

What this means is that debts will only fall for consideration under this section if they would have been allowed to be deducted under section 11(i) if they had become bad. As an example, an allowance in terms of this section cannot be claimed in the event that a taxpayer (who is not a money lender) lends money to a third party that becomes

[122] Haupt *Notes* 150.
[123] Haupt *Notes* 150.
[124] 1990 (2) SA 353 (A).
[125] 1990 (2) SA 353 (A) 366.

irrecoverable (because a deduction in terms of section 11(i) would not be allowed in such a circumstance).[126]

The taxpayer must provide SARS with a list of all doubtful debts for consideration. The Commissioner usually allows the taxpayer a deduction of 25 per cent of the list of doubtful debts, although a formula may be used by the Commissioner to determine a percentage allowance[127] (the workings of this formula will not be considered in this thesis).

2.6 The practical implications

Relating the law as set out above to a taxpayer who purchases a property with the view to letting it to produce income, the following can be concluded.

The principles which were established in *New State Areas* make it clear that the purchase of the property is a capital expenditure in that the property is an income-earning structure or a source of profit (the property will enable him to receive rental income). This expense will therefore be of a capital nature and not deductible.

The deductibility of other expenses which may have been incurred by the taxpayer must be considered. In this regard SARS, taking into account the principles that have been dealt with above, set out a list of expenditure that will comply with the requirements of the general deduction formula (together with the specific deductions which may be capital in nature but the legislature has made provision for these to be deducted) and therefore deductible (by a taxpayer carrying on the trade of renting out immovable property):[128]

1. rates and taxes;
2. bond interest;
3. advertisements;
4. agency fees of estate agents;
5. insurance (homeowners insurance only);
6. garden services;
7. repairs in respect of the area let; and
8. security and property levies.

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[126]Haupt *Notes* 151.
[127]Haupt *Notes* 151.
[128]South African Revenue Service *Rental Income.*

SARS has therefore ruled that the above-mentioned expenses (including repairs which are granted a specific deduction and interest that is dealt with in terms of section 24J) that may be incurred by a taxpayer who lets immovable property comply with the requirements of the preamble to section 11 and section 11(a) as follows:

1. The taxpayer is carrying on a trade as directly made provision for in the definition of “trade” in section 1 of The Act.

2. Income is derived from that trade in that the taxpayer will be receiving rent for the use of the property.

3. The taxpayer has actually incurred expenses; it is presumed that the taxpayer has incurred the various expenses during the year of assessment.

4. The expenditure has been incurred in the production of income; this may be the most onerous provision with regard to the letting out of property as each of the expenses will need to pass the two-fold test as laid out in *Port Elizabeth Electric Tramways*.

   Certain of the expenses listed by SARS are clearly in the production of income, for example, the payment of advertising expenses. Such a payment would be made with the purpose of earning income as the advertisement would have the goal of obtaining a tenant who would pay rent. With regard to the second stage of the test in *Port Elizabeth Electric Tramways*, the advertisement expense is incurred for the purpose of carrying on the trade of letting out the property, which may not have been possible without the advertisement; there is therefore a sufficiently close link between the expense and the business operation.

   The possibility of making deductions for expenses such as gardening services may not be so clear cut. While there is a strong argument for the fact that the hiring of garden services is done for the purpose of earning income (in the sense that not to do so may make it difficult to let the property), and not as an improvement to the property, this is not clear on the face of it. However, if one considers the decision in *Port Elizabeth Electric Tramways*, it can be argued that this expense is necessary for the performance of the business operation and closely connected with it.

5. The expenses are not of a capital nature. This must be based on the conclusion that the expenses are part of the income-earning operations of the trade of letting of property and/or that they are working a source of the profit in line with the principles laid down in *New State Areas* and *George Forest Timber*, respectively.

   It can be said with certainty that all these expenses listed by SARS (as set out above) are revenue in nature; none of them add to the income-producing structure and are all consumed in the process of operating the business (besides repairs). The taxpayer receives no enduring benefit from any of these expenses, nor do they add to his income-producing structures. It must, however, be kept in mind that there may be a fine distinction between improvements and repairs and the taxpayer must keep a careful record of all the work done on the property in order to distinguish between repairs and improvements carried out on the property.

Further to this, SARS has concluded that none of these expenses are prohibited by the provisions of section 23(g). The expenses listed by SARS as deductible are therefore all expenses which are laid out for the purpose of the trade of the letting of property.

An example of an expense which would be deemed to be of a capital nature is improvements made to a garage on the premises that are rented out. On the other hand, the cost of replacement of water-damaged carpets is an expense incurred in the production of income and therefore allowable as a deduction.[129]

The actual bond repayments are not deductible, as they relate to payment of a loan; and in terms of *New State Areas*, the fact that the payments on the bond are recurring costs is not enough to make them revenue in nature. The bond repayments are made to pay off the

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[129] South African Revenue Service *Practical example of how to deduct expenses* (2014) http://www.sars.gov.za/TaxTypes/PIT/Pages/Examples-for-tax-on-rental-income.aspx (accessed 16 September 2015).

loan incurred by the taxpayer to acquire a capital asset. The incurring of the loan is not in itself an expense.

It is therefore clear that a taxpayer who purchases immovable property with the aim of letting it to earn rental income will be entitled to deduct certain revenue expenses from his or her taxable income. SARS has provided a list of expenditure which may be deducted; this list may be used by taxpayers as a guide to determine which expenditure they may deduct. Taxpayers may, however, attempt to deduct other expenses which are not specifically listed by SARS. It is submitted that this is possible provided that the taxpayer uses the legal principles as set out above to argue their case to SARS (or before court).

2.7 Conclusion

As a starting point to investing in immovable property with the aim of receiving rental income, the taxpayer must be aware that the rental income which is received must be included in their “gross income”. The taxpayer must also include in their “gross income” the special inclusions, being leasehold improvements and lease premiums.

The general deduction formula, as set out in the preamble to section 11 and section 11(a), read with section 23(g), is an integral aspect of the tax benefits that are available to a taxpayer purchasing immovable property with the aim of letting.

To ensure compliance with the general deduction formula, the taxpayer must show that:

1. they were carrying on the trade;
2. that the income received must have been derived from that trade;
3. there were expenditure and losses;
4. which were actually incurred;
5. in the production of income; and
6. not of a capital nature.

Further to this, expenses will only be deductible to the extent to which they were incurred for the purposes of trade. If applied correctly, the taxpayer can use the general deduction formula to ensure that a large part of the expenses which are incurred in carrying on the trade of letting immovable property can be deducted from income to ensure a reduced taxable income and tax liability.

In addition to the general deduction formula, there are also specific deductions which the taxpayer may make use of. These include the deduction of legal expenses (incurred under very specific circumstances which were set out in detail above), repairs to the property and bad and doubtful debts. The taxpayer must understand the difference between capital and revenue expenditure when dealing with improvements and repairs to a property so as to ensure that only repairs on the tenanted property are deducted. The taxpayer must always keep the deductible expenses as listed by SARS in mind and ensure that a proper record is maintained of all expenses of this nature.

If a taxpayer purchases a property with the intention of letting it out occasionally, such as a property which will be used by the taxpayer as a holiday home for parts of the year, then the taxpayer must be aware that he or she may only deduct expenses to the extent to which they are incurred for the purposes of trade. This will probably involve an enquiry as to the length of time which they taxpayer rents out the property in order to apportion the expenses.

The taxpayer must also ensure that if the tenant pays a deposit, that this deposit must be kept in trust to ensure that it is not included in “gross income”.

While capital gains tax is not dealt with in detail in this thesis, a taxpayer must be aware that any improvements which are made to the property (which are capital in nature), can be added to the base cost of the property so as to reduce the possible capital gains tax in the event that the property is sold; this is presuming that the income from the sale is deemed to be capital in nature.

In the case of uncertainty, the interpretation principles which our courts are bound to apply will be used by the courts. This entails giving meaning to the words in the document while having regard to the context of the particular section in question by considering the document as a whole and the circumstances attendant upon its coming into existence.

This chapter has explained the many aspects of the Act which taxpayers need be aware of when deducting expenditure from their income in arriving at taxable income.

The following chapter deals with specific deductions which are only available to investors in immovable property. These deductions are in addition to the deductions discussed in this chapter (which are not restricted to property investors) and will serve to provide a comprehensive body of knowledge of the tax benefits which are available to taxpayers wishing to invest in immovable property.

CHAPTER 3 – Specific Deductions for Property Investors

3.1 Introduction

This chapter deals with specific provisions of the Act which have been promulgated in recent years and which are specifically aimed at encouraging taxpayers to invest in immovable property. Unlike Chapter 2, which discussed deductions available to all taxpayers carrying on a trade, this chapter will only discuss tax benefits that are available to investors in immovable property. These provisions are a very important aspect of the tax benefits which are available to property investors.

The main change came about in 2008 when the legislature introduced enabling provisions in the Revenue Laws Amendment Act as the world-wide recession had become a serious impediment to economic growth and investment. A resultant world-wide decrease in the price of property became clear. The legislature had the intention of assisting taxpayers wishing to invest in property by implementing provisions which would encourage developers to build low-cost residential housing units for rental purposes and which could then also be purchased by individual taxpayers for rental purposes.[130]

Section 13*sex* was introduced and will be dealt with in detail in this chapter. Section 13*ter,* which was replaced by section 13*sex,* will also be considered in order to provide an understanding of the change. While there has, up to this point, been no case law dealing specifically with this section of the Act, the interpretation principles (as set out in Chapter 2) will be used in order to analyse the meaning of this section.

Section 13*quat* is the other new section which will be dealt with in detail. This section was introduced in 2003 by the Revenue Laws Amendment Act[131] when the legislature decided that it wanted to encourage property investors, and particularly developers, to erect both residential and commercial buildings in certain designated urban areas in an attempt to rejuvenate the city centres of major South African centres. This section provides considerable incentives for developers to invest in designated urban areas.

Section 13*quin,* which is very similar to section 13*sex,* except that it deals with deductions available for commercial properties, will also be discussed, but in less detail as this thesis

[130] South African Revenue Service *Revenue Laws Amendment Bill.*
[131] No. 45 of 2003.

aims to concentrate mainly on the individual taxpayer who wishes to invest in immovable property and not the professional property investor who is more likely to invest in commercial properties due to their specialised nature and higher selling prices.

3.2 Section 13*sex*

Section 13*sex* of the Act reads as follows:

> "(1) Subject to section 36, there must be allowed to be deducted from the income of a taxpayer an allowance equal to five per cent of the cost to the taxpayer of any new and unused residential unit (or of any new and unused improvement to a residential unit) owned by the taxpayer if-
>
> (a) that unit or improvement is used by the taxpayer solely for the purposes of a trade carried on by the taxpayer;
>
> (b) that unit is situated within the Republic; and
>
> (c) the taxpayer owns at least five residential units within the Republic, which are used by the taxpayer for the purposes of a trade carried on by the taxpayer:
>
> Provided that if a taxpayer completes an improvement as contemplated in section 12N, the expenditure incurred by the taxpayer to complete the improvement shall be deemed to be the cost to the taxpayer of any new and unused residential unit (or of any new and unused improvement to a residential unit), for the purposes of this section."

This section came into effect on the 21st of October 2008[132] and will apply to any building which is acquired after this date or the erection of which commenced on or after this date.[133]

It should be noted in passing that section 36 of the Act (which is referred to in section 13*sex*) provides a deduction for the cost of employee housing for a taxpayer carrying on mining operations. This does not form part of the present research and will not be dealt with in this thesis. Section 12N of the Act, also referred to in section 13*sex*, deals with taxpayers that

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[132] Revenue Laws Amendment Act No. 60 of 2008.

[133] De Koker *et al SILKE* 8.27A.

make improvements to a property not owned by the taxpayer. This too will not be dealt with in this thesis as taxpayers who do not own the property which they are letting do not form part of the scope of this thesis.

What is evident from the plain reading of section 13*sex* is that the allowance will only apply to new and unused residential units which are used solely in carrying on a trade within the Republic of South Africa and provided the taxpayer owns at least five of these units. As will be discussed below, section 13*quat* defines what is meant by the term "cost" with regard to that section. Section 13*sex* does not, however, define this term. SARS has, however, stated the following:

> "A taxpayer may deduct an allowance of 5% of the cost of the erection, improvement or acquisition of any new and unused residential unit (or any new and unused improvement to a residential unit)."[134]

SARS has therefore provided some clarity on the section by stating that the allowance will apply to the cost of the erection, improvement or acquisition of the residential unit. This is aligned with section 13*sex*(3) which states that the direct cost of the acquisition or erection of the unit, or the improvement thereof is the cost to the taxpayer of a residential unit. This is also in line with the definition of the term "cost" in section 13*quat* (as dealt with below). It is therefore clear that the provision is not only aimed at taxpayers who build units, but also at taxpayers who purchase the units from developers.

As the definition of a "residential unit" in section 1 of the Act refers to a "building or self-contained apartment", it is clear that the cost excludes the cost of the land.

In order to provide more clarity as to the meaning of this section, and in particular what is meant by the term "new", SARS[135] referred to *ITC 672*[136] where it was held that the word "new" meant:

[134] South African Revenue Service *Building Allowances.*
[135] South African Revenue Service *Building Allowances*.
[136](1948) 16 SATC 227 (U).

> "The word '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."[137]

However, what is not entirely clear is what is meant by the term "improvement" in this context. The section states that the allowance applies to the cost of a new or unused "improvement" on a residential unit. Taking into account the interpretation principles as set out in Chapter 2, the language used in the document, the context of the language with regard to the document as a whole, as well as the circumstances attendant upon the document coming into existence, the following can be stated: The legislature has promulgated this section with the aim of encouraging taxpayers to invest in property and, from the plain reading of the section, the legislature probably envisaged a situation where the taxpayer either erects a building or purchases a property from a developer and decides to make improvements to that property. The taxpayer will then be able to deduct the cost of those improvements as well as the cost of the actual unit.

Alternatively, the section may also provide for a situation in which the taxpayer owns five properties in South Africa (which are not necessarily new) which are rented out and on which improvements are made in order to enhance the taxpayer's trade of letting. These improvements would enable the taxpayer to utilise the section 13*sex* allowance. With regard to either of these interpretations, it is clear that if the taxpayer is to qualify for the allowance in terms of improvements made to a property, the taxpayer must own at least five units that are used for trade purposes.

As the taxpayer must be carrying on a trade, a detailed analysis of this section must, therefore, begin by considering the definition of "trade".

Section 1(1) of the Act defines "trade" as follows:

[137] (1948) 16 SATC 227 (U) 227.

> "'trade' 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 as defined in the Patents Act or any design as defined in the Designs Act or any trade mark as defined in the Trade Marks Act or any copyright as defined in the Copyright Act or any other property which is of a similar nature."

It is therefore clear that if a taxpayer were to purchase a property with the intention of letting it to earn rental income, then this requirement of section 13*sex* will have been satisfied. Section 13*sex* also states that the unit must be used solely for the purposes of trade. A taxpayer cannot therefore live in a portion of the unit and rent out another portion to a tenant, nor can the taxpayer utilise the property for part of the year for personal use and let it out for the remainder of the year.

Section 13*sex* also deals with the term "residential unit". Section 1(1) of the Act contains a definition of this term:

> "'residential unit' means a building or self-contained apartment mainly used for residential accommodation, unless the building or apartment is used by a person in carrying on a trade as a hotel keeper."

The definition of a "residential unit" in section 1 of the Act refers to "a building or self-contained apartment **mainly** used for residential accommodation . . . (own emphasis). The tenant can therefore use the residential unit for purposes other than a residence, provided that part comprises less than fifty per cent of the total use. Thus, if a taxpayer purchases a property and lets it to a tenant and the tenant then uses a portion of the unit for business purposes, this will not affect the taxpayer's ability to claim the allowance. However, if the taxpayer uses the premises for business purposes, the allowance will not apply. It is not clear how the lessor will ascertain what use the tenant makes of the residential unit.

Section 13*sex* grants taxpayers who have complied with the requirements of the section a deduction in arriving at their taxable income equal to five per cent of the cost to the taxpayer of the units purchased. This means that the taxpayer can deduct five per cent of the total cost of the unit annually from their taxable income until the total cost is written off or the unit is sold.[138] Thus the taxpayer can write off the cost of the unit over a twenty year period.

Section 13*sex* allows the taxpayer to deduct five percent of the entire cost of the unit each year, which cannot be deducted in terms of the general deduction formula as it would amount to the deduction of a capital expense. The taxpayer will deduct the normal revenue expenses, such as interest on the mortgage bond and rates and taxes, in terms of the general deduction formula. These are not part of the cost of the erection, improvement or acquisition of the unit.

In terms of section 13*sex*(6), the deductions granted in terms of this section are not available to the taxpayer if the costs qualify for a deduction under another section of the Act. It is not therefore possible for a taxpayer to claim a deduction in terms of, for example, section 13*quat* as well, as section 13*sex.*

In order to determine the cost of the residential unit to the taxpayer, section 13*sex(3)* limits the cost on which the deduction is granted to the lesser of:

1. The actual cost of the residential unit to the taxpayer; or
2. Its arm's length price at time of acquisition.

The cost of the property must be determined as if the parties were independent of each other and were attempting to obtain the most beneficial result for themselves from the deal.[139] This prevents the situation where a taxpayer who is able to purchase a unit for less than its market value from being able to claim the allowance on market value.

[138]De Koker *et al SILKE* 8.27A.
[139] South African Revenue Service *Building Allowances*.

The section also provides an even greater incentive for "low-cost residential units". These are defined in section 1(1) of the Act as:

> "'Low-cost residential unit' means –
>
> (a) An apartment qualifying as a residential unit in a building located within the Republic, where –
>
> (i) The cost of the apartment does not exceed R350 000; and
>
> (ii) The owner of the apartment does not charge a monthly rental in respect of that apartment that exceeds one per cent of the cost; or
>
> (b) A building qualifying as a residential unit located within the Republic, where –
>
> (i) The cost of the building does not exceed R300 000; and
>
> (ii) The owner of the building does not charge a monthly rental in respect of that building that exceeds one per cent of the cost contemplated in subparagraph (i) plus a proportionate share of the cost of the land and the bulk infrastructure:
>
> Provided that for the purposes of (a)(ii) and (b)(ii), the cost is deemed to be increased by 10 per cent in each year succeeding the year in which the apartment or building is first brought into use."

If the taxpayer purchases five or more new residential units which cost less than these amounts, an additional annual allowance of five per cent will become available (in addition to the five percent allowed on "residential units" that do not fall within the category of "low cost residential units"). This means that the taxpayer will be allowed to deduct ten per cent of the cost of the units per year in arriving at taxable income.

Subsection (8) of section 13*sex* deals with the part-acquisition of a building, where the taxpayer has not erected or constructed the unit. The cost of acquisition in such a case is deemed to be 55 per cent of the acquisition price. In practice this means that only 55 per cent of the cost of purchasing a unit that forms part of a building will qualify for the deduction. This section would be applicable to a residential unit which only forms part of a building, for example, a flat forming part of a block of flats. SARS explains that:

> "The intention in limiting the qualifying cost is to prevent the allowance being allowed on the cost of the land on which the building is situated and which would form part of the cost of the flat."[140]

This section will therefore not apply to developers who erect apartment buildings, as they will be entitled to deduct the full cost of the property, provided they comply with the requirements of section 11(a), as the building will constitute trading stock in the hands of the developer.

A practical example of a deduction in terms of section 13*sex* is as follows:[141] A taxpayer purchases five residential apartments in an apartment block directly from a developer for R500 000.00 each (in South Africa). These apartments are then let to the public; these units qualify as "residential units" and as such the section 13*sex* allowance may be claimed.

The value of these five units is R2 500 000.00, but since they are apartments, in an apartment block, only 55 per cent of their acquisition price will qualify for the deduction (in terms of section 13*sex*(8)(a)). The following calculation determines the allowance which the taxpayer may claim.

R2 500 000.00 (value of the five apartments) x 55 per cent = R1 375 000.00.

R1 375 000.00 x 5 per cent (13*sex* allowance) = R68 750.00

The taxpayer will be able to deduct R68 750.00 annually from his or her income.

If the taxpayer lets the properties at 1 per cent of their value (although this is not a requirement as the properties are not low-cost residential units), being a monthly rental of R5 000.00 each, the taxpayer will receive R300 000.00 in yearly rental income from the five units. The taxpayer will be able to deduct R68 750.00 from taxable earnings of R300 000.00 to reduce the taxable income; the taxpayer will therefore be liable for tax on R231 250.00 in

[140] South African Revenue Service *Building Allowances*.
[141] South African Revenue Service *Building Allowances*.

respect of income from the property (not taking into account any other deductions that the taxpayer may claim in terms of section 11).

An example where the taxpayer purchases a property comprising five residential units (the facts remain the same as in the previous example):

R2 500 000.00 x 5 per cent = R125 000.00

The taxpayer will be able to deduct R125 000.00 per year from income in order to reduce the taxable income and therefore the tax liability. If the properties are let for R300 000.00 per year, the taxpayer will only be liable for taxation on rental income amounting to R175 000.00 (not taking into account any other deductions that the taxpayer may claim in terms of section 11).

The situation must be considered where the taxpayer purchases five low-cost, free-standing residential units (premised on the same facts as above, except the properties cost R300 000.00 each).

R300 000.00 x 5 = R1 500 000.00.

R1 500 000.00 x 10 per cent = R150 000.00.

The taxpayer will be obliged (in order to qualify for the section 13*sex* allowance) to charge a maximum of 1 per cent of the cost of the unit plus a proportionate share of the cost of the land and the bulk infrastructure as a monthly rental. Assuming that the monthly rental income from these units will be R3 000.00 per unit, this will result in a combined yearly rental income of R180 000.00. Assuming that no other deductions apply, the taxpayer will therefore only be liable for taxation on R30 000.00 of the yearly rental income (being the R180 000.00 rental income minus the R150 000.00 allowance in terms of section 13*sex*).

The final scenario which must be considered is a taxpayer purchasing five low-cost residential apartment units in an apartment complex from a developer (the same values as above will be used).

R1 500 000.00 x 55 per cent = R825 000.00

R825 000.00 x 10 per cent = R82 500.00

In such a scenario the taxpayer will be able to deduct R82 500.00 from income. Again assuming that no other deductions apply, the taxpayer will therefore be liable for taxation on R97 500.00 of the rental income (which may not exceed 1 per cent of the cost of each unit).

The legislature has deemed the construction and provision of low cost housing to be an area which needs support from the private sector and individual taxpayers and has provided this support to investors in order to encourage them to build or purchase residential property so as to provide more residential units on the rental market (and at a reasonable price).[142] It appears that the legislature considers the provision for rental of low cost housing as more important than middle and upper income residential housing, and therefore has made provision for an extra 5 per cent allowance for properties which fall within the definition of a "low-cost residential unit." It may be argued that the maximum cost of a new free-standing residence of R300 000.00 is too low as it will be difficult for developers to develop and investors to purchase new properties at this price. The amount of R300 000.00 came into effect from 1 April 2013[143] and it would be appropriate for the government to increase this amount if they wish to encourage developers to build low cost housing units and investors to invest in them.

[142] South African Revenue Service *Revenue Laws Amendment Bill.*
[143] De Koker *et al SILKE* 8.27C

3.3 Section 13*ter*

In order to gain a full understanding of what section 13*sex* aims to achieve, the provisions of section 13*ter* need to be considered (the section which was replaced by section 13*sex*). Section 13*ter* provided the taxpayer with an annual residential building allowance as well as an initial building allowance (this section only applied to units erected on or after 1 April 1982 and before 21 October 2008).[144] The initial residential building allowance enabled the taxpayer to deduct 10 per cent of the cost of the building or the residential units in the year in which the unit is first let. Taxpayers were only eligible for this deduction if they erected a building consisting of at least five residential units or five free-standing residential units, all of which had to be let for the allowance to apply. In addition to the initial building allowance was an annual allowance providing for an annual deduction of 2 per cent of the cost of the residential unit. This would enable the cost of the property to be written off over a period of 45 years, as compared to 20 years in terms of section 13*sex*. In addition, no additional deduction was available for low cost residential housing.

It is clear therefore that the new provisions which have been enacted are far more beneficial to the developer and purchaser. This suggests that the government took a decision to enhance the benefits which were available so as to actively encourage private companies and investors to provide reasonably priced housing to that sector of the population who cannot afford to buy their own homes.

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[144] South African Revenue Service *Building Allowances*.

3.4 Section 13*quat*

Section 13*quat* was promulgated by the legislature in 2003 with the aim of regenerating certain urban areas within the inner cities of South Africa. This section allows taxpayers to deduct the capital cost of the building where the building they constructed or purchased (either commercial or residential) is within certain designated Urban Development Zones (UDZ). This deduction is available until 31 March 2020.[145]

The section provides for a number of requirements which need to be met before a taxpayer may claim this allowance. Firstly the building requirements have been set out in section 13*quat*(2) as follows:

A person must have–

i. Erected an entirely new commercial or residential building;
ii. Extended, added to or improved an existing commercial or residential building or part of such building representing a floor area of at least 1000m²; or
iii. Purchased a building or part of a building directly from the developer that –
    a) has erected, extended, added to or improved either an entire building or a part of a building representing a floor area of at least 1000m²;
    b) has not previously claimed any Urban Development Zone (UDZ) deduction on the building or part of a building; and
    c) in the case of the improvement to a building or part of a building, has incurred expenditure on these improvements which is equal to at least 20% of the purchase price paid by the purchaser for the building or part of the building.

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[145] South African Revenue Service *Guide to the Urban Development Zone (UDZ) Tax Incentive Issue 4* (2014) www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-IT-G12%20-%20Guide%20to%20the%20Urban%20Development%20Zone%20Tax%20Incentive%20-%20External%20Guide.pdf (accessed 22 October).

It must be noted that the 1000m² requirement is only applicable where part of a building is purchased or erected, extended, added to or improved.[146]

> "For example, any improvements made to an existing building, such as the addition of an additional floor, must represent an area of at least 1 000 m² before the taxpayer will be entitled to the UDZ incentive on the cost of effecting the improvements. However, the 1 000m² requirement does not have to be complied with if an entire building is purchased or erected, whether stand-alone or as a sectional title unit."[147]

In terms of sub-sections 13*quat*(2), (3) and (3A) the property must be erected or purchased within a UDZ and be used by the taxpayer solely for the purposes of trade. As has been discussed earlier in this chapter, the term "trade" as defined in section 1 of the Act includes the letting of property. A taxpayer who erects or purchases a property within a UDZ area and lets the property will be able to claim this allowance (provided that the other requirements have been met). This thesis only deals with this incentive in terms of taxpayers who erect or purchase property with the aim of letting it and not with taxpayers who erect or purchase property to use to run their businesses.

Unlike section 13*sex,* section 13*quat* sets out exactly what is meant by the term "cost" so as to provide clarity as to exactly what may be deducted. Section 13*quat*(1) defines "cost" as:

> "the costs (other than borrowing or finance costs) actually incurred in erecting or extending, adding to or improving a building or part thereof and includes any costs incurred –
>
> (a) in demolishing any existing building or part thereof;
>
> (b) in excavating the land for the purposes of that erection, extension, addition or improvement; and
>
> (c) in respect of structures or works directly adjoining the building or part so erected, extended, added to or improved, for purposes of providing –

[146] South African Revenue Service *Urban Development.*
[147] South African Revenue Service *Urban Development.*

(i) water, power or parking with respect to that building or part;

(ii) drainage or security for that building or part;

(iii) means of waste disposal for that building or part; or

(iv) access to that building or part, including the frontage thereof”...

However, the cost of the land itself is not included in the cost. In *ITC 1619*[148] it was held that the word “building” does not include the land upon which the building stands.

> “Importantly, section 13*quat* limits the UDZ incentive to the cost incurred by the taxpayer for the erection, extension, addition to or improvement of a UDZ building, which clearly does not incorporate the cost of the land.”[149]

It must be noted that *ITC 1619* and the legal principle established also applies to section 13*sex*. That section refers to the cost of the “residential unit” and the definition of a “residential unit” in section 1 of the Act refers to “a building or self-contained apartment”.

In terms of section 13*quat*(3B), a taxpayer who purchases a building or part of a building from a developer may claim the “purchase price” of that building.

> “‘purchase price’” in relation to any building or part of the building purchased by the taxpayer means the lesser of –
>
> (a) the actual cost to the taxpayer to purchase that building or part; or
>
> (b) the cost which a person would have incurred had that person purchased that building or part under a cash transaction concluded at arm’s length on the date on which that taxpayer purchased that building or part.”

The “arm’s length” concept was discussed earlier in the chapter.

[148] 59 SATC 309 314 and 315.

[149] South African Revenue Service *Urban Development*.

The UDZ incentive which may be claimed also applies to taxpayers who purchase the property from a developer. However, in terms of section 13*quat*(3B), in the event of a taxpayer purchasing the building from a developer, the following restrictions will apply –

(a) In the case of a new building being erected, extended or added to by the developer, only 55 per cent of the "purchase price" of that building; and
(b) In the case of a building improved by the developer, only 30 per cent of the "purchase price" of that building,

will be deemed to be the cost incurred by the taxpayer for the erection, extension, addition to or improvement of the building or part of that building.

In terms of section 13*quat*(3)(a), when a taxpayer erects, extends or adds to a building, a 20 per cent deduction based on the cost of the erection, extension of or addition to the building in the year of assessment during which the building is brought into use by the taxpayer solely for the purposes of that taxpayer's trade becomes available. In addition to this initial allowance, the taxpayer is also granted a deduction equal to 8 per cent of the cost in each of the succeeding ten years of assessment. The cost would therefore be written off over eleven years.

An example of taxpayer purchasing a building in an UDZ from a developer is as follows:[150] The taxpayer purchases a sectional title unit in a security complex in an UDZ from a developer, which is immediately used for the purpose of his trade. The purchase price amounted to R1.2 million (which included both the cost of the building and the land). Fifty-five per cent of the purchase price is deemed to be the cost incurred by the taxpayer. The taxpayer will, therefore, assuming that the other requirements have been met, be able to claim a section 13*quat* UDZ deduction on 55 per cent of (R1.2 million, less the cost of the land). An apportionment will have to be made in order to determine the portion of the cost attributable to the building only. The method of apportionment must be fair and reasonable.

It is assumed for this example that a fair apportionment would value the land at R200 000.00. The taxpayer will be able to deduct a total amount of R550 000.00 (55 per cent

[150] South African Revenue Service *Urban Development.*

of R1 million) over 11 years from income. In the first year when the building is being used for the purposes of trade the taxpayer will be able to claim 20 per cent of the deemed cost, which will amount to R110 000.00 (R550 000.00 x 20 per cent). Thereafter, the taxpayer can claim, for the next ten years, 8 per cent per year of the deemed costs of the building; this will result in a yearly deduction of R44 000.00 (R550 000.00 x 8 per cent).

The next aspect of the UDZ incentive to be dealt with is improvements to an existing building or part of a building; this is dealt with in section 13*quat*(3)(b). This sub-section provides that the taxpayer will be granted a deduction equal to 20 per cent of the cost of the improvement to the building in the year of assessment during which the part of the building so improved is brought into use for the purposes of trade. This section also provides for a further 20 per cent deduction of the costs for the four succeeding years of assessment.

A practical example of such an incentive is as follows:[151] The owner of a building located within a designated UDZ zone installed an escalator in the building. It is presumed that the escalator covers a floor area of at least 1 000m² (so as to comply with section 13*quat*(2)(c)). The cost of the installation amounted to R200 000.00. The owner of the building will be able to claim the cost over a five year period (as the deduction amounts to 20 per cent per year over five years). The taxpayer will be able to claim a deduction of R40 000.00 per year over the next five years from income.

Section 13*quat* provides even greater incentives for the erection, purchase and improvement of "low-cost residential units", as defined earlier in this chapter. Section 13*quat*(3A)(a) provides for the following incentives for the erection of a new building or the extension of or addition to any building which qualifies as a "low-cost residential unit":

i. An amount equal to 25 per cent of the cost of the erection or extension of or addition to the unit in the year of assessment during which the unit is brought into use by the taxpayer;
ii. An amount equal to 13 per cent of the cost in each of the five years succeeding the first year of assessment; and
iii. An amount equal to 10 per cent of the cost in the seventh year of assessment.

[151] South African Revenue Service *Urban Development.*

In terms of section 13*quat*(3A)(b), in the case of an improvement to a "low-cost residential unit", the incentive provided for is:

i. An amount equal to 25 per cent of the cost of the improvement made in the year of assessment during which the part of the unit so improved is brought into use by the taxpayer;
ii. An amount equal to 25 per cent of the cost in each of the three succeeding years of assessment.

The legislature has provided the taxpayer with incentives to develop or purchase property within certain designated urban areas (either with the aim of renting them out or for their own business use). Even greater incentives to erect and improve "low-cost residential units" within a designated UDZ have also been provided. This reflects the intention of the legislature to encourage urban renewal.

3.5 Section 13*quin*

A further provision in the Act in relation to fixed property is section 13*quin.* This section was effective as of 1 April 2007[152] (it was therefore implemented separately from section 13*sex*).

This section reads as follows:

> "(1) There shall be allowed to be deducted from the income of the taxpayer an allowance equal to five per cent of the cost to the taxpayer of any new and unused building owned by the taxpayer, or any new and unused improvement to any building owned by the taxpayer, if that building or improvement is wholly or mainly used by the taxpayer during the year of assessment for purposes of producing income in the course of the taxpayer's trade, other than the provision of residential accommodation."

The taxpayer does not have to erect the building. It can be purchased from a developer; all that is required is that the building is new and unused. The construction or erection of the

[152] South African Revenue Service *Building Allowances*.

building must, however, have started after the 1st of April 2007 for this section to apply. Buildings which were used by the taxpayer prior to this date do not qualify for the allowance. In addition, a building purchased from a seller who used the building before the sale thereof also does not qualify for the allowance.[153]

If these requirements are met, the taxpayer is granted a five per cent allowance per year on the cost of the building; thus the building and improvements are written off over a period of twenty years.[154] In terms of section 13*quin* the allowance is only available to taxpayers if the costs do not qualify for a deduction in terms of another section of the Act. This section also has a provision relating to the acquisition of part of a building (such as a sectional title unit in a building);[155] in such a case 55 per cent of the acquisition price is deemed to be the cost of acquiring the building, or 30 per cent of the cost of acquisition in the case of an improvement being made. This is the same requirement as provided for in section 13*sex*.

This allowance would be calculated in the same way as the allowances in terms of section 13*sex* as the principles are the same. It is clear that the provisions of section 13*sex* are similar to section 13*quin*, with the difference being the type of properties to which the two sections relate. Section 13*quin* refers to a "building", therefore the cost of the land on which the commercial building stands, will therefore not qualify for the deduction.

From the plain reading of this section, it is clear that a taxpayer does not necessarily have to be in the business of letting commercial property in order to qualify. Taxpayers may also use the premises to run their businesses; the section provides for an allowance for taxpayers who carry on their trade from the building. As has been indicated earlier in the chapter, a person's "trade" includes any business, employment or occupation. As such, this section is more widely couched than section 13*sex* (where the allowance will not apply if the taxpayer uses the premises for a purpose other than letting for residential accommodation). However, in order for a taxpayer to qualify for this allowance the property may not be let for residential purposes.

[153] South African Revenue Service *Building Allowances*.
[154] South African Revenue Service *Building Allowances*.
[155] South African Revenue Service *Building Allowances*.

While this thesis does not attempt to deal with taxpayers whose business is other than the letting of immovable property, it is clear that this section applies to taxpayers running a variety of businesses. Taxpayers who are in the business of purchasing immovable property to rent out to other businesses (the letting of commercial property) will be able to utilise this allowance to reduce their income in the same way as taxpayers who let residential property. It is therefore an important tax benefit that is available to taxpayers who invest in property with the aim of letting.

3.6 Other building allowances

The Act also contains provisions dealing with allowances available for:

1. buildings used by hotel keepers (section 13*bis*);
2. employee housing (section 13*sept*);
3. buildings used in the process of manufacture, research and development (section 13).

These allowances fall outside the scope of this thesis as they do not relate to tax benefits available to taxpayers in the business of purchasing immovable property with the intention of letting; they will not be dealt with in this thesis.

3.7 The Property Market

The aim of this thesis is to establish the tax benefits that are available to taxpayers wishing to invest in immovable property. It does not, therefore, attempt to provide general investment advice. It must, however, be noted that the property market is not one in which growth is guaranteed. When the recession took effect in 2008, global property prices declined significantly. In Ireland, housing prices plummeted by 50 per cent when the property market slumped in 2008. The average asking price for a house in Ireland was

380 000.00 Euros at the peak of the market, whereas in 2014 it was 187 000.00 Euros.[156] In South Africa there has been a steady increase in the price of property since the 2008 recession ended. However, the increase in the price of the residential property market in real terms is minimal when inflation is taken into account.[157] There is a common misconception that property prices can only go up in value, or at least not decrease. This is, however, incorrect in the short term as there have been many years in South Africa where the prices of properties have declined (when inflation is taken into account).[158]

It is submitted that the legislature, when promulgating section 13*sex* (and possibly section 13*quin*), were aware of the likelihood of there being a significant decline in property prices. The aim of the legislature was, therefore, to encourage investors, who may otherwise have invested in assets other than property, to develop and purchase both residential and commercial property so as to reduce the negative effect which they envisaged the recession would have on property prices and, as a result, on the returns of investors in these properties.

3.8 Conclusion

This chapter discussed the various tax incentives available to investors in fixed property. The types of property for which these incentives have been made available are residential as well as commercial property and property in urban development zones.

It is submitted that the provisions of section 13*sex* are a direct attempt by the government to encourage both developers and investors to build and let residential accommodation so as to ensure an affordable rental property market for people unable to buy their own home. This is particularly clear when considering the deductions previously granted in terms of section 13*ter*, which was replaced by section 13*sex*. Taxpayers interested in developing residential properties, or purchasing them from developers with the goal of letting will be

[156] Fin24 *Irish Property Market Raises Bubble Fears* (2014)http://www.fin24.com/Economy/Irish-property-market-raises-bubble-fears-20140928 (accessed 27 October 2015).
[157] Fin24 *Little Evidence of House Price Bubble* (2014) http://www.fin24.com/Money/Property/Little-evidence-of-house-price-bubble-20141120 (accessed 27 October 2015).
[158] Fin24 *SA at Risk of Underestimating Property Value Decline* (2015) http://www.fin24.com/Economy/SA-at-risk-of-underestimating-property-value-decline-20151026 (accessed 27 October 2015).

able to utilise this section to their advantage. This is particularly so as the allowance enables the taxpayer to deduct the actual cost of the building, which is a capital expense as it adds to the income-producing structure of the taxpayer (as was discussed in Chapter 2). What the legislature has effectively done, therefore, is allow the taxpayer to deduct a capital expense (which would not normally be allowed in terms of the section 11(a)).

The taxpayer could, furthermore, utilise the allowance in relation to "low-cost residential units" so as to maximize the returns from investing in immovable property. The obvious restriction of section 13*sex* is the provision that the taxpayer must own at least five residential units. This will restrict the allowance to taxpayers who are already wealthy or at least have access to the necessary funds. Taxpayers could even consider basing their entire property investment strategy on the concession provided for by section 13*sex*.

The government's objective to rejuvenate certain urban areas is evident from the provisions of section 13*quat.* This regeneration process would not be possible without the private sector and, as a result, this section was introduced. When calculating the deductions that will be granted, the taxpayer must keep in mind that only the cost of the building (and not the land) will qualify for the allowance, which is based on the cost of the building. This section provides for greater incentives for developers of properties, which indicates the government's intention of encouraging taxpayers to build or improve properties in the interest of urban renewal.

The incentives provided for in section 13*quat* are substantial, but it is submitted that this section is directed more at companies that invest in property as a requirement of the section is that the taxpayer either constructs a property or purchases an entire building. This requirement will make the benefits provided by this section beyond the reach of the average individual taxpayer who wishes to begin investing in immovable property.

The provisions of section 13*quin* are clearly a means by which government wishes to encourage taxpayers to develop commercial property and to encourage taxpayers, not in the business of letting immovable property, to purchase their own properties from which to operate. The provisions of this section grant commercial property investors substantial benefits.

These three sections are therefore a crucial aspect of the benefits that are available to taxpayers who wish to invest in immovable property. Taxpayers may even structure their property investment strategy around these sections so as to ensure that the greatest tax benefits possible are achieved. The Act does not provide many opportunities for taxpayers to deduct capital expenses; these sections are therefore very beneficial to a taxpayer wishing to invest in immovable property.

The effect of the recession on property prices has also been referred to and the possibility that the government promulgated the legislation providing incentives for investment in property in an attempt to decrease the effect that a decline in property prices would have on taxpayers developing and purchasing property.

The next chapter will discuss the different vehicles which a taxpayer may use in order to gain the most out of their property investments. The provisions which have been discussed in this chapter will apply equally irrespective of the vehicle the taxpayer decides to use, as the legislature has not attempted to dictate the appropriate vehicle to be used.

CHAPTER 4 – Investment Vehicles

4.1 Introduction

This chapter will provide an analysis of four common investment vehicles which taxpayers may utilise when investing in fixed property. The vehicles are as follows:

1. taxpayers investing in their individual capacity (or as partners in a partnership);
2. taxpayers investing through a company; and
3. taxpayers investing through a trust.

Each vehicle has different legal implications and different taxation rates on rental income. These will be discussed in relation to all four types of vehicles.

When taxpayers invest in their individual capacity or as a partnership, the ring-fencing of assessed losses in terms of section 20A of the Act becomes a potential issue. This will, therefore, be discussed as its application can be avoided to a certain extent. The legal nature of a company will not be discussed in detail in this thesis, except for the various tax rates that are applicable to different types of companies (mainly dependent on their turnover), as well as the risks that taxpayers can reduce by operating through a company. This chapter will first discuss the general operation of trusts before their potential as an investment vehicle is analysed. A Real Estate Investment Trust provides a form of indirect investment in property and a brief analysis of Real Estate Investment Trusts will also be provided.

The advantages and disadvantages of each of the vehicles will be discussed and a suggestion will be made as to which vehicle is most beneficial for the average taxpayer.

4.2 Taxpayers Investing in their Individual Capacity or as Partners in a Partnership

When an individual or partnership decides to purchase a property with the aim of letting the tax implications that result are as follows: the net taxable rental income that the taxpayer or partner in a partnership earns will be added to any other taxable income that has been received and the taxpayer will be taxed according to the tax rates applying to an individual.[159] This principle has been dealt with in depth in Chapter 2, but as rental income is not a capital receipt, it is included in taxpayers' "gross income". The receipt of rental income will have to be declared to SARS and the individual will be taxed thereon at the marginal rate of tax. Other amounts paid to the taxpayer by the tenant, such as a lease premium, must also be included in the taxpayer's taxable income. This was also discussed in Chapter 2.

Rental income received from the following types of residential accommodation will be included in a taxpayer's income:[160]

1. holiday homes;
2. bed and breakfast establishments;
3. guesthouses;
4. sub-letting of part of your premises (e.g. a garden flat);
5. dwelling houses; and
6. other similar residential dwellings.

Net taxable rental income from the letting of commercial property will be included in the same way.

If a taxpayer pays tax at the maximum marginal rate of 41 per cent on other taxable income and purchases a property for which rental income is received, the additional income received by the taxpayer will also be taxed at the marginal rate of 41 per cent. For the 2016 tax year the maximum marginal rate will apply to taxpayers earning R701 301.00 and above.[161] In terms of the implications of the taxation of rental income, the letting of fixed property as an individual is fairly straight forward. The deductions that are available to an individual taxpayer investing in immovable property have been set out in Chapter 2 and Chapter 3. A taxpayer contemplating purchasing property with the aim of letting it should calculate the potential tax liability on the additional rental income; this will depend on the other taxable income the taxpayer earns and the rate of tax on this income and whether any additional income would increase the rate of marginal tax.

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[159] South African Revenue Service *Rental Income.*
[160] South African Revenue Service *Rental Income.*
[161] Rates and Monetary Amounts and Amendment of Revenue Laws Bill B-15B of 2015 Schedule 1.

4.2.1 Partnerships

A partnership is a legal relationship between two or more persons that is established and governed by a contract that allows the parties to carry on a lawful enterprise together.[162] The rights and duties of the partners are governed by the partnership agreement and the profits are divisible in proportion to the partners' contributions. There are certain features which must be present if the courts are to find that a partnership agreement has been entered into. These are as follows:[163]

(a) that each of the partners brings something of commercial value to the partnership, whether it is money, labour or skill;
(b) that the partners carry on business in common; and
(c) that their object is to make and share a profit.

Partnerships are not separate legal entities distinct from the partners.[164]

Section 24H of the Act deals with the taxation of partnerships. It reads as follows:

> "(1) For the purposes of this section, 'limited partner' means any member of a partnership *encommandite*, an anonymous partnership, any similar partnership or a foreign partnership, if such member's liability towards a creditor of the partnership is limited to the amount which the member has contributed or undertaken to contribute to the partnership or is in any other way limited."

The tax principles relating to limited partners fall outside the scope of this thesis.

A partnership is not a "person" as defined section 1 of the Act and partners are taxed in their individual capacity on their share of partnership profits and losses. The tax principles relating to partners in a partnership are set out in section 24H as follows:

> "(2) Where any trade or business is carried on in partnership, each member of such partnership shall, notwithstanding the fact that he may be a limited partner, be deemed for the purposes of this Act to be carrying on such trade or business…

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[162] F Du Bois *et al Wille's Principles of South African Law* 9 ed (2007) 1005.
[163] Du Bois *Principles* 1006.
[164] Du Bois *Principles* 1009.

(5) *(a)* Where any income has in common been received by or accrued to the members of any partnership or foreign partnership, a portion (determined in accordance with any agreement between such members as to the ratio in which the profits or losses of the partnership are to be shared) of such income shall, notwithstanding anything to the contrary contained in any law or the relevant agreement of partnership, be deemed to have been received by or to have accrued to each such member individually on the date upon which such income was received by or accrued to them in common.

(b) Where a portion of any income is under the provisions of paragraph *(a)* deemed to have been received by or to have accrued to a taxpayer, a portion (determined as aforesaid) of any deduction or allowance which may be granted under the provisions of this Act in the determination of the taxable income derived from such income shall be granted in the determination of the taxpayer's taxable income so derived."

Each partner will therefore include his or her share of partnership income, less his or her share of deductible partnership expenses or allowances, in his or her total taxable income.

A case which has dealt with this section of the Act is *Chipkin (Natal) (Pty) ltd v Commissioner, South African Revenue Service*.[165]In this case the taxpayer entered into a partnership agreement in which he contributed capital for a 30 per cent interest. The taxpayer attempted to deduct expenditure incurred by the partnership. The court dealt with partnerships and the taxation of their income. The following was held by Cloete JA:

"Income that has accrued to partners in common is deemed to have accrued to each of the partners individually in their proportionate share by s 24H(5)(a)..."[166]

It was held further that where income has accrued to a partner in terms of section 24H(5)(a), the partner is also entitled to deduct a proportionate share of deductions and allowances that are granted in various section of the Act.[167] Cloete JA held:

[165]2005 (5) SA 566 (SCA).
[166]2005 (5) SA 566 (SCA) 570.

> "The Act does not recognise a partnership. It recognises only income (gross income after allowing for tax-exempt income) that accrues to partners in common (in accounting terms, the income of the partnership) which it attributes to them proportionally, and it similarly attributes to the individual partners deductions and allowances that are granted by the Act, with a resultant 'taxable income' of the partners individually. A partnership cannot have a taxable income, simply because it is not a taxable entity."[168]

Partnerships are merely two or more individuals working together in a business or trade. The tax implications which apply to individuals, thus apply equally to taxpayers carrying on the trade of letting property in a partnership. Partnerships give taxpayers the opportunity to join together to invest in property. This can be highly advantageous as it allows taxpayers to combine capital, skill and labour. Taxpayers with different things to contribute can work together for a common goal. For example, a taxpayer with capital may not have the skill or time necessary to invest in fixed property. This taxpayer could form a partnership with someone who has the necessary skill set and time to ensure that his or her capital is effectively used.

4.2.2 Assessed Losses

The section of the Act that relates only to natural persons carrying on a trade is section 20A, which deals with the ring-fencing of assessed losses. The implications of incurring an assessed loss can be far-reaching. In order to gain an understanding of section 20A, section 20(2), which deals with assessed losses, must first be considered. This section states:

> "For the purposes of this section 'assessed loss' means any amount by which the deductions admissible under section 11 exceeded the income in respect of which they are so admissible."

If a taxpayer lets immovable property and receives, for example, R30 000.00 rental for the year, but the allowable deductions (for this particular trade of letting property) amount to R35 000.00; the taxpayer will have an assessed loss of R5 000.00.

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[167] 2005 (5) SA 566 (SCA) 570.
[168] 2005 (5) SA 566 (SCA) 573.

Section 20(1) of the Act reads as follows:

> "For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall, subject to section 20A, be set off against the income so derived by such person—
>
> (a) any balance of assessed loss incurred by the taxpayer in any previous year which has been carried forward from the preceding year of assessment: Provided that no person whose estate has been voluntarily or compulsorily sequestrated shall be entitled to carry forward any assessed loss incurred prior to the date of sequestration, unless the order of sequestration has been set aside, in which case the amount to be so carried forward shall be reduced by an amount which was allowed to be set off against the income of the insolvent estate of such person from the carrying on of any trade; or
>
> (b) any assessed loss incurred by the taxpayer during the same year of assessment in carrying on any other trade either alone or in partnership with other, otherwise than as a member of a company the capital whereof is divided into shares:"

Before an assessed loss can be set off, section 20(1) of the Act requires that a taxpayer must be carrying on a trade and that income is derived from the carrying on that trade.

For each trade that a taxpayer carries on during the year of assessment, the taxable income or assessed loss will be calculated. The taxpayer will then add up all the taxable incomes and assessed losses from the various trades engaged in to arrive at a total taxable income or assessed loss for the year of assessment.[169]

> "In the absence of section 20, one would merely add all the taxpayer's incomes together to arrive at a gross income, and then deduct all the expenses from all the trades to arrive at taxable income. It is only section 20 which requires a taxpayer to calculate an assessed loss from 'another trade' which the taxpayer

[169] Haupt *Notes* 297.

> carries on in the same year. The assessed loss from the 'other trade' then reduces the taxable income from the profitable trade."[170]

4.2.3 Ring-Fencing of Assessed Losses

The ring-fencing of an assessed loss may be relevant. Section 20 applies to both natural and juristic persons but section 20A applies only to natural persons. This section will apply equally to taxpayers carrying on their trade in the form of a partnership, as a partnership is two or more persons working together; it is not a juristic person. Section 20A does not replace the purpose or function of the general deduction formula; expenditure giving rise to a loss from a trade could be disallowed entirely by section 11(a) read with section 23(g), in which case section 20A would not be a consideration.[171] Section 20A is applied after the requirements in terms of the general deduction formula and any further provisions for allowances on the property have been met. It also provides a structure for determining whether or not a loss from the letting of property should be set off against other income (thereby reducing taxable income).[172]

> "It is as if a fence was put around the trade and the income and expenses kept on the inside of that fence. No part of the expenses and losses can leak out and be set off against the income from another trade."[173]

According to section 20A(5) if an assessed loss is ring-fenced, it is not lost or disallowed completely; the assessed loss will be carried forward to the next year of assessment and is available for set-off against any income derived from that specific trade in that year.

Section 20A contains four steps that determine whether an assessed loss will be ring-fenced (a loss is not therefore automatically ring-fenced). These are as follows:

1. the maximum marginal rate of tax requirement;

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[170] Haupt *Notes* 297.
[171] South African Revenue Service *Ring-Fencing.*
[172] South African Revenue Service *Ring-Fencing*.
[173] Haupt *Notes* 304 and 305.

2. the three out of five years requirement or the listed suspect trade requirement;
3. the facts and circumstances test; and
4. the six out of ten years requirement.

Step 1 – The maximum marginal rate of tax

Section 20A(2) applies to individuals whose taxable income for the year (before setting off any current or previous year's assessed losses from any trade) is equal to or greater than the amount at which the maximum marginal rate of tax will apply. If the taxpayer's taxable income is below the level at which the maximum marginal rate of tax applies then the assessed loss will not be ring-fenced. This is a pre-requisite for a potential ring-fencing of an assessed loss.[174] If a taxpayer carries on the trade of letting immovable property, and this trade gives rise to an assessed loss, the taxpayer would be able to set off the loss incurred against other taxable income (in order to reduce the tax liability) if the taxpayer's other taxable income is below the rate at which the maximum marginal rate of tax applies. If, however, the taxpayer's income is above the rate at which the maximum marginal rate of taxation applies, the assessed loss will potentially be ring-fenced. The next step will then need to be considered.

Step 2 – The three-out-of-five-years or listed suspect trade requirement

In terms of section 20A(2)(a) and (b) there are two situations where an assessed loss will be subject to potential ring-fencing:

(a) If, in at least three of the last five years, the taxpayer has incurred an assessed loss in the relevant trade (before utilising the balance of any assessed loss brought forward) then the loss will be subject to potential ring-fencing; or

(b) An assessed loss is incurred in any of the following suspect trades:

(i) any sport practised by the person;

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[174]Haupt *Notes* 305.

(ii) any dealing in collectibles;

(iii) the rental of residential accommodation (unless at least 80 per cent is used by persons who are not relatives of the person for at least half of the year of assessment);

(iv) the rental of vehicles, aircraft or boats;

(v) animal showing;

(vi) farming or animal breeding;

(vii) any performing or creative arts; or

(viii) any form of betting or gambling.

Due to the disjuncture "or" used in between subsection (a) and (b) it can be determined that the "three-out-of-five-years" pre-requisite applies to trades which are not listed as suspect trades. It must be noted further that an assessed loss that arises from any one of these suspect trades will be subject to automatic ring-fencing.[175]

For taxpayers carrying on the trade of letting immovable property, the applicability of this section will depend on the circumstances of each case; no blanket conclusion can be made. If taxpayers want to avoid an assessed loss being ring-fenced, they should ensure that the premises are leased for at least 80 per cent of the time to persons who are not relatives for at least half the year of assessment. The three-out-of-five year requirement is not something which a taxpayer will necessarily be able to guard against; each taxpayer's situation will need to be considered to determine whether this provision will apply.

Step 3 – Facts and circumstances test (the escape clause)

In terms of section 20A(3), the provisions of section 20A do not apply if the trade carried on by the taxpayer constitutes a business in which there is a reasonable prospect of deriving taxable income within a reasonable period. Section 20A(3) states that certain factors must be taken into account in determining whether a trade constitutes a business in respect of

[175] South African Revenue Service *Ring-Fencing.*

which there is a "reasonable prospect" of deriving taxable income within a "reasonable period". These factors are as follows:

(a) the proportion of the gross income derived from that trade in that year of assessment in relation to the amount of the allowable deductions incurred in carrying on that trade during that year;

(b) the level of activities carried on by that person or the amount of expenses incurred by that person in respect of advertising, promoting or selling in carrying on that trade;

(c) whether that trade is carried on in a commercial manner, taking into account-

(ix) the number of full-time employees appointed for purposes of that trade (other than persons partly or wholly employed to provide services of a domestic or private nature);

(ii) the commercial setting of the premises where the trade is carried on;

(iii) the extent of the equipment used exclusively for purposes of carrying on that trade; and

(iv) the time that the person spends at the premises conducting that business;

(d) the number of years of assessment during which assessed losses were incurred in carrying on that trade in relation to the period from the date when that person commenced carrying on that trade and taking into account-

(i) any unexpected events giving rise to any of those assessed losses; and

(ii) the nature of the business involved;

(e) the business plans of that person and any changes thereto to ensure that taxable income is derived in future from carrying on that trade; and

(f) the extent to which any asset attributable to that trade is used, or is available for use, by that person or any relative of that person for recreational purposes or personal consumption."

The term "business" was defined by Jessel MR (Master of the Rolls) as:

> "anything which occupies the time and attention and labour of a man for the purpose of profit is business."[176]

It is submitted, considering the above factors, that taxpayers who let even one fixed property are engaged in carrying on a "business". It is also submitted that this clause will almost always assist taxpayers whose trade is letting immovable property. There should always be a reasonable prospect of deriving taxable income (in the form of rent) within a reasonable period (presuming that the taxpayer is able to find a tenant for the property). The only foreseeable manner that taxpayers may not be able to utilise this provision in order to ensure that their assessed loss is not ring-fenced is if they purchase a property to let for which they will not be able to find tenants or for which the rental income is so low that there is no prospect of it covering the running expenses of the property, including interest on a mortgage bond secured by the property.

Step 4 – Six out of ten year (or catch-all provision)

Section 20A(4) provides that the escape clause, as provided for in section 20A(3), is not available where the taxpayer has incurred an assessed loss in at least six out of the last ten years of assessment (including the current year of assessment). This section is not applicable to taxpayers carrying on the trade of farming. Taxpayers who let property as a trade, but where that trade is a listed suspect trade and the taxpayer has incurred an assessed loss in

[176] *Smith v Anderson* (1880) 15 ChD 247 258.

at least six out of the last ten years, cannot use the escape clause, as contained in step three.

If, however, the assessed loss has been ring-fenced, the result is that the assessed loss becomes permanently ring-fenced and may not be set off against income derived from any other source by that person during that year of assessment. The assessed loss will be carried forward and can only be set off against income derived from that specific trade.[177]

Another factor which needs to be discussed in relation to the ring-fencing of assessed losses is whether a particular activity will constitute a single trade, in terms of section 20A(7). To determine whether more than one related activity will be considered as a single trade, the specific circumstances of that particular case need be considered.[178] SARS provided the following example to illustrate this issue:[179] a taxpayer buys five apartments at the same time with same method of financing and with the intention of conducting a rental trade. Such a taxpayer will have a strong case in arguing that a single trade is being conducted, the business of letting fixed property, rather than five separate trades. If, however, the apartments were bought over a period of time as separate investments, they may be regarded as five separate trades. In that case each trade's profitability will be considered separately in determining whether an assessed loss will be ring-fenced.

If a taxpayer's trade of letting property is held to be suspect, for example if the taxpayer occasionally lets the property as a holiday home, then taxpayers letting more than one property in this manner will have the income and expenditure examined on a separate basis in order to determine whether an assessed loss should be ring-fenced.[180]

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[177] Section 20A(5).
[178] South African Revenue Service *Ring-Fencing*.
[179] South African Revenue Service *Ring-Fencing*.
[180] South African Revenue Service *Ring-Fencing*.

4.3 Investing through a company

This thesis will not discuss the operation and legal requirements of companies in detail. The advantages and disadvantages of using a company as an investment vehicle will, however, be discussed.

4.3.1 Advantages

Setting up a company in order to purchase and let property has certain advantages. The major advantages are as follows:

1. Limited liability

In the case of a third party having a claim against the taxpayer, such as a tenant suing the taxpayer for breach of contract, the taxpayer's personal assets will not be capable of being attached. This limited liability could also be very useful in a situation where the taxpayer has had to borrow money from the bank in terms of a mortgage bond agreement and the bank forecloses on the property due to non-payment of bond repayments. The foreclosure and consequent sale of the property does not always settle the full mortgage debt and the taxpayer who uses a company to take out the mortgage bond would then not be liable to the bank in their personal capacity (presuming that they have not signed as surety for the mortgage bond) for the remaining debt. This is a major advantage over a taxpayer conducting the trade of letting property in their personal capacity. Such a taxpayer's personal assets will be capable of being attached and sold in execution.

2. Potentially lower taxation rates

The current corporate tax rate is levied at a flat rate of 28 per cent on the taxable income of any company.[181] When compared to the maximum marginal rate of tax of 41 per cent for an individual or a partner in a partnership and the flat rate of 41 per cent applying to a trust,

[181]Rates and Monetary Amounts and Amendment of Revenue Laws Act No. 42 of 2014 Appendix 1.

the rate of 28 per cent is beneficial. Whether the company rate of 28 per cent will be lower than the marginal rate applying to an individual or partner, will depend on the total taxable income of the taxpayer and the rate applying to that taxable income.

However, the effect of the Dividends Tax on the withdrawal of profits from the company in the form of a dividend must also be taken into account. Levied at the rate of 10 per cent, this would increase the marginal tax rate of a company to 35.2 per cent.

3. Small Business Corporations and Micro Businesses

These business models (Small Business Corporations are dealt with in section 12E of the Act and Micro Businesses in the Sixth Schedule to the Act) limit their applicability to private companies (in the case of a Small Business Corporations) and individuals (including partnerships) and private companies that earn not more than 20 per cent of their total receipts and accruals in the form of "investment income", which includes the letting of property. The benefits of being taxed as a Small Business Corporation or a Micro Business are therefore not available to a taxpayer investing in property for rent.

4.3.2 Disadvantages

1. Common disadvantages

There are disadvantages to investing through a company. Some of these include:

1. set up costs of establishing the company (including legal fees for drafting a Memorandum of Incorporation and Shareholder Agreement as well as having the company registered);
2. the requirement that the company keep accurate and complete accounting records[182] (and the monies spent employing accountants to attend to this should the taxpayer not have the requisite skills);

[182] Companies Act No. 71 of 2008 para 28.

3. monies spent on employing auditors each year to audit certain companies;[183]
4. the filing of an additional annual tax return[184] (as opposed to an individual who needs only to file one tax return);
5. general administrative tasks required to run a company; and
6. the fact that an assessed loss of the company is not available to the shareholder(s).

2. <u>Extraction of profits through a dividend</u>

One of the disadvantages of doing business in the form of a company is that profits can only be extracted from the company in two ways – by the declaration of a dividend or the payment of remuneration for services rendered to the company. In terms of section 64E of the Act a dividends tax is levied at the rate of 15 per cent on of the amount of any dividend paid by any company to shareholders, other than those exempt from the tax (for example, companies and Regulated Intermediaries and Micro Businesses to the extent that the total dividend distributed to all shareholders during the year of assessment do not exceed R200 000.00 (section 64F(1)(h)).

A “dividend” is defined in section 1 of the Act as follows:

> “'dividend' means any amount transferred or applied by a company that is a resident for the benefit or on behalf of any person in respect of any share in that company, whether that amount is transferred or applied-
>
> *(a)* by way of a distribution made by; or
>
> *(b)* as consideration for the acquisition of any share in,
>
> that company, but does not include any amount so transferred or applied to the extent that the amount so transferred or applied-
>
> (i) results in a reduction of contributed tax capital of the company;
>
> (ii) constitutes shares in the company; or
>
> (iii) constitutes an acquisition by the company of its own securities byway of a general repurchase of securities as contemplated in subparagraph (b) of paragraph 5.67 (B) of section 5 of the JSE Limited Listings

[183] Act No. 71 of 2008 para 90.
[184] Act No. 71 of 2008 para 33.

> Requirements, where that acquisition complies with any applicable requirements prescribed by paragraphs 5.68and 5.72 to 5.84 of section 5 of the JSE Limited Listings Requirements."

The Dividends Tax will apply to individual taxpayers who set up a company and subscribe for shares or who purchase the shares of an existing company. Any dividend that is received from the company will be taxed at the rate of 15 per cent in the hands of the shareholder, in terms of section 64EA of the Act. If a taxpayer's company is not a Small Business Corporation or a Micro Business, then the company will be taxed at a rate of 28 per cent on income and any dividends will be taxed at 15 per cent in the hands of the shareholder. The dividends tax may, therefore, make a substantial difference to the amount of tax which will be paid by individual taxpayers setting up companies to invest in fixed property.

3. Extraction of profits by means of remuneration

In terms of section 66(8) of the Companies Act,[185] a company may pay remuneration to a director for their service as a director. "Remuneration" is defined in section 30(6) of the Companies Act as follows:

> "'remuneration'" includes—
>
> (*a*) fees paid to directors for services rendered by them to or on behalf of the company, including any amount paid to a person in respect of the person's accepting the office of director;
>
> (*b*) salary, bonuses and performance-related payments;
>
> (*c*) expense allowances, to the extent that the director is not required to account for the allowance;
>
> (*d*) contributions paid under any pension scheme not otherwise required to be disclosed in terms of subsection (4) (b);

[185] No. 71 of 2008.

(*e*) the value of any option or right given directly or indirectly to a director, past director or future director, or person related to any of them, as contemplated in section 42;

(*f*) financial assistance to a director, past director or future director, or person related to any of them, for the subscription of options or securities, or the purchase of securities, as contemplated in section 44; and

(*g*) with respect to any loan or other financial assistance by the company to a director, past director or future director, or a person related to any of them, or any loan made by a third party to any such person, as contemplated in section 45, if the company is a guarantor of that loan, the value of—

(i) any interest deferred, waived or forgiven; or

(ii) the difference in value between—

(*aa)* the interest that would reasonably be charged in comparable circumstances at fair market rates in an arm's length transaction; and

(*bb*) the interest actually charged to the borrower, if less."

This remuneration will need to be included in a taxpayer's "gross income" and taxed according to the marginal rate of taxation for which the taxpayer is liable.[186] Taxpayers may, therefore, receive income from a company in terms of either a dividend (in the case of the taxpayer being a shareholder) or remuneration (in the case of the taxpayer being a director of the company). Section 69 of the Companies Act deals with the ineligibility of people to act as a director; this section does not prevent a shareholder of a company from also being a director of a company. Section 66(2)(a) of the Companies Act states that a board of a private company need only consist of one director. The intricacies of the operation of a company, however, fall beyond the scope of this thesis and will not be discussed in detail, however it must be noted that taxpayers may set up a company in which they are the sole director as well as the sole shareholder.

186South African Revenue Service *Personal Income Tax* (2015) http://www.sars.gov.za/TaxTypes/PIT/Pages/default.aspx (accessed 3 November 2015).

Only the reasonable amount of remuneration in relation to the services provided to the company will be granted as a deduction to the company in terms of section 11(a), read with section 23(g) of the Act. Excessive remuneration can be attacked as not being incurred in the "production of income" from carrying on a trade, but for some other non-trade motive. While the company will be denied the deduction for the excessive portion of the remuneration, the recipient will be taxed on the full amount.

These are some of the main concerns and costs involved when setting up and running a company. The money, time and tax implications are factors that need to be considered when taxpayers are deciding which vehicle to use; it is submitted that the advantages of using a company, however, outweigh the disadvantages.

4.4 Investing through a Trust

This subsection will start the analysis of the whether a trust should be used to invest by giving a brief explanation of the operation of trusts. There are three types of trusts in South African law:[187]

1. an ownership trust –

   This is a trust where the founder (donor) of the trust transfers ownership of assets to the trustee to be administered for the benefit of the beneficiaries.

2. a *bewind* trust –

   This is a trust where the founder transfers ownership of assets into the hands of the beneficiaries, but control of the assets is in the hands of the trustee.

[187] South African Revenue Service *Types of Trusts* (2015) http://www.sars.gov.za/ClientSegments/Businesses/Trusts/Pages/Types-of-Trust.aspx (accessed 18 September 2015).

3. a curatorship trust –

   This is a trust where the trustee administers the trust assets for the benefit of a beneficiary who does not have the capacity to do so e.g. a person with a serious disability. The beneficiary will have ownership of the assets in the same way as a *bewind* trust.

Taxpayers wishing to carry on a trade of letting property through a trust will be able to utilise either an ownership trust or a *bewind* trust, depending on how the taxpayer would like the property to be administered. There are two ways that a trust may be formed:[188]

1. *Inter vivos* –

   A trust that is created during the lifetime of a person.

2. *Mortis causa* –

   A testamentary trust that is set up in terms of a person's will and comes into effect after their death.

Taxpayers wishing to let property, for reasons other than estate planning, will need to set up an *inter vivos* trust. Trusts are further classified by the rights that they give the beneficiaries:[189]

1. Vesting trust –

   The income or assets of the trust is vested in the beneficiaries. The beneficiaries have a vested right to the income or assets of the trust.

[188] South African Revenue Service *Trusts.*
[189] South African Revenue Service *Trusts.*

2. Discretionary trust –

   The trustee has the choice whether to and how much of the income or capital of the trust to issue to the beneficiaries. The beneficiaries only have contingent rights to the income or capital.

Trusts have various purposes, namely the following:[190]

1. trading trusts;
2. asset-protection trusts;
3. charitable trusts; or
4. special trusts.

This thesis is concerned with trading trusts, their advantages and disadvantages, as well as their tax implications. There are different ways that the income of a trust may be taxed. It may be taxed in either the hands of the donor, the beneficiary or the trust.[191] If income is taxed in the hands of the trust, it is taxed at a flat rate of 41 per cent. If the trust's income is taxed in the hands of the donor or the beneficiary, the rate of taxation applying to the trust income will depend on the rate at which the person is taxed on their other taxable income earned. This thesis does not discuss the intricacies of how trusts are taxed, as this is beyond the scope of this thesis.

The *locus classicus* case on the functioning of trusts is *Land and Agricultural Bank of South Africa v Parker and Others.*[192] In this case the Respondent had formed a trust in which he and his wife where the sole trustees as well as beneficiaries. Their descendants were also beneficiaries. The court discussed the nature of a trust generally and stated that a trust is not a legal person, but an accumulation of assets and liabilities. These assets and liabilities constitute the trust estate which is a separate entity.[193]

[190]South African Revenue Service *Trusts.*
[191]South African Revenue Service *Trusts.*
[192] 2005 (2) SA 77 (SCA).
[193] 2005 (2) SA 77 (SCA) 83.

Cameron JA stated:

> "The core idea of the trust is the separation of ownership (or control) from enjoyment. Though a trustee can also be a beneficiary, the central notion is that the person entrusted with control exercise it on behalf of and in the interest of another. This is why a sole trustee cannot also be the sole beneficiary: Such a situation would embody an identity of interests that is inimical to the trust idea, and no trust would come into existence."[194]

The court held that it is this notion of separation that serves diligence on the part of the trustees as a lapse by a trustee of their duties or standard of care may result in action by the beneficiaries against the trustees.[195] The court held further that as long as the functions of trusteeship remain distinct from the beneficial interests, that there can be no objection to business trusts as the mechanism of the trust form will ensure proper governance.[196] In the current case it was evident that there was no separation of ownership and enjoyment. The control of the trust resides with people who are also the beneficiaries. There is thus no independence and the beneficiaries are not going to scrutinise their own work as trustees.[197]

The trust formed in this case was an "ownership trust" as discussed above in which the trustees were the owners of the property.

Cameron JA held further:

> "The debasement of the trust form evidenced in this and other cases, and the consequent breaches of trust this entails, suggest that the Master should, in carrying out his statutory functions, ensure that an adequate separation of control from enjoyment is maintained in every trust. This can be achieved by insisting on the appointment of an independent outsider trustee to every trust in

[194] 2005 (2) SA 77 (SCA) 86.
[195] 2005 (2) SA 77 (SCA) 87.
[196] 2005 (2) SA 77 (SCA) 87 and 88.
[197] 2005 (2) SA 77 (SCA) 88.

> which (a) the trustees are all beneficiaries and (b) the beneficiaries are related to one another."[198]

The findings of this case are very important for the purposes of this thesis. They show that a trust cannot be set up where a taxpayer is the sole trustee and sole beneficiary. This means that an individual taxpayer who wishes to invest in immovable property for his or her own benefit cannot set up a trust in this manner. Such taxpayers would need to at least ensure that there is an independent trustee. Taxpayers wishing to utilise a trust may set up an "ownership trust" where the taxpayer is both the trustee and the beneficiary. They would, however, have to appoint an independent trustee. This would allow the taxpayer the benefits associated with establishing a trust, but still allow them to maintain ownership of the assets, have limited control and benefit from the income received.

The advantage of setting up a trust is that it provides limited liability to trustees and subsists in perpetuity. If a trust is sequestrated, creditors will not be able to look to the trustees, beneficiaries or founder for assets to attach.[199] However, a trust (unlike a company) does not have separate legal personality; this means that if a court finds that a trust is actually a partnership or a trust was not actually set up then the veil will be pierced and the trustees will be held personally liable for the debts of the trust.[200] This is not an uncommon situation; two entrepreneurs will set up a trust where they do not separate control of assets from benefits derived from those assets.[201] The trust will carry on business where the entrepreneurs are the sole trustees and sole beneficiaries of that trust. If such an entity is formed (where there is an insufficient separation between control and enjoyment of trust assets), the entrepreneurs have not set up a trust, but have actually entered into a partnership; the court will pierce the veil of with the result that there will be no limited liability.[202]

This thesis does not deal with estate planning where the formation of a trust may be beneficial, but with taxpayers who engage in the trade of letting property for their own

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[198] 2005 (2) SA 77 (SCA) 90.
[199] W Geach and J Yeats *Trusts: Law and Practice* 3ed (2013) 216.
[200] Geach *et al Trusts* 296.
[201] Geach *et al Trusts* 208.
[202] Geach *et al Trusts* 297.

benefit. This thesis has the goal of discussing how taxpayers can invest in real estate in the most effective manner and maximize the tax benefits available. The major disadvantage to setting up a trust is the high tax rates associated with trusts (a flat rate of 41 per cent) or, if the taxpayer is a beneficiary (which he or she would want to be to ensure benefit from the receipt of rental income) income will be taxed at the marginal rate of tax that the taxpayer is taxed at on other income, which may be 41 per cent. The other disadvantage is that the taxpayer would have to appoint an independent third party, possibly an attorney or an accountant, to stand as a trustee. This will reduce the amount of control which the taxpayer has in conducting the trade of letting fixed property.

Setting up a trust for the purpose of investing in fixed property would be recommended if the taxpayer's goal was to provide income for someone other than him or herself, possibly children, and that the taxpayer's death would not affect the running of the trust and the beneficiaries' rights. If taxpayers are wishing to invest in property for their own gain, then the use of a trust will only be beneficial under very particular circumstances. Each taxpayer will need to consider their own personal circumstances to determine whether using a trust as a vehicle to invest would suit their needs.

4.5 Real Estate Investment Trusts

Real Estate Investment Trusts (REITs) are companies that manage, operate and own a real estate portfolio consisting of income-producing property. While they are called trusts, REITs have no characteristics which are the same as trusts. They are publicly listed companies that trade on the Johannesburg Securities Exchange as any other listed company would (an investor can receive distributions as well as a potential capital gain in the form of an increase in the share price).[203] These instruments allow investors to gain exposure to the property market without the large initial capital outlay and without having to directly own and manage the properties. They have the following features:[204]

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[203] Johannesburg Securities Exchange *Real Estate Investment Trusts* *https://www.jse.co.za/content/JSEPresentationItems/REITs.pdf* (accessed 18 September 2015).
[204] Johannesburg Securities Exchange *Investments Trusts*.

1. they must pay at least 75 per cent of their taxable earnings available for distribution to investors as dividends;
2. they earn their income from property leases (at least 75 per cent must be earned from rental);[205]
3. the leases are commercial property leases, usually with long lease periods;
4. they must own at least R300 million in property.

REITs are entitled to deduct, for their income tax purposes, all distributions that they pay out to shareholders. This encourages them to pay all of their income to shareholders so that they pay no tax at all.[206] The effect of this is that the tax on income of the REIT is borne by the investor. The investor will be taxed on distributions received as normal income at the normal tax rate (with no allowable deductions); these distributions are classified as taxable dividends. This is different from the usual company dividend tax of 15 per cent on a dividend that is paid out to shareholders, other than companies and regulated intermediaries, while the dividend itself is exempt from normal tax in terms of section 10(1)(k)(i) of the Act.

REITs give potential investors who have limited funds available or who do not have access to sufficient funds, a more affordable entry into the property market. Investors may become involved in a REIT by purchasing just one share in the company. However, the distribution that the taxpayer will receive is added to their other taxable income and taxed at the applicable rate. Depending on the marginal tax rate at which an individual taxpayer is taxed, this may be a positive or negative consequence of investing in this instrument. This thesis is aimed at discussing taxpayers who wish to purchase immovable property with the aim of letting it and therefore REITs will not be discussed in detail.

Section 12T provides for the exemption of interest on a tax-free investment in the hands of natural persons or their deceased or insolvent estates. Investments in REITs qualify as tax-free investments. The interest on investments of up to R30 000.00 a year in such tax-free

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[205] SA REIT Association *SA REIT Brochure* http://www.sareit.com/docs/SA_REIT_brochure.pdf (accessed 30 October 2015).
[206] P Cairns *REIT Investments and tax* (2014) http://www.moneyweb.co.za/uncategorized/reit-investments-and-tax/ (accessed 17 September 2015).

investments is exempted from tax (up to a maximum lifetime investment of R500 000.00). This exemption will add to the benefit of investing in property through a REIT.

4.6 Conclusion

The four potential investment vehicles have been discussed and their positive and negative aspects have been dealt with. From the analysis, a recommendation can be made that a good option for an individual is to set up a company in order to purchase immovable property and receive rental income. The benefits of doing so are related to the limited liability and potentially lower tax rates.

Taxpayers will naturally wish to extract the benefit of profits from the company. Dividends distributed by a company will be subject to the Dividends Tax of 15 per cent on the dividends distributed. In addition, any money paid as a salary to a director of the company will be taxed at the marginal rate of taxation at which the director is taxed at on his or her total taxable income. Rental income will be taxed at 28 per cent in the hands of the company.

While the beneficiaries of trusts also enjoy limited liability, founders who are also trustees and beneficiaries run the risk that the trust will be disregarded and the courts will deem that the parties have entered into a partnership agreement or that no trust was ever established. Trusts are often used appropriately for estate planning, but for the taxpayer wishing to invest in property to receive rental income and capital gains for their own benefit, a trust is only a favourable option if the taxpayer is not concerned with losing a portion of the control of the assets to an independent third party. The tax benefits that may be available to taxpayers setting up a trust only become applicable in the event that the trustee wishes to appoint other people, such as children, as beneficiaries. As this thesis is aimed at individuals wishing to benefit personally from investing in property, this aspect of trust law will not be discussed.

Taxpayers who are, however, wishing to avoid the disadvantages relating to a company form of enterprise (as discussed in this chapter) can invest in their personal capacity. This has the distinct disadvantage of no limited liability and, depending on the taxpayer's total taxable income from other sources, the net rental income received could be taxed at the maximum marginal rate of 41 per cent. Alternatively, taxpayers wishing to take on the challenge of investing in property may join up with another individual or individuals to form a partnership. This will allow taxpayers a shared capital outlay along with shared duties and shared risks. It also gives taxpayers the freedom to choose how to structure their business venture. One individual may contribute the capital and another may contribute skill and labour, or however the taxpayers wish to structure the partnership. However, the same tax disadvantages that apply to sole traders apply to partners in a partnership in relation to their share of net rental income.

Taxpayers choosing to carry on their trade as sole traders (or in the form of a partnership) must be aware of the provisions of section 20A that have the effect that the assessed loss a rising from the letting of their property may be ring-fenced.

It is crucial that taxpayers understand the investment vehicle that will best suit their needs so as to ensure that they utilise all the tax benefits that are available.

This is the final chapter of the thesis which discusses the tax benefits which are available to investors in immovable property. The next chapter will be a concluding chapter summing up the findings in Chapters 2, 3 and 4.

CHAPTER 5 – Conclusion

This thesis has discussed the tax benefits that are available to taxpayers wishing to invest in immovable property within South Africa, as well the investment vehicles which can be used in order to gain the maximum tax benefits that are available.

Chapter 2 discussed the deductions that are available to all taxpayers carrying on a trade and not just to investors in fixed property. The general deduction formula, as contained in the preamble to section 11, section 11(a) and section 23(g), was discussed in detail. The general deduction formula provides for deductions that are available to taxpayers wishing to invest in property and this warranted an in-depth look at all the factors, including relevant case law, required to comply with the provisions of the sections. These are as follows:

i) the taxpayer must be carrying on a trade;
ii) the income must be derived from the trade;
iii) the taxpayer must have incurred expenditure or losses;
iv) which were actually incurred;
v) in the production of income; and
vi) which were not of a capital nature.

Other factors which are connected with the income which taxpayers may receive as a result of letting immovable property were also discussed. This included receipt of amounts which needed be included in taxpayers "gross income", such as rental income, lease premiums and leasehold improvements. Situations were also discussed where taxpayers used a property partly as a holiday home and partly as a means of receiving rental income. It was found that the taxpayer would only be able to deduct the expenses in such a situation to the extent to which these expenses were laid out for the purposes of trade, in terms of the prohibition of non-trade deductions contained in section 23(g).

Certain specific deductions which are also available to investors in immovable property were also discussed in this chapter. This included a detailed discussion on the type of legal expenses which are deductible, repairs to rental property (and the difference between repairs and improvements), bad debts owed to taxpayers as well as doubtful debts.

These provisions of the Act allow the taxpayer to deduct certain revenue expenses incurred in the carrying out of their trade (such as mortgage bond interest, rates and taxes and insurance premiums) from their income in order to reduce their tax liability. It was found that there are many expenses, which SARS has specifically detailed,[207] that taxpayers carrying on a trade of letting immovable property may deduct in order to reduce their tax liability. This chapter also discussed the principles of interpretation relating to statutes and contracts so as to provide an understanding as to how the courts have interpreted existing legislation. These principles also provide a means by which legislation and contracts, which have not yet been interpreted by the courts, may be interpreted.

Chapter 3 dealt with deductions that are available specifically to investors in immovable property. The sections which were covered comprised section 13*sex*, section 13*qua*t and section 13*quin*. Section 13*sex* was introduced by the legislature in order to curtail the envisaged effects of the world-wide recession by giving taxpayers extra incentive to invest in immovable property. This incentive came in the form of a depreciation allowance on "residential units", allowing taxpayers who carry on the trade of letting immovable property within South Africa and who own at least five new residential units, to deduct 5 per cent of the cost of each unit per year. This section provides a further allowance to taxpayers developing or purchasing properties qualifying as "low-cost residential units" as defined in section 1 of the Act; this incentive allows the taxpayer to deduct a further 5 per cent (thus 10 per cent in total) of the cost of the unit per year. Examples were provided in which the exact benefit taxpayers may expect to receive if they are able to utilise the provisions of section 13*sex* were calculated. Section 13*sex* replaced section 13*ter,* which allowed the taxpayer a deduction on the cost of a residential unit, but a far less beneficial deduction. Section 13*sex* also allows taxpayers to deduct the cost of improvements made on properties which fall within the provisions of the section.

The next section that was discussed was section 13*quat*. This section provides for deductions on the capital expense of a building developed or purchased within designated urban development zones that are to be found within the city centres in South Africa. The provisions of this section have been promulgated with the goal of enticing property development companies to build both residential and commercial property in South Africa's

[207]South African Revenue Service *Rental Income*.

city centres. The extent of the deduction allowed varies depending on the cost of the building, and whether the investor has erected a building or made improvements to a building.

Both section 13*sex* and 13*quat* provide for lower incentives for investors purchasing the property. The goal of the legislature was, therefore, it is submitted, to encourage property developers to build more property in South Africa as there is a shortage of residential and commercial property available and, in the case of section 13*quat*, to effect urban renewal. A greater supply of property available for letting will reduce the costs of renting for many South Africans. Both sections also provide for greater incentives for “low-cost” residential properties.

Section 13*quin* was discussed, but not in detail, as it provides a capital deduction of the cost of property which is used by taxpayers in their trade for a purpose other than the provision of residential accommodation. It is aimed at taxpayers purchasing or developing property to either rent as commercial premises or to use for their own business purposes. This section provides taxpayers with a deduction of 5 per cent per year on property used for commercial letting purposes (this section also provides for a lower allowance on properties which the taxpayer has not developed).

All three sections allow taxpayers an unusual benefit of being able to deduct a capital expense (as capital expenses cannot be deducted in terms of the general deduction formula). These sections can, therefore, provide considerable tax benefits to investors in fixed property.

Chapter 3 also discussed the volatility of the property market and the fact that properties do not always increase in value. This was evidenced by the global decline in property prices when the recession came into force in 2008.

The sections of the Act discussed in Chapters 2 and 3 are an integral aspect of the benefits which are available to taxpayers wishing to invest in fixed property. These sections can be utilized in order to obtain substantial tax benefits. Taxpayers could, if they have the funds to purchase five new properties, structure their property investments around section 13*sex* to ensure a maximization of the benefits which are available.

An area of potential research in the future could entail an assessment of whether the specific inclusions in the Act as detailed in this work have had the desired effect that the legislature intended.

Chapter 4 discussed the four types of investment vehicles which taxpayers can use when investing in property:

i. investing in their personal capacity or as a partner in a partnership;
ii. investing through a company; and
iii. investing through a trust.

It was found that investing in a personal capacity or as a partner in a partnership is by far the least burdensome and least costly manner in which to invest, but that there are significant disadvantages associated with either of these vehicles. The major disadvantage being that the taxpayer may be held liable for any claim instituted by a third party in relation to that trade; the taxpayer's personal assets would be capable of attachment and sale in execution. Another significant disadvantage is that rental income will be taxed at the marginal rate applying to the taxpayer's total taxable income. This could result in the taxpayer paying tax on rental income at the maximum marginal rate of 41 per cent (which would result in a significant decrease in the net income received as a result of the carrying on of the trade of letting property). The other disadvantage is that the taxpayer may, depending on a number of different circumstances which were discussed, find that an assessed loss suffered in the trade of letting property is ring-fenced in terms of section 20A of the Act. This section applies only to individuals and partners in partnerships and would result in the taxpayer not being able to set off an assessed loss from the trade of letting property against any other income received.

It was found that taxpayers investing in property as members of partnerships are subject to the same taxation principles and business disadvantages as taxpayers investing in their individual capacity. This is because partnerships are not a separate legal entity and taxpayers are taxed on their share of income received by partnership in their individual capacity. A partnership does have the added benefit that taxpayers may combine their skill, capital and labour in order to work together more effectively and efficiently.

If taxpayers decide to set up a company, they will have limited liability for any debt or claim against the company and the company will be taxed at the rate of 28 per cent on income. A single taxpayer may set up a company in which he or she is the only person involved (as shareholder and director), unlike with a trust where independent trustees would have to be appointed. The disadvantages of investing through a company include set-up costs, administrative costs and, in certain instances, audit costs, amongst others. For a taxpayer who is a shareholder of the company and wishes to extract the profits of the company, any dividend paid by the company will be taxed in the hands of the shareholder at the rate of 15 per cent. However, even with the dividends tax, taxpayers may have a lower taxation rate than if they invested in their personal capacity or as a partnership.

In the event that the taxpayer is also the director of the company and wishes to benefit from the profits of the company by receiving a salary, this salary will be taxed at the marginal rate which applies to the taxpayer's total taxable income; it is added to the taxpayer's "gross income".

Investing through a trust is only recommended for taxpayers wishing to invest in property for their own benefit if they do not wish to lose part control of their assets. The purpose of a trust is to separate control from enjoyment and it is unlikely that taxpayers would want to lose control of the properties or not benefit from the income received. Trusts provide taxpayers with limited liability, but the courts can disregard the trust if it is found that the trust does not comply with the requirements of a trust; for example if there is not sufficient separation between control and enjoyment. This usually happens where investors are both the sole trustee and the sole beneficiary of the trust. Trusts are also subject to a high tax rate, being the flat rate of 41 per cent. Alternatively the beneficiaries of the trust can be taxed on the income received at the marginal rate of taxation that they are paying on other income.

Taxpayers who are not concerned with losing a portion of control may set up a trust in which they are one of the trustees and a beneficiary. This will not give the taxpayer a reduced rate of taxation, but would result in limited liability. Taxpayers wishing to invest in property with the goal of providing for their children in years to come would be wise to utilise a trust as they subsist in perpetuity and can be administered on behalf of someone else in the event that they are not able to do so themselves.

Real Estate Investment Trusts were also briefly discussed in this chapter. It was found that they have no common properties with trusts, despite their name. These trusts are companies listed on a securities exchange and allow taxpayers cheap and easy exposure to the property market. The income received in terms of such an investment would, however, be taxed at the marginal rate of taxation that applies to the taxpayer's total taxable income.

The deductions in terms of the general deduction formula, as discussed in Chapter 2, and the specific deductions for property investors, as discussed in Chapter 3, are available to taxpayers no matter which investment vehicle they choose to utilise. The only aspect of the Act which only applies to individuals and partnerships, besides the tax rates, is the ring-fencing of assessed losses in terms of section 20A.

The vehicles offer different benefits and risks. It is, therefore, crucial that taxpayers utilise the vehicle which will best suit their needs to ensure that the full extent of the benefits available are utilised. It is submitted that each taxpayer will have different circumstances that will influence which vehicle would best suit their needs.

There are clearly considerable tax benefits that are available to taxpayers wishing to develop or purchase immovable property with the goal of letting in order to receive rental income.

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