

## **TAX IMPLICATIONS OF A CREDIT AGREEMENT**

**Tax Implications of a Credit Agreement**

**Submitted as a dissertation component by**

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**to**

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## **ABSTRACT**

The aim of this dissertation is to provide a detailed analysis of, and commentary on, the tax implications of a credit agreement, based on current legislation, case law and practice as applied by the Commissioner.

The South African Acts that are the subject of this dissertation are as follows:

- The Income Tax Act 58 of 1962 (as amended).
- The Value-Added Tax Act 89 of 1991 (as amended).

The principal South African taxes dealt with in this dissertation are as follows:

- Normal tax.
- Value-added tax.

**DECLARATION**

I hereby declare that this dissertation is entirely my own work.

\_\_\_\_\_  
Signature

\_\_\_\_\_  
Date

## **ACKNOWLEDGEMENTS**

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## CHAPTER 1

### DEFINITIONS OF A CREDIT AGREEMENT

#### General

The term 'credit agreement' is not defined in the Income Tax Act (the Act) except for a reference to a credit agreement in s 24 as where

'any taxpayer has entered into any agreement with any other person in respect of any property the effect of which is that, in the case of movable property, the ownership shall pass or, in the case of immovable property, transfer shall be passed from the taxpayer to that other person, upon or after receipt by the taxpayer of the whole or a certain portion of the amount payable to the taxpayer under the agreement'.

An agreement where one party permits the other party the use of his asset for an agreed period and who is reimbursed for that period at an agreed rate, is called a lease agreement.

#### Generally accepted accounting practice

In terms of generally accepted accounting practice (GAAP) in statement AC105, a lease, a finance lease and an operating lease, are defined as follows:

#### Lease

'An agreement whereby the lessor conveys to the lessee in return for a payment or series of payments, the right to use an asset for an agreed period of time.'

#### Finance lease

'A lease that transfers substantially all the risks and rewards incident to ownership of an asset. Title may or may not eventually be transferred.'

Operating lease

'A lease other than a finance lease.'

## **ACCOUNTING PRACTICE**

The required accounting treatment is the following:

### **Accounting position of the lessee**

#### **Finance leases**

At inception the lease asset and liability should be recognised at fair value of the leased property or, if lower, at the present value of the minimum lease payments using the interest rate implicit in the lease agreement or at the lessee's incremental borrowing rate.

The lease payments made should be apportioned between the finance charges and the reduction of the outstanding liability to produce a constant periodic rate of interest.

The asset should be depreciated in terms of the lessee's depreciation policy.

#### **Operating leases**

The lessee must recognise payments on a straight-line or on another systematic basis which represents the time pattern of the user's benefit.

## **Accounting position of the lessor**

### **Finance lease**

The asset should be recognised as a receivable at the net investment in the lease.

Finance income should be recognised based on a pattern reflecting constant periodic rate of return on the net investment outstanding.

If the lessor deals in leased assets, he should recognise any selling profit or loss at inception.

### **Operating lease**

The lessee must capitalise the asset according to its nature.

He must recognise lease income on a straight-line or other systematic basis to reflect a pattern of benefits.

He should depreciate the asset in terms of his accounting policy for similar assets.

It should be noted that this treatment is different to the tax treatment of the same transactions. It should also be noted that paragraph 42 of the Fourth Schedule to the Companies Act requires specific disclosure of operating lease charges.

## **Definitions in the Act pertaining to leases**

### **Lease**

Most of the references to 'leases' in the Act (refer to section 23C(1) and paragraph 7(1)(b) of the Seventh Schedule), refer to the definition of an 'instalment credit agreement' in section 1 of the Value-Added Tax Act.

### **Finance lease**

Paragraph 7(1)(b) of the Seventh Schedule, and the Regulation promulgated in the *Government Gazette* which prescribes the rates per kilometre to apply in terms of section 8(1)(b)(2) of the Act, refer to a finance lease under the now defunct Sales Tax Act.

### **Operating lease**

An operating lease is defined in terms of section 23A of the Act as a lease of movable property concluded by a lessor in the ordinary course of a business (not being the business of a banker or financier) of letting property, if

- the property may be hired by members of the general public for a period of less than one month;
- the cost of maintaining the property and of carrying out repairs thereto required in consequence of normal wear and tear, is borne by the lessor; and
- subject to any claim that the lessor may have against the lessee by reason of the lessee's failure to take proper care of the property, the risk of destruction or loss of or other disadvantage to the property is not assumed by the lessee.

### **Instalment credit agreement**

An instalment credit agreement<sup>1</sup> is not defined in the Act.

### **Definitions of leases as contained in the Value-Added Tax Act**

#### **Lease**

The term 'lease' is not defined in the Value-Added Tax Act.

#### **Finance lease**

The term 'financial lease' was defined in the Sales Tax Act before it was repealed. The Value-Added Tax Act refers to the definition of an 'instalment credit agreement' (see above).

#### **Operating lease**

The term 'operating lease' is not defined in the Value-Added Tax Act. The operating lease as defined in the Act is referred to in the Value-Added Tax Act as a rental.

#### **Rental agreement**

A 'rental agreement' means

- any agreement entered into before, on or after the commencement date for the letting of goods, other than a lease referred to in paragraph (b) of the definition of an 'instalment credit agreement' in

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<sup>1</sup> Section 1 of the Value-Added Tax Act.



section 1 of the Value-Added Tax Act or the definition of a 'financial lease' as defined in the Sales Tax Act, prior to its repeal; and

- any rental agreement, as defined in the Sales Tax Act where the agreement is in force on or after the commencement date.

### **Instalment credit agreement**

An 'instalment credit agreement'<sup>2</sup> means any agreement entered into on or after the commencement date (30 September 1991) whereby any goods consisting of corporeal movable goods or of any machinery or plant, whether movable or immovable

- are supplied under a sale under which
  - the goods are sold by the seller to the purchaser against payment by the purchaser to the seller of a stated or determinable sum of money at a stated or determinable future date or in whole or in part in instalments over a period in the future; and
  - the sum of money includes finance charges stipulated in the agreement of sale; and
  - the aggregate of the amounts payable by the purchaser to the seller under the agreement exceeds the cash value of the supply; and
    - the purchaser does not become the owner of those goods merely by virtue of the delivery to or the use, possession or enjoyment by him thereof; or
    - the seller is entitled to the return of those goods if the purchaser fails to comply with any term of that agreement; or
- are supplied under a lease under which

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<sup>2</sup> Section 1 of the Value-Added Tax Act.

- the rental consists of a stated or determinable sum of money payable at a stated or determinable future date or periodically in whole or in part in instalments over a period in the future; and
- the amount of money includes finance charges stipulated in the lease; and
- the aggregate of the amounts payable under the lease by the lessee to the lessor for the period of the lease and any residual value of the leased goods on termination of the lease, as stipulated in the lease, exceeds the cash value of the supply; and
- the lessee is entitled to the possession, use or enjoyment of those goods for a period of at least twelve months; and
- the lessee accepts the full risk of destruction or loss of, or other disadvantage to, those goods and assumes all obligations of whatever nature arising in connection with the insurance, maintenance and repair of those goods while the agreement remains in force.

## CHAPTER 2

### TAX POSITION OF THE PURCHASER OF THE ARTICLE OR ITEM – GENERAL POSITION

#### NORMAL TAX POSITION

The purchaser of an article would like to obtain a tax deduction of the highest possible amount as soon as is possible and which is allowed in terms of the Act. In the process the after-tax cost will be as low as possible and because of the time value of money the tax benefits of the deduction should have been received.

#### General position for deductibility of an amount

Taxable income means the amount remaining after deducting from the income of any person all the amounts allowed to be deducted from or set off against the income. These deductions are set out in sections 11 to 37H.

General deductions allowed in the determination of taxable income are provided for in section 11(a) of the Act read with section 23.

In terms of section 11(a), the following requirements should be met before a deduction will be allowed.

- The taxpayer requiring the deduction must be carrying on a trade.
- Expenditure and losses must be actually incurred in the production of the income and provided that they are not of a capital nature.

The word 'trade' is defined in the Act<sup>3</sup> and includes every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent, trade mark, copyright or any other property which is of a similar nature.

Since the definition is prefixed by the word 'includes' it is regarded as not all encompassing and is not exhaustive.<sup>4</sup> Although most of the activities of a taxpayer may be regarded as a trade, the lack of continuity or lack of a profit motive may be regarded as not trading.<sup>5</sup>

The term 'actually incurred' has been discussed in numerous court cases and has been found to mean when an unconditional liability has been incurred and not when actual payment takes place. Thus any conditions stipulated when the liability was incurred should have been fulfilled.<sup>6</sup>

All bona fide expenses attached to the performance of a business operation performed for the purpose of earning income are deductible, provided they are so closely connected as to be regarded as part of the cost of performing it.<sup>7</sup> The court has to assess the closeness of the connection between the expenditure and the income-earning operations, having regard both to the purpose of the expenditure and to what it actually effects.<sup>8</sup> In *Financier v COT*,<sup>9</sup> the test applied by the court was whether the money on which the liability for interest was incurred, was borrowed for the purpose of an investment

- not producing income, or
- producing income.

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<sup>3</sup> Section 1 of the Act.

<sup>4</sup> *Burgess v CIR* 1994 SA 161 (A), 55 SATC 185.

<sup>5</sup> *De Beers Holdings (Pty) Ltd v CIR* 1986 (1) SA 8 (A), 47 SATC 229.

<sup>6</sup> *Nasionale Pers Bpk v KBI* 1986 (3) SA 549 (A), 48 SATC 55; *Port Elizabeth Electric Tramway Co v CIR* 1936 CPD 241, 8 SATC 13; *Concentra (Pty) Ltd v CIR* 1942 CPD 509, 12 SATC 95; and *Caltex Oil (SA) Ltd v SIR* 1975 (1) SA 665 (A), 37 SATC 1.

<sup>7</sup> *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241, 8 SATC 13.

<sup>8</sup> *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241, 8 SATC 13.

<sup>9</sup> *Financier v COT* Southern Rhodesia 1950 (3) SA 293 (SR), 17 SATC 34.

Tredgold J referred to the following as principles to be extracted from this case.

- Should a taxpayer borrow a specific sum of money and apply that sum to a purpose which is not in the production of the income, and not directly connected with the income-earning part of his business, then the interest paid on the borrowed money cannot be deducted as expenditure incurred in the production of the income.
- Where a taxpayer has for good and sufficient reasons borrowed money for use in the business producing his income, despite the fact that he subsequently, in pursuit of a legitimate business purpose, invested the money in an investment which does not produce income, the interest is still deductible for normal tax purposes.

It would seem that the test to be applied is the purpose for which the money was borrowed. In the *Allied Building Society* case,<sup>10</sup> the building society borrowed money on a retail basis from the public. The court held that if money was borrowed with the purpose to earn income, it is immaterial should some of the money be used for other purposes which may be incidental to the society's business.

To decide whether expenditure is of a capital nature, the test to be considered is whether the money was spent in creating or acquiring a source of profit or whether it was spent in working it.

'Money spent in creating or acquiring a source of profit' is of a capital nature and 'money spent in working it' is of an income nature.<sup>11</sup>

The enduring benefit test was discussed in *Southern v Borax Consolidated Ltd.*<sup>12</sup> Lawrence J refers to the general test laid down in *British Insulated and Helsby Cables v Atherton*<sup>13</sup> by Viscount Cave, which he described as follows:

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<sup>10</sup> *CIR v Allied Building Society* 1963 (4) SA 1 (A), 25 SATC 343.

<sup>11</sup> *CIR v George Forest Timber Co Ltd* 1924 AD 516, 1 SATC 20.

<sup>12</sup> *Southern v Borax Consolidated Limited* (1940, All. E.R. 413).

<sup>13</sup> *British Insulated & Helsby Cables Limited v Atherton* 1926 A.C. 205 (at 213-4).

‘When an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating the expenditure as properly attributable not to revenue but to capital.’

The problem is usually whether the expenditure in question should be regarded as part of the cost of performing the income-earning operations or a part of the cost of establishing or adding to the income-earning plant or machinery.<sup>14</sup>

Section 23(g) states that no deduction will be allowed for any moneys claimed as a deduction from income derived from trade, to the extent to which moneys were not laid out or expended for the purposes of trade. This provision thus allows for the circumstance where part of the amount may be allowed as a deduction and the other part disallowed.

## **VALUE-ADDED TAX POSITION**

### **General principles**

The general principles of VAT are that only registered VAT vendors may claim input tax.

Vendors need to be registered

- should their taxable supplies at the end of the month of registration exceed R300 000 for the twelve-month period ending at the end of the month of registration, or
- where there are reasonable grounds to believe the taxable supplies for the following twelve-month period will exceed R300 000.

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<sup>14</sup> *New State Areas Ltd v CIR* 1946 AD 610, 14 SATC 155.

In any other circumstances the vendor has the option to register as a vendor.

There is an obvious disadvantage of not being registered in that the cost of all purchases and supplies will include a VAT element. This additional cost of expenses is deductible for normal tax purposes since no input tax may be claimed and the section 23C prohibition is therefore not applicable.

The assumption applied in this dissertation is that taxpayers are registered VAT vendors.

Since financial services are financial transactions they are exempt supplies, and no input tax will be paid and thus no input tax may be claimed.

## **CHAPTER 3**

### **TAX POSITION OF THE PURCHASER OF THE ARTICLE OR ITEM IN TERMS OF AN OPERATING LEASE**

#### **At the commencement of the lease agreement**

##### **Normal tax position**

There are no normal tax implications for the lessee at the commencement of the lease agreement.

##### **Value-added tax position**

No input tax may be claimed at the commencement of the lease agreement.

#### **During the lease agreement**

##### **Normal tax position**

Whereas the position for accounting purposes of a lessor and a lessee has been discussed above, the normal tax position is different since it is the lessor in terms of a lease that may claim any qualifying capital allowances.

Section 23B of the Act prohibits a double deduction should it be possible to claim a deduction in terms of more than one provision of the Act. In terms of section 23B(3), no deduction shall be allowed under section 11(a) for any expenditure or loss of a type for which a deduction or allowance may be granted under any other provision of this Act, notwithstanding that the other provision may impose any limitation on the amount of the deduction or allowance.



The lessee may, during the lease period, claim the lease payments made in terms of the lease agreement, provided that they meet all the requirements to claim a section 11(a) deduction. The deduction will be based on expenses incurred even though actual payment has not yet been made. The amount that may be claimed will be the amount exclusive of any VAT, since section 23C of the Act prohibits the deduction of the input tax if the taxpayer is a registered vendor for VAT purposes and is entitled to a deduction of input tax in terms of section 16(3) of the Value-Added Tax Act.

There is, however, an additional requirement in terms of section 23C(1), should the lease agreement be defined as an 'instalment credit agreement' in terms of section 1 of the Value-Added Tax Act. This additional requirement is discussed under the heading of 'instalment credit agreement'.

### **Value-added tax position**

In terms of section 9(1) of the Value-Added Tax Act, the supply of goods or services is, unless otherwise provided, deemed to take place at the earlier of the time

- an invoice is issued by the supplier or the recipient for that supply, or
- any payment of consideration is received by the supplier for that supply.

In terms of section 9(2)(b), where that supply is a supply to which section 8(3) refers, the timing of the supply will take place on the day after the last day of the period during which the recipient may exercise the right under section 13 of the Credit Agreements Act 75 of 1980 to terminate the agreement.

Section 9(3)(a) states that where goods are supplied under any rental agreement or where services are supplied under any agreement or law which provides for periodic payments, they are deemed to be successively supplied for successive parts of the period of the agreement or as determined by the law, and each of the successive supplies is deemed to take place when a payment becomes due or is received, whichever is the earlier.

Thus the lessee will be able to claim input tax as the VAT portion that is included in each monthly instalment or when the payment becomes due, should it be earlier.

#### **At the end of the lease agreement**

At the end of the lease period the lessee has several options in relation to what to do with the item or asset.

#### **The lessee can continue using the asset for a reduced rental or for no rental**

##### **Normal tax position**

The lessee may still claim the reduced rentals (exclusive of any VAT) as a section 11(a) deduction should it still meet all the relevant requirements.

Section 8(5)(bA) states that if after the termination on or after 1 September 1983 by the effluxion of time or otherwise of a lease of property consisting of corporeal movable goods or of any machinery or plant for which the lessor under the lease was entitled to any allowance under the provisions of the Act, the person who was the lessee under the lease (hereinafter referred to as the former lessee) is, with the express or implied consent or acquiescence of the person who was the lessor under the lease (hereinafter referred to as the former lessor) or of the owner of the property, allowed to use, enjoy or deal with the property as the former lessee may deem fit

- without the payment of any consideration; or
- in the situation of a lease entered into on or after 1 September 1983, without the payment of any rental or other consideration or subject to the payment of any consideration which is nominal in relation to the fair market value of the property, the former lessee is deemed for the purposes of section 8(5)(b) to have acquired the property for no consideration and, if the property was owned by the former lessor, the fair market value thereof is, unless and until that value is otherwise determined to the satisfaction of the Commissioner, deemed for the said purposes to be the cost to the former lessor of the property

(or, where the said lease was a financial lease as defined in section 1 of the Sales Tax Act, the cash value of the property contemplated in paragraph 2 of Schedule 4 to the Sales Tax Act), less a depreciation allowance calculated in accordance with section 8(bB)(i) for the period from the commencement to the termination of the lease.

Section 8(5)(bB) provides for the purposes of section 8(5)(bA) that

- the depreciation allowance shall be calculated as an aggregate of annual allowances for the years in the period for which the depreciation allowance may be made, the allowance for the first year in the said period being calculated at the rate of 20% of the said cost or cash value, as the situation may be, of the property in question and the allowance for each succeeding year in that period being calculated at the said rate on the balance of the said cost or cash value, as the situation may be, remaining after the deduction therefrom of the allowance or allowances calculated for the year or years preceding the succeeding year;
- the former lessor of the property in question, or the owner thereof, as the situation may be, must, unless and until the contrary is proved, be deemed to have consented to the former lessee using, enjoying or dealing with the property as contemplated in the said paragraph if, at the end of a period of three months reckoned after the date on which the lease in question terminated, the former lessor has not instituted proceedings to compel the former lessee to return the property to the former lessor or to relinquish possession thereof or to dispose thereof in accordance with the terms of the lease;
- where any consideration is payable for the property in question for the period after the termination of the lease in question, the consideration is deemed to be nominal in relation to the fair market value of the property if that consideration, in relation to the period for which it is payable, amounts to less than 10 % a year of the fair market value as determined above.

There may be a recoupment in terms of section 8(5) that should be calculated, as indicated above, by first calculating the deemed fair market value (cost price to the lessor depreciated by 20% a year on the reducing-balance method) and then comparing 10% of the result with the reduced rental or no rental.

Should 10% of the deemed fair market value exceed the reduced annual rental, this difference will be regarded as a recoupment and must be included in the taxable income of the lessee.

If the lessee proves that the calculated deemed fair market value is higher than the actual fair market value, then the Commissioner may reduce the value of the recoupment.

### **Value-added tax position**

Input tax may still be claimed on the reduced monthly rentals since they will still be regarded as taxable supplies made by the lessor. The use of the asset in terms of the agreement is still regarded as a supply. In terms of section 10(3), the value of any consideration is

- the amount of money if the consideration is in money, and
- to the extent that the consideration is not a consideration in money, the open market value of that consideration.

Section 10(23) of the Value-Added Tax Act states that, save as otherwise provided in the provision, where any supply is made for no consideration the value of that supply is deemed to be 'nil'. It is thus submitted that there is a supply, although the value of the supply is at

- either the reduced rental, or
- at 'nil' when there is no further amount payable.

### **The lessee can give the asset back to the lessor**

#### **Normal tax position**

There is no normal tax effect.

### **Value-added tax position**

There is no VAT effect.

### **The lessee may acquire the asset for no consideration**

#### **Normal tax position**

Previously claimed rental payments will be recouped in terms of section 8(5) up to a maximum of the calculated fair market value (see above in this regard).

#### **Value-added tax position**

A supply has taken place but because it was for no consideration, the value of the supply will be regarded as 'nil' in terms of section 10(23) of the Value-Added Tax Act.

### **The lessee may acquire the asset for an agreed amount in terms of the agreement**

This amount is normally referred to as the residual amount.

#### **Normal tax position**

The deemed fair market value will be calculated (see above) and should it be higher than the agreed amount, lease payments previously claimed will be recouped up to a maximum of the difference between the fair market value and the agreed amount.

**Value-added tax position**

A supply will take place with the consideration equal to the agreed amount. Value-added tax will be added to this amount and may be claimed by the lessee should the lessee be a registered vendor.

## CHAPTER 4

### TAX POSITION OF THE PURCHASER OF THE ARTICLE OR ITEM IN TERMS OF AN INSTALMENT CREDIT AGREEMENT

#### **At commencement of the agreement**

##### **Normal tax position**

There is no normal tax effect.

##### **Value-added tax position**

The VAT is paid upfront at the commencement of the lease and is based on the cash cost of the asset, excluding any finance charges.

The time of the supply is either the date the goods are delivered or the time any payment is received by the supplier whichever is earlier.

The full amount may be claimed as an input deduction at the end of the first VAT period after the commencement of the transaction. The consideration for any goods supplied in terms of an instalment credit agreement is deemed to be their 'cash value'.<sup>15</sup> The cash value of the goods is

- the cost of the goods (inclusive of VAT) to the financier who is financing the supply, or
- in the instance of a dealer, the price (inclusive of VAT) at which the goods could be sold by him if bought from him for cash.

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<sup>15</sup> Section 10(6) of the Value-Added Tax Act.

The time of a supply under an instalment credit agreement is deemed to take place at the earlier of

- the date the goods are delivered, or
- the time any payment is received by the supplier.<sup>16</sup>

In a suspensive sale agreement, the date is when the 'cooling off' period of five days has expired.<sup>17</sup> This 'cooling off' period is a period of five days within which the buyer has the right to cancel the transaction.

### **During the agreement**

### **Normal tax and value-added tax positions**

The VAT position has an impact on the normal tax position and therefore the two positions are discussed at the same time.

A finance lease would in terms of the Value-Added Tax Act be regarded as an instalment credit agreement. The VAT on an instalment credit agreement is dealt with at the inception of the lease. The full amount of VAT may be claimed as input tax as calculated on the cash cost of the asset.

The lessee will, as is the situation with an operating lease, claim the lease payments as a tax deduction in terms of section 11(a), should all the requirements of that provision be met.

Whereas with an operating lease the amount that will be claimed is the payment exclusive of the VAT portion, the amount as calculated for a finance lease is the payment reduced by the VAT that was paid at inception of the agreement.

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<sup>16</sup> Section 9(3)(c) of the Value-Added Tax Act.

<sup>17</sup> Section 9(2)(b) of the Value-Added Tax Act.



Section 23C(1) provides that in the situation of any lease as contemplated in paragraph (b) of the definition of 'instalment credit agreement' in section 1 of the Value-Added Tax Act, there is excluded by the lessee from each rental payment made by him for the lease, an amount which bears to the input tax the same ratio as the rental payment bears to the sum of all rental payments in connection with the lease.<sup>18</sup>

Thus the section 11(a) deduction will be based on the actual monthly instalment due and payable reduced by the total input tax initially claimed divided in equal portions over the period of the agreement.

#### **At the end of the lease agreement**

At the end of the lease period the lessee has several options in terms of what to do with the item or asset.

#### **The lessee can continue using the asset for a reduced rental or for no rental**

##### **Normal tax position**

The lessee may still claim the reduced rentals (exclusive of any VAT portion) as a section 11(a) deduction should it still meet all the relevant requirements.

In terms of section 8(5)(a) any amount which has been paid, whether in the form of a rental or otherwise, by any person for the right of use or occupation of any movable or immovable property and which has been allowed as a deduction in the determination of that person's taxable income, and which (or the equivalent of which) is upon the subsequent acquisition of the property by that or any other person applied in reduction or towards settlement of the purchase price of the property, is included in the income of the person by whom the property is acquired as aforesaid for the year of assessment in which the person exercises the option or concludes the agreement, as the situation may be, in consequence of which the property is acquired by him. The provisions of section 8(5)(a) will not, however, apply in any instance

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<sup>18</sup> Keith Huxham and Philip Haupt *Notes on South African Income Tax* in 7.18.3.

where, in consequence of the acquisition of the property, the person who has acquired the property or any other person has derived a taxable benefit the cash equivalent of which has been included in his gross income in terms of the provisions of paragraph (i) of the definition of 'gross income' in section 1.<sup>19</sup>

Where any amount has been paid by any person for the right of use or occupation of any property which is thereafter acquired by that or any other person for a consideration which in the opinion of the Commissioner is not an adequate consideration or for no consideration, it is for the purposes of section 8(5)(a) deemed, unless the Commissioner having regard to the circumstances of the situation otherwise decides, that the said amount, or so much thereof as does not exceed the fair market value of the property as determined by the Commissioner less the amount of the consideration, if any, for which it has been acquired as aforesaid, has been applied in reduction or towards settlement of the purchase price of the property.

Section 8(5)(bA) provides that if after the termination on or after 1 September 1983 by the effluxion of time or otherwise of a lease of property consisting of corporeal movable goods or of any machinery or plant for which the lessor under the lease was entitled to any allowance under the provisions of the Income Tax Act, the person who was the lessee under the lease (the former lessee) is, with the express or implied consent or acquiescence of the person who was the lessor under the lease (the former lessor) or of the owner of the property, allowed to use, enjoy or deal with the property as the former lessee may deem fit

- without the payment of any consideration or,
- in the instance of a lease entered into on or after 1 September 1983, without the payment of any rental or other consideration or subject to the payment of any consideration which is nominal in relation to the fair market value of the property.

The former lessee will under these circumstances be deemed for the purposes of section 8(5)(b) to have acquired the property for no consideration and, if the property was owned by the former lessor, the fair market value thereof is, unless and until that value is otherwise determined to the satisfaction of the

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<sup>19</sup> Keith Huxham and Philip Haupt *Notes on South African Income Tax* in 7.18.5.

Commissioner, deemed for the said purposes to be the cost to the former lessor of the property. Where the said lease was a financial lease as defined in section 1 of the Sales Tax Act, the market value of the property will be the cash value of the property contemplated in paragraph 2 of Schedule 4 to the Sales Tax Act, less a depreciation allowance calculated in accordance with section 8(5)(bB)(i) for the period from the commencement to the termination of the lease.<sup>20</sup>

For the purposes of section 8(5)(bA) the depreciation allowance is calculated as an aggregate of annual allowances for the years in the period for which the depreciation allowance may be made, the allowance for the first year in the said period being calculated at the rate of 20% of the said cost or cash value, as the situation may be, of the property in question. The allowance for each succeeding year in that period is calculated at the said rate on the balance of the said cost or cash value, as the situation may be, remaining after the deduction therefrom of the allowance or allowances calculated for the year or years preceding the succeeding year.

Where any consideration is payable for the property in question for the period after the termination of the lease in question, the consideration is deemed to be nominal in relation to the fair market value of the property if that consideration, in relation to the period for which it is payable, amounts to less than 10 % a year of the said fair market value.

There may be a recoupment in terms of section 8(5), that is calculated, as indicated above, by first calculating the deemed fair market value (cost price to the lessor depreciated by 20% a year on the reducing-balance method). A comparison can then be made of 10% of the result with the reduced rental or no rental. Should 10% of the deemed fair market value exceed the reduced annual rental, this difference will be regarded as a recoupment and is included in taxable income.

If the lessee proves that the calculated deemed fair market value is higher than the actual fair market value, the Commissioner may reduce the value.

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<sup>20</sup> Keith Huxham and Philip Haupt *Notes on South African Income Tax* in 7.18.5.

### **Value-added tax position**

Input tax may still be claimed on the reduced monthly payments since they will still be regarded as taxable supplies made by the lessor. The use of the asset in terms of the agreement is still regarded as a supply. In terms of section 10(3), the value of any consideration is

- the amount of money if the consideration is in money, and
- to the extent that the consideration is not a consideration in money, the open market value of that consideration.

Section 10(23) of the Value-Added Tax Act provides that save as otherwise provided, where any supply is made for no consideration the value of that supply is deemed to be 'nil'. It is thus submitted that there is a supply, although the value of this supply is at either

- the reduced rental, or
- at no value when there is no further rental payable.

### **The lessee can give the asset back to the lessor**

#### **Normal tax position**

There is no normal tax effect.

#### **Value-added tax position**

There is no VAT effect.

### **The lessee may acquire the asset for no consideration**

#### **Normal tax position**

Previously claimed rental payments will be recouped in terms of section 8(5) up to a maximum of the calculated fair market value.

#### **Value-added tax position**

A supply has taken place but because it was for no consideration, the value of the supply will be regarded as 'nil' in terms of section 10(23) of the Value-Added Tax Act.

### **The lessee may acquire the asset for an agreed amount in terms of the agreement**

This amount is normally referred to as the residual amount.

#### **Normal tax position**

The deemed fair market value will be calculated and should it be higher than the agreed amount, the lease payments previously deducted will be recouped up to a maximum of the difference between the fair market value and the agreed amount.

A former lessor has three months after the termination of the agreement to reclaim the property. Should the lessor decide not to do so, he must within fourteen days thereafter, advise the former lessee of the cost of the asset or the cash value less the depreciation allowance of the asset.

The former lessor is also obliged to provide a copy of this advice to the Commissioner.

In terms of section 11(e) of the Act, a taxpayer may deduct from his income the amount by which the value of any machinery, plant, implements, utensils and articles, used by him for the purpose of his trade has been diminished because of wear and tear or depreciation.

The practice of the Commissioner is to allow wear and tear on the market value, should all the other requirements of this provision be complied with.

Section 12C of the Act provides for a deduction for any machinery or plant, which is used by the taxpayer for the purpose of his trade and is used by him directly in a process of manufacture or a similar process. This deduction is calculated at 20% of the cost of the item. Thus, any deductions of the lessee will be limited to the purchase price of the item and if it was acquired for no value, no section 12C deduction will be allowed.

Since section 11(e) specifically excludes any items for which a deduction may be granted in terms of section 12C, it is submitted that if the item is acquired for no consideration and is used by the taxpayer in the process of manufacture or a similar process, no wear-and-tear deduction will be allowed in terms of either section 11(e) or section 12C.

Should the lessee have the option to buy the asset at any time during the agreement and the lessee exercises that option at a price lower than its fair market value, the lessee will be taxed on the difference between the fair market value and the price at which the option was exercised. The amount taxable is, however, limited to the lease payments previously deducted.

If the lessee cedes this right to the agreement as provided in the option to somebody else, then this third party may be taxed on the difference (being the shortfall as discussed above) in terms of section 8(5)(a), even though the third party had not previously claimed any deduction for this asset.

Section 8(5)(bA) applies to a lease of property consisting of

- corporeal movable goods, or
- machinery or plant on which the former lessor was entitled to any allowance under the Act.

Since there is no specific requirement that the machinery or plant be movable, it is submitted that the machinery or plant that has become immovable because of it becoming a fixture will also be covered by these provisions.

If the lessor is not the owner of the asset but a lessor in terms of a sublease (being a lessee under the 'main' lease), the fair market value will be determined for the purposes of section 8(5)(b) by the Commissioner.

#### **Value-added tax position**

A supply will take place with the consideration being the agreed amount. Value-added taxation will be added to this amount and may be claimed by the lessee as an input deduction should he (the lessee) be a registered vendor and the asset a 'qualifying' asset.

## CHAPTER 5

### TAX POSITION OF THE PURCHASER OF THE ARTICLE OR ITEM IN TERMS OF A SUSPENSIVE SALE AGREEMENT

An agreement will be a suspensive sale agreement when there exists any condition that may suspend the workings of the agreement. Normally a suspensive sale agreement is used for finance purposes. A condition is that ownership will not pass until the buyer has paid the last instalment and the full capital amount of the sale has been settled.

#### **At commencement of the agreement**

#### **Normal tax position**

There is no normal tax effect.

#### **Value-added tax position**

This transaction will be regarded as a suspensive sale agreement and the full VAT portion of the agreement may be claimed as an input tax deduction at the end of the first VAT period following the date of the transaction.

The time of the supply is the date when the 'cooling off' period of five days has expired.<sup>21</sup> Normally the VAT is capitalised in the transaction and is financed over the period of the agreement.

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<sup>21</sup> Section 9(2)(b) of the Value-Added Tax Act.



## **During the agreement**

### **Normal tax position**

The agreement consists of the repayment of capital and the payment of interest. Whereas with a lease, the lessee may not claim tax allowances, the position is different with a suspensive sale agreement, since it is treated as an outright purchase with a finance agreement linked to it.

Capital allowances are available for the buyer (as the taxpayer) on condition that all the other relevant requirements of the Act are complied with.

The following qualifying allowances are those normally claimed

### **Section 11(e) allowance**

The section 11(e) allowance is the sum the Commissioner considers just and reasonable as the amount by which the value of machinery, plant, implements, utensils and articles used by the taxpayer for the purpose of his trade, has been diminished by reason of

- wear and tear, or
- depreciation.

This provision should be read with Practice Note 19 and Practice Note 39.

Although the practice is to apply the wear-and-tear rate to the cost of the asset, it is possible to claim wear and tear on an asset without any cost, since the provision refers to 'value'. Proviso (vii) to section 11(e) supports this view. It provides that where the value of any of this machinery, implements, utensils and articles acquired by the taxpayer on or after 15 March 1984 is for the purposes of this provision to be determined having regard to its cost, the cost is deemed to be the cost which, in the opinion of the

Commissioner, a person would, if he had acquired it under a cash transaction concluded at arm's length on the date on which the transaction for the acquisition of it was in fact concluded, have incurred for the direct cost of it, including the direct cost of the installation or erection thereof.

In terms of Practice Note 19 the cost is defined as the arm's length cost of a cash transaction, including the direct cost of installation or erection.

In terms of section 23C the VAT may not be added to the cost of the asset and may not therefore give rise to a deduction when the input tax is deductible. The VAT paid is then excluded from the cost of the asset or the amount of the expenditure. It is submitted that, in the instance of purchasing an asset where the input tax may not be claimed, the input tax may be capitalised and depreciated over the useful life of the asset. Although section 11(e) refers to the value and not to the cost, the reference to 'amount' indicates the intention that deductible input tax should not be included in the calculation of the deduction.

If the purchaser is, however, a financial institution, the value or cost should be calculated on the following basis.

The income stream of a financial institution is normally net interest and other income (mostly fee income). Since the interest income is an exempt supply for VAT purposes, a full input tax may not be claimed, since it has not been incurred for a taxable supply.

Most banks use the turnover method to calculate the deductible VAT ratio. This treatment is based on a directive issued by the Commissioner and directed to the South African Council of Banks. The deductible ratio is based on the taxable supplies (fee income) as a percentage of all supplies (taxable supplies and net interest). The deductible ratio is then applied to input tax where the actual item has been used for both taxable and exempt supplies.

The input tax, which is not claimed, is expended as a VAT cost item. It is submitted that where an asset is purchased by a bank, and the deductible ratio is applied to the input tax, the difference that may not be claimed for VAT purposes (being the non-deductible portion), represents part of the cost of the asset and should be depreciated. The reason for this is because section 23C has the following two requirements before VAT is excluded from the cost of the asset or the amount of the expenditure.

- The taxpayer must be a vendor in terms of the Value-Added Tax Act.
- The taxpayer is or was in any previous year of assessment entitled to a deduction of input tax.

Since part of the input tax could not be claimed as a deduction it is not excluded from the cost of the asset or the amount of the expenditure.

### **Section 12C allowance**

Section 12C is a special depreciation allowance given at a rate of 20% a year. The allowance is calculated on the cost of machinery or plant used by the taxpayer for the purposes of his trade and which is used by him directly in a process of manufacture or a similar process.

In terms of section 12C(2) the cost of the asset is deemed to be the lesser of

- the actual cost of the asset to the taxpayer, and
- its market value.

Market value can be construed as the deemed cost of acquisition. This deemed cost of acquisition will be with the assumption that the asset had been acquired under a cash transaction and concluded at arm's length. The market value must be determined as on the date on which the transaction for the acquisition of the asset was concluded.

Because section 23C excludes input tax which has been deducted from the cost of the asset, the cost to be applied for the purposes of section 12C will be the cost excluding deductible input tax.

### **Finance charges**

Any credit agreement that is concluded will normally have a finance charge component, since the party providing the finance has incurred a cost in providing the funds and should be reimbursed for providing the use of the funds, with the relevant margin added to the capital amount advanced.

Melamet J in ITC 1485<sup>22</sup> referred to interest as an expense to compensate a lender for the time period during which the money is lent to a second party. It cannot be incurred prior to the time during which the money is used. It is incurred and accrues from day to day.

Any finance charge that is incurred by the buyer of the item or asset may be claimed as a tax deduction in terms of either section 11(a) or section 11(bB).

Section 23B(3) provides that no deduction will be allowed under section 11(a) for any expenditure or loss of a type for which a deduction or allowance may be granted under any other provision of this Act, notwithstanding that the other provision may impose a limit on the amount of the deduction or allowance. Thus, since finance charges may be claimed in terms of section 11(bB), no claim in terms of section 11(a) may be made, unless the finance charges relate to assets not stipulated in section 11(bB).

This provision may have the effect of allowing expenditure of a capital nature as a deduction.

Before section 11(bB) was promulgated, the deduction of finance charges had to be decided under the general deduction formula (section 11(a)).

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<sup>22</sup> (1990) 52 SATC 337.

ITC 774 dealt with the finance charges incurred in terms of a hire purchase agreement.

Newton Thompson J who gave the judgment in this case made the following remark:<sup>23</sup>

'It seems to me that here the true nature of this contract is the sale of this motor vehicle on credit and this expenditure was part of the expenditure necessary for the purpose of acquiring a capital asset for the business.'

It seems that although the finance charges can be construed as being part of the cost of the asset, which normally could be depreciated, section 11(bB) explicitly provides for the deduction of the finance charges incurred.

In terms of section 11(bB), any finance charge incurred by the taxpayer for the purchase or contract price owing under an agreement for the acquisition, installation, erection or construction of any machinery, plant, aircraft, implement, utensil, article or livestock used by him for the purposes of his trade, including (but not limited to) mining, shipping or farming, which deduction is in lieu of any deduction or allowance for finance charge which may be allowable under any other provision of this Act.

Any finance charge (other than a finance charge which falls to be dealt with in terms of the provisions of section 24J) which is calculated or payable for a period of more than twelve months extending beyond the end of the current year of assessment, is deemed to have been incurred from day to day during the period.

Finance charges calculated or payable over a period of twelve months or less extending beyond the end of the current year of assessment, are deductible in the year of assessment in which they are incurred. The payment of this interest may happen only in the next year of assessment.

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<sup>23</sup> (1953) 19 SATC 311 at 313.

## **Interest paid**

When considering the tax deduction of interest paid or incurred in terms of the general deduction formula (section 11(a)), the following parts of the formula need specific clarification.

## **Incurred**

Interest will be incurred when an unconditional liability to pay it has arisen. It is a matter of fact whether expenditure has been actually incurred. No requirement exists that the expenditure must be necessarily incurred.

For the purposes of the general deduction formula the expenditure need merely be incurred and is it not a requirement that it should be paid. Since it is the date of incurral which will determine the timing of the deduction, the date of payment is irrelevant. It is possible that expenditure will be incurred in one year and be paid in the following year. The taxpayer becomes liable for payment when the liability may be regarded as absolute and unqualified.

In ITC 1496,<sup>24</sup> which dealt with an investment in a plantation development, a promissory note was issued during the year of assessment. The taxpayer sought to deduct the interest incurred on a promissory note. The interest was payable only five years later. The court held that the liability to pay interest is conditional upon the existence of a loan. There must be an absolute and unconditional legal obligation to pay the expenditure in an ensuing year. The interest will be deductible only in the year of assessment in which the condition is fulfilled. The loan's existence at the time it is sought to recover accrued unpaid interest is a requirement for the right to claim the interest incurred.

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<sup>24</sup> (1991) 53 SATC 229.

In the subsequent Appellate Division of the Supreme Court (now the Supreme Court of Appeal) decision of *Burgess v CIR*<sup>25</sup> the court found that the full amount of interest had been incurred at the outset of the loan transaction, although the payment of the interest was due only at the end of the relevant period. This latter judgment of the Appellate Division overrules the earlier Special Court judgment.<sup>26</sup>

The approach as referred to in the *Burgess* case was supported in ITC 1587. The court held as follows:<sup>27</sup>

‘We respectfully do not go along with the learned judge’s distinction between “a contractual liability to pay interest at some future date” and “the actual liability so to pay”. The liability to pay the amount due on a note arises upon issue thereof. It is in its nature contractual. It is actual in the sense that it is real, it exists, and it is not contingent. The interest was not separately specified on the promissory note and the debt payable on maturity could not be split ex facie the note into capital and interest. There was no way in which earlier payment of the note than on due date could bring about a reduction of interest unilaterally. The unlikely possibility of a later agreement to grant a reduction of interest upon earlier redemption of a note cannot affect the original unconditional nature of the transaction.’

The decision in ITC 1587 was followed by an amendment to the Act in the form of the introduction of section 24J. This section applies as from March 1995.

Section 24J deals in detail with the timing of incurral and accrual of interest on certain types of instruments.

### **In the production of the income**

Interest is a payment for the purpose of finance and is therefore of a revenue nature. In *CIR v Standard Bank of SA Ltd*,<sup>28</sup> a bank invested part of its borrowed funds in preference shares. The Commissioner disallowed the deduction of a portion of the interest it had incurred because the interest produced tax-free dividends and was therefore not incurred in the production of the income.

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<sup>25</sup> *Burgess v CIR* 1993 (A), 55 SATC 185.

<sup>26</sup> *Butterworths Income Tax in South Africa* in 10.2.5.

<sup>27</sup> (1994) 57 SATC 97 at 106.

<sup>28</sup> 1985 (4) SA 485 (A), 47 SATC 179.

The court disagreed with the Commissioner and held that the general purpose of the funds borrowed had to be looked at, and since the funds were generally raised to produce income, the interest incurred on all funds borrowed was held to be deductible.

The following principles arose out of the *Standard Bank* case.<sup>29</sup>

Generally, in deciding whether money paid by a taxpayer constitutes 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. In this regard the closeness of the connection between the expenditure and the income-earning operations must be assessed.

In determining whether interest (or other like expenditure) incurred by a taxpayer for moneys borrowed for use in his business is deductible in terms of the general deduction formula, a distinction may in certain instances have to be drawn between the situation where the taxpayer borrows

- a specific sum of money and applies it to an identifiable purpose, and
- money generally and upon a large scale in order to raise floating capital for use in its business.

In the former situation both the purpose of the expenditure (in the form of interest) and what it actually effects may easily be determined and identified. A clear and close causal connection may be traced. Both these factors are important considerations in determining the deductibility of the expenditure.

In the latter situation, however, and more particularly in the situation of institutions like the bank, there are certain factors which prevent the identification of the causal connection. It therefore cannot be said that the expenditure was incurred in order to achieve a particular effect. All that may be said is that the expenditure is incurred in order to provide the institution with the capital with which to run its business. It is impossible to link particular expenditure with the various ways in which the capital is in turn used.

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<sup>29</sup> *Silke on South African Income Tax* in paragraph 7.34.



The factors referred to above are the following:

- As a matter of commercial necessity the institution accepts, in other words, it borrows all moneys tendered to it by depositors.
- All moneys borrowed go into a common pool, which constitutes a general fund used for all purposes.
- Generally the institution's expenditure by way of interest on borrowed moneys is not aimed at any particular form of use of the borrowed moneys. Instead it is dictated by the nature of the institution's income-earning operations of borrowing all money offered cheaply and then lending out as much thereof as it may possibly invest.

When the general principle whether any expenditure was incurred in the production of the income is considered, the purpose of the expenditure and what it actually effects must be looked at.

In *CIR v Allied Building Society* the court held that the ultimate use of money borrowed was not a decisive factor in determining the deductibility of the interest payable on that money. In this regard the following statement is relevant.<sup>30</sup>

'What has to be inquired into is the true nature of the transaction. Its true nature is a matter of fact, and the purpose of the expenditure in question is an important factor (*New State Areas v CIR*, 1946 A D 610 at 627.)'

In *Producer v COT*,<sup>31</sup> the position was considered of a taxpayer who had borrowed money for the ordinary purposes of his business and who thereafter invested it in shares which did not produce any income. From *Producer v COT* and the cases on which it was based, the following principles may be extracted.<sup>32</sup>

- Where a taxpayer borrows a specific sum of money and applies that sum to a purpose unproductive of income, and not directly connected with the income-earning part of his business, then the interest paid on the borrowed money cannot be deducted as expenditure incurred in the production of the income.

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<sup>30</sup> 1963 (4) SA 1 (A), 25 SATC 343 at 351.

<sup>31</sup> Southern Rhodesia 1948 (4) SA 230 (SR), 15 SATC 405.

<sup>32</sup> *Butterworths Income Tax in South Africa* in 10.3.6.

- Where a taxpayer has for good and sufficient reasons borrowed money for use in the business producing his income, but has subsequently in pursuit of a legitimate business purpose invested the money in an investment which does not produce income. Any resulting interest incurred is still deductible for normal tax purposes. It is clear that the test to be applied is the purpose for which the money was originally borrowed.

Interest paid on money borrowed and used for the purposes of a business would appear to be expenditure actually incurred in the production of the income of the business, whether the loan was for the acquisition of fixed or floating capital.<sup>33</sup>

The above principle was stated in a slightly different way in *Burgess v CIR*.<sup>34</sup> In this case the taxpayer had borrowed funds to acquire an insurance policy, which would yield income. The Commissioner argued that this interest was of a capital nature on the basis that the insurance policy was a capital asset. Although the court held that the policy was not in fact a capital asset, it went further and stated the following:<sup>35</sup>

‘If one assumes that the policy which produces that income is a capital asset, the appellant would have borrowed money to procure the capital asset which produces the income.’

### **Timing of the deduction**

ITC 1485<sup>36</sup> dealt with the question of interest incurred on negotiable certificates of deposit. In this case the taxpayer, a bank, claimed interest which was payable only in the future. Melamet J said that since interest cannot be incurred prior to the time during which the money is used, it is incurred and accrues from day to day. He concluded that the taxpayer had failed to discharge the onus of proving that the interest was deductible under the provisions of section 11(a).

<sup>33</sup> *CIR v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A), 20 SATC 113.

<sup>34</sup> *Burgess v CIR* 1993 (A), 55 SATC 185.

<sup>35</sup> *Butterworths Income Tax in South Africa* at 10.3.6.

<sup>36</sup> (1990) 52 SATC 337.

Interest is the result of a contractual agreement between the lender and the borrower, where the terms of the agreement will determine when the borrower incurs the interest liability and when it accrues to the lender.

The lender and the borrower cannot agree that interest is incurred in advance, but that it is payable in advance.

Generally, interest is incurred

- from day to day on a call account, and
- when it is due and payable on a loan which has a fixed period.

In ITC 1587 the deductibility of a discount on a promissory note was considered. With reference to Melamet J's judgment in ITC 1485, Van Dijkhorst J said the following:<sup>37</sup>

"The expression "expenditure actually incurred" in section 11(a) of the Act does not mean expenditure actually paid during the year of assessment, but means all expenditure in respect of which the taxpayer has incurred an unconditional legal obligation during the year of assessment, whether or not that liability has been discharged during that year.

"The proposition that interest cannot be incurred prior to the time during which the money is used but is incurred and accrues from day to day is in my respectful view too widely stated. Nothing prevents parties to agree that interest on a loan for a fixed period will be payable in advance."<sup>38</sup>

"Nothing prevents parties to calculate the interest, which is compensation for money lent, not on a daily basis but on a weekly or monthly basis or just in a lump sum. In fact a borrower who has borrowed a lump sum for a year at a specified interest cannot under our common law unilaterally reduce the sum of interest by accelerated payment of the capital. If on the other hand the capital is repayable at will and the interest is calculated on a daily basis the above-stated proposition that the interest accrues from day to day is correct. The term over which it is to be calculated is undetermined, the quantum of whatever is to be paid is only determinable when the capital is repaid."<sup>39</sup>

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<sup>37</sup> (1994) 57 SATC 97 at 103.

<sup>38</sup> *Tucker v Ginsberg* 1962 (2) SA 58 (W) at 62E.

<sup>39</sup> *Voet* in 22.1.9; *Bernitz v Euvrard* 1943 AD 595.

'In the case of X Investments (Pty) Ltd No 9680 (unreported) in which judgment was delivered in this court on 28 March 1994, Melamet J (at p 23 of the typed judgment) stated:

"The date when a lender of money becomes "entitled" to interest on the loan depends upon the terms of the loan agreement. Having regard to the nature of a contract of loan in the present case where interest is payable only at the end of a fixed period, the lender's entitlement to interest is conditional upon his willingness and ability to make the money available to the borrower for the whole of the fixed period; and therefore the right to the interest does not accrue to him until the end of the fixed period, unless the contract otherwise provides." <sup>40</sup>

The reasoning seems to be that depending upon the terms of the contract of loan the right to interest may or may not accrue.

If the money is not made available to the borrower then no right to interest accrues. One cannot fault this reasoning. The contract of loan gives rise to reciprocal obligations and failure to perform disentitles the lender to claim performance from the borrower. It is difficult, however, to reconcile the above reasoning with that in ITC 1485 and ITC 1496.

In *CIR v Cactus Investments (Pty) Ltd*<sup>41</sup> the court held that the right to claim interest vested on the lender on the day the loan was made. In this regard the following was stated.<sup>42</sup>

'Therefore when the respondent entered into the agreements with UAL Merchant Bank, First National Bank and Bullion Merchants it immediately acquired the right to claim payment of the capital and the interest payable in terms of the agreements. Both were fixed irrespective of the date upon which they were paid. The respondent's right to claim interest was not subject to any further performance of any obligation by the respondent. It was simply subject to a time provision ("tydsbepaling") (*De Wet and Yeats Kontraktereg* 4ed at 146). It was certain that the period would elapse and it was certain that interest in terms of the agreements would accrue and become payable. The right to claim interest in terms of the agreements therefore vested in the respondent on the day when each investment was made and therefore accrued to the respondent on that date as gross income in terms of s 1 of the Act.'

The question of incurral of interest or finance costs arising from an 'instrument' is now decided in terms of section 24J and not in terms of legal precedent. The normal principles are, however, still applied to decide

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<sup>40</sup> (1994) 57 SATC 97 at 107.

<sup>41</sup> 60 SATC 141 at 157.

<sup>42</sup> *CIR v Cactus Investments (Pty) Ltd* 1996 (TPD), 60 SATC 141 at 157.

on whether the item is of a capital or revenue nature. All that section 24J does, is to spread the interest over the period (term) of the financial arrangement. It determines solely 'when' interest is incurred.

Sometimes a finance agreement will stipulate that the full amount payable in terms of the agreement should be paid at the end of the lease period. The finance charges calculated over the period of the agreement were then claimed as a section 11(a) deduction when the expenses were incurred, although actual payment would take place only at the end of the period of the agreement. With the introduction of section 24J this has changed.

The principles contained in section 24J have no effect on the source, or capital and revenue provisions of the Act, but are directed solely to the timing of the incurral and accrual of interest.<sup>43</sup>

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<sup>43</sup> *Silke on South African Income Tax* in paragraph 17.61.

## CHAPTER 6

### TAX IMPLICATIONS OF SECTION 24J

In terms of section 24J(2), any person who is the issuer in relation to an instrument during a year of assessment (the person who has borrowed the money – see below), is deemed to have incurred an amount of interest, equal to

- the sum of all accrual amounts in relation to all accrual periods falling, whether in whole or in part, within the year of assessment for the instrument; or
- an amount determined in accordance with an alternative method.

In terms of section 24J(3), any person who is the holder of an income instrument during any year of assessment, is deemed to have accrued to him during the year of assessment, an amount of interest equal to

- the sum of all accrual amounts in relation to all accrual periods falling, whether in whole or in part, within the year of assessment for the instrument; or
- an amount determined in accordance with an alternative method.

#### **An issuer**

An issuer is any person who has incurred any interest in terms of an instrument or where interest is due and payable in terms of the instrument.

## **A holder**

A holder, in relation to an income instrument means any person who

- has become entitled to any interest in terms of the income instrument; or
- if any interest payable in terms of the income instrument was due and payable at that time, would be entitled to receive payment of the interest.

## **Interest**

Interest is defined in section 24J(1) and includes the following:

- The gross amount of any interest or related finance charges, discount or premium payable or receivable in terms of or for a financial arrangement.
- The gross amount payable by a borrower to the lender, for any interest-bearing arrangement, irrespective of the term of the arrangement, which represents compensation for any amount to which the lender would have been entitled to, but for the lending arrangement.
- The absolute value of the difference between all amounts receivable and payable by a person in terms of a sale and leaseback arrangement as contemplated in section 23G throughout the full term of the arrangement, to which the person is a party, irrespective of whether the amount is calculated with reference to a fixed rate of interest or a variable rate of interest or payable or receivable as a lump sum or in unequal instalments during the term of the financial arrangement.

The definition of 'interest' applies irrespective of whether the amount is calculated

- on a fixed rate of interest, or
- a variable rate of interest, or
- is receivable or payable according to a fluctuating payment plan during the term of the financial arrangement.

Although discounts and premiums are specifically included in the definition of 'interest' and are included in the calculation of the yield to maturity, it is possible that the discounts and premiums constitute capital and therefore, it may be argued that they should not be included in interest. It is submitted that the accrual amount, obtained under the yield to maturity method, should be adjusted so that it will not include the impact of discounts and premiums, in the calculation of taxable income.<sup>44</sup>

The reason for this argument for the nature of accrual in the hands of the holder of an instrument, is that the capital or revenue nature of the accrual is only determined upon the transfer or redemption of the instrument. The accrual has, however, been deemed to have taken place in the intervening period without any reference to its capital or revenue nature.<sup>45</sup>

It is important to note that the normal rules for capital and revenue apply equally to the interest income or interest expense, which is deemed to have accrued or to have been incurred.

### **Instrument**

An instrument means any form of an interest-bearing arrangement, whether in writing or not, including

- any stock, bond, debenture, bill, promissory note, certificate or similar arrangement;
- any deposit with a bank or other financial institution;
- any secured or unsecured loan, advance or debt;
- any acquisition or disposal of any right to receive interest or the obligation to pay any interest, as the situation may be, in terms of any other interest-bearing arrangement; and
- any repurchase agreement or resale agreement,

which was issued or deemed to have been issued after 15 March 1995.

Any lease agreement (other than a sale and leaseback arrangement as contemplated in section 23G) is, however, excluded from the definition of an 'instrument'.

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<sup>44</sup> *Silke on South African Income Tax* in paragraph 17.63.

<sup>45</sup> *Silke on South African Income Tax* in paragraph 17.63.



Other instruments which do not fall within the scope of section 24J are

- savings and call accounts,
- fixed deposits not exceeding one year, and
- fixed deposits where, although the term exceeds one year, the interest payable is both fixed and paid annually.<sup>46</sup>

The accrual basis applies to all interest accrued or incurred for all instruments issued or acquired by a company. In the situation of any person other than a company the accrual basis applies only to an income instrument. An income instrument is an instrument which will, or is likely to exceed one year and which is issued or acquired at a discount or a premium or bears deferred interest.

#### **Income instrument**

An income instrument means

- an instrument in the situation of a company, but
- where the holder or issuer of the instrument is not a company,
  - any instrument where the terms of the instrument will, or are likely to exceed one year, and
  - which is issued or acquired at a discount or premium or bears deferred interest.

Since the definition of 'deferred interest' is prefaced by the word 'includes', it is wide and includes interest calculated at either

- a variable, or
- at a constant rate.

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<sup>46</sup> *Silke on South African Income Tax* in paragraph 17.63.

It was, however, stated in the Explanatory Memorandum on the Income Tax Bill, 1995, that any interest rate which is linked to a recognised base rate or index by applying a constant factor is regarded as a constant rate.<sup>47</sup>

‘Consequently, where interest is payable or receivable within 12 months from the date of commencement of the “accrual period”, unless the instrument is issued or acquired at either a discount or premium, the instrument will not be regarded as bearing “deferred interest” and will not fall under the definition of “income instruments”, thus rendering the provisions of s 24J inapplicable in respect of such instrument.’

### **Accrual amounts**

An accrual amount in relation to an accrual period, means an amount determined in accordance with the following formula:

$$A = B \times C$$

in which formula—

- ‘A’ represents the amount to be determined;
- ‘B’ represents the yield to maturity; and
- ‘C’ represents the adjusted initial amount.

Provided that

- where the commencement or end of any year of assessment falls within an accrual period, the amount so determined will be apportioned on a day-to-day basis over the term of the accrual period. The purpose in doing this will be to determine the relevant portion of the amount relating to that part of the accrual period falling within the year of assessment;
- where an instrument is transferred on a date other than at the end of an accrual period, the amount so determined will be apportioned on a day-to-day basis over the term of the accrual period in order to determine the relevant portion of the amount relating to the relevant transferor or transferee in relation

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<sup>47</sup> *Silke on South African Income Tax* in paragraph 17.63.

to the instrument. The amount so determined in the calculation will be appropriately adjusted by any amounts received or payments made other than at the end of an accrual period.

### **Accrual period**

An accrual period, in relation to an instrument, means

- the period between the regular payments where regular payments at intervals of equal length and not exceeding twelve months per interval are to be made throughout the term of the instrument; or
- any period not exceeding twelve months elected by the holder or issuer, which period will be applied consistently throughout the term of the instrument.

Thus, interest will be calculated for each accrual period. It is spread over the term of the instrument on a compounding accrual basis. The timing of the actual receipts or payments of the interest are ignored.<sup>48</sup>

The calculated interest is added to the outstanding capital portion of the debt.

The accrual period will vary according to the terms and conditions of the relevant instrument.

Although it is not necessary for this dissertation to define all the other terms used in section 24J it is important to investigate the process of yield to maturity.

### **Yield to maturity**

The yield to maturity is defined as the rate of compound interest per accrual period at which the present value of all amounts payable or receivable in terms of any instrument in relation to a holder or an issuer, as the situation may be, of the instrument during the term of the instrument equals the initial amount in relation to the holder or issuer of the instrument.

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<sup>48</sup> *Silke on South African Income Tax* in paragraph 17.63.

Provided that where<sup>49</sup>

- the instrument is a variable rate instrument, the rate of compound interest will be calculated with reference to the variable rate applicable on the date the rate of compound interest is to be calculated to determine all amounts payable or receivable after the date;
- in the situation of a variable rate instrument and the variable rate changes, the rate of compound interest is recalculated in relation to the variable rate instrument with reference to the appropriate adjusted initial amount in relation to the variable rate instrument determined before the change in the rate and the changed variable rate applicable on the date the rate of compound interest is to be recalculated to determine all amounts payable or receivable after the date;
- any variation in the terms or conditions of the instrument takes place which will result in a change in the rate of compound interest in relation to the instrument, the rate of compound interest is recalculated in relation to the instrument with reference to the appropriate adjusted initial amount in relation to the instrument determined before the variation; or
- there is a variation or alteration
  - of the rights or interests of a holder in relation to an income instrument to receive interest in terms of the income instrument, the rate of compound interest in relation to the income instrument is recalculated for the holder with reference to the appropriate adjusted initial amount in relation to the income instrument determined before the variation or alteration: or
  - in the obligations of an issuer in relation to an instrument to pay any interest in terms of the instrument, the rate of compound interest in relation to the instrument is recalculated for the issuer with reference to the appropriate adjusted initial amount in relation to the instrument determined before the variation or alteration.

The yield to maturity rate may be determined either

- at the end of the year of assessment for the application thereof or
- during the year of assessment, or
- on an ongoing basis.

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<sup>49</sup> Section 24J.

Where any changes occur in relation to the interest rate which will have the effect that future interest payments will be different from the amounts used to calculate the original yield to maturity, the yield to maturity will have to be recalculated. This recalculation need only be done at the end of the accrual period.

The effect of the recalculation of the yield rate will be that accrual amounts, which have already been taken into account in the taxpayer's taxable income, will not be effected by these changes in relation to the instrument.

The provision allows for an alternative method of calculating interest to be used for any class of instruments, as long as the following requirements are met;

- it must conform to generally accepted accounting practice, and
- it should be applied for the class of instruments to which the instrument belongs.

The method applied should achieve a result in so far as the timing of accrual and incurral of interest is concerned which does not differ significantly from the result achieved when the yield-to-maturity method is applied as provided for in section 24J(2).

A class of instruments<sup>50</sup> is to be regarded as the group of instruments which have similar characteristics pertaining to the

- terms and conditions,
- method of calculating interest,
- payment of interest, and
- intervals of compounding or the description thereof.

In the Explanatory Memorandum a difference of 8,7% was called acceptable, while a difference of 21% was called unacceptable. The 21% will thus be a significant difference when considering an alternative method.<sup>51</sup>

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<sup>50</sup> *Silke on South African Income Tax* in paragraph 17.63.

<sup>51</sup> *Silke on South African Income Tax* in paragraph 17.63.

Since there are no guidelines as to the meaning of the term significant difference, taxpayers may interpret the term either<sup>52</sup>

- ‘from the perspective of the percentage by which the result obtained under the alternative method differs from the result obtained under the yield-to-maturity method, or
- in the light of the absolute difference between the two methods.’

No approval from the Commissioner is required in this regard.

A third method to be used, is the method as provided for in section 24J(9). In terms of this provision a company which is dealing in instruments or interest rate agreements (in other words, its trading stock), may elect that the provision of section 24J(2) to section 24J(8) do not apply to its instruments or interest rate agreements (trading stock). The following requirements would, however, have to be complied with.

- Any election made must be made in writing.
- This election must be accompanied with details of the method used to determine the market value (see below) of the instruments or interest rate agreements.
- The Commissioner must approve the method used to determine the market value and the manner in which the market value will be taken into account to determine its taxable income.
- This election will be binding on it for the year of assessment and every succeeding year of assessment.

The market value must be determined in accordance with a commercially accepted practice which is applied by the company consistently for all the instruments and interest rate agreements for financial reporting purposes to its shareholders.

The definition of a ‘holder’ refers to ‘in relation to an income instrument’ and the definition of an ‘issuer’ refers to ‘in relation to an instrument’.

This difference in definition will have no importance to a company, since an ‘income instrument’ is defined as ‘any instrument’.

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<sup>52</sup> *Silke on South African Income Tax* in paragraph 17.63.

The term 'accrual period' is applied in practice as the intervals of equal length which do not exceed twelve months. This accrual period is calculated as the period between regular payments.

If reference is made to six-monthly payments, the intervals are not of equal length when counted in days. A six-month period can be 182 or 183 days in length. Although the legal application of equal length is to calculate the number of days in a period, the intention of the legislature surely was to include periods of equal length in months, and equal number of months should also meet this 'equal length' requirement.

Both the issuer and the holder may elect the period, being 'any period not exceeding twelve months elected by the issuer or holder'. The effect of this is that the same instrument may have different accrual periods as elected by the issuer and the holder.

The yield to maturity takes into account all cash flows of an instrument and represents the actual compound interest rate receivable or payable in terms of the instrument.

The definition of 'yield to maturity' is similar to the definition as applied in the financial management environment. The rate of return calculated for a fixed interest security, based on the present values of all the security's cash flows, is known as the security's yield to maturity.

The rate must be redetermined every time there is a change in the holder or the issuer of an instrument.

### **Applied in practice**

The yield to maturity is calculated on expected cash flows. This yield applies to this instrument until there is a change in the interest rate. To determine the interest accrued or incurred this yield then has to be applied to the capital amount borrowed, by multiplying the yield rate by the capital amount and the number of days between the date when the loan was raised and the end of the accrual period.

This capital amount or initial amount is then adjusted with the accrual amounts in relation to all previous accrual periods and also adjusted with the actual interest received or paid in terms of the income instrument. The yield rate will then be applied to this adjusted initial amount to calculate the interest for the current accrual period.



## CHAPTER 7

### TAX POSITION OF THE SELLER OR FINANCIER OF THE ARTICLE OR ITEM – GENERAL POSITION

#### Normal tax position

In terms of section 5 of the Act, there is paid annually for the benefit of the National Revenue Fund, an income tax calculated on the taxable income received by or accrued to or in favour of any person or any company during every financial year.

Taxable income is defined as the amount remaining after deducting from the 'income' of any person all the amounts allowed under Part 1 of Chapter II to be deducted from or set off against the 'income'.

Income is defined as the remaining 'gross income' after deducting 'exempt income'.

Gross income, in relation to any year or period of assessment, means, in the case of any person, the total amount, in cash or otherwise, received by or accrued to a resident of the Republic or in the situation of a non-resident from a source or deemed source in the Republic, during the year or period of assessment, excluding receipts or accruals of a capital nature, but including, without in any way limiting the scope of this definition, the amounts (whether of a capital nature or not) so received or accrued as are referred to in paragraphs (a) to (n) (generally referred to as specific inclusions in the definition of 'gross income').

The seller of an article will receive an amount or will become entitled to an amount.

In *Lategan v CIR*, it was stated that an amount is <sup>53</sup>

'not only money, but the value of every form of property earned by the taxpayer, whether corporeal or incorporeal, which has a money value'.

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<sup>53</sup> 1926 CPD 203, 2 SATC 16 at 19.

In *CIR v Delfos* it was held that<sup>54</sup>

‘something which is not money’s worth or cannot be turned into money, is not to be regarded as income’.

In *SIR v Silverglen Investments (Pty) Ltd*<sup>55</sup> it was held that the Commissioner is bound to assess the amount in the year of its accrual and does not have the right to elect that the amount be assessed when it is received.

The term ‘received by’ was decided in *Geldenhuis v CIR*<sup>56</sup> as meaning received by the taxpayer

‘on his own behalf and for his own benefit’.

Although the term ‘accrued to’ was first regarded as meaning ‘entitled to’,<sup>57</sup> it was later held to mean ‘due and payable’.<sup>58</sup> An amount accrues to the taxpayer in the year of assessment in which he is entitled to the right to claim payment and not in the year in which he eventually claims payment, which may be in a future year. This right to claim payment must be unconditional.

When goods are sold on credit and the transaction is subject to a discount if payment is made within a specified period, the amount accruing will not be the full selling price. The amount accruing will be the value of the resulting debt in the light of the discount available.

The meaning of the term ‘accrued to’ was finally decided in the *Peoples Stores* case<sup>59</sup> in which the meaning ‘entitled to’ was confirmed.

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<sup>54</sup> 1933 AD 242, 6 SATC 92 at 99.

<sup>55</sup> 1969 (1) SA 365 (A), 30 SATC 199.

<sup>56</sup> 1947 (3) SA 256 (C), 14 SATC 419.

<sup>57</sup> *Lategan v CIR* 1926 CPD 203, 2 SATC 16.

<sup>58</sup> *CIR v Delfos* 1933 AD 242, 6 SATC 92.

<sup>59</sup> *CIR v Peoples Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (A), 52 SATC 9.

## **Value-added tax position**

### **General principles**

Value-added taxation is charged on the supply of goods or services in the commencement, course or termination of a registered enterprise. Thus, should a registered vendor make a taxable supply, output tax needs to be collected and paid over to the Commissioner.

Section 7(1) of the Value-Added Tax Act reads as follows:

‘Subject to the exemptions, exceptions, deductions and adjustments provided for in this Act, there shall be levied and paid for the benefit of the National Revenue Fund a tax, to be known as the value-added tax—

- (a) on the supply by any vendor of goods or services supplied by him on or after the commencement date in the course or furtherance of any enterprise carried on by him;
- (b) on the importation of any goods into the Republic by any person on or after the commencement date; and
- (c) on the supply of any imported services by any person on or after the commencement date, calculated at the rate of 14 per cent on the value of the supply concerned or the importation, as the case may be.’

### **Exempt supplies**

Section 12 of the Value-Added Tax Act provides that the supply of certain qualifying goods or services will be exempt from the tax imposed under section 7(1)(a) (see above).

One of the qualifying exemptions is the supply of any financial services, but excluding the supply of financial services which would be charged with tax at the rate of 0% under section 11.

Section 2(1) of the Value-Added Tax Act states that certain qualifying activities will be deemed to be financial services. Included in these qualifying activities is the provision by any person of credit under an agreement by which money or money’s worth is provided by that person to another person who agrees to pay in the future a sum or sums exceeding in the aggregate the amount of the money or money’s worth.

Should a taxpayer be a registered vendor, VAT at the rate of 14% will be added to a taxable supply or will be included in the amount of a transaction. Should any finance charge be levied in a credit agreement, it will be regarded as an exempt supply and no VAT will be levied on it.

Input tax can be claimed only on services if they have been carried out in the making of taxable supplies. A financial institution may claim the input tax only where its supplies were in the making of a taxable supply (for example, in a transaction where only fee income is the proceeds). Since fee income or commission income is not regarded as a financial service, output VAT will be levied on these transactions and the input tax incurred relating to these transactions may be claimed.

Where the intended use of goods or services acquired by a vendor is less than 90% for making taxable supplies, an apportionment is necessary. The method of calculating the apportionment is the ratio of the intended taxable use to non-taxable use (section 17(1)).

Whilst the Value-Added Tax Act prescribes no details of the method to be used in calculating the apportionment, the Commissioner has stated in a guideline (VAT 404) that either the input-based or turnover-based method may be used.

The input-based method is used by calculating first the VAT (input tax) incurred on goods and services wholly to make taxable supplies. This calculated input tax amount is then divided by the input tax incurred in making all supplies. This calculated ratio, say, for example, 58%, is then applied to the total input tax for the tax period and claimed when completing the VAT return.

The following exclusions should be made from both the numerator and the denominator in calculating the VAT ratio on the input based method:

- Value-added taxation incurred on goods supplied in the same state under an instalment credit agreement.

- Value-added taxation incurred on capital goods or services (other than goods acquired for supply under a rental agreement) acquired for use in the enterprise.
- Value-added taxation incurred on goods or services for which an input tax deduction is denied.

The turnover method is used in calculating the apportionment ratio by dividing the total value of all taxable supplies during a tax period by the total value of all supplies (including exempt supplies). The amounts used in the calculation should be exclusive of VAT. The calculated ratio will be applied to the input tax incurred when completing the VAT return for the tax period.

No approval is necessary from the Commissioner but any other method which deviates from the above two methods, requires prior approval from the Commissioner.

## CHAPTER 8

### TAX POSITION OF THE SELLER OR FINANCIER OF THE ARTICLE OR ITEM IN TERMS OF AN OPERATING LEASE

#### Accounting treatment

In terms of AC 105, the accounting treatment may be summarised as follows:

- Lessors should disclose assets subject to operating leases in their balance sheets according to the nature of the asset.
- Lease income should be recognised in income on a straight-line basis over the lease term, unless another systematic basis is more representative of the time pattern in which the use benefit from the leased asset is diminished.
- The depreciation of leased assets should be on a basis consistent with the lessor's normal depreciation policy for similar assets, and the depreciation charge should be calculated on the basis set out in the statements on depreciation accounting and on property, plant and equipment.

#### At commencement of the lease

#### Normal tax position

There is no normal tax implication, since no amount has been received or accrued.

#### Value-added tax position

No taxable supply has taken place and thus no output tax is payable.

## **During the lease agreement**

### **Normal tax position**

Each instalment constitutes a receipt and forms part of gross income. The VAT portion of the instalment has been received on behalf of the Commissioner and does not form part of the amount to be included in gross income.<sup>60</sup>

Since the lessor is the owner of the asset, the lessor may claim any qualifying capital allowances.

In terms of section 11(e), the lessor may claim a wear-and-tear allowance should he not be able to claim an allowance in terms of section 12B or section 12C. This wear and tear will represent the sum, as the Commissioner may think just and reasonable as representing the amount by which the value of any plant, machinery, utensils or articles has been diminished. There are a number of other requirements that will have to be met in terms of section 11(e) to qualify for the allowance.

Practice Note 15 was issued on 16 March 1992 and deals with the section 11(e) allowance for wear and tear or depreciation of leased machinery, plant, implements, utensils and articles.

The main points of Practice Note 15 are summarised as follows:

- For normal tax purposes, leased articles must be capitalised in the books of the lessor.
- Lease charges received by or accrued to the lessor during a year of assessment for all lease agreements held by him, represent gross income in his hands. From the income the lessor is entitled to claim a deduction for, amongst other things, wear and tear or depreciation in terms of section 11(e) of the Act.
- The section 11(e) allowance and the deduction of other expenditure are governed by section 23A of the Act.

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<sup>60</sup> Section 23C.

- The section 11(e) allowance may be calculated on the straight-line basis on the cost of the leased article to the lessor over the period of the lease agreement where the useful life of the leased article is sufficiently short to warrant this procedure. In instances where the useful life of the leased article exceeds the period of the lease agreement, the cost of the leased article must be written off over the useful life of the article.

It must be borne in mind that the write-off periods set out in Practice Note 15 are inapplicable for articles for which the allowance is claimable in terms of section 12B or section 12C of the Act.

Where a lease is entered into for a period exceeding the period indicated in Practice Note 15, the article must be written off over the longer period.

Machinery or plant which was or is let by any taxpayer and was or is brought into use for the first time by the lessee for the purposes of the lessee's trade (other than in mining or farming), and is used by the lessee directly in a process of manufacture carried on by him or in a process similar to manufacture, may qualify for a section 12C allowance.<sup>61</sup> In terms of this allowance a deduction equal to 20% of the cost of the item let, will be allowed in the year of assessment during which the asset is so brought into use and in each of the four succeeding years of assessment.

It is important to note that no deduction is allowed under section 12C(3)(a) for any asset which has been let by the taxpayer under a lease other than an operating lease as defined in section 23A(1), unless the lessee under the lease derives 'income' as defined in the carrying on of his trade.

Section 12B(1)(b) provides that machinery or plant which is let by any taxpayer and is brought into use for the first time by the lessee for the purposes of the lessee's trade (other than mining or farming) and is used by the lessee directly in a process of manufacture carried on by him or any other process carried on by him which in the opinion of the Commissioner is of a similar nature, qualifies for an allowance for the year of

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<sup>61</sup> Section 12C(1)(b).



assessment during which the machinery, plant, implement, utensil or article is so brought into use and each of the two succeeding years of assessment.<sup>62</sup>

The allowance contemplated in section 12B(1) is calculated on the cost to the taxpayer of the asset, and the rate of the allowance is for the

- year of assessment during which the asset is so brought into use, 50% of the cost;
- second year, 30% of the cost; and
- third year, 20% of the cost.<sup>63</sup>

A similar limitation to the limitation in section 12C(4) is set out in section 12B(4). The limitation is that no allowance will be granted under section 12B for any asset which has been let by the taxpayer under a lease other than an operating lease as defined in section 23A(1).

The term 'operating lease' as defined in section 23A, has been discussed earlier in this dissertation, but may be summarised as a lease of movable property if

- the general public may hire the property for a period of less than one month,
- the cost of maintenance and repairs is borne by the lessor, and
- the risk of destruction or loss of the property is not assumed by the lessee.

#### **Limitation of allowances to lessors**

Section 23A(1) defines an 'affected asset' but this definition specifically excludes any asset let by the lessor under an operating lease or any asset which was during the year of assessment mainly used by the lessor in the course of any trade carried on by him, other than the letting of the asset.

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<sup>62</sup> Section 12B(1)(b).

<sup>63</sup> Section 12B(2).

Since the limitation of certain allowances in terms of sections 11(e) and (o), 12B, 12C and 14bis, apply only to affected assets let by him, this limitation will not apply to a lessor in terms of an operating lease.

In terms of the definition of an 'instrument' any lease agreement is excluded from the provisions of section 24J, except for a sale and leaseback agreement in terms of section 23G.

### **Value-added taxation position**

An operating lease is regarded as a rental agreement in the Value-Added Tax Act and is defined in section 1 of the Value-Added Tax Act.

A supply is deemed to take place each time a payment becomes due or is received, whichever is earlier, and tax is due on the consideration. The date of the invoice is irrelevant.

Section 9(3) states that notwithstanding anything in section 9(3)(1) or section 9(3)(2) where goods or services are supplied under any rental agreement or law which provides for periodic payments, the goods will be deemed to be successively supplied for successive parts of the period of the agreement, and each of these successive supplies will be deemed to take place when a payment becomes due or is received, whichever is the earlier.

### **At the end of the agreement**

#### **Normal tax position**

At the end of the lease period, the following events may occur.

- The lessor may reclaim the asset. No tax implications will flow from this event since there is no recoupment nor any amount received or accrued.
- The asset may be given to the lessee for no consideration. In this event there are no tax implications.

- The lessee may acquire the asset for an agreed amount in terms of the lease agreement. In this event the agreed amount (excluding the output tax) reduced with the tax value of the relevant asset item would be included in the lessor's gross income as a recoupment.
- The lessee may be permitted to continue using the asset either for a reduced rental or for no rental. Should the lessee continue to lease the asset at a reduced rental each instalment (exclusive of output tax) will be included in the lessor's gross income in the same basis as a monthly instalment was treated prior to the end of the initial lease.

### **Value-added tax position**

There will not be any VAT implications, unless there is a taxable supply.

At the end of the lease period, the following events may occur.

- The lessor may reclaim the asset. No VAT implications arise since there is no supply.
- The asset may be given to the lessee for no consideration. Although there will be a supply it will be for no consideration with the result that no VAT will be payable.
- The lessee may acquire the asset for an agreed amount in terms of the lease agreement This acquisition of the asset will be regarded as a supply and the consideration will be the agreed amount. The VAT portion must be calculated and paid over to the Commissioner as output tax.
- The lessee may be permitted to continue using the asset either for a reduced rental or for no rental. In this event a supply is deemed to take place each time a payment becomes due or is received, whichever is the earlier. Value-added taxation is due on each consideration.

## CHAPTER 9

### TAX POSITION OF THE SELLER OR FINANCIER OF THE ARTICLE OR ITEM IN TERMS OF AN INSTALMENT CREDIT AGREEMENT

#### **Accounting treatment**

Lessors should recognise assets held under a finance lease in their balance sheets and present them as a receivable at an amount equal to the net investment in the lease.

The recognition of finance income should be based on a pattern reflecting a constant periodic rate of return on the lessor's net investment outstanding for the finance lease.

Lease payments relating to the accounting period, excluding the cost for services, are applied against the gross investment in the lease to reduce both the principal and the unearned finance charges.

A manufacturer or dealer lessor should recognise the selling profit or loss in income for the period, in accordance with the policy followed by the lessor for outright sales. If artificially low rates of interest are quoted, the selling profit should be restricted to that which would apply if a commercial rate of interest were charged.

Initial direct costs should be recognised as an expense in the income statement at the inception of the lease.

#### **At commencement of the lease**

#### **Normal tax treatment**

There will be no normal tax implications since there has been neither a receipt nor an accrual.

## **Value-added tax treatment**

A finance lease is recognised as an instalment credit agreement in the Value-Added Tax Act. The VAT on the agreement is dealt with at the commencement of the lease.

An instalment credit agreement is defined in the Value-Added Tax Act to include agreements in terms of which movable goods and machinery or plant

- are sold by the seller to the purchaser against payment by the purchaser to the seller of a stated or determinable sum of money at a stated or determinable future date or in whole or in part in instalments over a period in the future, or
- are supplied under a lease under where the rentals consist of a stated or determinable sum of money payable at a stated or determinable future date or periodically in whole or in part in instalments over a period in the future.<sup>64</sup>

In terms of instalment credit agreements, the supply is deemed to take place when the goods are delivered or when any payment is received by the supplier.<sup>65</sup> In the situation of a suspensive sale agreement, the date is when the 'cooling off' period of five days has expired. This 'cooling off' period is provided for in section 9(2)(b) of the Value-Added Tax Act and has been discussed earlier in this dissertation. The date of the agreement is thus irrelevant.

For the purposes of the Value-Added Tax Act, where goods are supplied under an instalment credit agreement, the consideration in money for the supply is deemed to be the cash value of the supply.

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<sup>64</sup> Section 1 of the Value-Added Tax Act.

<sup>65</sup> Section 9(3)(c).

Cash value, in relation to the supply of goods supplied under an instalment credit agreement, means<sup>66</sup>

'(a) where the seller or lessor is a banker or financier, an amount equal to or exceeding the sum of the cost to the banker or financier of the goods, including any cost of erection, construction, assembly or installation of the goods borne by the banker or financier and the tax leviable under section 7(1)(a) in respect of such supply by the banker or financier; or

(b) where the seller or lessor is a dealer, an amount equal to or exceeding the price (including tax) at which the goods are normally sold by him for cash or may normally be acquired from him for cash (including tax) and any charge (including tax) made by the seller or lessor in respect of the erection, construction, assembly or installation of the goods if such charge is financed by the seller or lessor under the instalment credit agreement'.

## **During the lease**

### **Normal tax treatment**

The entire amount of each instalment must be included in gross income since it has been received or accrued. This is the amount inclusive of VAT.

Lease charges received by or accrued to the lessor during a year of assessment for all lease agreements held by him, must be included in his gross income.<sup>67</sup> The actual agreement is sufficient proof of entitlement and thus of accrual.

Because the lessor has the full rental included in his gross income, the Commissioner permits him to add the output tax on the lease agreement to the cost of the asset for the purposes of section 11(e) and section 12B and section 12C.

The section 11(e) allowance may be calculated on the straight-line basis on the cost of the leased article to the lessor over the period of the lease agreement where the useful life of the leased article is sufficiently short to warrant this procedure.

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<sup>66</sup> Section 1 of the Value-Added Tax Act

<sup>67</sup> Practice Note 15.

While section 23C prohibits the capitalisation of input tax for purposes of determining the section 11(e) allowance, it does not prohibit the capitalisation of output tax and therefore there is no need to change the present practice of lessors in this regard.<sup>68</sup>

The cost of the asset will thus be increased with the output tax and the depreciation allowance will be calculated on the amount inclusive of the output tax.<sup>69</sup>

Since the lessor is the owner of the asset, he may also claim qualifying capital allowances. Sections 11(e), 12B and 12C will be available to the lessor, should he be able to prove that all requirements of the relevant provisions have been met.

Should the taxpayer be the lessor of affected assets, any allowances claimable in terms of sections 11(e), 11(o), 12, 12B, 12C or 14bis will be limited to his taxable rental income.

The taxable rental income will include the taxable portion of rental income from non-affected assets.

Section 23A(3) allows for a portion of the expenses incurred for both rental and non-rental income to be deducted in calculating the taxable rental income.

If any allowance is not claimed in full as a deduction because of the limitations imposed by section 23A, the unclaimed portion of the allowance may be carried forward to the next year of assessment and be deducted from the taxable rental income of that year.

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<sup>68</sup> Practice Note 15.

<sup>69</sup> Keith Huxham and Philip Haupt *Notes on South African Income Tax* in paragraph 7.18.3.

Affected assets include machinery, plant, implements, utensils, ships, aircraft or articles, which have been let and for which the lessor is entitled to an allowance in terms of section 12B or section 12C. An operating lease is specifically excluded from the definition of an 'affected asset'.

Rental income is defined as income derived by way of rental from the letting of movable property or any machinery or plant for which an allowance has been granted to the lessor under sections 12, 12B or 12C, whether in the current or any previous year of assessment. Income from the letting of fixed property is excluded from this definition.

## **Section 24**

Section 24 of the Act deals specifically with credit agreements and debtors allowances. The purpose of this provision is to try to match the accrual of interest with actual interest received.

The implication of section 24 can be summarised as follows:

- Its application is subject to the provisions of section 24J.
- It applies where ownership or transfer of property passes after the receipt by the taxpayer of the whole or part of the amount payable in terms of an agreement.
- The whole of that amount is deemed to accrue to the taxpayer on the day the agreement is entered into.
- If at least 25% of the amount of the agreement becomes payable on or after twelve months from the date of the agreement, the Commissioner may make certain allowances.

It would be important to note the loose wording describing the Commissioner's discretion in applying the allowance. This wording being<sup>70</sup>

'the Commissioner, taking into consideration any allowance he has made under section 11(j), may make the further allowance as under the special circumstances of the trade of the taxpayer seems to him reasonable'.

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<sup>70</sup> Section 24(2) of the Act.



This decision of the Commissioner is subject to objection and appeal. It is the taxpayer's choice whether he would like to claim a section 24 allowance. Once he has claimed the allowance, he will not be allowed to decide in which year and what portion of the allowance should be applied.<sup>71</sup>

The allowance will apply to the amounts accrued but not yet received after taking into account the doubtful debt allowance granted under section 11(j). Any allowance for a particular year is added back in the following year and is therefore included in income.

In practice the section 24 allowance may be used only to reduce the taxable income to 'nil'. It may not increase or create an assessed loss. The portion not used may be carried forward to the next year of assessment.<sup>72</sup>

Two practice notes were published, being Practice Note 12 and 13. Since Practice Note 13 deals mainly with the situation before 1 March 1991, it is not relevant for the purpose of this dissertation.

### **Practice Note 12**

The provisions of Practice Note 12 may be summarised as follows:

- The effect of section 24 of the Act is, amongst other things, that where goods are sold under a suspensive sale agreement and ownership passes to the purchaser only after the payment of the whole or portion of the purchase price, the full amount of the transaction, including finance charges, is deemed to accrue to the seller on the day the agreement was entered into. It further provides that the Commissioner may, in certain circumstances and in his discretion, make an allowance for amounts, which are deemed to have accrued, but which have not yet been received.
- This allowance is also referred to as the hire purchase debtors allowance.

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<sup>71</sup> *Silke on South African Income Tax* in paragraph 17.26.

<sup>72</sup> *Silke on South African Income Tax* in paragraph 17.26.

- It is the practice of the Commissioner not to allow lay-by sales (defined in Chapter 10 of this dissertation) as being relevant in the context of section 24. This will be the situation even if it is clear in terms of the contract that ownership will not pass until the whole purchase price is paid.<sup>73</sup>
- The Margo Commission recommended that, in a transaction where there is both profit and finance charge elements, the two elements should be separated and the finance charge element should be amortised over the period of the loan with reference to the outstanding capital amount.<sup>74</sup> As a result of this recommendation, Practice Note 12 was issued to cater for relevant agreements after a qualifying date. Should interest be payable on instalments not paid on due date, this interest is deemed not to have accrued on the date of the agreement because of the uncertain future events that will have to take place before any amount will be payable.
- Finance charges are considered to be taxable over the period in which these charges are earned based on the amortisation of these charges over the period of the loan taking into account the capital balance outstanding in accordance with GAAP. In terms of AC 105, the recognition of finance income should be based on a pattern reflecting a constant periodic rate of return on the lessor's net investment outstanding for the finance lease. In essence this approximates finance charges accruing on a day-to-day basis and where payments are received, each payment must be allocated first to the finance charge element and then to the outstanding capital balance. The result will be a constant periodic rate of return on the outstanding capital balance at the effective rate of interest applicable.<sup>75</sup> The accounting provision for unearned finance charges will become the allowance granted should the method applied in terms of GAAP give substantially the same result.
- Taxpayers who earn both finance charges and a gross profit element qualify for the allowance on the gross profit element. This portion of the allowance is determined by calculating the allowance based on the seller's gross profit percentage. The gross profit percentage must not include finance charges.

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<sup>73</sup> *Silke on South African Income Tax* in paragraph 17.26.

<sup>74</sup> Practice Note 12.

<sup>75</sup> *Silke on South African Income Tax* in paragraph 17.26.

### **Practice Note 13**

The debtors allowance is calculated in Practice Note 13 as follows:

- Sale price (exclusive of VAT) minus cost of sales (exclusive of VAT) equals the gross profit.
- Gross profit divided by the sale price equals the gross profit percentage.
- This gross profit percentage should be applied to the debtors amount (exclusive of VAT)<sup>76</sup> for these transactions, after deducting the doubtful debt allowance provided for in section 11(j).

The answer to the above calculation will be the debtors allowance for the relevant year of assessment. In the next year of assessment the section 24 allowance for the previous year of assessment will be added back and a new allowance calculated.

The right is reserved by the Commissioner to limit the allowance on any particular transaction. This limit will not be applied to the normal business transactions of a taxpayer but will be applied when a taxpayer has entered into a transaction which is not related to his normal business activities, or where a tax-avoidance scheme has been entered into to make use of the gross profit element of the allowance.

### **Value-added tax treatment**

Since the VAT treatment of the transaction has taken place at the commencement of the agreement in terms of the time and supply rules, no further VAT implications are relevant. Thus no further output tax is payable and no input tax may be claimed.

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<sup>76</sup> Inland Revenue Circular 3 of 1998.

## CHAPTER 10

### TAX IMPLICATIONS OF A LAY-BYE CREDIT AGREEMENT.

#### Normal tax implication

A lay-by agreement is an agreement where ownership will be transferred of movable goods of (less than R10 000 in value), only when the full amount has been paid.

In terms of the agreement, a sale transaction has taken place and normally an amount (deposit) will be paid to reserve the goods. The goods may be claimed only by the purchaser when the full amount has been paid.

No finance is provided by the seller or a bank and no interest is payable.

It is the practice of a seller to include only the amounts received as turnover. This will include the deposit as well as any payments made. Stock will only be reduced by so much of the cost price of any amount received.

Since the condition for transfer of ownership is the payment of the full amount, the seller has not become entitled to the full sale value and may include in his gross income only the amount actually received.

It is also the practice of the Commissioner not to apply section 24 to lay-by sales, since it is unlikely that a lay-by sale will bring the provisions of the section 24 allowance into operation.

There is, however, a view that section 24 is applicable to lay-by sales, since ownership of the goods will not pass until the whole of the purchase price is paid.<sup>77</sup> Yet this view that section 24 should be applicable to lay-by sales may not be correct, since the seller has not yet become entitled to the full amount. It is

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<sup>77</sup> *Silke on South African Income Tax* in para 17.26.

possible for the seller to refund the buyer his deposit and the instalments paid, should the seller decide not to proceed with the transaction. This is different to a suspensive sale transaction, where the seller or financier is entitled to the full purchase price, although it is payable in instalments.

### **Value-added tax implications**

#### **Supply rules**

Any lay-by agreement whereby goods are sold for a consideration not exceeding R10 000 and are reserved by deposit for delivery when the purchase price or a determined portion thereof is paid, is deemed not to be a supply of goods or services until the goods are delivered to the purchaser.

Where the agreement is cancelled and the seller retains any amount paid by the purchaser or recovers any amount owing by the purchaser under the agreement, the seller is deemed to have supplied a service for the agreement.<sup>78</sup>

#### **Time of supply**

Where that supply is a supply to which section 8(4) of the Value-Added Tax Act refers, the time of the supply will be at the time at which the goods are delivered to the purchaser. Provided that in any situation in which a supply of services is deemed to take place under section 8(4)(b), that supply is deemed to take place at the time that the agreement of sale is cancelled.<sup>79</sup>

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<sup>78</sup> Section 8(4)(a) and section 8(4)(b) of the Value-Added Tax Act.

<sup>79</sup> Section 9(2)(c) of the Value-Added Tax Act.

### **Value of the supply**

Where a service is under section 8(4)(b) deemed to be supplied, the consideration for the supply is deemed to be an amount equal to the amount retained or recovered as contemplated in that section.<sup>80</sup>

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<sup>80</sup> Section 10(11) of the Value-Added Tax Act.

## **CHAPTER 11**

### **CONCLUSION**

There are numerous definitions of the different credit agreements to be found in the various Acts researched as well as in the accounting literature. Since each kind of agreement has its own intricacies, the tax treatment varies.

It would seem that it would make sense to co-ordinate the different definitions with the movement in the accounting field. Similarly it would make sense to have similar accounting and tax treatment for the same credit agreements. Reference here is specifically to finance leases where the accounting and tax treatment differ substantially.

Implementing the above may remove some of the confusion created with the different instruments and with the deferred tax problems which result.

Section 24J is a detailed and complicated provision of the Income Tax Act and it would seem that the same tax treatment could have been created by the legislature with a more simple approach to the wording of this provision. Over time and through judicial guidance this provision is likely to change and become more user friendly.

The tax implication of a credit agreement is regarded by most people, even some accountants, as simple. It does, however, require a clear understanding of the working of the relevant agreement from an accounting perspective as well as a detailed understanding of the Act and the practice as applied by the Commissioner.

Only after some research will one grasp the intricacies involved with the tax implication of a credit agreement.

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