**INTERPRETATION NOTE: NO. 74 (Issue 2)**

DATE: 14 December 2015

**ACT : INCOME TAX ACT NO. 58 OF 1962**

**SECTION : SECTIONS 11(*d*) AND 8(4)(*a*)**

**SUBJECT : DEDUCTION AND RECOUPMENT OF EXPENDITURE INCURRED ON REPAIRS**

***Preamble***

In this Note unless the context indicates otherwise –

- **"section"** means a section of the Act;
- **"the Act"** means the Income Tax Act No. 58 of 1962; and
- any other word or expression bears the meaning ascribed to it in the Act.

## 1. Purpose

This Note provides guidance on the interpretation and application of section 11(*d*) which allows a deduction for expenditure incurred on repairs for the purposes of trade.

## 2. Background

Expenditure on repairs to an asset not comprising trading stock is likely to be of a capital nature, particularly when it is not incurred at regular intervals.[1] The capital nature of the expenditure arises because it relates to the protection of a capital asset.[2]

Expenditure of a capital nature does not qualify as a general deduction under section 11(*a*). Nevertheless, section 11(*d*) makes provision for the deduction of expenditure incurred on repairs for the purposes of trade provided the requirements are met.

For purposes of section 11(*d*) it is important to distinguish between a "repair" and an "improvement" since only expenditure incurred on repairs is deductible under section 11(*d*). No hard and fast rules can be provided for this distinction. Each case must be decided on its own facts.[3]

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1 In *Rhodesia Railways Ltd v Collector of Income Tax Bechuanaland* 1935 AC 368, 6 SATC 225 the court held that the periodic replacement of railway lines was not of a capital nature.

2 ITC 849 (1957) 22 SATC 82 (C).

3 *Flemming v KBI* 1995 (1) SA 574 (A), 57 SATC 73 at 75 and 79.

## 3. The law

### Section 11(*d*)

> **11. General deductions allowed in determination of taxable income.**—For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived—
>
> (*d*) expenditure actually incurred during the year of assessment on repairs of property occupied for the purpose of trade or in respect of which income is receivable, including any expenditure so incurred on the treatment against attack by beetles of any timber forming part of such property and sums expended for the repair of machinery, implements, utensils and other articles employed by the taxpayer for the purposes of his trade;

## 4. Application of the law

Section 11(*d*) provides for the deduction of expenditure actually incurred during the year of assessment on repairs of –

- property occupied for the purposes of trade or from which income is receivable, including the treatment against attack by beetles of timber which forms part of such property; and
- machinery, implements, utensils and other articles employed by the taxpayer for the purposes of trade.

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

No deduction for expenditure incurred on repairs will be permissible if the expenditure is recoverable.[4]

### 4.1 The meaning of "repairs"

In order to determine whether an expense will constitute a repair it is necessary to establish the meaning of the word "repairs" as used in section 11(*d*). The Act does not contain a definition of the word "repairs" and it must, therefore, be given its ordinary grammatical meaning.

The Shorter Oxford English Dictionary[5] defines a "repair" as –

> "[r]estore (a structure, machine, etc) to unimpaired condition by replacing or fixing worn or damaged parts; mend".

Collins English Dictionary[6] defines a "repair" as –

> "[t]o restore (something damaged or broken) to good condition or working order".

Various court cases have considered the meaning of the word "repairs" extensively and produced relevant principles.

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4 Section 23(*c*).
5 6 ed (2007) Oxford University Press.
6 5 ed (2000) Harper Collins Publishers.

The Supreme Court of Appeal analysed the dictionary meaning ascribed to the word "repair" in *Flemming v KBI*.[7]

From this analysis the court concluded that "repair" involves the process of renewing, renovating or restoring decayed or damaged parts.[8] The court held that a deduction under section 11(*d*) will be available only if the original structure was in need of repair.[9]

In ITC 491[10] it was held that in the ordinary sense of the word, "repairs" means replacement or renewal of something that has become defaced or worn out or worn down by use or possibly by wear-and-tear.

In ITC 617[11] various court cases were reviewed from which the following principles emerged:

- Repair is restoration by renewal or replacement of subsidiary parts of the whole. Renewal as distinguished from repair is reconstruction of the entirety, meaning by the entirety not necessarily the whole but substantially the whole subject matter under discussion.
- In the case of repairs effected by renewal it is not necessary that the materials used should be identical with the materials replaced.
- Repairs are to be distinguished from improvements. The test for this purpose is – has a new asset been created resulting in an increase in the income-earning capacity or does the work undertaken merely represent the cost of restoring the asset to a state in which it will continue to earn income as before?

In ITC 626[12] it is mentioned that these tests are not exhaustive but are merely of assistance to the general enquiry. It is necessary in each case to determine whether what has been done actually constitutes "repairs" in the ordinary meaning of the word, and the extent to which it falls under that heading.

It is immaterial whether repairs occur as a result of some fortuitous act, such as a storm or fire, or as a result of the wearing out, damage or deterioration of an asset by use. Restoration involves a renewal or replacement of subsidiary parts of the structure and the expenditure incurred will be deductible. However, if the damage is of such an extent that the asset is partially destroyed, it will then be necessary to consider whether the repair or renovation is a reconstruction of the entire asset, in which event the expenditure will not be deductible.[13] To the extent that the cost of

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7 1995 (1) SA 574 (A), 57 SATC 73.

8 Above at 79.

9 Above at 80. See also ITC 1097 (1966) 28 SATC 290 (T) in which the taxpayer, who let his farm and was therefore not a farmer, incurred expenditure on sinking a new borehole. The court held that the cost of the new borehole was not a repair but rather an addition or improvement.

10 (1941) 12 SATC 77 (U).

11 (1946) 14 SATC 474 (U).

12 (1946) 14 SATC 530 (U).

13 A P de Koker & R C Williams Silke *on South African Income Tax* [online] (My LexisNexis: September 2015) in § 8.98.

repairs is recoverable under a policy of insurance the deduction will be prohibited by section 23(*c*).[14]

### 4.2 The meaning of "maintenance"

The Concise Oxford English Dictionary[15] defines "maintenance" as –

> "[t]he process of maintaining or the state of being maintained";

and defines "maintain" as –

> "[c]ause or enable (a condition or situation) to continue, keep at the same level or rate; keep (a building, machine, etc.) in good condition by checking or repairing it regularly".

In *Heerman's Supermarket (Pty) Ltd v Mona Road Investments (Pty) Ltd*[16] van Heerden J considered the meaning of the words "repair" and "maintenance" within a lease agreement and whether the wide dictionary meaning of the word "repair" was wide enough to cover "maintenance". The lessor claimed it was liable for repairs but not maintenance under the provisions of the lease agreement. The court found that the word "repairs" was capable of covering "maintenance".

In *Clanwilliam Municipality v Braude* the court expressed the view that –[17]

> "[t]he words "maintenance" and "repair" have "connotations which differ in accordance with the objects and circumstances to which they are applied".

The court accepted in Natal Motor Industries Ltd v Crickmay what was said at 859 by Donovan J in Reilly v British Transport Commission,[18] that –[19]

> "the terms 'repair', 'maintenance' and 'adjustment' are not mutually exclusive. One cannot, therefore, by describing some operation as 'maintenance' or 'adjustment', exclude the possibility that it is also a 'repair' ".

The court held that – [20]

> "[t]he whole object of "free service" is to ensure that the car is maintained in good working order and condition by doing such limited repair work as is necessary to keep or place it in good working order and condition".

### 4.3 Maintenance deductible as repairs under section 11(*d*)

Expenditure incurred on maintenance will be deductible under section 11(*d*) provided it complies with the essential elements of a repair and the other requirements of that section.

Maintenance requires keeping the asset in good working order and condition which implies that it has become defaced or worn out or worn down by use or possibly by

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14 J Zulman, M Preiss & J Silke *Income Tax Practice Manual* [online] (My LexisNexis: October 2015) in [A:R16].

15 11 ed (2006) Oxford University Press.

16 1975 (4) SA 391 (D) at 396.

17 1954 (3) SA 657 (C) at 666. An appeal was allowed on the basis that Braude was not liable under the contract and not on the maintenance v repairs issue.

18 (1956) 3 All E.R. 857.

19 1962 (2) SA 93 (N) at 97.

20 Above at 98.

wear-and-tear, a requirement considered by the courts that meets the broader meaning of repairs.[21]

### 4.4 Repairs in relation to the entire property

In judging whether a renewal or repair has been carried out, regard must be had to the extent of the restoration work in relation to the entire property of which the portion restored forms a part. The greater the restoration work in relation to that entirety, the less likely it is that a repair has taken place.[22]

In ITC 617[23] the court considered the deductibility of various expenses incurred on a racecourse comprising a number of buildings and the race track. The court stated the following on what constituted the subject matter:

> "[A]s far as the buildings are concerned the general principles applicable to the repair of each building as constituting a separate and distinct subject matter, are applicable to that particular building, whether used for one purpose, or conjointly for several purposes. In the case of the race-track or course itself the whole subject matter is to be regarded as comprising the track itself, the rails along it and the starting gates, discs indicating distances and so on."

One of the stands had been blown down and reconstructed of new materials. The court held that it was substantially a reconstruction of the whole of a separate subject matter and therefore not a repair.

In ITC 709[24] a weir which had suffered flood damage consisted of three parts, namely, a platform, a rock support and a wall. The platform remained intact but the greater number of rocks making up the rock support had to be replaced and the wall was rebuilt to a greater height. The court found on the facts that the entirety of the weir had not been replaced and allowed the cost of replacement as a repair with the exception of a sluice valve which was not present previously.

In *B v COT*[25] the appellant had embarked on a large scheme of reconstruction, which converted a building comprising doctors' consulting rooms from three suites of consulting rooms to five. In the course of these operations about half the original walls were pulled down and rebuilt, many in positions other than they had originally occupied, while doors and windows were placed in new positions. Only one room in the original building was entirely unchanged. In addition the roof was reconstructed on new plan and some 60 per cent of the timber replaced, a large portion of the flooring replaced and the electric wiring entirely replaced as the old installation did not conform with existing municipal regulations. Having regard to the extent of the work undertaken, the court held that there had been a substantial reconstruction and renewal of the building as a whole which constituted expenditure of a capital nature. The court noted that the operation must be viewed as a whole and that it was not permissible in such a case to isolate individual items of expenditure and attempt to allocate some to repairs of the old building.

In ITC 925[26] the appellant had derived rental income from the letting of five dwelling houses. During the year of assessment certain building work was carried out on each

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21 ITC 491 (1941) 12 SATC 77 (U).
22 *Rhodesian Railways v Collector of Income Tax Bechuanaland* 1935 AC 368, 6 SATC 225.
23 (1946) 14 SATC 474 (U).
24 (1950) 17 SATC 227 (C).
25 1955 (1) SA 404 (SR), 19 SATC 353.
26 (1959) 24 SATC 252 (C).

of the five houses which the appellant sought to allocate between repairs and improvements. On the facts and viewing the work done on the houses as a whole, the court concluded that the work was one of reconstruction of substantially the whole subject matter and not one of repairs and it was accordingly not permissible for the appellant to isolate individual items of expenditure and to allocate them to repairs.

In ITC 1408[27] the appellant replaced the brick façade of a commercial building which had deteriorated with concrete panels. The court found that the work related to a subsidiary part of the whole, namely, the exterior walls. The cost of replacing the brick façade with the concrete panels was accordingly allowed as a repair.

Even if a subsidiary part of the whole subject matter is replaced it must still be determined whether it constitutes a repair or an improvement.

### 4.5 Distinction between repairs and improvements

In view of the sometimes narrow distinction between "repairs" and "improvements", there are a variety of cases on this subject which are not always consistent. However, the following general principles have emerged:

- Has a new asset been created resulting in an increase in the income-earning capacity or does the work undertaken merely represent the cost of restoring the asset to a state in which it will continue to earn income as before?[28]
- Unless the structure or article on which repairs are deemed to have been done was damaged or had deteriorated and replacement was required, no repair for the purposes of section 11(*d*) has taken place and no further inquiry need be made.[29]
- Materials used for the repair need not be identical to the original materials that are being replaced. As long as the purpose of the work is to restore the asset to its original condition, as distinct from creating an improvement, the work constitutes a repair. The fact that new materials are substituted for the old at a greater cost than would have been incurred had the same materials been used is irrelevant. Each situation must be decided on its own merits in order to determine whether the use of new materials is for the purpose of improvement or merely for the purpose of restoring the asset to its original condition.[30]
- Repairs undertaken at the same time as improvements may qualify for deduction under section 11(*d*) if they can be clearly and separately identified from the improvements. Much will depend on the facts of the specific case and the taxpayer will bear the onus of showing that what was undertaken was a repair. In ITC 1457[31] the taxpayer converted residential flats on the upper floor of a two-storey building into offices after the flats had fallen into disrepair. A quantity surveyor could identify certain of the work as repairs. The court found that the work so identified comprised repairs notwithstanding that it had been undertaken at the same time as the overall improvements. The amounts in question were in fact severable from the overall

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27 (1985) 48 SATC 21 (T).
28 ITC 617 (1946) 14 SATC 474 at 476.
29 ITC 626 (1946) 14 SATC 530 (U).
30 *CIR v African Products Manufacturing Co Ltd* 1944 TPD 248, 13 SATC 164; ITC 1408 (1985) 48 SATC 21 (T).
31 (1989) 51 SATC 131 (T).

improvements and were allowable under section 11(*d*). Similarly, in ITC 915[32] certain work done in the process of improving a roof was accepted by the court as repairs on the basis that it could be separately identified from the improvements.

- The addition of something to an asset that was not previously there will usually be considered to be an improvement rather than a repair. The underpinning of foundations to remedy cracks in a building,[33] the strengthening of retainer walls by the construction of new beams[34] and the replacement of an existing solar heater with a better one[35] were held to be improvements because something was added that was not there before.

### 4.6 For purposes of trade or for which income is receivable

In respect of repairs of a property, a distinction is made between property occupied for the purposes of trade and property from which income is receivable. The reference to the word "receivable" in section 11(*d*) has the effect that repairs will be deductible regardless of whether income was received during the relevant year of assessment or not, as long as the property is capable of generating rental income during that year of assessment.

The preamble to section 11 clearly states that deductions will be allowed against the income derived by a person when determining the person's taxable income from carrying on any trade. The taxpayer must thus have carried on a trade in order to qualify for the deduction of repairs.

In ITC 243[36] the cost of repairs to a building was incurred before the letting of the property. The cost of repairs was allowed as a deduction. In this case rent was received during a portion of the year of assessment in which the repairs were effected. The court held, allowing the appeal, that the meaning of the word "receivable" was "capable of being received" and that it was not necessary for the admission of the expenditure as a deduction that there should be in existence an agreement for the receipt of income.

In ITC 1475[37] the taxpayer had vacated residential premises with a view of earning income from those premises. Whilst the premises were empty, expenditure was incurred on repairs in order to render the property attractive to a prospective lessee and in anticipation of finding one. The court held that trading had commenced and that expenditure was accordingly deductible, but issued the warning that a determination as to when trading has commenced for this purpose must be made in the light of the facts of the case.

### 4.7 Spare parts used in repairs

Paragraph (a)(iii) of the definition of "trading stock" in section 1(1) includes in that definition "any consumable stores and spare parts acquired by the taxpayer to be used or consumed in the course of the taxpayer's trade". The effect of deeming spare parts to be trading stock is to bring them into section 22 with the result that the

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32 (1960) 24 SATC 219 (F).
33 ITC 1213 (1974) 36 SATC 113 (R).
34 ITC 626 (1946) 14 SATC 530 (U).
35 ITC 1263 (1977) 39 SATC 120 (R).
36 (1932) 6 SATC 370 (U).
37 (1989) 52 SATC 135 (T).

deduction is effectively deferred until the spare parts are used and no longer included in closing stock.

### 4.8 Treatment against the attack by beetles

Section 11(*d*) permits the deduction of the cost of treatment against beetle infestation of timber forming part of premises used for purposes of trade or for which income is receivable. Such expenditure will be deductible irrespective of whether it has been incurred during an initial protective treatment or in the course of replacing infested woodwork.

### 4.9 Limitation of section 11(*d*)

Section 11(*d*) is limited by section 23H which provides that when any person has incurred any expenditure, which was or will be allowable as a deduction under section 11(*d*), amongst others, the amount allowed to be deducted in any year of assessment shall be limited to the expenditure relating to goods supplied or services rendered during the relevant year of assessment.

For example, section 23H may apply when a taxpayer purchases replacement parts for a delivery vehicle in need of repair and pays in advance for the goods, but only half of the goods are delivered by year-end. The taxpayer may only deduct so much of the expense relating to the goods actually delivered, the remaining amount will be deducted once the goods are delivered in the next year of assessment.

### 4.10 Recoupment of cost of repairs

The question whether the cost of repairs deducted under section 11(*d*) can be recovered or recouped under section 8(4)(*a*) when the property is sold was considered in *C: SARS v Pinestone Properties CC*.[38]

During the 1995 and 1996 years of assessment the taxpayer incurred expenditure on repairs of R626 519. On 8 November 1996 the taxpayer sold the property for R2,5 million. SARS included R626 519 in the taxpayer's income under section 8(4)(*a*) on the basis that a portion of the proceeds of R2,5 million represented a recoupment of the cost of the repairs. The court dismissed SARS's appeal stating the following on the relationship between the sale proceeds and the cost of the repairs:[39]

> "It is not axiomatic that repairs to a property necessarily improve its value – certainly not repairs which may have been done some time before its sale."

The court found that it was necessary for SARS to show by facts other than the mere sale at a profit greater than the cost of repairs that there had been a recoupment. However, the court emphasised that it should not be understood to hold that the costs of repairs can never be recouped under section 8(4)(*a*) and provided the following examples of situations in which expenditure on repairs might be recouped:

- Expenditure is incurred in order to repair defective work on a building and is recovered through a claim for damages against the builder.
- Expenditure is incurred in effecting repairs to an insured asset and is recovered through a claim against the insurer.

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38 2002 (4) SA 202 (N), 63 SATC 421.

39 At SATC 427.

- An agreement is concluded to sell an income-producing property for a higher selling price on the basis that the seller conducts specified repairs before the sale takes place.

Cases can arise in which major repairs are undertaken shortly before the sale of an asset. There may well be a recoupment of the cost of the repairs when it can be shown that these repairs result in a higher selling price.

## 5. Conclusion

In order for an asset to be repaired, there must be damage or deterioration to a part of the original asset or structure and the intention of the taxpayer must be to restore the asset or structure to its original condition. Because there are no set criteria as to what constitutes a repair and only principles derived from case law, each case will have to be determined on its merits.

The cost of repairs may be recovered or recouped under section 8(4)(*a*) provided that there is a causal link between the cost of the repairs and the amount received or accrued.

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