

INTERPRETATION NOTE 51 (Issue 5)

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ACT : INCOME TAX ACT 58 OF 1962
SECTION : SECTIONS 11, 11A AND 23
SUBJECT : PRE-TRADE EXPENDITURE AND LOSSES

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Preamble

In this Note unless the context indicates otherwise –

- “**pre-trade expenses**” mean expenditure and losses actually incurred by a person before the commencement of and in preparation for carrying on a trade;
- “**post-trade expenses**” mean expenditure and losses actually incurred after the commencement of the trade;
- “**section**” means a section of the Act;
- “**the Act**” means the Income Tax Act 58 of 1962; and
- any other word or expression bears the meaning ascribed to it in the Act.

All interpretation notes referred to in this Note are available on the SARS website at www.sars.gov.za. Unless indicated otherwise, the latest issue of these documents should be consulted.

1. Purpose

This Note provides guidance on the deduction of pre-trade expenses (sometimes also called start-up costs) under section 11A.

2. Background

New business formation is vital to the economy. Before the introduction of section 11A only certain pre-production interest [section 11(bA)] and certain finance charges [section 11(bB)] were permitted as a deduction for start-up costs incurred before the commencement of trade. Sections 11(bA)¹ and 11(bB)² were deleted and now all pre-trade expenses are dealt with under section 11A.³

The trade requirement in section 11(a) read with section 23(g)

The general deduction formula in sections 11(a) and 23(g) reads as follows:

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—

(a) expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature;

¹ The deletion of section 11(bA) by section 30(1)(a) of the Taxation Laws Amendment Act 24 of 2011 applies to years of assessment commencing on or after 1 January 2012.

² The deletion of section 11(bB) by section 14(1)(a) of the Taxation Laws Amendment Act 17 of 2009 came into operation as from the commencement of years of assessment ending on or after 1 January 2010.

³ For commentary on the interaction between the now repealed section 11(bA) and section 11A, see the first issue of this Note dated 4 November 2009.

23. Deductions not allowed in determination of taxable income.—No deductions shall in any case be made in respect of the following matters, namely —

(a) to (f) . . .

(g) any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade;

The opening words of section 11 contain a trade requirement while section 23(g) prohibits a deduction for monies not laid out or expended for the purposes of trade. Section 11(a) additionally requires that expenditure and losses be actually incurred in the production of income and not be of a capital nature in order to qualify as a deduction.

The trade requirement of section 24J(2)

Section 24J(2) does not draw a distinction between interest of a capital or revenue nature. It permits a deduction of the amount of interest which is deemed to have been incurred during a year of assessment, from the income derived from carrying on any trade of the “issuer” in relation to an “instrument”,⁴ if that amount was incurred in the production of the income.

The trade requirement of section 11D(2)

Section 11D(2) provides for a deduction of research and development expenditure actually incurred by a taxpayer, in the production of income and in the carrying on of any trade. Such expenditure must be directly and solely for research and development undertaken in the Republic.⁵

Pre-trade expenses of a capital nature

Pre-trade expenses often form part of the cost of creating a source of income. These expenses are therefore mostly of a capital nature.

In ITC 697⁶ the appellant company commenced to demolish its old building on 1 December 1947 after which it immediately began the erection of a new building. The new building was completed in October 1948, after which it was let to tenants. For the year of assessment ended 30 June 1948, the appellant claimed deductions for rates, sanitary fees and interest totalling £1 110. The Commissioner disallowed the portion of the expenditure for the period 1 December 1947 (when demolition began) to 30 June 1948 (the end of the 1948 year of assessment by which date the erection of the new building had not been completed). Price J stated the following:⁷

“The items disallowed by the Commissioner were disallowed because for a proportionate period in respect of which the expenditure was incurred the building was in the course of erection and was not an asset which could be used to let and to produce income, and that the expenditure, therefore, was of a preliminary or capital nature. It seems to me clear that until the asset becomes an asset capable of producing income any expenditure upon it is of a preliminary nature and is not deductible... If a taxpayer has no asset with which he can trade then he cannot be trading. The expenditure was incurred in the creation or equipment of an asset which

⁴ As defined in section 24J(1).

⁵ The term “research and development” is defined in section 11D(1).

⁶ (1950) 17 SATC 93 (T).

⁷ At 96.

was intended to be used at a later stage for the purpose of earning income. It was initial or preliminary expenditure designed to extend the scope of the business or to improve its earning capacity. It was money spent in an attempt to create a source of income or to acquire an advantage for the benefit of the business which was later to be undertaken.”

A similar outcome prevailed in *Borstlap v SBI*.⁸ In August 1974 the appellant in that case, a dentist, purchased erf 1456 with the intention of erecting flats on it for rental purposes. The plot contained an old dwelling and some outbuildings which were let for the first five months of the 1976 year of assessment at R250 a month after which the dwelling was occupied by a family of vagrants who managed to make use of the water and electricity. Demolition of these structures commenced in December 1975 and erection of the flats began during the first quarter of 1976 with the first flats being let during the 1978 year of assessment. During the 1976 year of assessment the appellant claimed a rental loss made up as follows:

	R	R
Rental income (5 × R250)		1 250
Less:		
Interest on bonds used to purchase erf 1456	3 435	
Insurance	161	
Rates	796	
Water and electricity (while dwelling occupied by vagrants)	53	
Approval of building plans	<u>108</u>	(4 553)
Rental loss		<u>(3 303)</u>

The Commissioner disallowed the rental loss, in so doing allowing only R1 250 of the expenditure as a deduction under section 11(a). Having lost his appeal in the Income Tax Special Court the appellant appealed directly to the Appellate Division. The court held that the amounts expended on water and electricity and building plans had to be excluded from consideration because the first was incurred when no trade was carried on while the second was clearly of a capital nature.

The appellant argued that the expenditure was incurred in the production of income, since income would be derived in the form of rent once the building was completed. It was also argued that the expenses were not of a capital nature because the appellant already had an asset in the form of erf 1456. On these arguments Corbett JA (as he then was) stated the following:⁹

“The first argument, in my view, runs counter to a series of previous decisions, including a decision of this court. The general approach of the courts is that where a stand is acquired with the object of erecting a building on it and to let it – and to derive an income from it – expenditure such as interest on a bond, municipal rates, etc that is incurred before the development has taken place and has produced income, is expenditure of a preliminary nature and not deductible under section 11(a) (see Income Tax Case No 697 17 SATC 93 and the cases therein cited, Income Tax Case No 736 18 SATC 207 to 209; *Reef Estates Ltd v CIR* 1954 (2) SA 593 (T), *CIR v Allied Building Society* 1963 (4) SA 1(A) at 18–19).”

(Translated from the Afrikaans.)

The court went on to cite ITC 697 (above) with approval, noting that the facts were in all material respects identical to those in the instant case.

⁸ 1981 (4) SA 836 (A), 43 SATC 195.

⁹ At SATC 204.

The court concluded as follows:¹⁰

“Such expenditure can be regarded as capital expenditure and it can also rightly be said that it was not actually incurred in the production of income nor incurred exclusively for the purposes of trade.”

(Translated from the Afrikaans.)

This principle was also confirmed in *Reef Estates Ltd v CIR*¹¹ which is discussed in 4.2.1.

In ITC 1593 Heher J stated that –¹²

“it is well established in our law that one cannot be involved in the performance of income-producing operations unless such operations are underway. It is not sufficient that one has the intention to set up an income-producing operation and in the course of fulfilling that intention to expend money and then to claim that as revenue”.

Effect of section 11A

Under section 11A pre-trade expenses which would have qualified under section 11 [excluding section 11(x)], 11D or 24J but for the trade requirement in those provisions, are deductible in the year of assessment in which trade commences, subject to specified requirements, irrespective of when these expenses were incurred, but subject to section 23H.¹³

3. The law

Section 11A

11A. Deductions in respect of expenditure and losses incurred prior to commencement of trade.—(1) For purposes of determining the taxable income derived during any year of assessment by a person from carrying on any trade, there shall be allowed as a deduction from the income so derived, any expenditure and losses—

- (a) actually incurred by that person prior to the commencement of and in preparation for carrying on that trade;
- (b) which would have been allowed as a deduction in terms of section 11 (other than section 11(x)), 11D or 24J, had the expenditure or losses been incurred after that person commenced carrying on that trade; and
- (c) which were not allowed as a deduction in that year or any previous year of assessment.

(2) So much of the expenditure and losses contemplated in subsection (1) as exceeds the income derived during the year of assessment from carrying on that trade after deduction of any amounts allowable in that year of assessment in terms of any other provision of this Act, shall not be set off against any income of that person which is derived otherwise than from carrying on that trade, notwithstanding section 20(1)(b).

Commencement date

Section 11A applies to any pre-trade expenses actually incurred by a taxpayer during any year of assessment ending on or after 1 January 2004.

¹⁰ At SATC 207.

¹¹ 1954 (2) SA 593 (T), 19 SATC 153.

¹² (1994) 57 SATC 251 (T) at 256.

¹³ See section 23H(1)(a).

4. Application of the law

4.1 Overview of section 11A(1)

A pre-trade expense qualifies as a deduction against the income from the trade to which it relates subject to the following four key requirements in section 11A(1):

- First, the trade, in respect of which the pre-trade expense was incurred, must have been commenced by the taxpayer [opening words of section 11A(1)].
- Secondly, the pre-trade expense must have been actually incurred before the commencement of and in preparation for carrying on that trade [section 11A(1)(a)];
- Thirdly, had the pre-trade expense been incurred after the commencement of the trade to which it relates, it would have been allowed as a deduction under section 11 [other than section 11(x), 11D or 24J [section 11A(1)(b)].
- Fourthly, the pre-trade expense must not have been allowed as a deduction in that year or any previous year of assessment [section 11A(1)(c)].

Once these requirements have been met, the pre-trade expense will be allowed as a deduction under section 11A(1) in the year of assessment in which the trade to which it relates commences, subject to the ring-fencing requirements of section 11A(2).

Apart from triggering a deduction under section 11A(1), the time when trade commences is important because, barring some exceptions,¹⁴ any post-trade expenses will not be ring-fenced against the income to which they relate.

4.2 Deduction of pre-trade expenses after trade has commenced [section 11A(1)]

4.2.1 Commencement of trade

There is not much direct precedent on exactly when trade commences in South African case law. Nevertheless, some principles can be drawn from the few available cases.

In ITC 777¹⁵ it was held that the mere intention to let property does not constitute the carrying on of a trade. As the company had endeavoured to let the property, it was held that the company did carry on a trade. In ITC 1476 Kirk-Cohen J stated the following:¹⁶

“In my view the carrying on of a trade involves an active step – something far more than merely watching over existing investments which are not, and are not intended or expected to be, income producing during the year in question.”

The active step must comprise more than the mere laying of plans. In *C: SARS v Contour Engineering (Pty) Ltd*, Eksteen AJ stated the following:¹⁷

“There is, however, a vast difference between the mere laying of plans for the respondent’s future, on the one hand, and the commencement of preparatory activities for a future venture, on the other . . .”

¹⁴ The Act contains a number of other ring-fencing provisions such as those in paragraph (b) of the proviso to section 20(1), sections 20A, 23A and 36 and paragraphs 8 and 11 of the First Schedule.

¹⁵ (1953) 19 SATC 320 (T).

¹⁶ (1989) 52 SATC 141 (T) at 148.

¹⁷ 1999 (E), 61 SATC 447 at 456.

In South Africa the absence of productive assets has been found to be an indicator of the absence of trading activity. In ITC 697 Price J stated the following:¹⁸

“If a taxpayer has no asset with which he can trade then he cannot be trading.”

For an in-depth examination of this topic, see Interpretation Note 33 “Assessed Losses: Companies: The ‘Trade’ and ‘Income from Trade’ Requirements”.¹⁹

It is not a prerequisite for income to have been earned before a trade can be said to have commenced. South African courts have consistently drawn a distinction between the “trade” requirement and the “income from trade” requirements in section 20.²⁰

Expenditure incurred in expanding an existing trade

The courts have interpreted the Act as requiring that a person’s taxable income be determined on a trade-by-trade basis with the overall taxable income being determined by aggregating the results from the separate trades,²¹ subject to certain ring-fencing provisions such as those applicable to foreign assessed losses.²²

In the context of a company, the trade-by-trade requirement is recognised in section 20(1)(b) which permits the set-off of an assessed loss derived from “any other trade” against income from any trade. It provides that for the purpose of determining the taxable income derived by any person from carrying on any trade, there shall, subject to section 20A, be set off against the income so derived by such person –

“any assessed loss incurred by a person during the same year of assessment in carrying on any other trade either alone or in partnership with others, otherwise than as a member of a company the capital whereof is divided into shares”.

The question arises whether expenditure incurred in expanding an existing trade of a specific type (for example, property letting) is a pre-trade expense. In ITC 984²³ the appellant company sought to deduct estate agent’s commission which it had incurred in securing a tenant for a building to be erected on land it had acquired for that purpose. The court held that the amount was not of a capital nature. The question whether the amount was a pre-trade expense was not considered and appears to have been accepted as a *fait accompli*. This was probably because the company was already carrying on a pre-existing trade of property letting and the expense in question was more related to the derivation of future rental income than for the purpose of developing an income-producing asset.

In *Reef Estates Ltd v CIR*²⁴ the taxpayer company carried on the business of letting property, and for this purpose held 10 properties, eight of which were township stands with the other two being farming properties.

¹⁸ (1950) 17 SATC 93 (T) at 96.

¹⁹ In 4.1.7.

²⁰ ITC 1679 (1999) 62 SATC 294 (O); ITC 1830 (2007) 70 SATC 123 (G).

²¹ ITC 729 (1951) 18 SATC 96 (N); *C v COT* 1966 (3) SA 6 (RAD), 28 SATC 127.

²² Paragraph (b) of the proviso to section 20(1).

²³ (1961) 25 SATC 59 (C).

²⁴ 1954 (2) SA 593 (T), 19 SATC 153.

One of these properties, which consisted of a vacant stand 485, situated in an out-of-the-way side street, was purchased by the taxpayer in 1935. No income was derived from this site until 1948 when it was let as a parking site for motor vehicles at an annual rental of £15. The taxpayer had acquired the stand with the intention of building shops on it as an investment, and deriving rental from them. During the year in question, the taxpayer had incurred expenditure of £366 for rates levied on the stand by the local authority.

The taxpayer claimed a deduction for this expenditure, which the Commissioner disallowed. The court dismissed the appeal, and held –

“that the expenditure had not been incurred for the purpose of earning the £15 of rental received, but primarily for the purpose of holding the stand as an asset to be used at a later stage for the purpose of earning income from buildings”.

The court held further that the expenditure was analogous to that incurred in the creation or equipment of an income-producing asset and was therefore of a capital nature.

On the question of whether the vacant stand was a separate business, Rumpff J stated the following.²⁵

“The facts of this matter indicate that stand 485 was acquired and is still being held with the intention of building shops thereon and deriving rentals therefrom. It is being held in order that it may in future become an income-producing unit. Even if the other properties of the appellant company together are considered as one business (a point which we need not decide) it cannot be said that stand 485 has become qualified to be regarded as part of that business.”

It follows that when a taxpayer expands an existing business by creating an asset for use in that business, the expenditure incurred on that asset before it is brought into use will be of a capital nature and not incurred in carrying on the existing trade.

Example 1 – Expenditure before the commencement of trade

Facts:

A company intended to carry on trade as a television station but had not yet secured a television licence. There was no certainty that the television licence would be secured because the company had to apply for it alongside a number of competitors. The company incurred preparatory expenditure on staff salaries and training costs.

Result:

The expenditure was not incurred in carrying on a trade, since the company did not yet have an asset with which to trade (amongst others, the television licence). See the United States case of *Richmond Television Corp. v Commissioner*²⁶ which dealt with a similar situation.

²⁵ At 156.

²⁶ 345 F.2d 901 (4th Cir. 1965). See Interpretation Note 33 for more details on this case.

Preparatory activities

As noted in the *Contour Engineering* case already discussed, the court drew a distinction between the laying of plans and the commencement of preparatory activities, in so doing implying that the commencement of preparatory activities may constitute the carrying on of a trade. What sort of preparatory activities would signal the commencement of a trade? In order to answer this question it must be determined whether the taxpayer has an asset (income-earning structure) with which to trade. Much will depend on the facts and circumstances of the particular case.

The following extract from the *Contour Engineering* case provides some guidance on when a wholesale or retail outlet commences to trade:²⁷

“What the evidence does clearly establish is that during 1988 the respondent had no premises, no equipment, no stock, no staff and, save for book debts, no assets. This is clearly indicative of a company which is not trading.”

Thus, depending on the nature of the trade, the absence of some or all of these factors (premises, equipment, trading stock and employees) may be indicative of a lack of trading activity.

On the other hand, as indicated earlier, the derivation of income is not a prerequisite for carrying on a trade. It is thus possible that trade can commence before the first sale is made. Schutz JA made the following *obiter* comment in *Robin Consolidated Industries Ltd v CIR*:²⁸

“In year one a retailer acquires premises, employs staff and buys stock, but does not open his doors until the beginning of year two. On the authority of *Sub-Nigel Ltd v CIR* 1948 (4) SA 580 (A) at 589-590 he would clearly be entitled to deduct the expenditure incurred in year one from revenue earned in year two.”

Although the court was dealing with the “in production of income” requirement of section 11(a), it seems to have accepted without question that the trade requirement was met in year 1.

Taxpayers rendering a service must at least hold themselves out as ready to provide services (in other words, such persons must have opened their doors for business).²⁹

Example 2 – Preparatory activities comprising the carrying on of a trade

Facts:

A taxpayer acquired a farm and planted trees which will bear fruit only in 10 years' time. During the 10-year period the taxpayer incurred recurring expenditure on salaries and wages, fertilizer and pesticides and also claimed wear-and-tear on equipment.

²⁷ At 456.

²⁸ [1997] 2 All SA 195 (A), 59 SATC 199 at 206.

²⁹ A similar approach is taken in the United States.

Result:

It is considered that trading commences with the preparation of the land for planting the trees.³⁰

4.2.2 Abandonment of a project before the commencement of trade

Pre-trade expenses relating to a project abandoned before the commencement of the relevant trade are not deductible under section 11A.

Example 3 – Abandonment of a project before the commencement of trade*Facts:*

X began preparations for the operation of a new business and incurred pre-trade expenses of R100 000. X decided to abandon the project before the commencement of the trade.

Result:

The pre-trade expenses are not allowable as a deduction under section 11A because the trade to which they relate never commenced.

4.2.3 Change in intention or in the nature of the trade

Both section 11A(1)(a) and (b) refer to “that trade”.

The references to “that trade” mean that only pre-trade expenses actually incurred in the preparation for carrying on that trade will be allowed as a deduction from the income resulting from that specific trade.

Example 4 – Change in nature of the trade*Facts:*

Company X began an airport project and incurred expenses of R5 million for technical staff salaries, telephone costs and rates and taxes (all pre-trade expenses) while the application for the airport operating licence was being considered by the relevant authorities. The licence was finally declined and the project abandoned.

Two months after the project was abandoned, Company X decided to use the land and buildings for a document-storage business. This business generated income of R230 000 against which Company X sought to claim the amount of R5 million as a deduction.

Result:

The pre-trade expenses of R5 million incurred in preparing for the airport operation are not allowable as a deduction against the income from the document-storage business, since section 11A(2) permits a set-off of pre-trade expenses only against income from the same trade, namely, the airport project.

³⁰ For a case involving the incurral of expenses in maintaining a rubber tree plantation before the trees were productive, see *Vallambrosa Rubber Co., Ltd., v Farmer* (Surveyor of Taxes) 5 TC 529.

4.2.4 Meaning of “that trade”

The opening words of section 11A(1) refer to taxable income derived during any year of assessment by a person from carrying on “any trade”. Section 11A(1)(a) then refers to expenditure and losses –

“actually incurred by that person prior to the commencement of and in preparation for carrying on that trade”.

The question arises whether the words “that trade” refer to the taxpayer’s trade generally or the carrying on of trade in relation to a specific asset.

For example, a taxpayer may let out three properties and then commence to erect a fourth building for the purposes of letting it when completed. Any expenses such as interest, insurance and rates incurred before the fourth building is brought into use will be of a capital nature and not in the production of income. Since the taxpayer is already carrying on a trade of letting of property, concern has been expressed that the taxpayer will not be entitled to claim the expenses under section 11A(1).

By way of background, section 11(bA) used to grant a deduction for pre-production interest when a qualifying asset was brought into use. It was deleted with effect from years of assessment commencing on or after 1 January 2012 because it was considered that any expenditure claimable under section 11(bA) could, subject to ring-fencing, be claimed under section 11A. Similarly, the ambit of paragraph 20(1)(g) of the Eighth Schedule was restricted to exclude from base cost specified recurring costs incurred in relation to assets used exclusively for business purposes because such expenses should also qualify for deduction under section 11A.³¹

It is a factual question whether a person is carrying on a single trade of letting property or whether each new property constitutes an independent or new trade. Having regard to the above background and the overall policy objective, SARS is of the view that in a situation such as that described in the above example, it is highly likely that the letting of the new property will comprise a trade that is independent from the letting of the existing properties. Consequently pre-production expenses contemplated in section 11A will qualify for deduction notwithstanding that a person may be carrying on letting activities in relation to other properties.

4.3 Pre-trade expenses actually incurred before the commencement of and in preparation for carrying on a trade [section 11A(1)(a)]

The expenditure and losses must have been actually incurred by a taxpayer before the commencement of and in preparation for the carrying on of that specific trade.

For an expense to be “actually incurred” there must be an accrued present obligation, whether absolute or defeasible.³²

³¹ The amendment to paragraph 20(1)(g) applies to disposals made on or after 1 January 2014.

³² Hoexter JA in *Nasionale Pers Bpk v KBI* 1986 (3) SA 549 (A), 48 SATC 55 at 71.

In *Edgars Stores Ltd v CIR* Corbett JA (as he then was) stated the following.³³

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

In order for preliminary expenditure to qualify as a deduction under section 11A(1) it must be incurred in preparation for the carrying on of a trade. The word “preparation” requires an act of preparation, and there must be a close link between the expenditure and the trade to be undertaken. The expenditure incurred in the *Reef Estates* case discussed in 4.2.1 would, probably not have qualified under section 11A(1), since it was not incurred in preparing for the trade of letting. Preparation for carrying on a trade involves an active step taken – something more than just passively holding a piece of land for many years until the conditions are conducive for preparatory activities to begin.

4.4 Pre-trade expenses which would have qualified under section 11, 11D or 24J had they been incurred after the trade had commenced [section 11A(1)(b)]

In order for any pre-trade expenditure and losses to qualify as a deduction under section 11A(1), a pre-trade expense must pass a “post-trade” test under one of a number of specified sections, namely –

- section 11 (general deduction), excluding section 11(x);
- section 11D (deduction for scientific or technological research and development); or
- section 24J (incurral and accrual of interest).

The relevant expense or loss will qualify as a deduction under section 11A only if actually incurred during any year of assessment ending on or after 1 January 2004.

The exclusion of section 11(x) from expenditure that would have qualified under section 11 but for the trade requirement

Section 11(x) provides for a deduction as follows:

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—

- (x) any amounts which in terms of any other provision in this Part, are allowed to be deducted from the income of the taxpayer.

³³ 1988 (3) SA 876 (A), 50 SATC 81 at 90.

The words “in this Part” refer to Part I (Normal Tax) of Chapter II of the Act which consists of sections 5 to 37G.³⁴

Section 11A(1)(b) has the effect that any pre-trade expenses falling outside sections 11(a) to (w), 11D and 24J do not qualify for a deduction under section 11A. Examples include the depreciation deduction granted under either section 12B or 12C which have their own “brought into use for the purposes of trade” requirements.

The post-trade test

An amount will qualify for deduction under section 11A(1) if it would have been allowed as a deduction under sections 11 [but for section 11(x)], 11D or 24J had it been incurred after the commencement of the particular trade.

Since this “post-trade test” focuses only on the trade requirement of the specified sections, it becomes necessary to consider whether the test overcomes other requirements of these sections such as –

- the “production of income” requirement of section 11(a);
- the bar on the deduction of expenditure of a capital nature, as for example, in sections 11(a) and (c);
- the requirement that the deduction applies to “expenditure and losses”; and
- the “use” requirement of, for example, section 11(e).

Whether these requirements are met must be determined by the facts and circumstances of each case.

In most situations it should be a relatively simple matter to show that once trade commences the relevant expenditure would have been capable of producing income if incurred at that time.

Recurring-type expenditure incurred before trade commences invariably takes on the character of expenditure of a capital nature because it is incurred in the setting up of an income-earning structure (see *Borstlap*'s case discussed in 2). The effect of the post-trade test on such expenditure is to change it to a revenue nature because the presumption is that it is incurred after the income-earning structure has been established. Examples of pre-trade expenses qualifying under section 11A(1)(a) typically include the cost of accounting and audit services, advertising and marketing, electricity and water, insurance, rates, rent, salaries and wages, staff training, trading stock acquired before the commencement of trade and telephone costs.

However, pre-trade expenses that retain their capital nature even if incurred after trade commences will not qualify for deduction under section 11A(1). Examples include the cost incurred by a lessee in drawing up a lease agreement,³⁵ the legal costs incurred in securing a trading licence,³⁶ the cost of drawing up building plans³⁷ and the cost of a feasibility study. Such expenses are incurred once-off and are a

³⁴ Section 37H, which formed part of Part I of Chapter II, was repealed by section 67(1) of the Taxation Laws Amendment Act 22 of 2012 with effect from the commencement of years of assessment commencing on or after 1 January 2013.

³⁵ ITC 50 (1926) 2 SATC 123 (NA) ; ITC 215 (1931) 6 SATC 133 (U).

³⁶ ITC 1224 (1974) 37 SATC 30 (T).

³⁷ See *Borstlap*'s case above.

direct cost of setting up the income-earning structure and cannot be divorced from it by the post-trade test.

Section 11A(1)(b) refers to “expenditure and losses”. The question is whether this wording includes an “allowance” as opposed to “expenditure”. Examples of allowances include the allowance for any lease premium granted under section 11(f) and the allowance for specified intellectual property granted under section 11(gA). Despite an allowance sometimes colloquially being understood to be an otherwise inadmissible expense, the section 11 allowances are in principle deductible as pre-trade expenses, because of the wording of section 11A which refers to “expenditure . . . allowed as a deduction”. The allowances granted under section 11(cA); (e) (subject to what is stated below), (f), (g), (gA), (gC), (gD) or (hB) will therefore potentially qualify for deduction under section 11A(1) after the particular trade has commenced

A taxpayer may thus be entitled to claim amounts that could not previously be claimed during the pre-trade period.

Although the wear-and-tear or depreciation allowance in section 11(e) is based on the “value” of an asset rather than on its cost, SARS in most instances interprets the term “value” to mean “cost to the taxpayer” for the purpose of determining the allowance. However, section 11A will not apply to the wear-and-tear or depreciation allowance on assets that do not have a cost to the taxpayer, such as those acquired by donation or inheritance, since in these instances the allowance will be based on market value and not actual expenditure.

In addition, it is a requirement of section 11(e) that the asset be “used” by the taxpayer for the purposes of his or her trade. Thus, an asset acquired before the commencement of trade that is not “used” during the pre-trade period will not qualify for a deduction under section 11A. This situation could happen if the asset is placed in storage pending the commencement of trade.

Example 5 – Wear-and-tear allowance qualifying for deduction under section 11A

Facts:

Company A’s financial year ends on the last day of February. On 1 September 2016 Company A hired premises for the purposes of carrying on trade as a general dealer.

Before trade could commence, Company A had to install various shop fittings and equipment such as cash registers and refrigerators. On 1 September 2016 Company A purchased a delivery vehicle for R200 000 which it used during the pre-trade period to transport shop fittings and equipment to its premises. On 1 March 2017 the company commenced trading. Interpretation Note 47 provides that delivery vehicles may be written off over four years under section 11(e).

Result:

Year ended 28 February 2017

Company A is not entitled to the wear-and-tear allowance for the six-month period 1 September 2016 to 28 February 2017 because it did not trade during this period.

Year ended 28 February 2018

On 1 March 2017 the company is entitled to a deduction under section 11A(1) of R25 000 ($R200\ 000 \times 25\% \times 6 / 12$) for the wear-and-tear allowance applicable during the pre-trade period 1 September 2016 to 28 February 2017. The company also qualifies for the wear-and-tear allowance for the 12 months ended 28 February 2018 under section 11(e) of R50 000 ($R200\ 000 \times 25\%$). Thus in the 2018 year of assessment the company is able to claim wear-and-tear allowances totalling R75 000 ($R25\ 000 + R50\ 000$).

4.5 Pre-trade expenses not allowed as a deduction in the current or any previous year of assessment [section 11A(1)(c)]

Only pre-trade expenses which were not allowed as a deduction in the current or any previous year of assessment will qualify for a deduction under section 11A.

4.6 Ring-fencing of the deduction for pre-trade expenses [section 11A(2)]

4.6.1 Limitation of pre-trade expenses to taxable income from the relevant trade

Section 11A(2) limits the deduction allowable under section 11A(1) to the taxable income from the relevant trade. If the pre-trade expenses exceed the taxable income of that trade, the excess pre-trade expenses may not be set off against the income from any other trade notwithstanding section 20(1)(b). Section 20(1)(b) permits a taxpayer to set off an assessed loss incurred in one trade against any income from another trade derived during the same year of assessment. Any pre-trade expenses not allowed because of insufficient taxable income from the particular trade must be carried forward for set-off against any future taxable income from that trade (see 4.6.3).

Pre-trade expenses cannot create an assessed loss in respect of the trade to which they relate, and cannot increase an assessed loss from that trade.

It is, therefore, possible for a taxpayer to carry forward an assessed loss and any pre-trade expenses from the same trade at the same time. The assessed loss brought forward would result from post-trade expenses, while the pre-trade expenses carried forward would arise from the limitation under section 11A(2).

Example 6 – Limitation of deduction of pre-trade expenses

Facts:

The following details relate to Company X, which commenced trading during the current year of assessment.

	R
Pre-trade expenses	100 000
Income from trade	150 000
Deductible post-trade expenses	80 000

Result:

Income from trade	150 000
Less: Deductible post-trade expenses	<u>(80 000)</u>
Subtotal before deducting pre-trade expenses	70 000
Less: Pre-trade expenses of R100 000 limited to	<u>(70 000)</u>
Taxable income	<u>Nil</u>

Pre-trade expenses	100 000
Less: Pre-trade expenses deducted limited to	<u>(70 000)</u>
Balance of pre-trade expenses carried forward	<u>30 000</u>

The balance of the pre-trade expenses of R30 000 will be carried forward and will be available for set-off against future taxable income from this trade.

4.6.2 Impact of assessed loss brought forward on ring-fencing

Any assessed loss brought forward from the previous year of assessment (referred to as any "balance of assessed loss" in section 20) must be allocated between the various trades to which it relates in order for section 11A(2) to be applied. The deduction for pre-trade expenses relating to a particular trade is limited to the taxable income from that trade which remains after the set-off of any balance of assessed loss incurred in that trade.

Example 7 – Assessed loss brought forward

Facts:

References in this example to years 1, 5 and 6 are to the respective years of assessment ending on the last day of February.

Company Y carries on two trades, A and B. Trade B commenced during year 1 while Trade A commenced during year 5. At the end of year 5 the company had assessed losses carried forward of R50 000 from Trade A and R10 000 from Trade B. The company had unclaimed pre-trade expenses of R40 000 from Trade A at the end of year 5. During year 6 the company had income of R100 000 from Trade A and R200 000 from Trade B. Allowable post-trade expenses incurred during year 6 for Trades A and B amounted to R20 000 and R50 000 respectively.

Result:

Company Y's taxable income for year 6 is determined as follows:

	Trade A R	Trade B R
Income	100 000	200 000
Less: Allowable post-trade expenses	(20 000)	(50 000)
Assessed loss brought forward	<u>(50 000)</u>	<u>(10 000)</u>
Subtotal	30 000	140 000
Pre-trade expenses brought forward	40 000	
Less: Pre-trade expenses deducted in current year <u>(30 000)</u>	(30 000)	
Balance of pre-trade expenses carried forward	<u>10 000</u>	
Taxable income	<u>Nil</u>	<u>140 000</u>

Under section 11A(2) the balance of pre-trade expenses of R10 000 from Trade A may not be set off against the taxable income of R140 000 from Trade B.

4.6.3 Claiming of pre-trade expenses limited by section 11A(2)

The mechanism for claiming pre-trade expenses limited under section 11A(2) is contained in section 11A(1). The opening words of section 11A(1) refer to the determination of taxable income derived during *any* year of assessment in which the trade is being carried on. The words “any year of assessment” could be either the year of assessment in which trade commences or any subsequent year of assessment.

5. Conclusion

While this Note provides general guidance on the application of section 11A, the facts and circumstances of each case must be considered in determining when and if pre-trade expenses will qualify for a deduction under this section.

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