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Preamble

In this Note unless the context indicates otherwise –

- “**Close Corporations Act**” means the Close Corporations Act No. 69 of 1984;
- “**Companies Act**” means the Companies Act No. 71 of 2008;
- “**Co-operatives Act**” means the Co-operatives Act No. 14 of 2005;
- “**qualifying entity**” means a “close corporation”, a “co-operative” and any “private company” as defined in section 1 of the Companies Act (see **4.1.1**);
- “**SBC**” means small business corporation;
- “**Schedule**” means a Schedule to the Act;
- “**section**” means a section of the Act;

- “**TA Act**” means the Tax Administration Act No. 28 of 2011;
- “**the Act**” means the Income Tax Act No. 58 of 1962;
- “**VAT Act**” means the Value-Added Tax Act No. 89 of 1991; and
- any other word or expression bears the meaning ascribed to it in the Act.

All guides, interpretation notes and practice notes referred to in this Note are available on the SARS website at www.sars.gov.za.

1. Purpose

This Note provides guidance on the interpretation and application of section 12E which provides accelerated depreciation allowances for a taxpayer that qualifies as an SBC.

This Note does not address other sections in the Act which contain provisions that refer to or are applicable to a “small business corporation” as defined in section 12E. For example, section 8FA(3)(a) provides that section 8FA, which deems hybrid interest to be a dividend in specie, does not apply to a debt owed by an SBC. Section 8FA is not discussed in this Note.

Section 10(1)(zK) and section 23O apply when an amount of funding has been received by or accrued to an SBC from a “small business funding entity” as defined in section 1(1). Generally, these sections provide for the exemption of such receipts and accruals and the reduction of the deduction available for related expenditure. In this regard, this Note considers only the impact of such receipts and accruals on the allowances available under section 12E(1) and (1A).

Some of the requirements in section 12E refer to the Companies Act. This Note discusses those requirements with reference to that Act but does not discuss the requirements, which may have been different in some respects, when the Act previously referred to the Companies Act No. 61 of 1973.

2. Background

Section 12E sets out the requirements which must be met in order for a specified entity to qualify as an SBC. It provides accelerated depreciation allowances on certain capital assets brought into use by an SBC.

In addition, section 5(2) and the annual Rates and Monetary Amounts and Amendment of Revenue Laws Acts provide for concessionary tax rates which follow a graduated marginal structure (0%, 7%, 21% and 28%)¹ as opposed to a flat corporate rate of 28%.

The ITR14 return contains a question asking taxpayers whether they are an SBC as referred to in section 12E. The question must be answered “yes” if a taxpayer meets the requirements of an SBC as stipulated in section 12E. If the question is answered “yes”, a further set of questions relating to section 12E will be asked within the return. The answers to these additional questions will determine whether the taxpayer will be assessed as an SBC for that year of assessment.

¹ See the *Guide for Tax Rates/Duties/Levies* (Issue 12) dated 29 March 2016, for the rates and marginal structure applicable to different years of assessment.

3. The law

The relevant provisions are quoted in **Annexure A**.

4. Application of the law

4.1 Qualifying requirements

In order to qualify as an SBC, an entity must meet the requirements stipulated in the definition of “small business corporation” in section 12E(4)(a). These requirements comprise four key areas, namely:

- A legal entity requirement (see **4.1.1**)
- A holder of shares requirement (see **4.1.2**)
- A gross income limitation requirement (see **4.1.3**)
- A business activity requirement (see **4.1.4**)

In addition, the entity may not be a “personal service provider” as defined in the Fourth Schedule. The prohibition relating to personal service providers is discussed in **4.1.5**.

The requirements must be reconsidered every year of assessment since an entity could meet all the requirements and be an SBC in one year of assessment but not in another year of assessment.

4.1.1 Legal entity requirement [section 12E(4)(a)]

One of the requirements in qualifying as an SBC is that the taxpayer must be a juristic person in the form of a “close corporation”, “co-operative” or “private company” as defined in section 1 of the Companies Act. In this Note these entities, which are included in the definition of “company” in section 1(1), are referred to as “qualifying entities”.

(a) Close corporation

A “close corporation” is defined in section 1(1) as a close corporation within the meaning of the Close Corporations Act. The Close Corporations Act defines a “corporation” as a close corporation referred to in section 2(1) which has been registered under that Act. A close corporation is therefore a juristic person, with between one and ten² persons who qualified for membership, which has complied with that Act’s requirements for the registration of its founding statement and has duly registered under that Act.

A person or group of persons is prohibited from registering a close corporation as from 1 May 2011. However close corporations incorporated and registered before this date may still qualify as an SBC if the other requirements of section 12E(4)(a) are met.

² Section 28 of the Close Corporations Act.

(b) Co-operatives

A “co-operative” is defined in section 1(1) as any association of persons registered under section 27 of the Co-operatives Act No. 91 of 1981³ or section 7 of the Co-operatives Act.

The Co-operatives Act and Regulations⁴ provide a regulatory framework for co-operatives by setting out the requirements and procedures for the functioning and operations of the various types of co-operatives.

While it is accepted that a large number of co-operatives may operate informally and, as such, may not be formally registered, only entities that are duly registered under the Acts referred to above may qualify as SBCs.

(c) Private company

A “private company” is defined in section 1 of the Companies Act as –

“a profit company that—

- (a) is not a public,⁵ personal liability,⁶ or state-owned company;⁷ and
- (b) satisfies the criteria set out in section 8(2)(b);”

Under the Companies Act No. 61 of 1973 a personal liability company was a private company which was not specifically defined or excluded from being a private company. As a result it could historically have qualified as an SBC. This situation, however, no longer prevails since a personal liability company is specifically excluded from the definition of “private company”.⁸

A “company” is in turn defined in section 1 of the Companies Act as a juristic person which is incorporated under the Companies Act, is a domesticated company or immediately before 1 May 2011 was –

- registered under the Companies Act No. 61 of 1973 (other than as an “external company” as defined in that Act) or under the Close Corporations Act (if subsequently converted under Schedule 2 to the Companies Act); or

³ A co-operative registered under the Co-operatives Act No. 91 of 1981 may continue to operate as if that Act had not been repealed subject to the transitional provisions in section 97 of the Co-operatives Act.

⁴ GNR. 366 of 30 April 2007: Regulations.

⁵ A “public company” is defined in section 1 of the Companies Act as a profit company which is not a state-owned company, a private company or a personal liability company.

⁶ A “personal liability company” is defined in sections 1 and 8(2)(c) of the Companies Act as a profit company which meets the criteria for a private company and its Memorandum of Incorporation states that it is a personal liability company. Personal liability companies are typically incorporated associations of professional persons in which the directors are jointly and severally liable for the debts and liabilities of the company See *Henochsberg on the Companies Act 71 of 2008*, Notes on Section 8 [online] (My LexisNexis: May 2015).

⁷ A “state-owned company” is defined in section 1 of the Companies Act as a) a company which is either listed as a public entity in the relevant Schedules of the Public Finance Management Act No. 1 of 1999 or b) is owned by a municipality as contemplated in the Local Government: Municipal Systems Act No. 32 of 2000 and is otherwise similar to a).

⁸ The Draft Taxation Laws Amendment Bill, 2016 proposes that the definition of an SBC be amended to include a personal liability company as one of the entities which can potentially qualify as an SBC. This Draft Bill and, in due course, the amending legislation must be consulted to determine the exact nature and effective date of potential changes.

- in existence and recognised as an “existing company” under the Companies Act No. 61 of 1973; or
- deregistered under the Companies Act No. 61 of 1973 and subsequently re-registered under the Companies Act.

A profit company is one which is incorporated for the purpose of financial gain for its shareholders.⁹

Section 8(2)(b) of the Companies Act provides that a private company’s Memorandum of Incorporation must prohibit it from offering its securities to the public and it must restrict the transferability of its securities.

A private company is, therefore, generally a juristic person that has been incorporated under the Companies Act for the purposes of making financial gain and whose founding document prohibits the offer of its shares to the public and restricts the transferability of its shares. The definition of “private company” specifically excludes a public, personal liability or state-owned company.

A company which is incorporated and registered under foreign legislation will not qualify as an SBC. However, a foreign company which has successfully applied under section 13(5) to 13(11) of the Companies Act to transfer its registration from the foreign jurisdiction in which it is registered to South Africa is deemed to have been incorporated in South Africa. Such a company will exist as a company under the Companies Act as if it had originally been so incorporated and registered. A foreign company that has transferred its registration to South Africa is called a “domesticated company” and may qualify as an SBC if it satisfies the requirements of a private company as discussed above and the other requirements of section 12E(4)(a).

4.1.2 Holder of shares requirement

(a) The holding of shares in the potential small business corporation [section 12E(4)(a)]

Section 12E(4)(a) provides that all the holders of shares or members, as appropriate, of a qualifying entity must, at all times during the relevant year of assessment, be natural persons. No part of the share capital or members interest of an SBC can therefore be held by a juristic person such as another company. A contravention of this requirement, even if for one day during the year of assessment, will disqualify a qualifying entity from being an SBC for the year of assessment in which the requirement was not met, irrespective of whether all of the other requirements are met.

A qualifying entity whose shares or members interest are held in a trust may qualify as an SBC provided that the beneficiaries hold a vested right in those shares or members interest throughout the year of assessment and are all natural persons. The holders of shares requirement looks at the beneficial ownership of the shares or members interest.¹⁰ Therefore, if the shares or members interest held by a trust are beneficially owned by natural persons, the share or interest in the qualifying entity would be viewed as being held by a natural person. However, to the extent that the

⁹ Definition of “profit company” in section 1 of the Companies Act.

¹⁰ See paragraph 3.2 of the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011 in relation to section 7(1)(zO) of the Taxation Laws Amendment Act No. 24 of 2011.

shares are beneficially held by the trust, the company will not qualify as an SBC even if its trustees are natural persons. The trustees are merely the representative taxpayer of the trust and do not have any beneficial interest in the trust assets.

(b) The holding of shares in any other company by the holders of shares or members of the close corporation or co-operative [section 12E(4)(a)(ii)]

The holders of shares in, or members of, the qualifying entity may not at any time during the particular year of assessment hold any shares or have any interest in the equity of any other “company” as defined in section 1(1), except in those companies specifically permitted. The reason for the limitation is to prohibit multiple shareholdings or arrangements which may be used to split income between various qualifying entities, thus providing taxpayers with an undue tax benefit. A share or interest held in the equity of another “company”, as defined in section 1(1), which is held as a trustee or nominee will generally not be regarded as contravening this requirement provided the holder or member is not the beneficial owner of the share or interest and is not entitled to any profits, income or capital of that other company for the relevant year of assessment.

The companies in which a holding of shares is permitted are listed in **Annexure B**. Any shares or interest in any company not specifically permitted, even if held for one day during the relevant year of assessment, will lead to the qualifying entity being disqualified as an SBC for that year of assessment.

Example 1 – Limitation on shares held by holders of shares

Facts:

Company A, which renders information technology (IT) services to a number of clients, has six full-time employees (two holders of shares, X and Y, and four other employees). The employees are all involved in rendering IT services to clients throughout the year of assessment. Company A’s gross income for the year of assessment was R5,6 million.

In addition to the shares in Company A, X is the holder of a number of shares in a share block company and Y is the holder of shares in Company Z. Company Z was listed on the JSE but was delisted during the year of assessment.

Result:

The shares held by X in a share block company are permissible under section 12E(4)(a)(ii)(cc). The shares held by Y in Company Z are impermissible owing to the company being delisted during the year of assessment.

Company A cannot therefore qualify as an SBC for the year of assessment as a result of the shares held by Y in Company Z.

4.1.3 Gross income limitation requirement [section 12E(4)(a)(i)]

The gross income of a qualifying entity may not exceed R20 million for the particular year of assessment.¹¹ Key factors for consideration are what constitutes gross income, what is a year of assessment and the circumstances in which the limitation of R20 million must be reduced. These are considered below.

(a) Gross income

The term “gross income” is defined in section 1(1) and means, in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of that resident¹² during the year or period of assessment excluding receipts or accruals of a capital nature but including the amounts (whether of a capital nature or not) listed in paragraphs (a) to (n) of that definition.

In *Geldenhuys v CIR*, Steyn J stated that the words “received by” as used in the definition of “gross income” –¹³

“must mean ‘received by the taxpayer on his own behalf for his own benefit’”.

The term “accrued to” was held by Watermeyer J (as he then was) in *WH Lategan v CIR* to mean –¹⁴

“to which he has become entitled”.

In the Lategan case it was also noted that the fact that an amount may be due and payable only in a subsequent year of assessment did not mean that it had not accrued to a taxpayer.

If an amount is subject to any conditions, a person will become entitled to it only once the conditions have been fulfilled.¹⁵ The entitlement must therefore be unconditional in order for an amount to be included in gross income.

Gross income includes income that is exempt from normal tax, for example, a government grant of a non-capital nature which qualifies for an exemption under section 12P. Taxable capital gains are not included in gross income since section 26A specifically provides for the inclusion of a taxable capital gain in taxable income.

¹¹ The R20 million limitation is deemed to have come into operation on 1 April 2013 and applies in respect of years of assessment ending on or after 1 April 2013 [section 7(1) of the Rates and Monetary Amounts and Amendment of Revenue Laws Act No. 23 of 2013 and section 140 of the Taxation Laws Amendment Act No. 25 of 2015].

¹² The position for non-residents is not discussed since it is unlikely that a non-resident company with South African-source income will qualify as an SBC.

¹³ 1947 (3) SA 256 (C), 14 SATC 419 at 430.

¹⁴ 1926 CPD 203, 2 SATC 16 at 20. The correctness of the interpretation of “accrued to” in Lategan’s case was subsequently confirmed by Hefer JA in *CIR v People’s Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (A), 52 SATC 9 at 24.

¹⁵ *Mooi v Secretary for Inland Revenue* 1972 (1) SA 674 (AD), 34 SATC 1.

(b) Year of assessment

The term “year of assessment” as defined in section 1(1) “means any year or other period in respect of which any tax or duty leviable under this Act is chargeable ...”. Under section 5(1)(d) normal tax is payable in respect of the taxable income received by or accrued to or in favour of “any company during every financial year of such company”. A company’s year of assessment is thus its financial year.

Qualifying entities are included in the definition of “company”. It follows that the definition of “year of assessment” in section 1(1) applies to qualifying entities and a qualifying entity’s year of assessment is its financial year.¹⁶

The term “financial year” is defined in section 1(1) in relation to any company and hence also applies to a qualifying entity. The financial year of a newly incorporated or created company is the period commencing on the date of incorporation¹⁷ or creation and which ends on the last day of February immediately succeeding that date or any other date that the Commissioner, having regard to the circumstances of the case, may approve as the date on which the first year of assessment ends. For subsequent years the financial year commences immediately after the last day of the immediately preceding year of assessment and ends on the anniversary of that last day or any other date that the Commissioner, having regard to the circumstances of the case, may approve as the date on which a subsequent year of assessment will end.

Depending on the facts, a financial year may be shorter than, equal to or longer than 12 months in duration.

Therefore, the last day of a year of assessment may differ from qualifying entity to qualifying entity and a qualifying entity’s year of assessment, while often 12 months, may be shorter than, equal to or longer than 12 months. The impact of a longer or shorter year of assessment on the calculation of the gross income limitation is discussed in **4.1.3(c)**.

(c) Variation of the gross income limitation

The gross income of an SBC is limited to R20 million for a year of assessment. An exception to this rule is contained in the proviso to section 12E(4)(a)(i) which provides that if a qualifying entity carries on a trade, in which an asset contemplated in section 12E is used, for a period which is *less* than 12 months, the limitation of R20 million must be reduced proportionately. The ratio applied to the R20 million limitation is the number of months the qualifying entity traded divided by 12. In determining the number of months during which a qualifying entity traded, a part of a month is treated as a full month. The proviso does not increase the denominator of 12 if the year of assessment is longer than 12 months.

The date on which trade commences (for example, a newly incorporated company which subsequently commenced trade) and ceases (for example, a company in the process of liquidation which has ceased trade) are important considerations in determining an entity’s gross income limitation for purposes of section 12E(4)(a)(i). The point at which a trade commences or ceases must be determined on a case-by-case basis taking the detailed facts and circumstances into account. For a detailed discussion on the trade requirement, see Interpretation Note No. 33 (Issue 4) dated

¹⁶ Definitions of “company” and “year of assessment” in section 1(1).

¹⁷ Under section 27(2)(a) of the Companies Act, date of incorporation is the date that the incorporation of the company is registered, as stated in its registration certificate.

22 July 2014 “Assessed Losses: Companies: The ‘Trade’ and ‘Income from Trade’ Requirements”.

The proviso does not increase the R20 million limitation when the year of assessment or the period of trading is longer than 12 months. Therefore, when a qualifying entity has, for example, a 14-month year of assessment and traded for 13 months in that year of assessment, the R20 million limitation still applies. In contrast, if a company has an 8-month year of assessment it could only have traded for 8 months in that year and the limitation of R20 million must be reduced.

Example 2 – Determination of gross income limitation

Facts:

A qualifying entity, which carries on a manufacturing business, with a year of assessment ending 28 February started trading activities on 15 August 2015. Gross income for the period 15 August 2015 to 28 February 2016 amounted to R15 million.

Result:

The period of trade from 15 August 2015 to 28 February 2016 is less than 12 months and the taxpayer must therefore reduce the gross income limitation in proportion to the number of months it has traded.

The qualifying entity has traded for 6½ months, however under section 12E(4)(a)(i) part of a month must be treated as a full month. The qualifying entity is, therefore, treated as if it traded for 7 months.

R20 million × $\frac{\text{number of full months traded}}{12 \text{ months}}$

$$= \text{R20 million} \times \frac{7}{12}$$

$$= \text{R11,67 million}$$

The gross income limitation for the taxpayer for the year of assessment ended 28 February 2016 is therefore R11,67 million. Gross income for the year of assessment is R15 million which exceeds the limitation of R11,67 million. Therefore, the qualifying entity has not met the gross income limitation requirement and cannot qualify as an SBC for the year of assessment ended 28 February 2016.

4.1.4 Business activity requirement [section 12E(4)(a)(iii) and (iv)]

Broadly, section 12E(4)(a)(iii) imposes a limitation on the amount of income which may be generated from certain income streams, namely investment income and income generated from personal services. An entity cannot qualify as an SBC if more than 20% of the total of all receipts and accruals (excluding capital receipts) and capital gains, consists of investment income and income from the rendering of a personal service.

The terms “investment income” and “personal service” are specifically defined in section 12E(4)(c) [see 4.1.4(a)] and (d) [see 4.1.4(b)] respectively. The calculation of the 20% limitation is discussed in 4.1.4(c).

(a) Definition of “investment income” [section 12E(4)(c)]

Section 12E(4)(c) defines “investment income” as –

“(c) ‘investment income’ means—

- (i) any income in the form of dividends, foreign dividends, royalties, rental derived in respect of immovable property, annuities or income of a similar nature;
- (ii) any interest as contemplated in section 24J¹⁸ (other than any interest received by or accrued to any co-operative bank as contemplated in paragraph (a)(ii)(ff)), any amount contemplated in section 24K¹⁹ and any other income which, by the laws of the Republic administered by the Commissioner, is subject to the same treatment as income from money lent; and
- (iii) any proceeds derived from investment or trading in financial instruments (including futures, options and other derivatives), marketable securities or immovable property;”.

The application of the definition of “investment income” does not generally give rise to problems, however, the treatment of “income” from serviced accommodation potentially raises questions. The view taken by SARS is that the “income” a qualifying entity earns from providing serviced accommodation on a short-term basis in, for example, a guesthouse, a lodge, a bed and breakfast establishment or a hotel, will not be regarded as rental derived in respect of immovable property. However, in circumstances where a person has the exclusive use of property or a portion of the property on a long-term basis, for example, periods exceeding one month whether under one or more contracts, and it was not done on an isolated basis, a portion of the income earned may potentially be regarded as rental in respect of immovable property. All the facts and circumstances will need to be taken into account in these cases to determine whether a portion of the income is considered to be rental in respect of immovable property.

The definition of “investment income” must be interpreted within the context of section 12E(4)(a)(iii) because that provision provides that not more than 20% of the total receipts and accruals (other than those of a capital nature) and capital gains may *consist* of investment income and income from the rendering of a personal service. “Consist” means to “be composed or made up of”²⁰ and therefore for an amount to be investment income it must first have been included in the qualifying entity’s total receipts and accruals (other than those of a capital nature) or capital gains.

For example, if a qualifying entity had gross income of R400 and also disposed of shares held on capital account with a base cost of R90 for R120, section 12E(4)(a)(iii) requires that not more than 20% of R430 (gross income of R400 plus the capital gain of R30) may consist of investment income and income from rendering a personal service. Under paragraph (iii) of the definition of investment income “proceeds” must be interpreted to refer to the capital gain of R30 because that is the amount which has been included in the total of R430 in respect of the disposal of financial instruments held for investment purposes (that is on capital account as opposed to being held for trading or revenue purposes). The gain of R30, and not the full proceeds of R120, was included in the total of R430.

¹⁸ Section 24J deals with the incurral and accrual of interest.

¹⁹ Section 24K deals with the incurral and accrual of amounts in respect of interest rate agreements.

²⁰ www.oxforddictionaries.com/definition/english/consist [Accessed 25 July 2016].

Therefore, $R30 \text{ investment income} / R430 \times 100 = 6,98\%$ and the limitation has not been exceeded. If the shares had been held on revenue account then the total under section 12E(4)(a)(iii) would be R520 (R400 + R120) and investment income would be R120. Therefore, $R120 / R520 \times 100 = 23,08\%$ and the limitation would have been exceeded with the result that the qualifying entity could not qualify as an SBC even if all the other requirements under section 12E(4)(a) were met.

Example 3 – Determination of investment income

Facts:

A close corporation conducts two trades, namely, the rental of houses owned by the close corporation on a long-term basis and the provision of short-term serviced residential accommodation to guests in two guesthouses.

The period of the rental agreements for the houses varies in duration depending on the tenant's requirements but are generally longer than 3 months.

The guesthouse offers accommodation on a bed-and-breakfast basis. The duration of a guest's stay varies but is generally between a few days to two weeks. Guests can request dinner at an additional cost.

Gross income consisted of rental from the houses of R12 million, income from the bed-and-breakfast accommodation at the guesthouse of R4 million and income from the supply of dinner meals of R400 000.

Result:

Gross income for the year of assessment is R16 400 000 which means it has not exceeded the gross income limitation of R20 million.

Total receipts and accruals (other than those of a capital nature) and capital gains = R16 400 000 + Rnil = R16 400 000.

The rental income from the houses is "investment income" as defined. The income from the serviced accommodation and the provision of dinner meals is not "investment income" as defined.

Investment income / Total receipts and accruals (other than those of a capital nature) and capital gains = $R12\,000\,000 / 16\,400\,000 \times 100 = 73,17\%$.

The 20% limitation has been exceeded and as a result the close corporation has not met the business activity requirement and cannot qualify as an SBC.

(b) Definition of "personal service" [section 12E(4)(d)]

For the purposes of the 20% limitation, one of the tainted income streams besides investment income is income from the rendering of a personal service.

Section 12E(4)(d) defines "personal service" as –

- "(d) **'personal service'**, in relation to a company, co-operative or close corporation, means any service in the field of accounting, actuarial science, architecture, auctioneering, auditing, broadcasting, consulting, draftsmanship, education, engineering, financial service broking, health, information technology, journalism, law, management,

real estate broking, research, sport, surveying, translation, valuation or veterinary science, if—

- (i) that service is performed personally by any person who holds an interest in that company, co-operative or close corporation; and
- (ii) that company, co-operative or close corporation does not throughout the year of assessment employ three or more full-time employees (other than any employee who is a holder of a share in the company or a member of the co-operative or close corporation, as the case may be, or who is a connected person in relation to a holder of a share in the company or a member), who are on a full-time basis engaged in the business of that company, co-operative or close corporation of rendering that service.”

In general, a personal service refers to a service rendered for which the income derived is mainly a reward for the personal efforts or skills of an individual. In determining whether a service falls within the ambit of a “personal service” as defined, the ordinary grammatical meaning is given to each word in that definition. The words “any service in the field of” preceding the categories of services listed in the definition suggest that a wide interpretation must be applied to these categories. Therefore, the list must be interpreted to include every service in the specified field irrespective of whether it is of a professional nature.

The list of services included in the definition of “personal service” is limited in two respects. Thus, a qualifying entity will be regarded as rendering a “personal service” only if –

- the service falling within the list is personally performed by any person holding an interest in that qualifying entity; and
- that qualifying entity does not throughout the year of assessment employ three or more full-time employees (excluding an employee who holds a share in that company or who is a member of the close corporation or co-operative, or who is a connected person²¹ in relation to a holder of a share in that company or a member of the close corporation or co-operative), who are on a full-time basis engaged in the business of that company of rendering that service.

If one of these requirements for a personal service is not met, the qualifying entity will not be rendering a personal service for purposes of section 12E. Stated differently, both of these requirements must be met for the qualifying entity to be regarded as rendering a personal service for purposes of section 12E.

It may happen that a qualifying entity provides a service falling within the ambit of the services listed in section 12E(4)(d) which is performed by a person holding an interest in the qualifying entity and the qualifying entity employs less than three full-time employees who are not connected to that person in the business of rendering that service. In this situation only the service rendered by the person holding the interest is regarded as a personal service. This is important because, when calculating whether the 20% limitation on investment income and income from rendering a personal service has been exceeded [see **4.1.1(c)**], it is necessary to determine the amount of income from the rendering of a personal service and that will require a Rand-value apportionment of the income which is attributable to that

²¹ The term “connected person” is defined in section 1(1). For more information, see Interpretation Note No. 67 (Issue 2) dated 14 February 2014 “Connected Persons”.

person's involvement. The Act does not prescribe a specific method of record-keeping or apportionment in calculating the income from personal services; it may be done either by means of an hourly charge out system or per job or any other appropriate method.

The personal service definition encourages the creation of full-time employment in qualifying entities by setting a minimum employee threshold when a person holding an interest in the qualifying entity is involved in performing a service included in the list in section 12E(4)(d) and the qualifying entity would like to benefit from the exclusion from the personal service income requirement. A qualifying entity wishing to use the exclusion must maintain a minimum of three full-time employees *throughout* the year of assessment despite any lay-offs or resignations that may occur. An employee must –

- be engaged on a full-time basis in the qualifying entity's business of performing the relevant service;
- not be a holder of shares in or a member of the qualifying entity; and
- not be a connected person in relation to a holder of shares in or a member of the qualifying entity.

The number of shares held or the size of the member's interest and how the shares or interest were acquired are irrelevant since section 12E(4)(d)(ii) merely refers to "a holder of a share in the company or a member of the co-operative or close corporation". Thus, for example, an employee who holds one share cannot be included in the three or more full-time employee count.

The persons considered in the employee count need not necessarily be involved in an activity that directly generates the income from the potential personal service. For example, a receptionist in an accounting firm who does not directly perform the accounting services for which a client is invoiced but is involved on a full-time basis in the support services which allow that accounting service to be provided, will be considered to be involved in the business of performing that service. The receptionist would be included in the three or more full-time employee count because he or she is engaged in the business of the qualifying entity of rendering *that service*, '*that service*' meaning the accounting service falling in one of the categories listed in section 12E(4)(d).

The term "full-time employee" is not defined for purposes of section 12E and must therefore be given its ordinary grammatical meaning taking into account the context in which the term appears and the purpose to which it is directed.²² The terms "full-time" and "employee" are considered separately below.

The Merriam-Webster Dictionary describes "full-time" as –²³

"working the full number of hours considered normal or standard...done during the full number of hours considered normal or standard ...requiring all of or a large amount of your time".

The Oxford Online Dictionary defines "full-time" as –²⁴

"occupying or using the whole of someone's available working time".

²² *Natal Joint Municipal Pension Fund v Endumeni Municipality* 2012 (4) SA 593 (SCA).

²³ www.merriam-webster.com/dictionary/full-time [Accessed 25 July 2016].

²⁴ www.oxforddictionaries.com/definition/english/full-time [Accessed 25 July 2016].

The facts and circumstances of each case are thus critical in determining if an employee is a full-time employee at a particular employer because it is necessary to consider the number of hours the employee works for that employer in relation to the full normal working hours for other employees at that employer. Casual, temporary or part-time employees are not employed on a full-time basis since they work less than the standard full number of hours and they are therefore not taken into account when determining the employee count in the personal service definition.

Although not directly relevant to section 12E, the definition of “part-time employee” in section 198C(1) of the Labour Relations Act No. 66 of 1995 is consistent with the interpretation above.

The Business Dictionary defines “employee” as follows:²⁵

“An individual who works part-time or full-time under a contract of employment, whether oral or written, express or implied, and has recognised rights and duties. Also called worker.”

Under common law, an employee does not include an independent contractor since this type of contract does not generally result in an employer-employee relationship. An independent contractor who has been hired by a qualifying entity will therefore not be taken into account when determining the employee count in the personal service definition. The definition of “employee” in the Fourth Schedule, which includes independent contractors in certain instances, is applicable only to the Fourth Schedule and not section 12E.

Example 4 – The amount of income attributable to the rendering of a personal service

Facts:

Company A renders services in the field of actuarial science. The services are performed by X and Y. X holds shares in Company A.

Company A also employs a full-time receptionist whose duties relate only to the actuarial services part of the business. Z is also employed on a full-time basis to write articles for various financial magazines.

The following amounts have been received by or accrued to Company A during a year of assessment:

Income from the rendering of actuarial services by X	R250 000
Income from the rendering of actuarial services by Y	R350 000
Income from articles written for financial magazines	R150 000

Result:

The actuarial services rendered by Company A fall within the “actuarial science” category listed in section 12E(4)(d). Some of the services were performed by X who is a holder of shares in the company [section 12E(4)(d)(i)].

²⁵ www.businessdictionary.com/definition/employee [Accessed 25 July 2016].

Y and the receptionist are employed on a full-time basis in the business of the rendering of actuarial services. However, Z is engaged in a different service [section 12E(4)(d)(ii)]. The income from the actuarial services performed by X of R250 000 is thus income from rendering a personal service. The income from the actuarial services performed by Y of R350 000 is not income from rendering a personal service because Y is not a holder of shares in the company.

The income of R150 000 from writing articles for financial magazines falls outside the definition of “personal service”. Although the service falls within the “journalism” category listed in section 12E(4)(d), it is not performed by a holder of shares in the company.

Example 5 – Three or more full-time employees

Facts:

Skin Care (Pty) Ltd is a company owned by three dermatologists, each holding an equal percentage of shares in the company.

The practice consists of the three dermatologists, one receptionist and three pathologists who are involved in analysing skin and blood samples of patients in their own in-house laboratory. All the employees are employed on a full-time basis. The receptionist is appointed to schedule appointments for the dermatologists and pathologists and to handle patient accounts. One of the pathologists is married to one of the dermatologists.

Result:

The services rendered by the dermatologists and pathologists fall within the “health” category listed in section 12E(4)(d).

The services are being performed personally by the three holders of shares in Skin Care (Pty) Ltd [section 12E(4)(d)(i)]. However, their services are not a personal service because the company employs three employees who are not holders of shares in the company and are not related to, and therefore connected to, any of the holders of shares, on a full-time basis in the business of rendering the services. These three employees are the receptionist and the two pathologists who are not connected persons in relation to the holders of shares in Skin Care (Pty) Ltd [section 12E(4)(d)(ii)].

The pathologist who is married to the dermatologist is a connected person in relation to one of the holders of shares in Skin Care (Pty) Ltd and is therefore not included in the three-or-more employee count.

(c) Calculation of the 20% limitation on investment income and income from rendering a personal service [section 12E(4)(a)(iii)]

As noted in 4.1.4, the aggregate income from investment and personal services may not exceed 20% of the qualifying entity’s total receipts and accruals (excluding receipts and accruals of a capital nature) and capital gains.

The words “of a capital nature” are not defined in the Act. The South African courts have considered the meaning of these words in a number of capital versus revenue disputes and in deciding these cases have developed a number of tests or guidelines

for distinguishing between the two concepts. However, as Smalberger JA put it in *CIR v Pick 'n Pay Employee Share Purchase Trust* there is –²⁶

“no single infallible test of invariable application”.

See paragraph 2.4 of the *Comprehensive Guide to Capital Gains Tax* (Issue 5) for a detailed discussion on the various tests and guidelines. The onus of proving that an amount is of a capital nature rests upon the taxpayer under section 102 of the TA Act.

The term “capital gain” is defined in section 1(1) as “an amount determined in terms of paragraph 3 of the Eighth Schedule”. Under paragraph 3(a) of the Eighth Schedule, a person’s capital gain on the disposal of an asset in the current year of assessment, is the amount by which the proceeds received or accrued on the disposal exceed the base cost of the asset. It may also happen that an asset disposed of in a previous year of assessment gives rise to a capital gain which must be accounted for in the current year of assessment. Paragraph 3(b) of the Eighth Schedule deals with the circumstances in which this may arise. See paragraph 5.1.2 of the *Comprehensive Guide to Capital Gains Tax* (Issue 5) for more detail.

The total of different capital gains arising in a year of assessment must be determined and used when calculating a qualifying entity’s total receipts and accruals (excluding receipts and accruals of a capital nature) and capital gains. For example, if the qualifying entity realised a capital gain of R50 000 on asset A and a capital gain of R60 000 on asset B, the sum of the capital gains of R110 000 must be taken into account under section 12E(4). Capital losses arising on the disposal of assets by a qualifying entity are not taken into account in this calculation.

The term “capital gain” must be distinguished from an “aggregate capital gain”, “aggregate capital loss”, “net capital gain” and “taxable capital gain”. The latter four terms take into account, amongst other things, the sum of all capital gains and capital losses and any assessed capital loss brought forward from the previous year of assessment.²⁷

The amount received or accrued on disposal of an allowance asset held on capital account is of a capital nature even though part of it may represent a recoupment included in the taxpayer’s gross income under paragraph (n) of the definition of that term. The definition of “gross income” includes amounts “whether of a capital nature or not”. While the effect of the special inclusions in gross income is to treat an amount of a capital nature as gross income, they do not deem amounts of a capital nature to be of a revenue nature. The full amount received or accrued on disposal of an allowance asset held on capital account must therefore be excluded from the denominator in the 20% limitation formula. The capital gain, if applicable, is included.

²⁶ 1992 (4) SA 39 (A), 54 SATC 271 at 279.

²⁷ See paragraphs 6, 7, 8 and 10 of the Eighth Schedule.

Example 6 – Nature of amount derived on disposal of allowance asset for purposes of the 20% limitation formula

Facts:

Manufacturing Company A acquired a machine at a cost of R100 and claimed allowances under section 12E of R100. It disposed of the asset for R110.

Result:

There is a recoupment of R100 of the capital allowances under section 8(4)(a) which is included in Manufacturing Company A's "gross income" under paragraph (n) of the definition of that term.

There is also a capital gain of R10 arrived at as follows:

	R
Amount received or accrued on disposal of machine	110
Less: Recoupment [paragraph 35(3)(a) of Eighth Schedule]	<u>(100)</u>
Proceeds	10
Less: Base cost (see below)	<u>Nil</u>
Capital gain	<u>10</u>

The base cost of the asset is determined by reducing the acquisition cost of R100 by the capital allowances under paragraph 20(3)(a) of the Eighth Schedule.

The denominator in the 20% limitation formula is determined as follows:

	R
Amount received or accrued	110
Less: Amount of a capital nature derived on disposal of machine	(110)
Capital gain	<u>10</u>
Denominator	<u>10</u>

Example 7 – Determination of whether a close corporation qualifies as an SBC by considering the 20% limitation of income from rendering a personal service and investment income

Facts:

Compzone CC trades mainly in the supply of computer hardware and pre-packaged software. The company employs three full-time sales assistants who are engaged in the processing of sales orders, merchandising of stock and assisting customers in the store.

On a smaller scale, the company offers its clients a computer software development service which is performed by three holders of shares in the company and independent contractors who are occasionally hired for specific projects.

In addition, the close corporation disposed of a capital asset that was used for purposes of trade, received an award under a will and derived royalty income. Proceeds from the disposal of the asset were R900 000, with a capital gain derived of R40 000.

The receipts and accruals of Compzone CC for the year of assessment are as follows:

	R
Income from sales	3 900 000
Income from computer software development service	1 100 000
Royalties received	23 000
Cash payment under a will (capital receipt)	50 000
Amount received from the sale of a capital asset	<u>900 000</u>
Total receipts and accruals	<u>5 973 000</u>

Result:

The main business activity, that is, the supply of hardware and software, concerns the sale of goods and is therefore not a service or personal service.

The computer software development service constitutes a “personal service” as defined because –

- the computer software development service falls within the “information technology” category listed in section 12E(4)(d); and
- the service is rendered by persons who hold shares in Compzone CC and Compzone CC does not employ three or more other employees, who are not connected to the members of Compzone CC, on a full-time basis in rendering that service.

The fact that Compzone CC employs three full-time employees in the part of its business dealing with the supply of computer hardware and software is irrelevant since they are not engaged in the rendering of the computer software development service.

The royalty income constitutes investment income [section 12E4(c)(i)].

The total of all receipts and accruals (other than those of a capital nature) and all capital gains for the purposes of calculating the 20% limitation is R5 063 000 (R5 973 000 total receipts and accruals – R50 000 payment under a will – R900 000 proceeds from disposal of a capital asset + R40 000 capital gain).

The 20% limitation calculation is as follows:

- $[(\text{investment income} + \text{personal service income}) / (\text{total receipts and accruals of non-capital nature} + \text{capital gains})] \times 100$
- $[(R23\ 000 + R1\ 100\ 000) / R5\ 063\ 000] \times 100 = 22,18\%$

Investment income and income from the rendering of a personal service **exceeds** the 20% limitation for the relevant year of assessment and accordingly the close corporation will not qualify as an SBC even if all the other requirements of section 12E(4)(a) are met.

Example 8 – Determining whether a company qualifies as an SBC by considering the 20% limitation of income from rendering a personal service and investment income

Facts:

A and B hold shares in PetDoc (Pty) Ltd and practice as veterinarians. Besides consulting, the practice also generates income from the dispensing of medicine and the selling of pet goods such as nutritional supplements, pet food and treats.

PetDoc (Pty) Ltd has a full-time receptionist, sales assistant and cleaner.

The company disposed of two assets that were used in the veterinary practice.

An X-Ray machine was disposed of for R500 000 generating a capital gain of R35 000. A veterinary table was disposed of for R2 000 which resulted in a loss of R1 000 under section 11(o).

The receipts and accruals of PetDoc (Pty) Ltd for the year of assessment are as follows:

	R
Income from sales of pet goods	1 360 000
Income from veterinary services	5 000 000
Amount received from the sale of the X-Ray system	500 000
Amount received from the sale of the table	<u>2 000</u>
Total receipts and accruals	<u>6 862 000</u>

Result:

The total of receipts and accruals (other than those of a capital nature) and all capital gains for the purposes of calculating the 20% limitation is R6 395 000 (R6 862 000 – R500 000 – R2 000 + R35 000 capital gain). The loss of R1 000 under section 11(o) on the disposal of the veterinary table is disregarded for purposes of this calculation.

The sale of goods is not a service and as a result does not fall within the definition of “personal service”.

Veterinary services falls within the “veterinary science” category listed in section 12E(4)(d). The veterinary services are rendered by the two holders of shares. Although the full-time receptionist is also engaged in the business of rendering the veterinary services, the sales assistant and cleaner are not engaged in the business of rendering the veterinary services on a full-time basis. PetDoc (Pty) Ltd does not therefore employ three or more full-time employees who are not connected to the holders of shares in the business of veterinary services, and the income from the veterinary services constitutes a “personal service” as defined.

PetDoc (Pty) Ltd does not earn any investment income [section 12E4(c)].

The 20% limitation calculation is as follows:

- $[(\text{investment income} + \text{personal service income}) / (\text{total receipts and accruals of non-capital nature} + \text{capital gains})] \times 100$
- $[(R\text{nil} + R5\,000\,000) / R6\,395\,000] \times 100 = 78,19\%$

Investment income and income from the rendering of a personal service **exceeds** the 20% limitation for the relevant year of assessment and the company will not therefore qualify as an SBC even if all the other requirements of section 12E(4)(a) are met.

4.1.5 Prohibition of personal service providers [section 12E(4)(a)(iv)]

Section 12E(4)(a)(iv) excludes a company which is a “personal service provider” as defined in paragraph 1 of the Fourth Schedule from qualifying as an SBC.

A “personal service provider” is defined in the Fourth Schedule as a company²⁸ if the services rendered on behalf of such company to a client are rendered personally by a connected person²⁹ in relation to the company and –

- the connected person would be regarded as an employee of the client if that person had rendered the service directly to the client; or
- the services must be performed mainly at the premises of the client and the connected person or the company is subject to the control or supervision of the client as to the manner in which the services are rendered; or
- more than 80% of the income of the company during the year of assessment is or is likely to be received directly or indirectly from any one client or associated institution in relation to that client,

except if the company, throughout the year of assessment, employs three or more full-time employees who are engaged on a full-time basis in the business of the company of rendering any such service excluding any employee who is a holder of a share in the company or is a connected person in relation to a holder of a share in the company. A full-time employee who holds one or more shares in the company is not included in the “three or more full-time employee” count even if that employee is not a connected person in relation to the company.

A “personal service” as discussed in **4.1.4(b)** is different to a “personal service provider”. Although the definitions of a “personal service” and a “personal service provider” share some common features, they also contain some distinct differences. Both definitions must therefore be considered in light of the facts of a particular case. A company that is not a “personal service provider” under the Fourth Schedule may render a “personal service” under section 12E and *vice versa*. A company will need to ensure that it is not a “personal service provider” as defined in the Fourth Schedule and that its investment income and income from personal services is equal to or less than 20% of its total receipts and accruals (excluding those of a capital nature) and capital gains in order to potentially qualify as an SBC.

4.2 Small business corporation assets [section 12E(1) and (1A)]

Under section 12E, two sets of accelerated depreciation rates potentially apply to the assets of an SBC. Subject to certain conditions, assets used directly in a process of manufacture or a process of a similar nature may qualify for a 100% write-off in the year of assessment in which the asset is brought into use. Assets that do not fall into

²⁸ The definition refers to companies and trusts; however, in the context of an SBC, trusts are irrelevant.

²⁹ The term “connected person” is defined in section 1(1). For more information, see Interpretation Note No. 67 (Issue 2) dated 14 February 2014 “Connected Persons”.

this category may qualify for write-off over a period of three years at a rate of 50, 30 and 20% in the respective years.

4.2.1 Plant or machinery used directly in a process of manufacture or a process of a similar nature [section 12E(1)]

An SBC may deduct the cost³⁰ of any plant or machinery used directly in a process of manufacture, or any other process which is of a similar nature, carried on by that SBC in the year of assessment in which the SBC brings the plant or machinery into use, provided it is –

- brought into use for the first time by that SBC on or after 1 April 2001;
- brought into use for the purposes of the taxpayer's trade (other than a trade of mining or farming); and
- owned by the SBC or the SBC acquired the plant or machinery as purchaser under paragraph (a) of the definition of "instalment credit agreement" in section 1(1) of the VAT Act.

The total amount of the allowance available under section 12E(1) may be limited to less than 100% of the cost of the plant and machinery concerned if funding was received from a small business funding entity or in the form of a government grant (see 4.2.4).

(a) Plant and machinery

Plant

The term "plant" is not defined in the Act. The term has, however, been considered in various court cases. In *Blue Circle Cement Ltd v CIR*³¹ the issue was whether a 41 kilometre extension to an existing railway line was "plant and machinery" under section 12. The railway line was used to convey limestone from the taxpayer's quarry, where it was conceded the process of manufacture began, to the factory where it was made into cement. The court agreed with the taxpayer's concession that the railway line was not "machinery" and proceeded to determine the meaning of "plant". Referring to the definition of "plant" in the Oxford English Dictionary, the court held that the relevant enquiry in determining if the railway line was "plant", was whether it constituted fixtures, implements, machinery or apparatus used in carrying on an industrial process. The court reviewed a number of English cases in which the term was considered and agreed that in making that determination, it was useful to apply a functional test and a durability test. The English cases held that "plant" connoted a degree of durability and did not include articles that were quickly consumed or worn out in the course of a few operations.³² The functional test considers how the particular asset is used and whether it is employed to carry on or promote the taxpayers business activities. In applying the above tests to the facts, the learned judge concluded that the function performed by the railway line of conveying materials was part of the taxpayer's industrial process and that the railway line was part of the apparatus used in carrying on the industrial process of manufacturing cement. The railway line, in spite of needing repairs from time to time, was intended to last the life of the limestone deposits (approximately 40 years) and

³⁰ See 4.2.3.

³¹ 1984 (2) SA 764 (A), 46 SATC 21.

³² See also *Hinton v Maden and Ireland Ltd* (1959) 3 All ER at 356.

clearly met the durability test. The railway line thus qualified as plant for purposes of section 12.

In ITC 1468,³³ a case which concerned a shoe manufacturer, it was held that knives and lasts (implements used by the taxpayer in manufacturing shoes) constituted “plant”. The court referred to the definition and tests applied in *Blue Circle Cement Ltd v CIR*.³⁴ The items passed the functional test because they were used by the taxpayer in the course of the business of manufacturing shoes and enabled the machines in the factory to perform their manufacturing function. They also passed the durability test since the lasts had a minimum life of two to three years and after that period were kept for possible use again in the future. The knives were used for shorter periods but were also stored for possible future re-use and met the durability test.

Applying the same approach in ITC 1469,³⁵ lithographic plates and embossing dies were held not to constitute plant. The items were used directly in an industrial process (hence meeting the functional test) but were only used for a single job before being discarded and as a result lacked the required degree of durability and permanence to constitute plant.

Machinery

The term “machinery” is not defined in the Act. The ordinary grammatical meaning will therefore be applied having regard to the context in which it is used. According to the Collins Dictionary “machinery” is defined as –³⁶

“machines, machine parts, or machine systems collectively... [a] particular machine system or set of machines”.

(b) Process of manufacture or similar process

The Act does not define a “process of manufacture”. However, the courts have provided general guidelines which are helpful in determining whether the taxpayer is engaged in a process of manufacture. The following is an extract from *Ovation Recording Studios (Pty) Ltd v CIR*.³⁷

“The phrase ‘a process of manufacture’ in this context is a familiar one, which has been considered in many cases, including two decided in this court: *Secretary for Inland Revenue v Hersamer (Pty) Ltd* 1967(3) SA 177(A) and *Secretary for Inland Revenue v Safranmark (Pty) Ltd* 1982(1) SA 113(A). It is clear from these cases that there are no hard and fast rules for deciding whether a taxpayer’s activities fall within or outside the ambit of the section, but the following general propositions emerge as governing the enquiry: the term ‘process of manufacture’ comprises activities which constitute the production of a thing which is essentially different from the materials or components which went into its making; the concept of ‘essential difference’ necessarily involves an element of degree in determining whether the change brought about between the original material and the finished product is sufficient for the process to qualify as being one of manufacture; whether the requirement of an essential difference in relation to such change is satisfied cannot be determined by any fixed criteria or any fixed universal test; in each individual case the particular

³³ (1989) 52 SATC 32 (C).

³⁴ 1984 (2) SA 764 (A), 46 SATC 21.

³⁵ (1989) 52 SATC 40 (C).

³⁶ www.collinsdictionary.com/dictionary/english/machinery [Accessed 25 July 2016].

³⁷ 1990 (3) SA 682 (A), 52 SATC 163 at 172. Also see *SIR v Safranmark* 1982 (1) SA 113 (A), 43 SATC 235.

facts must be examined and analysed in order to assess and evaluate the 'change... in regard to the nature or form or shape or utility, etc, of the previous article or material or substance'; and in doing so the ordinary natural meaning of the phrase 'process of manufacture' in the English language must not be disregarded (see *Hersamer's case supra* at 186 *if* – 187E and *Safranmark's case supra* at 116G-117D and 122D-123B).

In the extract quoted above from *Hersamer's case*, viz 'change . . . in regard to the nature or form or shape or utility, etc, of the previous article . . .', the words 'form' and 'shape' refer to physical attributes, but neither the word 'nature' nor the word 'utility' is so limited, and under the umbrella of 'etc' must certainly be included, I consider, the factor of 'value'. As a matter of principle I can see no reason for generally according more weight to features of 'form' and 'shape' than to the attributes of 'nature' (in a non-physical sense), 'utility' and 'value'. The relative weight to be given to the various features of change must depend on the particular facts of each case."

(Footnotes suppressed.)

Practice Note No. 42 dated 27 November 1995 "Income Tax: processes of manufacture, processes similar to a process of manufacture and processes not regarded as processes of manufacture or processes similar to a process of manufacture" may be referred to in establishing whether a process constitutes a process of manufacture or similar process.³⁸ If an activity is not listed in the practice note, the guidelines provided above should be considered.

(c) Owned by and brought into use by the small business corporation

The introductory words of section 12E(1) refer to any plant or machinery owned by or acquired as purchaser under an instalment sale agreement by a taxpayer which qualifies as a SBC. Section 12E(1)(a) requires that the plant or machinery should be brought into use for the first time by that taxpayer, that is, the SBC that owns the asset or acquired it as a purchaser under an instalment sale agreement.

A lessee of plant and machinery will not qualify for a deduction under section 12E(1) because a lessee does not own the leased asset.

The plant and machinery may be new or second-hand, provided it is being brought into use for the first time by the SBC seeking to claim the allowance.

Example 9 – Asset brought into use before becoming an SBC

Facts:

ABC (Pty) Ltd (ABC) manufactures kitchen kettles which are sold on the local market. ABC acquired and started using a machine in its manufacturing process on 30 August 2014. Its year of assessment ends on 30 September.

During its 2015 year of assessment ABC met the requirements under section 12E(4)(a) and qualified as an SBC.

³⁸ The lists contained in the Practice Note are not exhaustive.

Result:

ABC cannot claim an allowance under section 12E(1) because ABC was not an SBC in the 2014 year of assessment when it first brought the machine into use. In addition, in 2015 even though ABC was an SBC, the machine was not brought into use by ABC for the first time in that year. However, in the 2014 year of assessment, an allowance may be claimed for the machine under section 12C if the requirements of that section are met.

Example 10 – Asset brought into use by an SBC*Facts:*

XYZ (Pty) Ltd (XYZ) manufactures food mixers which are sold on the local market. Its year of assessment ends on 30 September. On 30 August 2014 XYZ acquired a machine for use in its manufacturing process but only commenced using the machine on 10 October 2014.

During its 2015 year of assessment XYZ met the requirements under section 12E(4)(a) and qualified as an SBC.

Result:

XYZ can claim an allowance under section 12E(1) in its 2015 year of assessment because it was an SBC when it brought the asset into use for the first time during that year of assessment. The machine was therefore owned by an SBC when first brought into use.

(d) Meaning of used “directly in a process of manufacture” or similar process

The use of the word “directly” indicates an intention by the legislature to draw a distinction between plant and machinery used directly in a process of manufacture or similar process and plant and machinery which is used indirectly in such processes. In ITC 1061, Corbett J (as he then was) held that:³⁹

“The word ‘directly’ in this sense, is defined by the Shorter Oxford English Dictionary to mean –

‘Without the intervention of a medium; immediately; by a direct process or mode’.

The same dictionary defines the adjective ‘direct’, in a cognate sense, as meaning –

‘Without intervening agency; immediate’.

Sections 12(1) and 12(2) [the sections relevant to the case which used the same wording used in section 12E(1)], therefore, have reference to plant and machinery used directly, i.e. without the intervention of some other medium or agency, in the process of manufacture etc. The words ‘in the process’ are also deserving of emphasis.”

Plant and machinery is used “directly” in a process if it is an integral part of the process. Determining the starting⁴⁰ and ending point of the process of manufacture and, if the plant or machinery is used in that process, whether the item of plant and

³⁹ (1964) 26 SATC 317 (C) at 319.

⁴⁰ *SIR v Cape Lime Company Ltd* 1967 (4) SA 226 (A), 29 SATC 131; ITC 1114 (1967) 30 SATC 14(N); ITC 1247 (1975) 38 SATC 27(N).

4.2.4 Limitation on the amount of the allowance available under section 12E(1) and 12E(1A)

Section 10(1)(zK) exempts from normal tax any amount received by or accrued to or in favour of a small, medium or micro-sized enterprise from a small business funding entity.⁵⁹ Section 23O limits the deduction by the small, medium or micro-sized enterprise as a result of the amount received or accrued under section 10(1)(zK). Section 12P exempts from normal tax a government grant listed in the Eleventh Schedule or one which is identified by the Minister in the *Government Gazette*. It also contains provisions limiting expenditure funded by such an exempt grant.

Sections 10(1)(zK), 12P and 23O⁶⁰ are of potential application to an SBC that receives funding –

- for the acquisition, creation or improvement of an asset that qualifies under section 12E(1) or 12E(1A); or
- as a reimbursement for expenditure incurred in respect of the acquisition, creation or improvement of that asset.

The funding may take the form of –

- a “government grant” as defined in section 12P; or
- an amount from a small business funding entity.

The consequences for the SBC are generally that –

- the amount received by or accrued to or in favour of it is exempt from normal tax under section 10(1)(zK) or section 12P; and
- the aggregate amount of the deductions allowable to the SBC in respect of the asset concerned may not exceed an amount equal to the aggregate of the expenditure incurred, reduced by an amount equal to the sum of
 - the amount received or accrued from the government or small business funding entity for that purpose; and
 - the aggregate amount of all deductions and allowances previously allowed to that SBC in respect of that asset.

A taxpayer will therefore effectively not be allowed to claim more than the actual expenditure incurred net of the amount of exempt funding received in respect of that expenditure.

Example 16 – Limitation of allowances

Facts:

On 1 March 2015 JHK (Pty) Ltd, which qualifies as an SBC and has a financial year ending on the last day of February, received an amount of R10 000 from the DEF Trust. The DEF Trust is an approved small business funding entity and provided the funding for the purpose of subsidising the cost of machinery to be purchased by JHK (Pty) Ltd. On 1 April 2015 JHK (Pty) Ltd purchased a machine at a cost of R100 000 (not used in a process of manufacture).

⁵⁹ Defined in section 1(1) as an entity approved by the Commissioner in terms of section 30C.

⁶⁰ Section 23O applies to small, medium or micro-sized enterprises which are defined in section 1(1) as specifically including an SBC.

Moving costs were incurred during the year of assessment in which the asset was brought into use. Therefore, the write-off period for the moving costs is the same as the write-off period for the cost of the asset under section 12E(1A)(b), that is, three years. The moving costs must be deducted in three equal instalments over three years.

Asset moved on 1 July 2012 (2013 year of assessment) [section 12E(3)(a)]

2013 year of assessment: $R6\ 000 / 2 = R3\ 000$

2014 year of assessment: $R6\ 000 / 2 = R3\ 000$

2015 year of assessment: Nil

Two years (the current year of assessment and the 2014 year of assessment) remain in which the cost of the asset may be deducted under section 12E(1A)(b). Therefore, the moving costs must be claimed over two years of assessment in equal instalments.

Asset moved on 1 January 2015 (2015 year of assessment) [section 12E(3)(b)]

2015 year of assessment: $R6\ 000 / 1 = R6\ 000$

The asset was fully written off under section 12E(1A) by the end of the 2014 year of assessment. Therefore, the moving costs are claimed in full in the 2015 year of assessment.

b) Calculation of section 12E(3)(b) deduction of moving costs of asset B

Asset moved on 1 July 2011, 1 July 2012 or 1 January 2015

The full cost of asset B was allowed as a deduction under section 12E(1) in the 2011 year of assessment. Irrespective of whether asset B is moved in the 2012, 2013 or 2015 year of assessment, the full amount of the moving costs (R4 000) must be allowed as a deduction in the year of assessment in which the moving costs were incurred.

4.2.6 Assets acquired for no consideration

Assets acquired for no consideration, for example, by donation, inheritance or as a dividend *in specie*, are not eligible for a deduction under section 12E(1) and 12E(1A). The deduction under section 12E(1) and 12E(1A) is based on cost and there is no cost in these circumstances.

In addition, expenditure incurred by an SBC in moving an asset acquired in these circumstances will not qualify for a deduction under section 12E(3). Section 12E(3) applies only to expenditure incurred in moving an asset in respect of which a deduction was allowed or allowable under section 12E. No deduction is allowed or allowable under section 12E on assets acquired for no consideration.

An asset acquired for no consideration, as well as expenditure incurred in installing, erecting or moving that asset, may qualify for a deduction under section 11(e) based on the amount by which the value of the asset is reduced owing to wear and tear. The requirements of section 11(e) must be met in order to qualify for a deduction under that section. See Interpretation Note No. 47 (Issue 3) dated 2 November 2012 "Wear-and-Tear or Depreciation Allowance" for a detailed discussion on section 11(e).

other than those of a capital nature, plus capital gains may consist of “investment income” and income from rendering a “personal service”. In addition, the entity may not be a “personal service provider” as defined in the Fourth Schedule (see 4.1).

Section 12E provides for an accelerated depreciation allowance on certain capital assets acquired and brought into use by an SBC. There are two sets of accelerated depreciation rates which may apply. Subject to certain conditions, assets used directly in a process of manufacture or process of a similar nature, may qualify for a 100% write-off of cost in the year of assessment in which the asset is brought into use. Assets that do not fall into this category may be subject to a write-off under section 12E(1A), the amount of which may, at the election of the SBC, be calculated under the provisions of section 11(e) or over a period of three years at a rate of 50%, 30% and 20% of cost in the respective years. The term “cost” is specifically defined in section 12E(2). In addition to the accelerated depreciation allowance the section also deals with the deduction of costs incurred in moving assets which fall within the ambit of the section.

SBCs are subject to concessionary tax rates which follow a graduated marginal structure and are not taxed at the corporate tax rate of 28%.

In order to qualify as an SBC an entity must meet the requirements of section 12E in each year of assessment.

Legal Counsel

SOUTH AFRICAN REVENUE SERVICE

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Annexure A – The law

Section 12E

12E. Deductions in respect of small business corporations.—(1) Where any plant or machinery (hereinafter referred to as an asset) owned by a taxpayer which qualifies as a small business corporation or acquired by such a taxpayer as purchaser in terms of an agreement contemplated in paragraph (a) of the definition of “instalment credit agreement” in section 1 of the Value-Added Tax Act,—

- (a) is brought into use for the first time by that taxpayer on or after 1 April 2001 for the purpose of that taxpayer’s trade (other than mining or farming); and
- (b) is used by that taxpayer directly in a process of manufacture (or any other process which is of a similar nature) carried on by that taxpayer,

a deduction equal to the cost of such asset shall be allowed in the year that such asset is so brought into use.

(1A) Subject to subsection (1), where any machinery, plant, implement, utensil, article, aircraft or ship in respect of which a deduction is allowable under section 11(e) (“the asset”) is acquired by a small business corporation under an agreement formally and finally signed by every party to the agreement on or after 1 April 2005, the amount allowed to be deducted in respect of the asset must, at the election of the small business corporation and subject to the provisions of that section, be either—

- (a) the amount allowable in terms of and subject to that section; or
- (b) an amount equal to 50 per cent of the cost of the asset in the year of assessment during which it was first brought into use, 30 per cent in the first succeeding year and 20 per cent in the second succeeding year.

(2) For the purposes of this section the cost to a taxpayer of any asset shall be deemed to be the lesser of the actual cost to the taxpayer to acquire that asset or the cost which a person would, if he had acquired the said asset under a cash transaction concluded at arm’s length on the date on which the transaction for the acquisition of the said asset was in fact concluded, have incurred in respect of the direct cost of acquisition of the asset, including the direct cost of the installation or erection thereof or, where the asset has been acquired to replace an asset which has been damaged or destroyed, such cost less any amount which has been recovered or recouped in respect of the damaged or destroyed asset and has been excluded from the taxpayer’s income in terms of section 8(4)(e), whether in the current or any previous year of assessment.

(3) Any expenditure (other than expenditure referred to in section 11 (a)) incurred by a taxpayer during any year of assessment in moving an asset in respect of which a deduction was allowed or is allowable under this section from one location to another must—

- (a) where the taxpayer is or was entitled to a deduction in respect of that asset under subsection (1A) in that year and one or more succeeding years, be allowed to be deducted from his or her income in equal instalments in that year and each succeeding year in which that deduction is allowable; or
- (b) in any other case, be allowed to be deducted from that taxpayer’s income in that year.

(3A)

Annexure B – Permissible holding of shares or interests

Under section 12E(4)(a)(ii), no holder of shares or member of a qualifying entity may hold shares or have any interest in the equity of any other “company” as defined in section 1(1) except in those entities specifically listed in paragraphs (aa) to (ii) of section 12E(4)(a)(ii). These entities are:

- A company contemplated in paragraph (a) of the definition of “listed company” [section 12E(4)(a)(ii)(aa)]. Under paragraph (a) of the definition of “listed company” in section 1(1), it is a company whose shares or depository receipts for its shares are listed on an “exchange” as defined in section 1 of the Financial Markets Act No. 19 of 2012 and licensed under section 9 of that Act. Therefore, shares in a company listed on the Johannesburg Stock Exchange are permissible.
- Any portfolio in a collective investment scheme contemplated in paragraph (e) of the definition of “company” [section 12E(4)(a)(ii)(bb)]. Paragraph (e) includes two types of portfolios:
 - A portfolio in any investment scheme carried on outside South Africa that is comparable to a portfolio of a collective investment scheme in participation bonds or a portfolio of a collective investment scheme in securities. This portfolio must be in pursuance of any arrangement under which “members of the public” (as defined in section 1 of the Collective Investment Schemes Control Act No. 45 of 2002) are invited or permitted to contribute to and hold participatory interests in that portfolio through shares, units or any other form of participatory interest [definition of “company” in section 1(1), paragraph (e)(ii)].
 - A portfolio of collective investment scheme in property that qualifies as a “REIT” as defined in paragraph 13.1(x) of the Johannesburg Stock Exchange Limited Listing Requirements [definition of “company” in section 1(1), paragraph (e)(iii)].⁶⁴
- A company contemplated in section 10(1)(e)(i)(aa), (bb) or (cc) [section 12E(4)(a)(ii)(cc)], namely:
 - A body corporate established under the Sectional Titles Act No. 95 of 1986;
 - A share block company established under the Share Block Control Act No. 59 of 1980, and
 - Any other association of persons (other than a “company” as defined in the Companies Act, any co-operative, close corporation and trust, but including a “non-profit company” as defined in that Act) formed solely to manage the collective interests common to all its members and that is not permitted to distribute its funds to any person other than to a similar association. For example, a homeowners association.

For more information on the above entities see paragraph 4.1 of Interpretation Note No. 64 (Issue 3) dated 17 August 2015 “Income Tax Exemption: Bodies Corporate, Share Block Companies and Associations of Persons Managing the Collective Interests Common to All Members”.

⁶⁴ Effectively applicable to years of assessment commencing on or after 1 January 2015. Previously, for years of assessment commencing on or after 1 April 2013, it referred to a collective investment scheme in property.

