1 April 2021

To: The National Treasury
240 Madiba Street
PRETORIA
0001

Via email: National Treasury - taxincentivereviews@treasury.gov.za

Dear Colleagues,

RE: WRITTEN SUBMISSIONS ON THE TAX INCENTIVE SUNSET DATES

In a Media Statement released regarding the publication of the 2021 Draft Tax Bills and other regulations for public comment, National Treasury published a list of tax incentives that are scheduled to lapse upon reaching their respective sunset dates.

We provide our response hereunder in respect of the following incentives:

Income Tax Act	Tax incentive description	Effective date	Sunset date
Section 12F	Deduction in respect of airport and port assets	01/01/2001	28/02/2022
Section 12DA	Deduction in respect of rolling stock	01/01/2008	28/02/2022
Section 13*sept*	Deduction in respect of sale of low-cost residential units on loan account	21/10/2008	28/02/2022
Section 12O	Exemption in respect of films	01/01/2012	01/01/2022

Please do not hesitate to contact us should you need further information.

Yours sincerely,

South African Institute of Tax

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All references to legislation are to the Income Tax Act, No. 58 of 1962, unless otherwise indicated.

PART 1: Addressing section 12F, section 12DA, and section 13*sept*

"Over many years South African courts have developed or adopted a number of principles for determining whether expenditure is of a capital or revenue nature.

Although capital expenditure may be incurred in the production of income and in carrying on a trade, it is nevertheless excluded from deduction under the general deduction formula in section 11(a). The Act addresses this issue by granting a deduction for specific types of capital expenditure incurred in carrying on a trade, usually in the form of an allowance spread over a number of years based on the cost or value of an asset. Section 11(e) is one such specific provision and provides for an allowance on the value of any machinery, plant, implements, utensils and articles used by the taxpayer as owner in the carrying on of a trade."[1]

I. <u>General considerations</u>

Most commonly, section 11(e) provides for a deduction equal to the amount by which the value of any machinery, plant, implements, utensils and articles have diminished by reason of wear and tear during the tax year. Typically, these assets must be owned by the taxpayer, or must be in the process of being acquired. Section 11(e) is mainly intended for movable assets. Section 11(e) is not an "incentive" provision but merely intended to roughly match wear and tear accounting impairments in a simplified way. Incentives exist only exist elsewhere – such as section 12B and 12C – the latter of which provide for "accelerated" depreciation (i.e. are actual incentives).

Immovable property is addressed in various scattered provisions all over the Income Tax Act. These provisions provide for comparable wear and tear accounting impairments for buildings. The basic regime for immovable property applies to manufacturing (section 13*ter*), commercial (section 13*quin*) and residential rental of larger scale (section 13*sex*). These write-off rates vary between 2 and 5 per cent. Internationally, normal tax write-offs for buildings vary between 2.5, 4 and 5 per cent where tax systems are providing basic wear and tear impairments without incentives. As a practical matter, one can argue that physical wear and tear for large immovable structures ranges from roughly 2-to-4 per cent if one simply looks at physical condition. However, replacement is often required more frequently due to obsolescence. Commercial and manufacturing facilities often need to be renovated every 10 or 15 years to remain competitive.

Therefore, the review of section 12F, section 12DA, and section 13*sept* needs to be conducted in this light. Stated differently, airport and (sea)port assets, rolling stock (e.g. locomotives and railroad cars) and low-cost residential units experience economic depreciation over their useful life like all other assets. This economic decline in value should accordingly be taken into account to match the economics – not dispensed with altogether. Only the incentive element should be removed.

[1] SARS INTERPRETATION NOTE 47 (Issue 5) DATE: 9 February 2021

II. <u>Specifics</u>

SAIT acknowledges the policy intent highlighted in the 2020 and 2021 Budgets in that government is reducing the number of tax incentives in the tax system. In that sense, the value of any accelerated depreciation will depend on government's aims and the fiscal constraints, and the specific industries affected will be better placed to motivate for any specific value (to be translated into a percentage).

From a SAIT perspective, we are comfortable that the incentive nature of section 12F, section 12DA, and section 13*sept* can be removed with minimal adverse impact on the economy. However, as a matter of good tax policy, basic wear and tear should be continued to account for normal economic decline.

To determine the base line wear and tear that would be fair, we recommend that detailed analysis be conducted to determine the service or economic life of the assets that are the subjects of the sections. In contrast to the physical life of an asset, the economic or service life of an asset refers to how long it will be useful for revenue-generating activities, whilst its physical life refers to how long it will function for purposes of trade.

Although there are various analysis available internationally regarding the economic life of the assets subject to section 12F and section 12DA (including utilisation frequency and intensity), these do not account for differences in climate in various parts of the world, such as different ranges of temperature, precipitation levels, humidity, sun exposure and wind erosion. As a result, a specific South African study in conjunction with the affected industries would be appropriate.

At a drafting level, section 12DA for rolling stock can be removed with normal depreciation to be allowed under section 11(e) via SARS interpretation notes. Section 12F can be made part of section 13*quin* (commercial buildings). The useful life of airport assets is probably 20 years, but a lower rate can be utilised in section 13*quin* if one deems the useful life to be longer. We note that both section 12DA and section 12F – airport, port and rail assets) are mainly owned by Transnet, PRASA, ACSA, all of which are government owned parastatals. Hence, accelerated depreciated under current law only amounts to excess losses in any event. It is also questionable whether one needs an incentive for these state-owned enterprises to undertake construction that their normal mandate require.

Section 13*sept* has a different market-focus. This section provides for a deduction for the sale of low-cost residential units by an employer to its employee through an interest-free loan. According to our understanding the measures were put in place address the challenges in providing low-cost residential houses to employees by means of lease agreements. Depending on the current environment and availability of housing, this specific section may no longer be necessary. Our members do not appear to have a great appetite in preserving this incentive. The depreciation for residential assets falling under this category should merely fall under the basic residential rental regime under section 13*sex*.

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PART 2: Addressing section 12O

Section 12O contains an incentive aimed at stimulating the production of films within South Africa (the film incentive). The incentive was previously contained under section 24F. Section 24F provided an upfront deduction, or in some circumstances a deduction which was spread over 10 years, for certain production or post-production costs actually incurred by the taxpayer. This incentive was replaced by the provisions of section 12O, which provides for the exemption from normal tax of income derived from the exploitation rights of approved films. Section 12O came into effect on 1 January 2012 and applies to all receipts and accruals of approved films if principal photography commenced on or after this date but before 1 January 2022.

At the outset, we recommend the separation of the deliberation of the continued existence of the film incentive, with the exemption from tax for the Department of Trade and Industry and Competition (DTIC) incentive (i.e. cash grant).

The DTIC incentive (cash grant), was introduced by the DTIC in 2008. The aim of the DTIC incentive is to support the local film industry and to contribute towards employment opportunities in South Africa. The DTIC incentive is in the form of a grant calculated at 35% of the first R6 000 000 of qualifying South African production expenditure and 25% on the amounts of qualifying South African production expenditure above R6 000 000. For more detail, refer to SARS' Guide to the Exemption from Normal Tax of Income from Films.

We recommend that the DTIC grant continue to be exempted and in line with other similar government grants, be included under the Eleventh Schedule.

We have reached out to our colleagues in the industry regarding the film incentive: A session is being held in the week of 5 April 2021 to get insight into the experience of the affected industry. We shall provide feedback from the session as soon as possible.

In the interim, we can report the following observations: The film industry creates employment on a grass roots level, and the supply chain is massive. However, the environment is cyclical (much the same as tourism) and whilst the incentive does attract local investment, section 12O is still very technical with barriers perceived as too complex.

Rather than withdrawing the incentive, we recommend investigating the viability of expanding the incentive to encompass the creation and development of broader media technology, such as the intellectual property created in programmes created for broadcast (e.g. Netflix), as well as electronic games and similar content. The barrier to entry is low and a targeted incentive has the potential to form a technology centre in South Africa that could benefit the entire region.

We also doubt whether section 12O costs much to the fiscus because the exemption system has not led to abuse (like the former section 24F). Film productions and related media communication often generate more losses than net income.

End.

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