

INTERPRETATION NOTE: NO. 45 (Issue 2)

DATE: 10 December 2014

ACT : INCOME TAX ACT NO. 58 OF 1962
SECTION : SECTIONS 11(a) AND (e), 18A, 22(8), 23(b) AND (g), 24D, PARAGRAPHS 20 AND 53 OF THE EIGHTH SCHEDULE AND PART II OF THE NINTH SCHEDULE
SUBJECT : DEDUCTION OF SECURITY EXPENDITURE

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Preamble

In this Note unless the context indicates otherwise –

- “**Schedule**” means a Schedule to the Act;
- “**section**” means a section of the Act;

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

1. Purpose

This Note provides guidance on whether security expenditure incurred by a taxpayer is deductible for income tax purposes.

2. Background

Taxpayers incur a variety of expenditure for the purpose of preventing and combating crime in South Africa. Such security expenditure usually falls into one of the following categories:

- Expenditure of a domestic or private nature
- Donations
- Business-related expenditure

This Note examines each of these categories of expenditure.

3. The law

The following provisions of the Act are relevant to this Note:

- Section 11(a) – general deduction formula
- Section 11(e) – wear-and-tear or depreciation allowance
- Section 18A – deductible donations
- Section 22(8) – deemed inclusion in income of trading stock
- Section 23(b) – prohibition on the deduction of domestic or private expenses
- Section 23(g) – prohibition on deduction of moneys not laid out or expended for the purposes of trade
- Section 24D – security expenditure
- Paragraphs 20 and 53 of the Eighth Schedule – the base cost of assets and the disregarding of capital gains and capital losses on personal-use assets respectively for capital gains tax purposes
- Part II of the Ninth Schedule – public benefit activities for purposes of section 18A

4. Application of the law

4.1 Expenditure of a domestic or private nature

Section 23(b) prohibits the deduction of domestic or private expenditure.

In *CIR v Hickson*,¹ Beyers JA stated the following:

“Domestic and private expenses’ are, I should say, without attempting an exhaustive definition, expenses pertaining to the household, and to the taxpayer’s private life as opposed to his life as a trader.”

¹ 1960 (1) SA 746 (A), 23 SATC 243 at 249.

Thus the cost of securing an individual's private residence does not qualify as a deduction. Examples include defensive walls, burglar alarms, electric fences, razor wire, guard dogs, insurance, 24-hour monitoring and armed-response services. In the event that part of a taxpayer's private residence is used for purposes of trade, for example, a home office, an appropriate apportionment will have to be made for the security expenditure incurred (see **4.3.3**).

Capital gains tax

Some security expenditure may qualify as part of the base cost of immovable property held for domestic or private purposes, such as a primary residence or holiday home. Paragraph 20(1)(e) of the Eighth Schedule includes in the base cost of an asset –

“the expenditure actually incurred in effecting an improvement to or enhancement of the value of that asset, if that improvement or enhancement is still reflected in the state or nature of that asset at the time of its disposal;”.

Examples of such improvement or enhancement expenditure include the cost of installing an electric fence or the cost of a burglar alarm system which is integrated into the fabric of a building. To qualify for inclusion in the base cost of an asset, the relevant improvement must still be on hand at the time of disposal of the property.

Owners of sectional title units have an undivided share in the common property. Sometimes they are required to pay a special levy for the purpose of effecting improvements to the common property, such as the installation of a security fence. Expenditure of this nature will normally be of a capital nature as it provides an enduring benefit. Since it enhances the value of the owner's right in the common property it forms part of the base cost of the sectional title unit. The same principle applies to owners of share block units who enjoy a right of use in the common property since such expenditure will enhance the value of their right of use.

Movable assets, used by individuals mainly for non-trade purposes, such as firearms or private vehicle tracking or alarm systems are personal-use assets as contemplated in paragraph 53(2) of the Eighth Schedule, and capital gains and capital losses on the disposal of such assets must be disregarded.

4.2 Donations

Generally donations tend not to be deductible for income tax purposes because they will either be of a private or domestic nature or not be incurred for purposes of carrying on a trade.

Despite section 23, section 18A(1) provides for the deduction of any *bona fide* donations to –

- a public benefit organisation (PBO) contemplated in paragraph (a)(i) of the definition of “public benefit organisation” in section 30 (1) approved by the Commissioner under section 30;
- an institution, board or body contemplated in section 10(1)(cA)(i) which carries on in South Africa any public benefit activity contemplated in Part II of the Ninth Schedule or other activity determined by the Minister by notice in the *Government Gazette* and meets certain other requirements;

- any PBO approved by the Commissioner under section 30 which provides funds or assets to any PBO, institution, board or body contemplated in section 18A(1)(a);
- any agency contemplated in the definition of “specialized agencies” in section 1 of the Convention on the Privileges and Immunities of the Specialized Agencies, 1947, set out in Schedule 4 to the Diplomatic Immunities and Privileges Act, 2001; or
- any department of government of South Africa in the national, provincial or local sphere as contemplated in section 10(1)(a) to be used for the purpose of any activity contemplated in Part II of the Ninth Schedule.

The protection of the safety of the general public is listed in paragraph 1(k) of Part II of the Ninth Schedule.

The deduction for all qualifying *bona fide* donations made by a person other than a portfolio of a collective investment scheme² is limited to 10% of the taxpayer’s taxable income (excluding any retirement fund lump sum benefit, retirement fund lump sum withdrawal benefit and severance benefit) as determined before allowing any deduction of donations under section 18A.³ Any qualifying donations that exceed the 10% threshold are carried forward to the next succeeding year of assessment and deemed to be a donation actually paid or transferred in that year.

Donations must be supported by an official receipt issued under section 18A by the PBO, institution, board, body, agency or department concerned.⁴

4.3 Business-related expenditure

4.3.1 Own business expenditure of a revenue nature

For an expense to be deductible under section 11(a), it must be –

- actually incurred,
- during the year of assessment,
- in the production of income, and
- not of a capital nature.

Conversely, section 23(g) prohibits the deduction of any moneys against income derived from trade to the extent such moneys were not laid out or expended for the purposes of trade.

Expenditure incurred in securing business premises will generally be incurred in the production of income since it is closely connected with the business operations.

² The deduction granted to a portfolio of a collective investment scheme is determined by using a formula.

³ For years of assessment commencing before 1 March 2014, deductible donations were limited under section 18A(1)(B) to 10% of the taxable income (excluding any retirement fund lump sum benefit and retirement fund lump sum withdrawal benefit) as calculated before allowing any deduction under section 18 or 18A.

⁴ For further information on deductible donations see paragraph 13 of the *Tax Exemption Guide for Public Benefit Organisations in South Africa* (Issue 3). For further information on the VAT consequences of donations and for PBO’s see the *VAT 404 – Guide for Vendors* and the *VAT 414 – Guide for Associations not for Gain and Welfare Organisations*. All these guides are available on the SARS website.

Recurring costs which do not create an enduring benefit are likely to be of a revenue nature and will be deductible under section 11(a). Examples include the monthly service fees for a satellite tracking system for motor vehicles, monthly payments to an armed-response company, salary costs of security personnel and the cost of food and veterinary bills for a guard dog.

Capital expenditure is not deductible under section 11(a). Characteristically it is incurred “once and for all” and creates an enduring benefit.⁵ Examples of capital expenditure include the cost of installing an alarm system, an electric fence and in acquiring a guard dog.

While capital expenditure is not deductible under section 11(a), it may qualify for a deduction, albeit over a period, elsewhere under the Act, for example, under section 11(e) (wear-and-tear or depreciation allowance – see 4.3.5) or section 24D (security expenditure – see 4.3.6).

4.3.2 Contributions to anti-crime initiatives

Contributions to crime-prevention initiatives may take the form of –

- donations which are not deductible;
- donations which are deductible under section 18A (see 4.2); or
- advertising or sponsorship expenditure deductible under section 11(a).

The common law meaning of a donation was summed up by Trollip JA in *Ovenstone v SIR*⁶ when he stated the following:

“In a donation the donor disposes of the property gratuitously out of liberality or generosity, the donee being thereby enriched and the donor correspondingly impoverished, so much so that, if the donee gives any consideration at all therefor, it is not a donation... .”

Sponsorship on the other hand, generally involves the support or promotion of an activity such as a sporting event in return for advertising of the sponsor’s products or services. In terms of security expenditure, a company that, for example, provides an armed response service or installs security gates may offer to secure a certain premises in return for extensive advertising of such company’s logo at the premises or at a high-profile event. The sponsorship may also take the form of the provision of products related to the advancement of crime-initiative projects.

From an income tax perspective, the question has been raised whether contributions to anti-crime initiatives are deductible under section 11(a) read with section 23(g). The contributions may take the form of cash, goods and products, or services rendered free of charge. In order for the contributions to qualify as a deduction under section 11(a) they must be incurred in the production of income in the carrying on of a trade, such as advertising a contributor’s business.

⁵ For the tests applied in distinguishing capital and revenue expenditure, see Chapter 2 of the *Comprehensive Guide to Capital Gains Tax* (Issue 4) available on the SARS website.

⁶ 1980 (2) SA 721 (A), 42 SATC 55 at 73.

The treatment of the contributions will be as follows:

(a) Cash contributions

The deduction will be limited to so much of the contributions as the taxpayer can prove produced commercial value for the business through exposure of its name or products.

(b) Contributions of trading stock

The cost of trading stock generally qualifies for deduction under section 11(a) and is deductible in the year of assessment in which the trading stock was purchased.

However, section 22(8) provides for a deemed inclusion in a taxpayer's income when trading stock has been disposed of otherwise than in the ordinary course of trade for a consideration which is not market-related. The deemed inclusion applies, for example, when trading stock is –

- donated [section 22(8)(b)(i)];
- disposed of other than in the ordinary course of trade for less than its market value [section 22(8)(b)(ii)]; or
- applied for any other purpose other than the disposal thereof in the ordinary course of trade [section 22(8)(b)(iv)].

In these circumstances the taxpayer is deemed to have recovered or recouped an amount equal to the market value of the trading stock [section 22(8)(B)]. If, however, a donation of trading stock qualifies for a deduction under section 18A, the inclusion in income is equal to the value of the trading stock that was taken into account during the year of assessment in question (that is, the cost price less any write-down for loss in value) [section 22(8)(C)].

A taxpayer who can prove that the contribution of trading stock produced commercial value for the business through exposure of the taxpayer's name or services will be allowed a deemed deduction under paragraph (a) of the proviso to section 22(8). This could apply, for example, to the contribution of a car by a motor vehicle manufacturer as part of an anti-crime campaign.

(c) Provision of services

The deduction will be limited to so much of the actual cost of providing the services as the taxpayer can prove produced commercial value for the business through exposure of its name or services in any anti-crime campaign.

Examples of such services include free airtime supplied by cell phone operators, daily newspapers carrying safety and security messages including theme-related pamphlets, and operating a data centre where the public can blow the whistle on criminals.

4.3.3 Dual-purpose expenditure

The Act is not concerned with the method employed in advertising and promoting a taxpayer's business or products. In this regard the courts have looked at the dominant purpose of the expenditure. If a contribution is made with a dual purpose, an apportionment under section 23(g) may be made between the expenditure incurred for business purposes and that which relates to philanthropy. Any method of

apportionment must be logical, fair and reasonable and take into account the facts and circumstances of the particular case.

At the time the case of *CIR v Pick 'n Pay Wholesalers (Pty) Ltd*⁷ was heard, section 23(g) required deductible expenditure to be wholly or exclusively laid out for the purpose of trade. The court had to consider whether the taxpayer's purpose was solely the promotion of its business or whether it was of a dual nature, including philanthropy.

The company made a series of donations to the Urban Foundation, an organisation concerned with the upgrading of housing and the provision of community facilities, as a means of "indirect advertising" to secure valuable publicity. The announcement of the donations had a positive effect on its turnover. The majority of the Appellate Division of the Supreme Court found that, on the probabilities, the taxpayer failed to show that in making the donation it did not have a philanthropic purpose as well as a business purpose. As a result the company's claim for a deduction was disallowed. However, based on the current wording of section 23(g) it is possible that the company may have been able to apportion the expenditure and claim the business-related part as a deduction.

In ITC 696⁸ the taxpayer incurred expenditure for the purchase of footballs which it presented to school football clubs. The footballs were inscribed with words connecting them with articles in which the taxpayer traded. The court held that the expenditure was incurred for advertising purposes and thus qualified as a deduction.

4.3.4 Costs incurred in providing security to employees

(a) Employer

Employers sometimes incur security costs in relation to their employees such as the following:

- The cost of an armed-response service at an employee's home.
- The provision of bodyguards for employees.
- The supply of a guard to protect an employee's home or family while the employee is away on business or on leave.
- The installation of a security system at an employee's home.

From the employer's perspective these costs are simply a cost of employment or a form of insurance and should qualify for deduction under section 11(a), unless they are of a capital nature, in which case the expenditure may qualify for deduction under section 11(e) (for example, when the employer retains ownership of the asset supplied to the employee).

(b) Employee

Note: References under this heading to paragraphs are to paragraphs in the Seventh Schedule and references to an employee include a director.

Security costs incurred by an employer in relation to employees may give rise to a taxable benefit in the hands of the employees under the Seventh Schedule with

⁷ 1987 (3) SA 453 (A), 49 SATC 132.

⁸ (1950) 17 SATC 86 (C).

attendant employees' tax implications. A taxable benefit will arise, for instance, when –

- an asset is acquired by an employee from the employer or any associated institution in relation to the employer or from any person by arrangement with the employer (for example, the employer arranges to have a security system installed at an employee's home and ownership of the system passes to the employee) [paragraph 2(a)];
- an employee is granted the right to use any asset for private or domestic purposes (for example, the employer installs a security system at the employee's home but retains ownership of it) [paragraph 2(b)];
- any service has at the expense of the employer been rendered to the employee (whether by the employer or by some other person), and that service has been used by the employee for his or her private or domestic purposes (for example, the employer pays the monthly cost of an armed-response service) [paragraph 2(e)]; or
- an interest-free or low-interest loan has been granted to an employee (for example, to enable the employee to erect a wall or electric fence around the employee's residence) [paragraph 2(f)].

4.3.5 Wear-and-tear or depreciation allowance

The cost or value of certain capital assets may qualify for a deduction by way of an allowance under section 11(e). In such cases the expense will usually be allowed over a number of years of assessment.

For the purposes of section 11(e), individual items costing less than R7 000 which do not form part of a set may be written off in full in the year of assessment in which the expenditure is incurred. This threshold applies to all qualifying assets acquired on or after 1 March 2009.

Removable security systems may be written off over five years of assessment. This write-off period as well as the threshold of qualifying assets can be found in the Annexure to Interpretation Note No. 47 (Issue 3) dated 2 November 2012 "Wear-and-Tear or Depreciation Allowance".

Security expenditure comprising a structure or work of a permanent nature will not qualify for the wear-and-tear or depreciation allowance under section 11(e) [paragraph (ii) of the proviso to section 11(e)]. Examples of such structures include walls or electric fences around the perimeter of business premises. See, for example, ITC 773⁹ in which the cost of erecting a partition in leased premises to protect trading stock was held to be a structure of a permanent nature, and ITC 225¹⁰ in which the court held that the cost of erecting fencing was a work of a permanent nature.

Farmers are entitled to claim the cost of fencing under paragraph 12(1)(e) of the First Schedule, but the deduction is limited under paragraph 12(3) to taxable income derived from farming operations, with any excess being carried forward to the succeeding year of assessment.

⁹ (1953) 19 SATC 308 (C).

¹⁰ (1931) 6 SATC 158 (U).

4.3.6 Security expenditure under section 24D

Section 24D provides a deduction for certain security expenditure actually incurred by a taxpayer in a year of assessment which is not otherwise allowable as a deduction under the Act. The deduction applies to a “**National Key Point**” as defined in section 1 of the National Key Points Act, 1980, or “**place**” or “**area**” which, although not declared as an National Key Point, has been evaluated and approved by the Minister of Defence or any person or committee appointed by the Minister as such a place or area on which measures for the efficient security of the place or area ought to be taken by the taxpayer.

No deduction will be granted unless confirmation has been received by the Commissioner for SARS from the Minister of Defence or any person or committee appointed by the Minister to the effect that the expenditure incurred was deemed necessary or expedient [section 24D(2)]. Section 24D is restrictive in its application and will therefore only be relevant to a limited number of taxpayers.

5. Conclusion

In deciding whether security expenditure qualifies for a deduction the facts and circumstances of each case must be taken into account.

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