Synopsis

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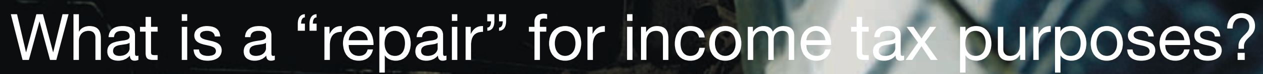
Tax today*



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What is a 'repair' for income tax purposes?

Section 11(d) of the Income Tax Act 58 of 1962 provides that a taxpayer is entitled to a deduction in respect of expenditure incurred on "repairs" of property occupied for purposes of trade or which produces income.

But what exactly is a "repair"? The Act contains no definition, and it has fallen to the courts to interpret this elastic word.

The crucial distinction that has been drawn by the courts in this regard is between, on the one hand, "repairs" (expenditure on which is deductible in terms of section 11(d) of the Act) and an "improvement, reconstruction or renewal" (expenditure on which is regarded as being of a capital nature, and therefore not deductible).

Such capital expenditure may however qualify for a wear and tear or depreciation allowance in terms of section 11(e) of the Income Tax Act, which allows qualifying capital expenditure to be deducted in instalments over the estimated productive life of the item in question. This, of course, is second prize – it is far more valuable for taxpayer to be entitled to deduct the whole of the expenditure, as a "repair", in the year in which in was incurred.

Repair presupposes a defect or malfunction

In *Flemming v KBI* 1995 (1) SA 574 (A), 57 SATC 73 the Appellate Division said that our courts, as with the English courts, have not succeeded in laying down precise guidelines to distinguish between a 'repair' and an 'improvement'.

The court went on to say the common element of the various dictionary definitions was that they "refer to the rectification, refurbishing or repair of an object which, in comparison with its previous condition, had developed a defect or shortcoming".

In *Flemming's* case, the taxpayer had a usufruct over a farm. An existing borehole on the farm, to which a windmill was attached, ran dry, apparently because of dwindling underground water and not because of any defect in the borehole.

At the insistence of the lessee of the farm, the taxpayer arranged to have a new borehole drilled some hundreds of metres from the first one, and the new borehole yielded adequate water.

The taxpayer claimed the cost of drilling the new borehole and the cost of acquiring and erecting a new windmill over it as a "repair" in terms of section 11(d).

The court held that there was no evidence that the first borehole was faulty, thereby necessitating its replacement. It was held that the taxpayer had incurred the expenditure in question, not on "repairs of property", as contemplated in section 11(d), but on the improvement of the water supply. The expenditure was held not to be deductible.

A "repair" can involve replacement, so long as it is of a subsidiary part of a larger entirety

The difficulty with the proposition, accepted by our courts, that a "repair" must be distinguished from an "improvement", is that "repair" inevitably results in an "improvement" to the property in question, in that what was defective has now been put right.

Nor is there a clear dividing line between a "repair" and a "renewal", for many repairs involve renewal; for example, a broken window pane is replaced with a new pane, and a malfunctioning machine component is replaced with a new component.

The unsatisfactory attempt to identify a (deductible) "repair" by contrasting it with a (non-deductible) "improvement" has driven the courts to try to differentiate between the two concepts on the basis of the proposition articulated in the seminal English case of *Lurcott v Wakely and Wheeler* in 1911, in which it was held that –

> "Repair" and "renew" are not words expressive of a clear contrast. Repair always involves renewal; renewal of a part; of a subordinate part . . . Repair is restoration by renewal or replacement of subsidiary parts of a whole. Renewal, as distinguished from repair, is reconstruction of the entirety, meaning by the entirety not necessarily the whole but substantially the whole subject-matter under discussion.

This approach has been endorsed by the courts in South Africa. (See for example *CIR v African Products Manufacturing Co Ltd* 1944 TPD 248.)

The problem is that this approach merely exchanges one difficult question ("what is a repair?") for another, no less difficult question (namely, how to determine whether the property that has been put right is a "subordinate part "of a larger "entirety").

Thus, for example, it may be self-evident that, if a taxi-owner removes a malfunctioning spark plug from his taxi and installs a new one, the expenditure incurred is in respect of a "repair" (and qualifies for an outright deduction) because a spark plug is a subordinate part of a larger entirety, namely the vehicle as a whole, or at least the engine.

But the matter may become more difficult when one considers larger installations, such as a production line, comprised of a number of specialized machines, each with a separate function, that are configured sequentially to produce a particular product in an entirely automated process. For example the first machine takes in a sheet of metal and cuts out shapes, the second presses the shapes to the desired form, the third coats the products with a protective coating, the fourth dries the coating, and the fifth wraps and packs the products. If one of the machines is replaced, is this a repair, or is each machine an "entirety"?

The difficulty of distinguishing between a "subordinate part" and the "entirety" came to the fore in *Rhodesia Railways Ltd v Income Tax Collector, Bechuanaland* [1933] AC 368.

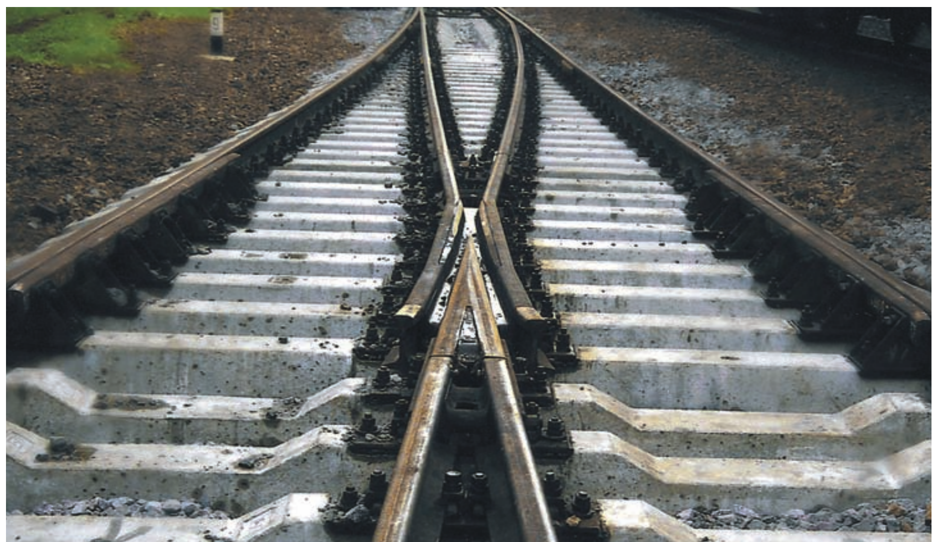
In this case, Rhodesia Railways Ltd, which owned and operated a railway, including the railway line, had replaced rails and sleepers on 33 miles of a railway line whose total length was 394 miles.

Was this a "repair" (and thus deductible expenditure) or was it a reconstruction or improvement (which did not qualify for deduction as a repair)?

It was clear that if Rhodesia Railways had replaced one sleeper, this would have been a "repair". It was equally clear that if it had replaced the rails and sleepers over the entire 394 miles, this would not have constituted a "repair", but a "reconstruction" of the line.

So, at what point on the 394 miles of the track would the replacement of one more sleeper have caused the taxpayer company to cross the threshold between a "repair" and a "reconstruction"?

Fortunately, the court did not have to resolve this metaphysical question, but



What is a ‘repair’ for income tax purposes? cont/

Courts only have to deal with the facts of the matter before them, and in the Rhodesia Railway case the court held that where, in the circumstances of this particular case, the taxpayer had replaced 33 miles of sleepers and rails, this constituted a “repair”, and the expenditure thus qualified for an outright deduction.

Whether a component is a subsidiary part is determined with regard to its economic function

In Australia, the practice of the revenue authorities, in determining whether property is an entirety or a subordinate part, is to ask whether the property in question provides a useful function without regard to any other components; whether it is separately identifiable as a principal item of capital equipment and whether it is physically or functionally an inseparable part of a larger entirety.

It has been suggested that the question as to what is a “subordinate” part and what is an “entirety” must be answered by looking to the economic function of the relevant part within the structure of the particular taxpayer’s business.

Thus, in *Samuel Jones & Co (Devonvale) Ltd v IRC* (1951) 32 TC 513 the taxpayer company, which carried on a business of processing paper, claimed as a deduction the cost of replacing an old chimney in its factory with a new one, and contended that the expenditure qualified for an outright deduction as a “repair”, on the grounds that the chimney was a subsidiary part of the factory.

The judge agreed, holding that –

> the facts seem to me to demonstrate without a doubt that the chimney … is physically, commercially and functionally an inseparable part of an ‘entirety’ which is the factory …It is doubtless an indispensable part of the factory, doubtless an integral part, but none the less a subsidiary part, and one of many subsidiary parts, of a single industrial profit-making undertaking.

Can SARS leapfrog the claims of the other creditors of a company in liquidation?

The Australian legal and commercial community has been shaken by the recent decision of the Full Federal Court in *Commissioner of Taxation v Bruton Holdings Pty Limited (in liq)* [2008] FCAFC 184.

Fundamental to insolvency law is the concept of a *concursus creditorum* – that, once the process of sequestration or winding-up commences, creditors can no longer enforce their claims against the insolvent estate individually, but must do so collectively, and that the available assets of the insolvent individual or entity must be shared between the creditors in accordance with the principles of insolvency law.

The principle was expressed thus in the United Kingdom in the *Cork Committee’s* 1982 report into insolvency law and practice:

> It is a fundamental objective of the law of insolvency to achieve a rateable, that is to say pari passu, distribution of the uncharged assets of the insolvent among the unsecured creditors.

The decision in *Bruton Holdings* flouts this cardinal principle in holding that the Australian revenue authorities have the right, in certain circumstances, to leap-frog the claims of other creditors in a corporate liquidation, and to secure payment of a tax debt ahead of all other creditors. Thus, the court held that the revenue authorities are entitled to garnish debts owed to the liquidated company by third parties even after the winding up of the company has commenced.

“Garnishment “is a legal procedure by which a creditor (in this case, the revenue authorities) can secure payment of a debt owed by a debtor by requiring a third party, who owes money to the debtor, to pay those funds directly to the creditor.

Given the similarity between the relevant provisions of Australian company and tax legislation and those of South Africa, the Bruton Holdings decision has disturbing implications for the integrity of the insolvency procedures in this country as well.

The decision in Bruton Holdings

Bruton Holdings Pty Limited was the trustee of the Bruton Educational Trust (the Trust).

On 28 February 2007 A$450 000 was placed in the trust account of Bruton Holding’s attorneys to cover legal costs in an appeal against Bruton Holding’s failed application for approval as an income tax-exempt charity.

In March 2007, the Commissioner issued an assessment to Bruton Holdings (in its capacity as a trustee of the Trust) for a tax debt in the amount of $7 715 873.73 for the tax year ending 30 June 2004.

It remains to be seen whether SARS will be inspired to attempt to invoke section 99 of our Income Tax to recover moneys due from a third party to a company where the winding-up of that company has already commenced.

On 30 April 2007, Bruton Holdings was placed in a creditors' voluntary liquidation. In terms of the relevant statutory provisions, the deemed commencement date of the winding-up was backdated to 28 February 2007.

In May 2007, the Commissioner served statutory notices in terms of Australia's Taxation Administration Act on Bruton Holding's attorneys, requiring payment of the remaining $447 420.20 held in the attorneys' trust account.

That Act empowers the Commissioner to serve notice on a third party who "owes or may later owe" money to a taxpayer, requiring direct payment of those moneys to the revenue authorities, up to the amount of the taxpayer's assessed tax liability.

This provision is similar, in effect, to section 99 of our own Income Tax Act which empowers SARS to declare a person to be an agent of a particular taxpayer, and to require that person to remit to SARS moneys held by that person on behalf of the taxpayer.

Bruton Holdings opposed the notice on the grounds that it conflicted with section 500(1) of Australia's Corporations Act 2001 which provides that –

any attachment, sequestration, distress or execution put in force against the property of [a] company after the passing of [a] resolution for voluntary winding up is void.

This provision is strikingly similar to section 359(1)(b) of South Africa's Companies Act of 1973 which provides that –

any attachment or execution put into force against the estate or assets of the company after the commencement of the winding-up shall be void.

In *Bruton Holdings*, the court took the view that the validity of the Commissioner's claim to the $447 420.20 turned on whether the notice, issued by the revenue authorities after the commencement of winding up, effected an "attachment" of Bruton Holding's property as envisaged in section 500(1) of the Corporations Act, quoted above. If it did constitute an attachment, the notice would be in breach of that section, and consequently invalid.

The Full Federal Court held that the statutory notice in question did not create an "attachment" and was therefore valid.

In the earlier case of *Commissioner of Taxation v Donnelly* (1989) 25 FCR 432, Australia's Full Federal Court had held that the word "attachment" should be accorded a narrow interpretation and be limited to attachments pursuant to an order of court.

In *Macquarie Health Corp Ltd v Commissioner of Taxation* (1999) 169 ALR 16 the Full Federal Court had occasion to consider again the meaning of "attachment" in the context of the winding-up provisions of Australia's Corporations Act. The court identified several arguments that militated against according a narrow meaning to the term "attachment" in the context of a corporate winding up, but in the result the court did not have to determine this issue.

The effect of the decision in *Bruton Holdings* is that the Australian revenue authorities can, by garnisheeing debts owed by third parties to the company in liquidation, obtain payment of an assessed tax debt in preference to the company's other creditors, (secured and unsecured), by taking such garnishee action even after commencement of the winding up.

Implications for South Africa

It remains to be seen whether, in a South African context, SARS will be inspired by the Bruton Holdings judgment to attempt to invoke section 99 of our Income Tax to recover moneys due from a third party to a company where the winding-up of that company has already commenced.

If this stratagem were to be upheld by our courts, SARS would, as in the Bruton Holdings case, have gained a preference over other creditors of the company in addition to the limited preference already given to SARS in terms of section 99(1)(b) of the Insolvency Act 24 of 1936.

All the King's horses and all the King's men ...

Where a company or other trading entity wants to wriggle out of a contract, a common knee-jerk tactic is to assert that the individual who professed to enter into the contract on its behalf had no authority to do so – in other words, that he or she lacked the requisite authorisation to act as an agent in entering into the contract in question.

Commercial and corporate law has developed elaborate rules to determine whether a particular individual has authority to act on behalf of (in other words, as agent for) another individual or legal entity.

A converse ploy, where two feuding businesses are locked in a dispute, is for one to allege that, in the course of negotiations regarding that dispute, a settlement agreement was entered into, which has extinguished the dispute and expunged the legal claim arising from it.

In short, a common element in commercial disputes is whether a particular individual had authority, as agent, to enter into a commercial agreement, or an agreement to settle a dispute on behalf of another party.

It is of course fundamental that a person cannot clothe himself with authority to bind another person to a contract merely by claiming to have authority to do so. Authority to represent and bind another person can only arise where the latter has bestowed such authority on the agent, or has acted in such a way that a reasonable person would believe that such authority had been bestowed, thereby giving rise to an estoppel and so-called "ostensible authority".

In some legal entities, a person has authority to enter into agreements that bind the entity merely by virtue of the position he or she holds. This is true, for example, of a partner, since a person, merely by virtue of being a partner, has implied authority to bind the partnership. Similarly, in a close corporation, any member, merely by virtue of being a member, has authority to bind the corporation (see section 46(1)(b) of the Close Corporations Act 69 of 1984). In a company, the managing director has at least ostensible authority to bind the company.

However, in the case of SARS, authority to bind the South African Revenue Service to a settlement agreement in terms of Part IIIA of the Income Tax Act is strictly regulated by the Act, both as to the individuals who have authority to enter into such agreements on behalf of SARS and as to the form of such agreements.

Agreements for the settlement of tax disputes which do not satisfy the statutory requirements are invalid, and are not binding on SARS.

In the course of the litigation spawned by the much-publicised and drawn-out dispute between SARS and one David King, where the latter has been contesting a large tax assessment, SARS was thunderstruck when King's legal team produced a rabbit out of the hat in the form of a document which, on its face, was an agreement with King, professedly entered into on behalf of SARS, and which recorded a settlement of the tax dispute.

This "settlement agreement" professed to be signed on behalf of SARS by an entity described as "Deville Whatley and Associates", and recorded that the latter entity had been authorized to enter into the settlement agreement on behalf of SARS –

> by a written authority furnished by P Erasmus, an authorized representative of [SARS], alternatively by Leonard Radebe.

The documents produced by King's legal team included a letter signed by a P Erasmus on a SARS letterhead which purported to appoint "Delville Whatley and Associates" to settle the dispute on behalf of SARS.

Exactly who "P Erasmus" was – if indeed he existed at all – and whether he was an official of SARS and, if so, how he came to write such a letter on a SARS letterhead, has never been explained. The reported judgment implies that SARS regarded the letter as a fraud. The innuendo seems to be that someone in the ranks of SARS was induced to lay his hands on a SARS letterhead, and write a letter authorising the mysterious "Delville Whatley and Associates" to enter into a settlement agreement with King.

No details of SARS's investigation into the alleged fraud have ever been made public.

SARS's powers to enter into settlement agreements are circumscribed by statute

If such a signed authority had been given on the letterhead of a partnership, close corporation, company or other legal entity, established legal rules would have come into play to determine whether the signatory to the letter had actual or ostensible authority to sign it.

SARS is, however, in a different situation from a company or other legal entity when it comes to entering into agreements for the settlement of a dispute.

In terms of the South African Revenue Service Act 34 of 1997, SARS is an organ of state within the public administration. It is thus a creature of statute, with such powers as are given to by Parliament.

In terms of Part IIIA of the Income Tax Act, SARS has power to enter into agreements for the settlement of disputes, but the validity of any such agreement is conditional on compliance with the prescribed statutory requirements.

Thus, in terms of section 88E(1), any such agreement must be entered into "by the Commissioner personally or an official delegated by the Commissioner for that purpose".

Even at face value, it did not appear from the "settlement agreement" produced by King's legal team that it had been entered into on behalf of SARS by the Commissioner or "an official delegated by the Commissioner".

The mysterious "P Erasmus" whose signature appeared in the letter on the SARS letterhead was clearly not the Commissioner, nor did that letter assert that P Erasmus had been delegated by the Commissioner to sign the letter. And even if Erasmus had been so delegated, he could not, as a matter of law, sub-delegate that authority to "Delville Whatley and Associates" or anyone else.

This fundamental *lacuna* was, in and of itself, a fatal deficiency in King's claim that SARS was bound to the ostensible settlement agreement.

The SARS legal team identified six other legal flaws in King's argument that SARS was bound by the ostensible settlement agreement, but it was unnecessary for the court to make a decision on these issues. The court ruled that King had not made out a case that SARS was bound to the purported settlement agreement.

And there the matter rests – a plot of breathtaking *chutzpah*, worthy of a Hollywood scriptwriter, but fatally flawed by an insufficient knowledge of the closely-textured provisions of Part IIIA of the Income Tax Act, whose drafters were clearly mindful of the need to tightly circumscribe the circumstances in which SARS can enter into agreements with taxpayer for the settlement of disputes.

The full story will probably remain forever shrouded in the secrecy mandated by section 4 of the Income Tax Act.

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