DLA CLIFFE DEKKER HOFMEYR

TAX

ALERT

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ALLOWANCES IN RESPECT OF PUBLIC PRIVATE PARTNERSHIPS

On 17 July 2014, the National Treasury released the draft Taxation Laws Amendment Bill (TLAB) which aims to give effect to the various tax proposals announced in the 2014 Budget.

One important proposal relates to the tax treatment of allowances in respect of Public Private Partnerships (PPPs). PPP's can essentially be described as an arrangement between Government and the private sector, whereby Government undertakes to provide underlying land for the construction of buildings or the improvement of the land, without parting with ownership of such land.

PPPs are important in respect of the development of public infrastructure especially in circumstances where Government lacks the necessary upfront cash to directly undertake the desired construction. However, the success of PPPs is dependent on the financial viability of these projects, and tax incentives play an important role in this regard.

Currently, s12N of the Income Tax Act (Act) allows for private parties to a PPP to claim capital allowances in respect of improvements to land or buildings owned by Government, even though the private party only has a right of use or occupation of the land.

The effect of s12N of the Act is to deem the lessee to be the owner of the land and buildings in respect of which the improvements are made, so that the lessee may qualify for the usual capital allowances under the Act, which it would otherwise not have been entitled to claim.

A private party must meet the following criteria in order to qualify under s12N of the Act:

- hold a right of use or occupation of land or buildings;
- effect improvements on the land or buildings in terms of a PPP;
- incur expenditure to effect the improvements; and
- use or occupy the land or buildings for the production of income, or derive income from the land or buildings.

However, under certain PPP arrangements the private party will not be able to meet these criteria. Specifically, the private party will not necessarily have the right of use or occupation of the land or buildings. The private party may, for example, only have a right to access the land or building in order to perform under the PPP. As a result, the private party will not be able to claim any capital allowances, and this has an effect on the overall pricing of the project.

The TLAB proposes the insertion of s12NA into the Act. The proposed s12NA will essentially allow a private party to claim a special capital allowance in respect of improvements to state-owned land and buildings where Government has the right to use or occupy the land or buildings, and not the private party. The private party must be a party to a PPP agreement with Government and incur expenditure of

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a capital nature.

Maintenance and operating expenses should be claimable under s11(a) of the Act.

The TLAB also proposes an "*anti-double-dipping*" rule. Since the receipt and accruals by private parties of certain funds received from Government for the performance of obligations under a PPP arrangement is exempt in terms of s10(zl) of the Act, provision will be made so that the private party does not stand to benefit by getting a capital allowance in addition to the exemption.

To the extent that the contribution by Government is used to effect the improvements, the allowance claimable by the private party will be reduced by the amount of the contribution.

The proposed amendments will come into operation on 1 April 2015 and will apply in respect of expenditure incurred to effect improvements during any year of assessment commencing on or after that date.

Comments on the proposed tax proposals are to be submitted by 17 August 2014.

Nicole Paulsen and Gigi Nyanin

CAPITAL GAINS TAX, SAVINGS AND INFLATION

Consider the following example: A taxpayer bought shares for R100 000 on 1 June 2004, and sold them on 1 June 2014. Assume that:

- the inflation rate during the period the shares were held was 6% per year compounded;
- the value of the shares grew at a (generous) rate of 10% per year compounded;
- the taxpayer has no other capital gains during the tax year ending 28 February 2015 and has no assessed capital loss; and
- the taxpayer pays income tax at the highest marginal rate of 40%.

The actual proceeds in respect of the sale of the shares (at compound annual growth of 10%) will be R259 374.

The tax payable (ignoring brokers' charges and the like) will be determined as follows:

Proceeds	R 259 374
Less: Base cost	R 100 000
Capital gain	R 159 374
Less: Annual exclusion	R 30 000
Aggregate capital gain	R 129 374
Taxable capital gain (apply inclusion rate of 33.3%)	R 43 082
Tax at 40%	R 17 233

However, the <u>actual</u> return after tax, and taking into account inflation, will be the following:

Actual return (4% (10% – 6%) per year compounded)	R 148 024
Less: Original cost	R 100 000
Net actual return (after inflation)	R 48 024
Less: Tax	R 17 233
Actual return after inflation and tax	R 30 792

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Put differently, after taking into account inflation and tax, the annual compounded rate of return will be 2.72%.

So, in today's money, the taxman takes an amount equal to about 56% of the actual return!

The cause of this inequitable result is that the effects of inflation are not taken into account when determining capital gains tax (CGT) – i.e. there is no indexation.

When CGT was introduced in 2001, the National Treasury said that indexation was not appropriate in the light of the "low" inclusion rate of 25%. However, the inclusion rate was recently increased by one third to 33.3% in the case of individuals (and from 50% to 66.6% in the case of companies and trusts).

In addition, a taxpayer is not entitled to set off capital losses against income tax. In other words, if a person has an assessed income tax loss, the person must reduce the assessed loss by the capital gain. But if a person is in an income tax paying position, the person is not allowed to reduce that position by capital losses – the capital losses can only reduce future capital gains.

It is submitted that the current CGT system does not encourage savings in South Africa.

The erstwhile Minister of Finance, Pravin Gordhan, does not think that the CGT regime is unfair. In his 2014 Budget Speech, referring to the developments in fiscal policy during the past two decades he stated: "We have also improved the fairness of the tax system by taxing residents on their worldwide income and taxing capital gains."

In the same speech, the Minister did however announce that legislation would be introduced to allow for tax-exempt savings accounts this year, to encourage household savings.

Draft legislation to this effect was published on 17 July 2014 in the Draft Taxation Laws Amendment Bill of 2014. Put simply, what is being proposed is that, with effect from 1 March 2015, persons will be able to contribute R30 000 per year, and R500 000 in aggregate during a lifetime to a tax free investment. The income and capital gains realised in respect of the tax free investment is free of income tax and CGT.

The proposal is a good one. As the famous economist, Milton Friedman said: "I am in favour of cutting taxes under any circumstances and for any excuse, for any reason, whenever it's possible." However, at a rate of R30 000 per year, it will take approximately 16 years to fill up the R500 000 limit. In 16 years' time R30 000 will be worth about one third in today's money at an inflation rate of about 6% per year. Once again, unless indexation is built in, the concession will not add up to much over time.

It is submitted that the only way to encourage savings is to give taxpayers a proper return on their investments by taking into account the ravages of inflation when determining fiscal policy.

Ben Strauss

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