SOUTH AFRICAN REVENUE SERVICE

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SECTION : SECTION 11A
SUBJECT : PRE-TRADE EXPENDITURE AND LOSSES

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Preamble

In this Note references to –

- **“pre-trade expenses”** are to expenditure and losses actually incurred by a person before the commencement of and in preparation for carrying on a trade;
- **“post-trade expenses”** are to expenditure and losses actually incurred after the commencement of trade;
- **“pre-production interest”** are to interest deductible under section 11(*b*A); and
- **“sections”** are to sections of the Act.

1. Purpose

This Note provides guidance when pre-trade expenses (sometimes also called start-up costs) will be allowed as a deduction for income tax purposes.

2. Background

New business formation is vital to the economy. Before the introduction of section 11A, ordinary tax principles did not, with the exception of section 11(*b*A) and the soon-to-be repealed section 11(*b*B)[1] permit the deduction of start-up costs incurred before the commencement of trade.

The trade requirement in section 11(a)

The general deduction formula, contained in section 11(*a*) and section 23(*g*), reads as follows –

> **11. General deductions allowed in determination of taxable income.—**For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived—
>
> (*a*) expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature;

> **23. Deductions not allowed in determination of taxable income.—**No deductions shall in any case be made in respect of the following matters, namely—
>
> (*a*) to (*f*) . . .
>
> (*g*) any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade;

The opening words of section 11 contain a trade requirement while section 23(*g*) prohibits a deduction for monies not laid out or expended for the purposes of trade. Section 11(*a*) additionally requires that expenditure and losses be incurred in the production of income and not be of a capital nature in order to qualify as a deduction.

[1] The deletion of section 11(*b*B) by section 14(1)(*a*) of the Taxation Laws Amendment Act, No. 17 of 2009 is deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2010.

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The trade requirement of section 24J(2)

Although it does not draw a capital-revenue distinction, section 24J(2) permits a deduction of the amount of interest which is deemed to have been incurred during a year of assessment, from the income derived from carrying on any trade of the "issuer" in relation to an "instrument",[2] if that amount was incurred in the production of the income.

The trade requirement of section 11D

Section 11D(1) allows a deduction for expenditure incurred on scientific or technological research and development activities. The deduction is against income derived by any taxpayer from carrying on any trade. The resulting information, invention, design, computer programme or knowledge must, among others, be intended to be used by the taxpayer in the production of income or must have been discovered, devised, developed or created by the taxpayer for purposes of deriving income. Section 11D also permits deductions of expenditure by a taxpayer in respect of any building or part thereof, machinery, plant, implement, utensil or article which must, among others, be brought into use by the taxpayer solely and directly in relation to the above-mentioned research and development purpose.

Pre-trade expenses of a capital nature

Pre-trade expenses often form part of the cost of creating a source of income. They are therefore mostly of a capital nature.

In ITC 697[3] the appellant company commenced on 1 December 1947 to demolish its old building after which it immediately began the erection of a new building. The new building was completed in October 1948, after which it was let to tenants. For the year of assessment ended 30 June 1948, the appellant claimed deductions for rates, sanitary fees and interest totalling £1 110. The Commissioner disallowed the portion of the expenditure for the period 1 December 1947 (when demolition began) to 30 June 1948 (the end of the 1948 year of assessment by which date the erection of the new building had not been completed). Price J stated the following:[4]

> "The items disallowed by the Commissioner were disallowed because for a proportionate period in respect of which the expenditure was incurred the building was in the course of erection and was not an asset which could be used to let and to produce income, and that the expenditure, therefore, was of a preliminary or capital nature. It seems to me clear that until the asset becomes an asset capable of producing income any expenditure upon it is of a preliminary nature and is not deductible . . .
>
> "If a taxpayer has no asset with which he can trade then he cannot be trading.
>
> "The expenditure was incurred in the creation or equipment of an asset which was intended to be used at a later stage for the purpose of earning income. It was initial or preliminary expenditure designed to extend the scope of the business or to improve its earning capacity. It was money spent in an attempt to create a source of income or to acquire an advantage for the benefit of the business which was later to be undertaken."

[2] As defined in section 24J(1).
[3] (1950) 17 SATC 93 (T).
[4] At 96.

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A similar outcome prevailed in *Borstlap v SBI.*[5] In August 1974 the appellant in that case, a dentist, purchased erf 1456 with the intention of erecting flats on it for rental purposes. The plot contained an old dwelling and some outbuildings which were let for the first five months of the 1976 year of assessment at R250 per month after which the dwelling was occupied by a family of vagrants who managed to make use of the water and electricity. Demolition of these structures commenced in December 1975 and erection of the flats began during the first quarter of 1976 with the first flats being let during the 1978 year of assessment. During the 1976 year of assessment the appellant claimed a rental loss made up as follows:

	R	R
Rental income (5 x R250)		1 250
Less:		
Interest on bonds used to purchase erf 1456	(3 435)	
Insurance	(161)	
Rates	(796)	
Water and electricity (while dwelling occupied by vagrants)	(53)	
Approval of building plans	(108)	(4 553)
Rental loss		(3 303)

The Commissioner disallowed the rental loss, thereby allowing only R1 250 of the expenditure as a deduction under section 11(*a*). Having lost his appeal in the Income Tax Special Court the appellant appealed directly to the Appellate Division. The court held that the amounts expended on water and electricity and building plans had to be excluded from consideration because the first was incurred when no trade was carried on while the second was clearly of a capital nature.

The appellant argued that the expenditure was incurred in the production of income, since income would be derived in the form of rent once the building was completed. It was also argued that the expenses were not of a capital nature because the appellant already had an asset in the form of erf 1456. On these arguments the Corbett JA (as he then was) stated the following:[6]

> "The first argument in my view runs counter to a series of previous decisions, including a decision of this court. The general approach of the courts is that where a stand is acquired with the object of erecting a building on it and to let it – and to derive an income from it – expenditure such as interest on a bond, municipal rates, etc that is incurred before the development has taken place and has produced income, is expenditure of a preliminary nature and not deductible under section 11(*a*) (see Income Tax Case No 697 17 SATC 93 and the cases therein cited, Income Tax Case No 736 18 SATC 207 to 209; *Reef Estates Ltd v CIR* 1954 (2) SA 593 (T), *CIR v Allied Building Society* 1963 (4) SA 1 (A) at 18–19)."

(Translated from the Afrikaans.)

The court went on to cite ITC 697 *supra* with approval, noting that the facts were in all material respects identical to those in the instant case.

The court concluded as follows:[7]

[5] 1981 (4) SA 836 (A), 43 SATC 195.
[6] At 204.
[7] At 207.

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> "Such expenditure can be viewed as capital expenditure and it can also rightly be said that they were not actually incurred in the production of income and incurred exclusively for the purposes of trade."

(Translated from the Afrikaans.)

This principle is also confirmed in *Reef Estates Ltd v CIR*[8] which is discussed in **4.2.2**.

In ITC 1593 Heher J stated that –[9]

> "it is well established in our law that one cannot be involved in the performance of income-producing operations unless such operations are underway. It is not sufficient that one has the intention to set up an income-producing operation and in the course of fulfilling that intention to expend money and then to claim that as revenue."

Effect of section 11A

Under section 11A pre-trade expenses which would have qualified under sections 11 (excluding section 11(*x*)), 11B, 11D and 24J but for the trade requirement in those provisions, are deductible in the year of assessment in which trade commences, subject to certain requirements, irrespective of when they were incurred, but subject to section 23H.[10]

3. The law

Section 11A

11A. Deductions in respect of expenditure and losses incurred prior to commencement of trade.—(1) For purposes of determining the taxable income derived during any year of assessment by a person from carrying on any trade, there shall be allowed as a deduction from the income so derived, any expenditure and losses—

(*a*) actually incurred by that person prior to the commencement of and in preparation for carrying on that trade;

(*b*) which would have been allowed as a deduction in terms of section 11 (other than section 11(*x*)), 11B, 11D or 24J,[11] had the expenditure or losses been incurred after that person commenced carrying on that trade; and

(*c*) which were not allowed as a deduction in that year or any previous year of assessment.

(2) So much of the expenditure and losses contemplated in subsection (1) as exceeds the income derived during the year of assessment from carrying on that trade after deduction of any amounts allowable in that year of assessment in terms of any other provision of this Act, shall not be set off against any income of that person which is derived otherwise than from carrying on that trade, notwithstanding section 20(1)(*b*).

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8 1954 (2) SA 593 (T), 19 SATC 153.

9 (1994) 57 SATC 251 (T) at 256.

10 See section 23H(1)(*a*).

11 The reference to section 24J was inserted by section 15(1) of the Taxation Laws Amendment Act, No. 17 of 2009. This insertion is deemed to have come into operation on 1 January 2005 and applies in respect of any expenditure or losses incurred on or after that date. Section 24J(2) and (3) were amended to make section 24J a charging provision from this date.

Commencement date

Section 11A applies to any pre-trade expenses actually incurred by the taxpayer during any year of assessment ending on or after 1 January 2004. Section 11D took effect on 2 November 2006. Any pre-trade research and development expenditure incurred before that date must be considered for deduction under section 11B which was inserted in 2003.

4. Application of the law

4.1 Overview of section 11A(1)

Section 11A(1) contains four key requirements before a pre-trade expense can qualify as a deduction against income from the trade to which it relates.

First, the trade in respect of which the pre-trade expense was incurred must have commenced [opening words of section 11A(1)].

Secondly, the pre-trade expense must have been actually incurred before the commencement of and in preparation for carrying on that trade [section 11A(1)(*a*)].

Thirdly, had the pre-trade expense been incurred after the commencement of the trade to which it relates, it would have been allowed as a deduction under section 11 [other than section 11(*x*)], 11B, 11D or 24J [section 11A(1)(*b*)].

Fourthly, the pre-trade expense must not have been allowed as a deduction in that year or any previous year of assessment [section 11A(1)(*c*)].

Once these requirements have been met, the pre-trade expense will be allowed as a deduction in the year of assessment in which the trade to which it relates commences, subject to the ring-fencing requirements of section 11A(2).

4.2 Expenditure claimable when the trade commences

4.2.1 Introduction

Section 11A requires that pre-trade expenses be claimed in the year of assessment in which the trade to which they relate commences. Such expenses could be actually incurred in the current or a previous year of assessment.

Apart from triggering a deduction under section 11A(1), the issue as to when trade commences is important because the trade requirement in various deduction provisions such as sections 11(*a*) and 24J will cease to be a factor in restricting a taxpayer's deductions.

4.2.2 When trade commences

There is not much direct precedent on exactly when trade commences in South African case law. Nevertheless some principles can be drawn from the few cases that are available.

In ITC 777[12] it was held that the mere intention to let property does not constitute the carrying on of a trade. In ITC 1476[13] Kirk-Cohen J stated the following:

[12] (1953) 19 SATC 320 (T).
[13] (1989) 52 SATC 141 (T).

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> "In my view the carrying on of a trade involves an active step – something far more than merely watching over existing investments which are not, and are not intended or expected to be, income producing during the year in question."

The active step must comprise more than the mere laying of plans. In *C: SARS v Contour Engineering (Pty) Ltd,* Eksteen AJ stated the following:[14]

> "There is, however, . . . a vast difference between the mere laying of plans for the future, on the one hand, and the commencement of preparatory activities for a future venture, on the other . . .."

In South Africa the absence of productive assets has been found to be an indicator of the absence of trading activity. In ITC 697 Price J stated the following:[15]

> "If a taxpayer has no asset with which he can trade then he cannot be trading."

For an in-depth examination of foreign case law on this topic, see Interpretation Note No. 33 dated 4 July 2005 "Assessed Losses: Companies: The Trade and Income from Trade Requirements".[16]

It is not a prerequisite for a person to have earned some income from trade before trading can commence. South African courts have consistently drawn a distinction between the "trade" requirement and the "income from trade" requirements in section 20.[17]

Expenditure incurred in expanding an existing trade

The courts have interpreted the Act as requiring that a person's taxable income be determined on a trade-by-trade basis with the overall taxable income being determined by aggregating the results from the separate trades,[18] subject to certain ring-fencing provisions such as those applicable to foreign assessed losses.[19]

In the context of a company the trade-by-trade requirement can be seen from section 20(1)(*b*) which permits the set off against income derived from "any trade" –

> "any assessed loss incurred by the taxpayer during the same year of assessment in carrying on any other trade either alone or in partnership with others, otherwise than as a member of a company the capital whereof is divided into shares".

The question arises as to whether expenditure incurred in expanding an existing trade of a specific type (for example, property letting) is a pre-trade expense. In ITC 984[20] the appellant company sought to deduct estate agent's commission which it had incurred in securing a tenant for a building to be erected on land it had acquired for that purpose. The court held that the amount was not of a capital nature. The question whether the amount was a pre-trade expense was not considered and appears to have been accepted as a *fait accompli*. This was probably because the company was already carrying on a pre-existing trade of property letting and the expense in question was more related to the derivation of future rental income than for the purpose of developing an income-producing asset.

[14] 1999 (E), 61 SATC 447 at 456.
[15] (1950) 17 SATC 93 (T) at 96.
[16] In 4.1.7.
[17] ITC 1679 (1999) 62 SATC 294 (O); ITC 1830 (2007) 70 SATC 123 (G).
[18] ITC 729 (1951) 18 SATC 96 (N), *C v COT* 1966 (3) SA 6 (RAD), 28 SATC 127.
[19] Paragraph (*b*) of the proviso to section 20(1).
[20] (1961) 25 SATC 59 (C).

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In *Reef Estates Ltd v CIR*[21] the taxpayer company carried on the business of letting property, and for this purpose held 10 properties, eight of which were township stands with the other two being farming properties.

One of these properties, which consisted of a vacant stand 485, situated in an out-of-the-way side street, was purchased by the taxpayer in 1935. No income was derived from this site until 1948 when it was let as a parking site for motor vehicles at an annual rental of £15. The taxpayer had acquired the stand with the intention of building shops on it as an investment, and deriving rental from them. During the year in question, the taxpayer had incurred expenditure of £366 for rates levied on the stand by the local authority.

The taxpayer claimed a deduction for this expenditure, which the Commissioner disallowed. The court dismissed the appeal, holding that the expenditure had not been incurred for the purpose of earning the £15 of rental received, but primarily for the purpose of holding the stand as an asset to be used at a later stage for the purpose of earning income from buildings. The court held further that the expenditure was analogous to that incurred in the creation or equipment of an income-producing asset and was therefore of a capital nature.

On the question of whether the vacant stand was a separate business, Rumpff J stated the following:[22]

> "The facts of this matter indicate that stand 485 was acquired and is still being held with the intention of building shops thereon and deriving rentals therefrom. It is being held in order that it may in future become an income-producing unit. Even if the other properties of the appellant company together are considered as one business (a point which we need not decide) it cannot be said that stand 485 has become qualified to be regarded as part of that business."

It follows that when a taxpayer is expanding an existing business by creating an asset for use in that business, the expenditure incurred on that asset before it is brought into use will be of a capital nature and not incurred in carrying on the existing trade.

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Example 1 – Expenditure before the commencement of trade

Facts:

A company intends to carry on trade as a television station but has not yet secured a television licence. There is no certainty that the licence will be secured as the company has to apply for it alongside a number of competitors. The taxpayer incurs preparatory expenditure on staff salaries and training costs.

Result:

The expenditure is not incurred in carrying on a trade since the taxpayer does not yet have an asset with which to trade (amongst others, the television licence). See the United States case of *Richmond Television Corp. v Commissioner*[23] which dealt with a similar situation,

[21] 1954 (2) SA 593 (T), 19 SATC 153.

[22] At 96.

[23] 345 F.2d 901 (4th Cir. 1965). See Interpretation Note No. 33 for more details on this case.

Preparatory activities

As noted in the *Contour Engineering* case *supra*, the court drew a distinction between the laying of plans and the commencement of preparatory activities, thereby implying that the commencement of preparatory activities may constitute the carrying on of a trade. The issue arises as to what sort of preparatory activities would signal the commencement of a trade. In order to answer this question it must be determined whether the taxpayer has an asset (income-earning structure) with which to trade. Much will depend on the facts and circumstances of the case.

In the case of a wholesale or retail outlet, the following extract from the *Contour Engineering* case *supra* provides some guidance:[24]

> "What the evidence does clearly establish is that during 1988 the respondent had no premises, no equipment, no stock, no staff and, save for book debts, no assets. This is clearly indicative of a company which is not trading."

Thus, depending on the nature of the trade, the absence of some or all of these factors (premises, equipment, trading stock and employees) may be indicative of a lack of trading activity.

On the other hand, as indicated earlier, the derivation of income is not a prerequisite for carrying on a trade. It is thus possible that trade can commence before the first sale is made. Schutz JA made the following *obiter* comment in *Robin Consolidated Industries Ltd v CIR*:[25]

> "In year one a retailer acquires premises, employs staff and buys stock, but does not open his doors until the beginning of year two. On the authority of *Sub-Nigel Ltd v CIR* 1948 (4) SA 580 (A) at 589-590 he would clearly be entitled to deduct the expenditure incurred in year one from revenue earned in year two."

Although it was dealing with the "in production of income" requirement of section 11(*a*), the court seems to have accepted without question that the trade requirement was met in year 1.

In the case of service businesses taxpayers must at least hold themselves out as ready to provide services (in other words, such persons must have opened their doors for business).[26]

Example 2 – Preparatory activities comprising the carrying on of a trade

Facts:

A taxpayer acquires a farm and plants trees which will only bear fruit in ten years' time. During the ten-year period the taxpayer incurs recurring expenditure on salaries and wages, depreciation on equipment, fertilizer and pesticides amongst others.

Result:

In this example it is considered that trading begins with the preparation of the land for planting.[27]

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[24] At 456.
[25] [1997] 2 All SA 195 (A), 59 SATC 199 at 206.
[26] A similar approach is taken in the United States.

4.2.3 Abandonment of a project before the commencement of trade

Should a person abandon a project before the trade to which it relates commences, the pre-trade expenses associated with that project will not be deductible under section 11A.

> **Example 3 – Abandonment of a project before the commencement of trade**
>
> *Facts:*
>
> X began preparations for the operation of a business on 1 July 2005 and incurred pre-trade expenses of R100 000. X later decided to abandon the project before the commencement of the trade.
>
> *Result:*
>
> The pre-trade expenses will not be allowable as a deduction under section 11A since the trade to which they relate never commenced.

4.2.4 Change in intention or in the nature of the trade

Both section 11A(1)(*a*) and (*b*) refer to “that trade”.

The references to “that trade” mean that only pre-trade expenses actually incurred in the preparation for carrying on that trade will be allowed as a deduction from the income resulting from that specific trade.

> **Example 4 – Change in nature of the trade**
>
> *Facts:*
>
> A taxpayer began an airport project and incurred expenses of R5 million for technical staff salaries, telephone costs and rates and taxes (all pre-trade expenses) while the application for the airport operating licence was being considered by the relevant authorities. The licence was finally declined and the project abandoned.
>
> Two months after the project was abandoned, the taxpayer decided to use the land and buildings for a document-storage business. This business generated income of R230 000 against which the taxpayer sought to claim the amount of R5 million as a deduction.
>
> *Result:*
>
> The pre-trade expenses of R5 million incurred in preparing for the airport operation are not allowable as a deduction against the income from the document-storage business since section 11A(2) only permits a set-off of pre-trade expenses against income from the same trade.

4.3 Actually incurred before the commencement of and in preparation for carrying on that trade [section 11A(1)(*a*)]

The expenditure or loss must have been actually incurred by the person before the commencement of and in preparation for the carrying on of that specific trade.

[27] For a case involving the incurral of expenses in maintaining a rubber tree plantation before the trees were productive, see *Vallambrosa Rubber Co., Ltd., v Farmer* (Surveyor of Taxes) 5 TC 529.

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For an expense to be "actually incurred" there must be an accrued present obligation, whether absolute or defeasible.[28]

In *Edgars Stores Ltd v CIR* Corbett JA (as he then was) stated the following:[29]

> "Thus it is clear that only expenditure (otherwise qualifying for deduction) in respect of which the taxpayer has incurred an unconditional legal obligation during the year of assessment in question may be deducted in terms of s. 11(*a*) from income returned for that year. The obligation may be unconditional *ab initio* or, though initially conditional, may become unconditional by fulfilment of the condition during the year of assessment; in either case the relative expenditure is deductible in that year. But if the obligation is initially incurred as a conditional one during a particular year of assessment and the condition is fulfilled only in the following year of assessment, it is deductible only in the latter year of assessment (the other requirements of deductibility being satisfied)."

In order for preliminary expenditure to qualify as a deduction under section 11A(1) it must be incurred in *preparation for* the carrying on of trade. The word "preparation" requires an act of preparation, and that there must be a close link between the expenditure and the trade to be undertaken. The expenditure incurred in the *Reef Estates* case discussed in **4.2.2** would, probably not have qualified under section 11A(1), since it was not incurred in preparing for the trade of letting. Preparation for carrying on trade involves an active step – something more than just passively holding a piece of land for many years until the conditions are conducive for preparatory activities to begin.

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4.4 The pre-trade expense would have qualified under section 11, 11B, 11D or 24J had it been incurred after the trade commenced [section 11A(1)(*b*)]

In order to qualify as a deduction under section 11A(1), a pre-trade expense must pass a "post-trade" test under one of a number of specified sections, namely –

- section 11, excluding section 11(*x*),
- section 11B (deduction for research and development),
- section 11D (deduction for scientific or technological research and development), or
- section 24J (incurral and accrual of interest).

Expenditure and losses incurred before the commencement of section 11A

In order to qualify the relevant expense or loss must have been incurred after the effective date of section 11A, namely, during any year of assessment ending on or after 1 January 2004.

The exclusion of section 11(x) from expenditure that would have qualified under section 11 but for the trade requirement

Section 11(*x*) provides for a deduction as follows:

> **11. General deductions allowed in determination of taxable income.—**For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived—

[28] Hoexter JA in *Nasionale Pers Bpk v KBI* 1986 (3) SA 549 (A), 48 SATC 55 at 71.
[29] 1988 (3) SA 876 (A), 50 SATC 81 at 90.

(x)	any amounts which in terms of any other provision in this Part, are allowed to be deducted from the income of the taxpayer.

The words "in this Part" refer to Part I (Normal Tax) of Chapter II of the Act which consists of sections 5 to 37H.

Section 11A(1)(*b*) has the effect that pre-trade expenses falling outside sections 11(*a*) to 11(*w*), 11B, 11D and 24J do not qualify for a deduction under section 11A. Examples include the depreciation deductions granted under sections 12B and 12C which have their own "brought into use for the purposes of trade" requirements.

The post-trade test

An amount will qualify for deduction under section 11A(1) if it would have been allowed as a deduction under sections 11 (but for section 11(*x*)), 11B or 11D had it been incurred after the commencement of the particular trade.

Since this "post-trade test" only focuses on the trade requirement of the specified sections, it becomes necessary to consider whether the test overcomes other requirements of these sections such as –

- the "production of income" requirement of section 11(*a*);
- the bar on the deduction of expenditure of a capital nature, as for example, in section 11(*a*) and (*c*);
- the requirement that the deduction applies to "expenditure and losses"; and
- the "use" requirement of, for example, section 11(*e*).

This must be determined by the facts and circumstances of each case.

In most cases it should be a relatively simple matter to show that once trade commences the relevant expenditure would have been capable of producing income if incurred at that time.

Recurring-type expenditure incurred before trade commences invariably takes on the character of expenditure of a capital nature because it is incurred in the setting up of an income-earning structure (see *Borstlap's* case discussed in **2**). The effect of the post-trade test on such expenditure is to change it to a revenue nature because the presumption is that it is incurred after the income-earning structure has been established. Examples of pre-trade expenses qualifying under section 11A(1)(*a*) typically include the cost of accounting and audit services, advertising and marketing, electricity and water, insurance, rates, rent, salaries and wages, staff training, trading stock acquired before the commencement of trade and telephone costs.

However, pre-trade expenses that retain their capital nature even if incurred after trade commences will not qualify for deduction under section 11A(1). Examples include the cost incurred by a lessee in drawing up a lease agreement,[30] the legal costs incurred in securing a trading licence,[31] the cost of drawing up building plans[32] and the cost of a feasibility study. Such expenses are incurred once-off and are a

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[30] ITC 215 (1931) 6 SATC 133 (U).
[31] ITC 1224 (1974) 37 SATC 30 (T).
[32] See *Borstlap's* case *supra*.

direct cost of setting up the income-earning structure and cannot be divorced from it by the post-trade test.

Section 11A(1)(*b*) refers to "expenditure and losses". The question is whether this wording includes an "allowance" as opposed to "expenditure". Examples of such allowances include the lease premium allowance under section 11(*f*) and the allowance granted under section 11(*g*A) for certain intellectual property). Despite an allowance sometimes colloquially being understood to be an otherwise inadmissible expense the section 11 allowances are in principle deductible as pre-trade expenses, because of the wording of section 11A which refers to "expenditure . . . allowed as a deduction". The allowances granted under the following paragraphs of section 11 will therefore potentially qualify for deduction under section 11A(1) after the particular trade has commenced:

- (*c*A); (*e*) (subject to what is stated below); (*f*); (*g*); (*g*A); (*g*C); (gD); (*h*B); (*t*) and (*w*).

A taxpayer may thus be entitled to claim amounts that could not previously be claimed during the pre-trade period.

Although the wear-and-tear or depreciation allowance in section 11(*e*) is based on the "value" of an asset rather than on its cost, SARS in most instances interprets the term "value" to mean "cost" for the purpose of determining the allowance. However, section 11A will not apply to the wear-and-tear or depreciation allowance on assets that do not have a cost, such as those acquired by donation or inheritance, since in these instances the allowance will be based on market value and not expenditure.

In addition, it is a requirement of section 11(*e*) that the asset be "used" by the taxpayer for the purposes of his or her trade. Thus an asset acquired before the commencement of trade that is not "used" during the pre-trade period will not qualify for a deduction under section 11A. This could happen if the asset is placed in storage pending the commencement of trade.

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Example 5 – Wear-and-tear allowance qualifying for deduction under section 11A

Facts:

ABC (Pty) Ltd's financial year ends on the last day of February. On 1 September of year 1 ABC hired premises for the purposes of carrying on trade as a general dealer. Before trade could commence ABC had to install various shopfittings and equipment such as cash registers and refrigerators. On 1 September of year 1 the company purchased a bakkie for R200 000 which it used during the pre-trade period to transport shop fittings and equipment to its premises. On 1 March of year 2 the company commenced trading. Interpretation Note No. 47 provides that delivery vehicles may be written off over four years under section 11(*e*).

Result:

Year 1

ABC is not entitled to the wear-and-tear allowance for the six months ending 28 February of year 1 because it was not trading during this period.

Year 2

In year 2 the company will be entitled to a deduction under section 11A(1) of R25 000 (R200 000 x 25% x 6/12). The company will also qualify for the wear-and-tear allowance under section 11(*e*) of R50 000 (R200 000 x 25%). Thus in year 2 the company will be able to claim total allowances of R75 000 (R25 000 + R50 000).

4.5 The pre-trade expenses must not be otherwise allowable [section 11A(1)(*c*)]

The pre-trade expense must not previously have been allowed as a deduction in the current or any previous year of assessment. Thus pre-production interest allowable in the current year of assessment under section 11(*b*A) will not also qualify as a deduction under section 11A.

4.6 Ring-fencing of deduction for pre-trade expenses [section 11A(2)]

4.6.1 Limitation to taxable income from the relevant trade

Under section 11A(1) any qualifying pre-trade expenses not previously allowed as a deduction are allowed as a deduction once trade commences.

However, under section 11A(2) the section 11A(1) deduction may only be set off against the taxable income[33] from the particular trade. If the pre-trade expenses exceed that taxable income, the excess may not be set off against the income from any other trade notwithstanding section 20(1)(*b*). Section 20(1)(*b*) permits a taxpayer to set off an assessed loss incurred in one trade against any income from another trade derived during the same year of assessment. Any pre-trade expenses not allowed because of insufficient taxable income from the particular trade must be carried forward for set off against any future taxable income from that trade (see ***4.6.3***).

Thus pre-trade expenses cannot create an assessed loss in respect of the trade to which they relate. Nor can they increase an assessed loss from that trade.

While pre-trade expenses can never create or increase an assessed loss, it is possible for a person to carry forward an assessed loss and pre-trade expenses from the same trade at the same time. The assessed loss brought forward would result from post-trade expenses, while the unused pre-trade expenses would arise because of the limitation under section 11A(2).

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[33] Section 11A(2) refers to "the income derived during the year of assessment from carrying on that trade after deduction of any amounts allowable in that year of assessment in terms of any other provision of this Act".

Example 6 – Limitation of pre-trade expenses

Facts:

	R
Qualifying pre-trade expenses	100 000
Income	150 000
Deductible post-trade expenses	80 000

Result:

	R
Income	150 000
Less: Deductible post-trade expenses	(80 000)
Subtotal before deducting pre-trade expenses	70 000
Less: Pre-trade expenses of R100 000, but limited to	(70 000)
Taxable income	**Nil**
Pre-trade expenses brought forward	100 000
Less: Allowed in current year of assessment	(70 000)
Pre-trade expenses carried forward	30 000

The balance of the pre-trade expenses of R30 000 is carried forward and will be available for set-off against future taxable income from this trade.

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4.6.2 Impact of assessed loss brought forward on ring-fencing

Any assessed loss brought forward from the previous year of assessment (referred to as a "balance of assessed loss" in section 20) must be allocated between the various trades to which it relates in order for section 11A(2) to be applied. The deduction for pre-trade expenses relating to a particular trade is limited to the taxable income from that trade which remains after the set-off of any balance of assessed loss incurred in that trade.

Example 7 – Assessed loss brought forward

Facts:

References in this example to years 1, 5 and 6 are to the years of assessment ending on 28 February 20x1, 20x5 and 20x6 respectively.

XYZ (Pty) Ltd carries on two trades, A and B. Trade B began in year 1 while Trade A began in year 5. At the end of year 5 the company had an assessed loss to be carried forward of R50 000 from Trade A and R10 000 from Trade B. The company had unclaimed pre-trade expenses of R40 000 from Trade A at the end of year 5. During year 6 the company had income of R100 000 and R200 000 from Trades A and B respectively. Allowable post-trade expenses incurred during year 6 for Trades A and B amounted to R20 000 and R50 000 respectively. Determine XYZ (Pty) Ltd's taxable income for year 6.

Result:

		Trade A	Trade B
		R	R
Income		100 000	200 000
Less: Allowable post-trade expenses		(20 000)	(50 000)
Assessed loss brought forward		(50 000)	(10 000)
Subtotal		30 000	140 000
Pre-trade expenses brought forward	40 000		
Less: Allowed in current year	(30 000)	(30 000)	
Pre-trade expenses carried forward	10 000		
Taxable income		Nil	140 000

Under section 11A(2) the unused pre-trade expenses from Trade A of R10 000 may not be set off against the taxable income from Trade B of R140 000.

4.6.3 Claiming of pre-trade expenses limited by section 11A(2)

The mechanism for claiming pre-trade expenses limited under section 11A(2) is not contained in section 11A(2), but in section 11A(1). The opening words of section 11A(1) refer to the determination of taxable income derived during *any* year of assessment in which the trade is being carried on. This could be the year of assessment in which trade commences, or a subsequent year of assessment if section 11A(2) applies. Section 11A(1)(*c*) permits the deduction for pre-trade expenses –

> "which were not allowed as a deduction in that year or any previous year of assessment".

This would include any pre-trade expenses not allowed in a previous year of assessment because of the application of section 11A(2).

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4.7 Interaction with section 11(*b*A)

> **11. General deductions allowed in determination of taxable income.—**For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived—
>
> (*b*A) any interest (including related finance charges) which is not otherwise allowable as a deduction under this Act, which has been actually incurred by the taxpayer on any loan, advance or credit utilized by him for the acquisition, installation, erection or construction of any machinery, plant, building, or any improvements to a building, or any pipeline, transmission line or cable or railway line as contemplated in section 12D, or any aircraft hangar, apron, runway or taxiway as contemplated in section 12F, to be used by him for the purposes of his trade, and which has been so incurred in respect of a period prior to such machinery, plant, building, improvements, pipeline, transmission line or cable, railway line, aircraft hangar, apron, runway or taxiway, being brought into use for the purposes of the taxpayer's trade, such deduction to be allowed in the year of assessment during which such machinery, plant, building, improvements, pipeline, transmission line or cable, railway line, aircraft hangar, apron, runway or taxiway is or are brought into use for the said purposes;

Section 11(*b*A) provides that any interest and related finance charges actually incurred by the taxpayer on any loan, advance or credit used by the taxpayer for the

acquisition, installation, erection or construction of certain assets to be used for the purposes of trade are allowable only once those assets are brought into use.

It applies only to situations in which the interest and related finance charges are not otherwise deductible and have been incurred by the taxpayer for a period before the assets are brought into use for the purposes of the taxpayer's trade. The interest in question is allowable only from the year of assessment in which the asset is brought into use for the purposes of the taxpayer's trade.

It may happen that an asset is acquired or erected before trade commences and is only brought into use after that trade has commenced. In these circumstances the deduction of the pre-production interest or finance charges will be postponed under section 11(*b*A) until the asset is brought into use. This may occur only after the particular trade has commenced. Section 11A will not override section 11(*b*A) to enable an earlier deduction to be claimed, since section 11A(1)(*b*) requires that the pre-trade expense be deductible under section 11 assuming that trade has commenced. This requirement is not met because section 11(*b*A) additionally requires the asset to have been brought into use.

In ITC 1619[34] the court rejected the contention that land and buildings were indivisible for the purposes of section 11(*b*A). It was held that when a loan is used to purchase land and buildings, only the pre-production interest relating to the buildings will qualify as a deduction under section 11(*b*A).

Pre-production interest in terms of an "instrument" as defined in section 24J which is used to raise the finance to enable the issuer to acquire land, will however qualify as a deduction under section 11A, provided the other requirements of the section are met.

Example 8 – Asset brought into use after the commencement of trade

Facts:

ABC (Pty) Ltd's year of assessment ends on 30 June. The company commenced trading on 1 April 2008. On 1 February 2008 the company purchased an asset under an instalment credit agreement, but only brought it into use on 15 August 2008.

Result:

All interest payable during the period 1 February to 14 August 2008 will be allowed in the 2009 year of assessment of the company under section 11(*b*A) when the asset is brought into use. Section 11A does not result in an earlier deduction when trade commences because the "brought into use" requirement of section 11(*b*A) takes precedence under section 11A(1)(*b*).

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[34] (1996) 59 SATC 309 (C).

5. Conclusion

While this Interpretation Note provides general guidance on the application of section 11A, the facts and circumstances of each case must be considered in determining when and if an amount will qualify for deduction under the section.

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