higher education & training

Department: Higher Education and Training REPUBLIC OF SOUTH AFRICA

Tshwane South TVET College

"achieve the future"

# SUBJECT: Financial Management

**LEVEL: 4**

**Date: 31/07/2020**

**MODULE NAME:** Understand and calculate Capital allowances.

**UNIT 2**

# After completing this topic, you will be able to:

- Explain the concept of Capital allowances, with examples.
- Demonstrate calculation of capital allowance with the purpose to make appropriate entries on an income tax return for a sole trader

# TOPIC 5

Content

- Unit 2: Understand and calculate Capital allowances

# Introduction:

- Remember, Capital expenditure is not allowed as a deduction for income purposes.
- However, a capital asset that is used in the production of income can be depreciated or written off over a number of years.
- In the Income Tax Act, depreciation is called a Capital Allowance and is calculated in terms of the rules determined by SARS.

# What is a Capital Allowance?

- It has been explain previously that an expense is only deductible from income if it is incurred as part of the business process and is not Capital in nature.
- Now we can consider why a capital expense is not deductible from income for tax purposes.
- The Income Tax Act does not allow Capital expenses to be deducted from taxable income directly.
- It allows Capital expense to be written off over an agreed period that represents the lifetime of the asset.

# Assets used in the production process

- In terms of Section 12C of the Income Tax Act, Capital assets used in the production process can be written over 5 years.
- E.g. If a company buys a production equipment for R250000, the cost of this equipment can be written off over 5 year at a rate of R50 000 per year as a Capital Allowance.
- At the beginning of the $6^{th}$ year, no further deductions can be made against the income because the asset would have been written off for tax purposes.

# Assets not used in the production process.

- In terms of Sec 11(e) of the Income Tax Act, Capital Assets that are not permanent in nature but have been used in the business during the period can be depreciated over a period determined by SARS. E.g. Vehicle
- Motorcycle are depreciated over a period of 4 years. Motorcycle is not used in the production process but is used to deliver goods to customers.
- Do Activity 5.2.

# Capital Allowances for permanent structure

- Sec 13 of the Income Tax Act provides for a Capital Allowance of 5% per annum on the cost of permanent structure that are used for manufacturing purposes such as a factory building.
- If you buy a building for R200 000 with a view to do manufacturing, your business qualify for Capital allowance of (R200 000x5%0= R10 000 per year for 20 years, provided your business will be in operation for that period.
- The above R10 000 will be deducted from the business income every year.
- But if the building is used for administrative purposes only it will not qualify for Capital Allowance in terms of Sec13 of the Income Tax Act.
- VAT paid on Capital Assets is excluded from the calculation of Capital Allowance.

# Capital Allowances For SMME's

- Small manufacturing businesses are allowed special relief at the beginning of the business life-cycle in terms of Sec 12E
- This is meant to help small businesses to get on their feet by avoiding larger tax burden during the start up period.
- Income Tax Act defines a small business as
- Any closed corporation, business or private company that is registered in terms of the Companies Act of 1973.
- Gross income for the year of assessment should not exceed 14 million.
- Shareholders must not hold shares in other companies.
- Not more than 20% of total income should comprise investment income or income from rendering personal service.
- The company must not be an employment company.

# The following capital allowances will be applicable provided a business falls within the above definition:

- All plant, machinery and equipment acquired for the first time and used in the manufacturing process is subject to the following:
  - 1st year of use: 50% allowance on the cost value of the item.
  - 2nd year of use: 30% allowance on the cost value of the item.
  - 3rd year of use: 20% deduction on the cost value of the item.
- The above section provides tax relief to small businesses in the first year of operation as it allows higher deduction for capital assets against taxable profit.

# Capital Allowance for intellectual copyright

- Sec 11D of the Income Tax Act provides an allowance of up to 150% of the initial expenditure, used in the production of income for the processes of:
  - Developing a novel or musical work.
  - Buying, acquiring or developing an invention in terms of the Patent Act of 1978.
  - Buying, acquiring or developing a design in terms of the Design Act of 1993.
  - Buying, acquiring or developing a computer program in terms of the Copyright Act of 1978.
- NOTE: If the expenditure is more than the total income, the deduction allowed is limited to the value of the income. This therefore means the above allowance cannot create a tax deficit.

# Addition to above:

- Any building, machinery, plant or utensils acquired for the use in the above process also receive the following allowances:

- 1st year of use: 50% allowance on the cost value of the item.
- 2nd year of use: 30% allowance on the cost value of the item.
- 3rd year of use: 20% deduction on the cost value of the item.

- If the business developed a patent using a building that cost R3 million, the machinery costing R400 000 and other expenditures of R500 000, the following will apply.

# Remember: Allowances may not exceed Income

| Year 1 | Calculations | Allowances |
|---|---|---|
| Expenditures | 500 000x 150% | R750 000 |
| Building allowance | 3000 000x50% | R1500 000 |
| Machinery | 400 000x50% | R200 000 |
| Year 2 | | |
| Building Allowance | 3000 000 x 30% | R900 000 |
| Machinery | 400 000x30% | R120 000 |
| Year 3 | | |
| Building Allowance | 3000 000x20% | R600 000 |
| Machinery | 400 000x20% | R 80 000 |
| | | |
| | | |

# Allowances for doubtful debt

- If you are convinced that you might not be paid by a existing debtor, you can claim a deductible allowance of 25% of the doubtful debt.
- If you claim this allowance and the debt is subsequently paid, you must add the provision you made in the previous year to the taxable income next year.
- Do Activity 5.3