COLLEGE OF ACCOUNTING

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# Video Transcription: Capital Allowances

Hi, I'm Riyaan. In this video we are going to be looking at capital allowances, recoupments, and disposal allowances.

The distinction between capital and revenue is a foundational principle of income tax. In our "Capital and Revenue" video, we explained that capital expenditure is not deductible under section 11(a) because the expenditure gives the taxpayer an enduring benefit. This means that capital expenditure has the capacity to continue to generate income for the taxpayer over a period of time.

However, while a capital asset is used by a taxpayer to generate income over a long time, it is probably being slowly used up by that process. Ultimately the asset will need to be replaced by the taxpayer if he or she is going to continue to earn income. The taxpayer's income tax calculation includes the income the asset generates, so it should also reflect the gradual using up of the asset. It does this in the form of a capital allowance.

Capital allowances are different from deductions, because deductions are claimed in full when they are incurred, whereas allowances are claimed over time as the asset is used. Generally, allowances are claimed from the time the asset is brought into use until either the allowances claimed add up to the cost of the asset, or the asset is taken out of use.

At a basic level, capital allowances in income tax are similar to the concept of depreciation in financial reporting. There are, however, a number of important distinctions between capital allowances and depreciation:

1. Capital allowances can only be claimed on assets for which a specific section provides for a capital allowance. For example, section 11(e) provides for capital allowances on moveable assets (such as a delivery vehicle), and section 12C provides for allowances on plant and machinery used for manufacturing. Section 13 provides for allowances on industrial buildings, while, section 13 quin provides for allowances only on new commercial buildings. No allowances can be claimed on a commercial building that has already been used by another taxpayer, or on a building like an old house that has been converted into a commercial building.

2. There are some exceptions, but in most circumstances you need to be the legal owner of the asset in order to claim capital allowances, whereas in financial reporting an asset is recognised when control has been transferred, not necessarily legal ownership.

3. The period over which allowances may be claimed – what we would refer to as the "write-off period" is set out in, or governed by, the section under which the allowances are claimed. In contrast, for financial reporting purposes it is up to the accountant to determine the asset's expected useful life over which the asset is depreciated. For example, section 13 quin provides that commercial buildings are written off over 20 years. It is not up to the taxpayer to decide what write-off period seems appropriate.

4. In some instances, when an asset is brought into use part-way through the year of assessment, the allowance claimed in that year is apportioned to reflect this, but in many instances allowances are not apportioned. For example, if an asset, for which there is a capital allowance of 20% per year, is purchased halfway through the year, it may be that the taxpayer can claim only a 10% allowance in that year, or may be able to claim the full 20% depending on the rules of the section under which the allowance is claimed.

Because of the differences between the way in which capital assets are dealt with for income tax and for financial reporting, capital allowances frequently give rise to deferred tax consequences. You can learn more about this in our "Deferred Tax" videos in the Financial Reporting section.

Capital allowances are intended to reflect the fact that the taxpayer's asset is being used up in the process of generating the income on which they are being taxed. The cost of the asset less the sum of the capital allowances claimed to-date is called the asset's tax value. The tax value of an asset could be thought of as the extent to which the asset has not yet been used up. But the truth is that we don't really know how much of the asset has been used up until the taxpayer sells the asset. It is only then that we know how much someone else is willing to pay for the asset, and whether the tax value of the asset really represents its current worth. If the taxpayer sells the asset for less than its tax value, then more of the asset has been used up than the capital allowances claimed. This suggests that the taxpayer should have been allowed to claim more deductions, and we correct this by allowing for the deduction referred to as a disposal allowance.

A disposal allowance is the amount by which the asset's tax value exceeds the price for which it is sold. It is calculated as the cost of the asset minus the sum of the selling price and the capital allowances claimed. A disposal allowance is not available in every instance though, for example, in respect of disposals to connected persons, so it is important to consult the provisions of section 11(o) in each case.

Let's look at an example. Assume our taxpayer runs a furniture removal business, and uses a delivery van purchased exactly three years ago for R300 000. Under section 11(e), delivery vehicles are written off over four years. To-date, allowances of R225 000 have been claimed, so the tax value of the vehicle is R75 000. The best offer that the taxpayer receives from a potential buyer is R50 000. If the offer is accepted, would he be able to claim a disposal allowance?

Well, the cost of the vehicle was R300 000. The sum of the asset's selling price of R50 000 and allowances claimed of R225 000, is R275 000. The asset's cost exceeds the sum of the selling price and allowances claimed, by R25 000. The taxpayer is therefore entitled to claim a disposal allowance of R25 000, which reduces the taxpayer's taxable income.

On the other hand, if the taxpayer sells an asset and the selling price is greater than the asset's tax value, this suggests that the taxpayer has been allowed to claim more than the value of the asset that has actually been used up. In this situation we reverse some of the allowances that he has previously claimed. This reversal is called a recoupment. A recoupment is added to a taxpayer's income. For example, let's say that, instead of accepting the offer of R50 000, our taxpayer continues looking for another buyer, until he finds one who is willing to pay R90 000 for his van. The selling price of the vehicle is now R90 000, whereas its tax value is only R75 000, being R300 000 minus the R225 000. The taxpayer will therefore have to include a recoupment of R15 000 in his taxable income.

It is important to remember that a recoupment represents the recovery of previous allowances, so a recoupment can never be higher than the sum of all previous allowances claimed in respect of the asset. To make sure we don't calculate a recoupment higher than our previous allowances, the formula for calculating a recoupment is: selling price (limited to cost), minus the tax value of the asset at the date of sale. Remember that if the taxpayer is able to sell an asset for more than its original cost, this could lead to a capital gain. You can learn more about this in our video, "Introduction to Capital Gains Tax".

Because the calculation of capital allowances depends on the particular section under which it is to be claimed, it is important to be familiar with the provisions of each section before attempting a capital allowance calculation. Likewise, the recoupment and the disposal allowances sections contain a number of complexities and restrictions, and it is important to get to grips with the details of these too.

Thanks for watching.