

Tax: damaged buildings

INSURANCE: IF PAYOUT EXCEEDS ACQUISITION COST IS IT CAPITAL GAIN?

Barbara Curson

Whereas most people would understand the meaning of a repair, and could differentiate the repair of a damaged section from a "repair" that enhances the building's value, and easily distinguish between a repair and a major construction, the tax law in this area is surprisingly complex.

The recent wave of looting and attacks on buildings has resulted in a range of types of destruction, from buildings being somewhat damaged to being completely destroyed.

The insurance payouts may be made by insurance companies on behalf of state-owned insurer Sasria. However, the tax implications would be the same:

►If the business is registered for VAT, the insurance payout will result in a deemed output VAT.

►If the insurance payout is greater than the base cost or acquisition cost of the building, this will be a capital gain.

►If building allowances had been claimed as tax deductions by the owner, the insurance payout may have to be included in income for that year.

Amounts incurred for repairs in the same year using the insurance payout would then be claimed as deductions. Joon Chong, tax partner at Webber Wentzel, said: "Building allowances are for capital type expenses, for example building costs. There is a recoupment (i.e. include the insurance payout in "income") if the payout is for the destruction of the building. There is a disposal (through the destruction) and the proceeds is the payout."

►Where the insurance payout is used to rebuild or purchase replacement assets within 12

months, the owner could elect to spread any recoupment or capital gain over the new write-off period, if the payout is greater than the base costs of the assets.

Assets or structures within the buildings may have been damaged or destroyed, for example, an escalator, air conditioning system, CCTV security system, fire systems, and water tanks in warehouses. The assets or structures that are not part of the building would be treated as separate assets, such as "plant and machinery", and with a different set of tax implications.

Where buildings require repairs, the full amounts incurred for the repairs can be claimed as deductions in the year of assessment/financial year incurred. The insurance payout will be included in taxable income in the year of assessment/financial year received as the payout is a "recovery" of the expenses incurred.

There is a fine line between expenses incurred for repairs, and the cost incurred in a major restoration that would reconstruct a substantial portion of the building. Whereas expenses incurred for repairs are "revenue in nature", and thus deductible from taxable income, expenses incurred on a major reconstruction would be "capital in nature", and is not usually tax deductible.

A repair would restore an asset to its original position as opposed to effecting an improvement. Case law has laid out certain guidelines, that a repair or restoration involves a renewal or replacement of subsidiary parts of the structure.

There is no certainty in regard to where, due to the passage of time that has lapsed from when

the building was first constructed, the repair may be viewed as an improvement by the SA Revenue Service.

Chong said: "Where the damage is [of] such an extent the asset is destroyed, it is possible the renovation involves reconstruction of the entire or substantially the whole asset, in which case the expenditure is capital in nature and usually not deductible."

"The capital expenditure would only be deductible if a specific building allowance applied, for example the building allowance over 20 years available for buildings used in the process of manufacture or research and development."

"Capital expenditure incurred which is not deductible in terms of a specific provision and which exceeds the Sasria compensation received would then form part of the base cost of the building, reducing capital gains on the future sale of the building."

She added: "Where the Sasria compensation is greater than the base cost of the building and the compensation is used to construct the replacement building within 12 months and brought into use within three years, the owner can elect to have any resulting capital gains or recoupment proportionately spread over the new write-off period."

A lessee impacted by the riots should study the lease agreement. The lease agreement may require the lessee to carry out improvements to the land or building leased. In this case, the lessee would usually be able to claim as a deduction the "fair and reasonable value" incurred.

The lease improvement will be

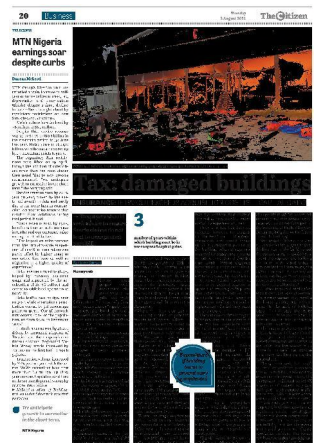
subject to tax in the lessor's hands "in the year in which the right to have the improvement accrues to the lessor, less the present value of the full value of the improvements over the lease period discounted at 6%".

Chong cautioned that "capital type expenditure necessary where the building is burnt to the ground is more complicated". The "remaining unclaimed 'leasehold improvement' deductions potentially give rise to a capital loss for the tenant, with the Sasria compensation payment as proceeds".

"This could give rise to a recoupment for deductions claimed previously and/or capital gain. Where the Sasria compensation is greater than the base cost of the building and the compensation is used to construct the replacement building, the tenant can have any capital gains spread over new write-off period."

► **Taxpayers should seek advice to ensure Sasria claims do not lead to unexpected Sars bill.**

Expenditure if building burnt to ground more complicated





DON'T GET BURNT. Insurance settlements may give rise to an unexpected tax bill. Picture: Reuters