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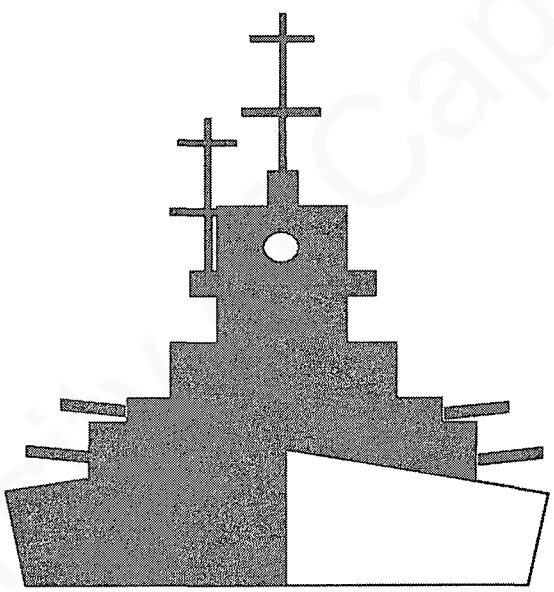
# INSURANCE SPARES, SAFETY EQUIPMENT AND SPARE PARTS ON SHIPS



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## INTRODUCTION

This paper deals with the treatment of spare parts on ships, in accordance with the Income Tax Act, No. 58 of 1962 (as amended), (hereafter 'the Act').

The question that is central to this issue is specifically when a spare part is brought into use. Flowing from this is the question of the purpose of a spare part.

In summary the issues are as follow:

- What expenditure should properly be regarded as forming part of the cost of a ship? The expenditure envisaged here comprises essential safety equipment and spares included in a ship at the time of its construction prior to commissioning and its maiden voyage.

- If such expenditure is considered not to form part of the cost of a ship, should it in the alternative be deducted as operating expenditure? Should it then be included in trading stock as 'consumable stores and spare parts ... used or consumed' by virtue of having been brought into use or consumed when added to the ship?

- Should the cost of the subsequent replacement of the above items properly be regarded as operating expenditure?

Apparently an airline received a written ruling from the Commissioner for the South African Revenue Services[1] that if an aircraft is acquired with a spare engine[2], it will be regarded as part and parcel of the plane. It will be regarded as one asset for taxation purposes on which wear and tear is permitted. The airline is not required to include this 'spare' engine as a spare part for trading stock purposes.

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[1] Hereafter only refer to as 'the Commissioner'.

[2] This is also referred to as 'transferable' assets. In some instances a transferable gearbox for example, act as a spare gearbox for a number of aircraft. Due to strenuous engineering standards a gearbox will have to be overhauled after a period of time. At such time the existing gearbox is replaced with the transferable gearbox, to allow the aircraft to carry on with its operation. The existing gearbox will then, after its overhaul, act as the transferable 'spare' gearbox.

## BACKGROUND

The company periodically contracts for the building of new ships to add to its fleet. Typically, each ship is separately designed with its own unique specifications, and would therefore usually not be exactly similar to any other ship.

Once a ship has been built, classification thereof will be sought through one of the classification societies such as Lloyds Register of Shipping, Nippon Kaiji Kyokai, etc. to determine the class of the ship concerned. This is essential for insurance purposes and without such classification the ship would simply not be allowed to trade internationally.

Although there are certain international and other regulations or industry practices governing the specification of ships, it is nevertheless up to each shipowner and his appointed naval architects and shipyards to decide on the specifications for any ship that is to be built.

The ship classification societies referred to above would typically recommend that certain minimum safety equipment and spares be carried aboard any ship for the purpose of safety at sea, but do not prescribe what these should be. Each ship operator, such as this company, based on its risk profile, decides what safety equipment and spares will form part of the ship.

Typically, the type of safety equipment and spares that might be included in a ship are those whose absence, if required urgently at sea, could endanger the lives of crew or the operational safety of the ship, and would usually include:

- Spare anchor and chain
- Critical bearings, valves and pumps
- Spare cylinder and cylinder sleeve
- Propeller and tail shaft
- Seals, wires and pipes

The components required for the construction of a ship may be supplied either by shipyard under the construction contract or by the company as so-called "Buyers' Supplies". All such costs incurred are aggregated to determine the cost of the ship.

Once a ship leaves a shipyard, no additional safety equipment or spares, other than possible minor items, are issued to the ship since this directly effects the vessel's operating costs for any voyage, and whether or not the company is able to make a profit out of such voyage. However, minor stores such as seals, rings, valves etc. are issued to the ship periodically to replenish items which have been exhausted aboard the ship.

When any of the items, which were regarded as forming part of the original ship, are brought into active use, an issue from the on-shore store in Cape Town replaces them. The company accounts for the stocks in the on-shore store as part of its trading stock for accounting and tax purposes. Once items from the on-shore store have been issued they are expensed, and are not returned to the store again.

## COMPANY'S TREATMENT FOR TAXATION PURPOSES

The company submitted that the cost of the safety equipment and spare parts referred to above which are included in the initial specification of any ship, prior to its commissioning and departure from a shipyard, should form part of the cost of that ship.

The company then uses this cost as the 'adjustable cost' or the adjustable cost price' as defined in section 14(2) of the Act. This is the basis for the 10% allowance in terms of subsection (1)(a) and the one-time *initial allowance* of 40% in terms of subsection (1)(b) of section 14 of the Act. The company makes this allowance in the year in which a contract is concluded for the construction of a new ship.

All spare parts and consumables (except fuel) are regarded having been brought into use or consumed for the company's trade.

The company regards the fuel and the bunker fuel[3] as trading stock and is reflected as such in the annual financial statements.

[3] Fuel in an unrefined form.

**RELEVANT PROVISIONS OF THE ACT**

The definition of 'trading stock' in terms of section 1 of the Act:

*1. Interpretation.—In this Act, unless the context otherwise indicates—*

***"trading stock"** includes ... any consumable stores and spare parts acquired by him to be used or consumed in the course of his trade, ...*[4]

Section 22(1) and (2) of the Act provides inter alia as follow:

*'(1) The amount which shall, in the determination of the taxable income derived by any person during any year of assessment from carrying on any trade (other than farming), be taken into account in respect of the value of any trading stock held and not disposed of by him at the end of such year of assessment,...*

*(2) The amount which shall in the determination of the taxable income derived by any person during any year of assessment from carrying on any trade (other than farming), be taken into account in respect of the value of any trading stock held and not disposed of by him at the beginning of any year of assessment, shall—*
*(a) if such trading stock formed part of the trading stock of such person at the end of the immediately preceding year of assessment be the amount which was, in the determination of the taxable income of such person for such preceding year of assessment, taken into account in respect of the value of such trading stock at the end of such preceding year of assessment; or*
*(b) if such trading stock did not form part of the trading stock of such person at the end of the immediately preceding year of assessment, be the cost price to such person of such trading stock.*

Section 14 (1)(a) and (b) of the Act provides inter alia:

*'(1) There shall be allowed to be deducted from the income of any person referred to in section 9(1)(c) –*

[4] Definition of "trading stock" was amended by Act No. 101 of 1990 to include consumable stores and spare parts.

*(a) in respect of any ship used by such person for the purposes of his trade during the year of assessment an allowance equal to ten per cent of the adjustable cost to him of such ship: ...*

*(b) in the case of a person who during any year of assessment concludes a contract for the acquisition by him of a new ship (whether built or still to be built), ... , an allowance in respect of that year of assessment equal to forty per cent of the adjustable cost to the said person of that ship, or, if at the time at which the allowance under this paragraph has to be made, the cost price of the ship has not yet been determined, of the adjustable estimated cost price of that ship, ...'*

(my emphasis)

The terms 'adjustable cost' or 'adjustable cost price' are defined in section 14 as follow:

*'(2) For the purposes of this section –*

***"adjustable cost" and "adjustable cost price"**, in relation to any ship, means the cost to the taxpayer of such ship, ... , and **"adjustable estimated cost price"** shall be construed accordingly;'*

Paragraph (g) of section 12C has been added by section 13(1)(b) of Act No. 21 of 1995 and replaces section 14(1)(a) and (b) and determine the following:

*'(1) In respect of any –*

*(g) ship which was or is brought into use on or after 1 April 1995 for the first time by the taxpayer for the purposes of his trade (other than a ship in respect of which an allowance has been granted to the taxpayer in terms of section 14(1)(a) and (b),*

*a deduction equal to 20 per cent of the cost of such ... ship ... : Provided that where –*

*(a) the deduction shall be calculated on the adjustable cost as determined in terms of section 14 ... ;and*

*(b) ...*

*the deduction under this subsection shall be increased to 33 1/3 per cent of the cost...'*

Section 11(d) of the Act provides:

*' 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 within the Republic, there shall be allowed as deductions from the income of such person so derived—*

*(d) expenditure actually incurred during the year of assessment on repairs of property occupied for the purpose of trade or in respect of which income is receivable, including any expenditure so incurred on the treatment against attack by beetles of any timber forming part of such property and sums expended for the repair of machinery, implements, utensils and other articles employed by the taxpayer for the purposes of his trade;'*

## WORDS AND PHRASES NOT LEGALLY DEFINED

The answer to the issues mentioned is nestled in the meaning of certain words and phrases employed in the above sections.

The critical term *'ship'* is not defined at all. A proper definition of the word *'ship'* would at least have provided one of the so-called canons of taxation propounded by Adam Smith, *viz.* certainty.

Other words and phrases not defined are 'cost to the taxpayer', 'spare parts', 'brought into use' and 'course of his trade'.

The state of affairs invites conflicting interpretations of the sections and should provide fertile conditions for litigation.

## WHAT IS A 'SHIP'?

The meaning of the noun 'ship' and what would be seen as a ship for taxation purposes will provide the solution to these issues.

The word 'ship' is used in a number of sections in the Act. It would be assumed that the meaning of the word would be the same in every context[5].

The dictionaries' description is not that helpful.

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[5] In ITC 1420 (49 SATC 69) Kriegler J held that unless the contrary is clearly indicated, the legislature intends to use a particular word in a statute with a consistent meaning. The court considered this rule in respect of terms specifically defined, but I am of the opinion that this presumption will suffice for other words as well.

Microsoft Word's Thesaurus describes a 'ship' as a 'large boat'.

The Oxford Pocket Dictionary refers to a 'ship' as a 'large sea going vessel'.

The South African Student's Dictionary describes a 'ship' by using the following full-sentence definition: 'A ship is any large boat designed[6] to carry passengers or cargo, especially on a sea journey.'

The question from a mechanical point of view, is whether a ship is more than the hull, the engine, the propeller and all the permanent fixtures and fittings. Should it include the furniture, tools and all the spare parts and consumable stores which are placed or stored aboard a ship?

If the ship should only be regarded as the hull, the engine, the propeller and all the permanent fixtures and fittings, then the cost of the ship will be limited to this mechanical structure. The flip side of this argument is that if spare parts and consumables (and for this matter furniture and tools) actually form part of the ship, the cost thereof should properly be regarded as part of the cost of the ship.

There is clearly a broader and narrower meaning ascribed to the word 'ship'.

Should the ship be regarded as the whole commercial or industrial undertaking or should the entire ship be regarded as that which physically constitutes the separate ship?

The question of what constitutes the entirety of an asset has been argued in numerous tax cases dealing with the meaning of repairs. Section 11(d) of the Act is not applicable, but the manner in which entirety is addressed, could be relevant to the issue at hand.

In ITC 617[7] it has been held, based on numerous authorities cited, that repair is a restoration by renewal or replacement of a subsidiary part(s) of a whole. Renewal as distinguished from repair is

[6] It is interesting to note that the place and way any of these spares are carried on board are carefully taken into account in the design. These design criteria are essential for balancing purposes.
[7] 14 SATC 474

a reconstruction of the entirety, meaning by entirety not necessarily the whole but substantially the whole matter under discussion.[8]

In cases decided on this matter it appears that courts have stuck to the physical matter under discussion.

In ITC 617 a race course owner effected repairs by replacing the starting gate, posts and fencing, course rails and telephone poles and this was all held to be subsidiary parts of the race-course. On the other hand, in the same case a re-erection with new materials of a course stand, which had been blown over, was held to be substantially a reconstruction of the whole subject matter.

In the case of capital (expenditure or revenue) no definition exists. In the nature of things it is also not possible to lay down a precise definition that will cover all cases.

An interesting aspect is that at this level of the Act there is reference to the commercial or industrial undertaking. The guide used by Innes CJ in George Forest Timber[9] is that the money spent should create or acquire a source of profit. Watermeyer CJ's application in New State Areas[10] is that cost of establishing or improving or adding to the income-earning structure, is the most reliable test in determining the nature of an expense.[11]

The problem is that although there might be reference to the ship as a income-producing concern and is therefore of a capital nature, the spare parts might still be regarded as income-earning articles in their own right. The problem however is that the items in question are not structurally incorporated in the ship. These items do not lose their separate identity.

From a physical, structural point of view, section 11(e) is also not in aide of the notion that a ship is more than just the hull, the engine, the propeller and all the permanent fixtures and fittings.

The section refers to machinery, plant, implements, utensils and articles. It is not clear under which a ship will classify.

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[8] Meyerowitz on Income Tax, 1997 – 1998, p.12-7.
[9] 1924 AD 516, 1 SATC 20
[10] 1946 Ad 610, 14 SATC 155
[11] Unfortunately this test cannot be utilised with the same assurance in determining the nature of an asset.

Section 11(bB) of the Act contains a further conundrum through its specific reference to assets being used in trades including 'mining, shipping or farming'. Does the reference to shipping imply that a ship falls into the category of 'implements, utensils or articles'? [12]

Presumably a ship does not constitute machinery or plant in the same way that an aircraft and impliedly does not fall into the meaning of those words. It is by no means clear why ships are not expressly referred to in the same way as aircraft.

Section 11(e)'s reference to 'plant' widens the scope however.

In determining whether any structure is 'plant', the United Kingdom authorities[13] and also the Appellate Division[14] have applied the functional test, that is, regard is to be had to the use which is made of the structure.

In Blue Circle[15] Corbett JA (as he then was) relied on the functional test in this regard:

> *'In recent years there have been a number of decisions by the English courts concerning the meaning of the word 'plant', as it occurs in certain successive statutory provisions in English fiscal legislation .... These statutory provisions all employ the same verbal formula authorising capital allowances, from the taxation point of view, in respect of capital expenditure incurred by a person carrying on a trade 'on the provision of machinery or plant for the purpose of the trade' (see Benson v Yard Arm Club Ltd [1979] 2 All ER 336, at 338h). Most, if not all, of the relevant decisions are referred to in Benson's case (supra), a decision of the Court of Appeal, in Inland Revenue Commissioners v Scottish and Newcastle Breweries Ltd [1982] 2 All ER 230, a decision of the House of Lords, and in Leeds Permanent Building Society v Procter [1982] 3 All ER 925, a decision given in the Chancery Division.*
>
> *The starting point of these decisions has, almost without exception, been a dictum of Lindley LJ in Yarmouth v France (1887) 19 QBD 647, a case concerned with the meaning of the word*

[12] Jooste *Revenue Law (1995)* an article by D Clegg *The description of assets qualifying for certain income tax allowances – A plea for consistency* at 5.
[13] IRC v Barclay Curle [1969] 1 All ER 732 (HL); Haigh v Ireland [1973] 3 All ER 1137 (HL); Benson v Yard Arm Club [1979] 2 All ER 336 (CA).
[14] Blue Circle Cement Ltd v CIR 1984 (2) SA 764 (A), 46 SATC 21.
[15] Blue Circle (n 12) at 30

*'plant', as it occurred in certain non-fiscal legislation, viz the Employers' Liability Act 1880. In this connection Lindley LJ stated (at 658):*

*'There is no definition of plant in the Act: but, in its ordinary sense, it includes whatever apparatus is used by a business man for carrying on his business, not his stock-in-trade which he buys or makes for sale; but all goods and chattels, fixed or movable, live or dead, which he keeps for permanent employment in his business.'*

*In the subsequent cases, dealing with fiscal legislation providing for capital allowances similar to those contained in s 12 of the Act, the English courts have placed emphasis upon the use which was made of the item alleged to be plant and in this connection have evolved what is termed the functional test. This test has been of particular value in applying the distinction which the courts have been constrained to draw between the 'setting' in which a business is carried on and the apparatus with which a business is carried on. The general approach has been described by Buckley LJ in a judgment subsequently described by Lord Hailsham LC as 'expository' (see Cole Bros Ltd v Phillips [1982] 2 All ER 247, at 254b) as follows:*

*'In all these cases the court had regard to the use which was made of the subject-matter under consideration. To an extent this was necessitated by the statutes, for to qualify for capital allowances the subject-matter must have been provided "for the purposes of the trade". This, however, is not the end of the matter, for stock-in-trade is provided for the purposes of the trade but is admittedly not "plant". The building in which a business is carried on may accurately be described as "provided for the purposes of the business", but again admittedly is not for that reason alone to be held to be plant. A structure attached to the soil may be plant. The dry dock in Inland Revenue Commissioners v Barclay Curle & Co ([1969] 1 All ER 732) was such, as also were the pools in Cooke (Inspector of Taxes) v Beach Station Caravans Ltd ([1974] 3 All ER 159). On the other hand, a structure of the nature of a building which was not attached to the soil was held not to be plant in St John's School (Mountford and Knibbs) v Ward (Inspector of Taxes) ([1974] STC 69).*

*The distinction, I think, is that in the one case the structure is something by means of which the business activities are in part carried on; in the other case the structure plays no part in the carrying on of those activities, but is merely the place within which they are carried on. So, in the case at any rate of a subject-matter which is a building or some other kind of*

*structure, regard must be paid to the way in which it is used to discover whether it can or cannot be properly described as plant. This is what has been referred to as the functional test. Indeed I think that this test is applicable to every kind of subject-matter. In some cases the effect of the functional test may be so immediately apparent that the character of the subject-matter as plant goes without saying and the test need not be consciously applied. But in cases nearer the line, in my opinion, the functional test provides the criterion to be applied. Is the subject-matter the apparatus, or part of the apparatus, employed in carrying on the activities of the business? If it is, it is no matter that it consists of some structure attached to the soil. If it is not part of the apparatus so employed, it is not plant whatever its characteristics may be.' (See Benson's case (supra) at 342g-343d.) In addition, it has been held that the word 'plant' connotes some degree of durability and would not include articles which are quickly consumed or worn out in the coarse of a few operations (see Hinton v Maden & Ireland Ltd [1959] 3 All ER 356.*

*I think that this general approach and in particular the functional test can be fruitfully applied in the interpretation...'*

If a ship was compared to plant; Lindley LJ would most probably argue that a ship would include whatever apparatus is used by a businessman for carrying his business as shipper. It will not include the trading stock acquired for resale purposes, but all goods and chattels, fixed or movable, which is kept for permanent employment on board.

The functional test draws the distinction between the 'setting' in which the business is carried on and the apparatus with which a business is carried on. Buckley LJ draws the parameters on the one side as the trading stock for resale purposes and on the other side the building.

So, in the case of any subject-matter which is a structure of some kind, regard must be paid to the way in which it is used to discover whether it can or cannot be properly described as plant.

It seems however as a matter of fact that the ship cannot be, and is not, operated without such items being carried on board. The spare parts are therefore allocated to such ship for permanent employment on such ship.

From the company's point of view, the mere fact that the ship is not operated without the 'necessary' spare parts is an indication that the whole structure is a functional unit. Lindley's businessman who operates a ship will be able to regard the lose items on board as part of the ship, but not the trading stock for resale purposes.

The company's spare parts have not been acquired for resale purposes but is reconcilable with the ship's purpose.

## THE COST TO THE TAXPAYER

The Act defines the terms 'adjustable cost' and 'adjustable cost price', but this definition is not in any aide. The meaning of the word 'cost' is found wanting.

The South African Student's Dictionary describes cost by using the following sentence: 'The cost of something is the total amount of money needed to do or have it.'

The question is whether the cost of a ship should include the cost of the initial spare parts and whether this cost should be the basis for allowance purposes.

In the case SIR v Eaton Hall (Pty) Ltd [16] Trollip JA held the following on whether interest should be included in the cost of erection of any building or improvement for allowance purposes:

> *'The crucial words, common to each of these allowances, is therefore 'the cost to the taxpayer of any portion of a building'. (I shall henceforth, for brevity's sake, merely refer to 'any building' as meaning any portion thereof). What does that expression mean? Firstly, it is obvious from the context that 'the cost of any building' means the cost of erecting that building. Secondly, in the absence of any definition in the Act of such cost one must look at its ordinary meaning. The Oxford English Dictionary defines 'cost' as meaning: 'That which must be given or surrendered in order to acquire, produce, accomplish, or maintain something; the price paid for a thing.' Hence 'the cost to the taxpayer of the building' ordinarily means the price or consideration given or paid by him for the erection of the building. It does not, therefore, include expenses incurred by the taxpayer in connection with the erection of the building unless, of course, they are part of the price or consideration paid*

[16] 1975 (4) SA 953 (A), 37 SATC 343: 347 - 349

*for the erection. Thirdly, as counsel for the Secretary rightly pointed out, the use of the preposition 'of' instead of a phrase with a wider connotation, like 'in respect of', between 'cost' and 'any building', indicates that the connection between them must be direct and close; in other words, the expression comprehends the cost of erecting the building and nothing more. Fourthly, as a counsel for the Secretary again rightly contended, that limited connotation is also manifested by the use of the physical, identifiable, concrete object of 'any building' or 'any improvements' instead of the abstract, gerundive concept of 'building' or 'improving' a structure. Thus, 'the cost of building or improving' something is not as well delineated as 'the cost of any building or improvements'. The former might well cover certain expenses incurred incidentally in building or improving a structure, whereas under the latter the cost is delimited by the very physical nature of the building or improvements.*

*All those considerations point in one direction, namely, that the ordinary, grammatical meaning of the words 'the cost to the taxpayer of any building' in those provisions is that such cost is limited to the price or consideration given or paid by the taxpayer for the erection of the building. Hence there is no need to invoke the aid of any of the other canons of construction or the authorities canvassed in the arguments of counsel for the parties to ascertain its true meaning.*

...

*The fees paid to the architects and civil engineers in the present case in regard to the erection of the building were treated and allowed as part of the cost of erection. Counsel for respondent used this fact to support his argument. But they were probably directly and closely connected with the erection of the building; if so, they would then have been correctly treated and allowed as part of the price or consideration paid by respondent for the erection of the building. The reference to these fees, therefore, does not assist the respondent.*

*The basis on which the Special Court upheld the appeal is epitomized in the following passage in its judgment:*

*'Dit is gemene saak dat die algemene praktyk en elementêre begrip is dat die rente gedurende oprigting deel van die koste van die gebou is. Rekeningkundig is dit algemene gebruik. Enige rekenmeester of sakeman sal met die woorde "koste vir die belastingpligtige" net een ding verstaan en dit is wat dit gekos het om die gebou te voltooi en die rente is 'n integrale deel van die koste. Ek sien geen rede om van die gewone betekenis van die woorde af te sien nie.'*

*It is not clear on what the dicta relating to accountancy or commercial practice and the ordinary meaning of the crucial words in such circles are based. No viva voce evidence was adduced at the hearing. Presumably the dicta were based on what was submitted by the representatives of the parties at the hearing and the views held by the accountant and commercial members of the Special Court. But, be that as it may, the point at issue – the correct interpretation of the relevant statutory provisions – was a 'matter of law arising for decision before the court' which, according to s 83(15), had to be decided by the president of the court, and the other members of the court had no voice therein. Moreover, in deciding on the true meaning of those provisions, the president ought to have regarded the language used in those provisions and not accountancy or commercial practice. On that particular aspect the following statement by Centlivres JA (later CJ), in Sub-Nigel Ltd v Commissioner for Inland Revenue 1948 (4) SA 580 (AD)[12] at 588, is apposite and decisive:*

*'At the outset it must be pointed out that the court is not concerned with deductions which may be considered proper from an accountant's point of view or from the point of view of a prudent trader, but merely with the deductions which are permissible according to the language of the Act.'*

(my emphasis)

In this case the crucial words are 'the cost to the taxpayer of such ship'.

In Eaton Hall case the 'cost of any building' means the cost of erecting that building. The 'cost to the taxpayer of such ship' could also then be construed to mean the cost of construction of the ship. The cost of construction of the ship includes the cost of the initial spare parts.

Trollip JA further held that in the absence of any definition of the word 'cost' one should look at its ordinary meaning. The Oxford English Dictionary defines 'cost' as meaning amongst other things, that, which must be surrendered in order to produce or maintain something. The cost production clearly includes the cost of the initial spare parts, which will also be utilized to maintain the ship.

Trollip further argues that the preposition 'of' in the expression 'cost ... of ... a building', indicates that the connection between them must be direct and close. In the case of 'the cost of such ship', it should therefore also be interpreted as the cost of the 'such ship' and nothing more. The initial spare parts are integrated with such ship and in my opinion direct and close for the purposes of the preposition.

A limited connotation is also manifested by the use of the physical, identifiable, concrete object of 'such ship'. The initial spare parts are also physical, identifiable, concrete objects, which are part of the ship.

This again relies on what exactly is the meaning of the word 'ship' and whether a ship and its spare parts are one and the same.

## WHAT IS A 'SPARE PART'?

The second part to the definition of trading stock, namely '...the proceeds from the disposal of which forms or will form part of his gross income', was held by the Appellate Division, in De Beers Holdings (Pty) Ltd v CIR[17], to refer only to things acquired with the intention of disposal for income. The court felt that to stretch the definition to cover things acquired without an intention of disposal would introduce a hypothesis which would not come to pass and that to do so would do violence to the plain meaning of the words used.[18]

The definition of trading stock was amended in 1990 to specifically include consumable stores and spare parts.[19]

Trading stock, except for consumable stores and spare parts, is by its very nature a revenue item, because its sale is the income – producing activity of a trader.

Spare parts are different to normal trading stock in that its not sold or consumed in the ordinary sense. [20] Huxham[21] refers further to the relative durability of spare parts; to the fact that these parts become integrated into the income-earning structure, such as plant and machinery; and the fact that it is capital in nature.

Huxham makes a further statement[22] that if the spares are sold; the proceeds can only be included in gross income to the extent that it is a recoupment of section 11(d) of the Act.

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[17] 1986 (1) SA 8 (A), 47 SATC 229.
[18] Huxham & Haupt, Notes on South African Income Tax (1996) p. 191.
[19] Definition of 'trading stock' substituted by section 2(1)(e) of Act No. 101 of 1990.
[20] Huxham *loc cit* 195.
[21] *ibid*
[22] *ibid*

The amendments referred to above superseded Practice Note No.6, which was issued on the 5th of May 1987. The practice note is not descriptive in nature but sought to explain the practice of Inland Revenue in the light of the law as found in the De Beers judgement. The practice note held that articles that are affected by this judgement are 'spare parts, cleaning materials, fuel, oil, etc'.

Normally the terms 'consumable stores' and 'spare parts' do not present any problem. The following descriptions could be helpful in classifying an item as a spare part, prior to be used or consumed:

- More than which is needed or wanted to operate the vessel, from a pure functional point of view (the bare minimum), without being distracted by any safety regulations / standards or international accepted standards;
- In excess of the normal number already in function or in physical use;
- In addition or as an added item to those in operation;
- More than which is needed or *necessary* to operate it, whether one's allowed or not;
- Some use that is postponed for a later occasion, when an existing part should be replaced from its function due to failure or engineering standards;
- Or postponed for a future use.

It is useful at this point to reexamine the nature of the assets that are being used and which should be depreciated since one tend to discuss the use or depreciation in terms of a single asset. We overlook the fact that most assets are actually combinations of other assets. Consider, for instance, a truck. It can be considered a single item but it can equally be viewed as an assembly of major parts, such as a frame, an engine and a transmission. Each of these consists of a variety of more minor parts such as the carburetor, the engine valves and so on. When we speak of the decline of the service potential of that truck, we could equally be speaking of the decline in service potential of the parts which make up the truck, but which are themselves assets.

Spare parts' service potential will not decline in the same manner as those parts actually in use in the asset. [23]

From this point of view it is easy to identify spare parts.

[23] Section 22(1) of the Act however acknowledge the fact that value of spare parts can decrease due to damage, deterioration, a decrease in the market value or any other satisfactory reason.

It appears prima facie that the spare parts abroad the ship could colloquially be referred to as spare parts. If one takes the example of a spare propeller carried on board, i.e. in addition to the propeller that actually propels the ship, I have no doubt that it does constitute a 'spare part'.

## WHAT IS THE MEANING OF 'TO BE USED ... IN THE COURSE OF HIS TRADE'?

The Act does not define the word 'use' or 'to be used' in any manner and uses the word in numerous sections. The meaning of 'use' or 'to be used' appears prima facie to mean an occurrence or an event.

The Oxford Dictionary describes the word use as 'cause to act or serve for a purpose'.

The South African Student's Dictionary describe the verb 'use' as 'you use something when you do something with it for some purpose, or as the means of carrying out some task'.

In the case Secretary for Customs and Excise v Wijtenburg[24] the Court had to interpret a phrase appearing in a tariff item of Schedule 4 of the Customs and Excise Act[25]. The phrase reads as follow:

> *'provided that such vehicle has been owned and used by such returning resident for not less than six months prior to his departure to the Republic.'*

In this context Trollip JA held the following[26]:

> *'I now turn to consider the meaning of the word 'used' in the phrase - ... An owner ordinarily uses his vehicle ... by driving it for the purpose for which it is designed and acquired. But sometimes, usually in order to enable it to perform that function properly or satisfactorily, the owner has also to do other things with it, ie other than to drive it, for example, repair, service, or maintain it; garage, store, protect, or preserve it in inclement weather, during his absence etc; transport it to some other place where he wishes to use it. Things of that kind that the owner does with his vehicle in order to preserve or facilitate the exercise of his proprietary right of driving it are, I think, also comprehended within the meaning of its being 'used' by him, as stipulated in the tariff item; or putting it another way, such acts are so closely incident to the driving of the vehicle that they can justifiably be regarded as being so comprehended.'*

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[24] 1976 (4) SA 891 (A)
[25] No. 91 of 1964
[26] See n 24 at 895C - E

The court held that the vehicle had been 'used' by the respondent while it was stored by the manufacturer after the respondent had taken delivery but before it was driven.

Trollip JA held that the aforesaid act of storage *'were so closely incident to the driving of the vehicle that they can be regarded as being tantamount to using it in terms of the tariff item'*[27].

In Tayob v Secretary for Customs and Excise[28] the issue was whether a period while a motor vehicle was being repaired could be regarded as being used by the applicant. Irving Steyn J held that the accident which lead to the repairs, is an incident to the using of the motor vehicle and that the applicant had to be taken to have 'used' the vehicle while it was in the course of being repaired.

In Griffiths v Controller of Custom and Excise[29] the dispute was whether the period while the motor vehicle was shipped to South Africa was to be included in the period of at least six months of use specified in the tariff. After stating the ratio decidendi with regards to the preparation for shipment in Wijtenburg's case, Bruger J dealt with the period while the vehicle was on board ship as follows[30]:

> *'Clearly the transportation by ship was closely incident to the subsequent driving of the vehicle in the Republic and logically there is no reason why the period that it was actually on the ship should not be treated on the same basis as its preparation for shipping.'*

In ITC 1538[31] an architect acquired and taken delivery of a helicopter he intended to use in the course of his trade. The helicopter had crashed shortly after the taxpayer had taken delivery while his pilot was undergoing a 'conversion course', i.e. being trained to fly it, and the helicopter had to be scrapped. The question was whether the taxpayer was entitled to claim a scrapping allowance in terms of section 11(o) of the Act.

The section determines inter alia that the helicopter should have been used by the taxpayer for the purposes of his trade.

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[27] *ibid* at 896E
[28] 1976 (1) SA 263 (T)
[29] 1978 (1) SA 1103 (C)
[30] See n 29 at 1105F - G
[31] 54 SATC 387

It was argued on behalf of the Commissioner that the phrase 'used for the purposes of trade' had to be interpreted restrictively and that this initial stage was merely preparatory to such use.

Melunsky J (as he then was) held as follows[32]:

> *'In the sub-section now under consideration the word 'used' is qualified by the phrase 'for the purposes of the taxpayer's trade'. The object of the qualification is simply to ensure that the scrapping allowance is not available where the article is used for purposes unconnected with the taxpayer's trade. ... I can think of no compelling reason why the Legislature should have intended that the deduction may be claimed only after the article has been used in the production of income. Nor does the language of the section or any other provision of the Act[33] lead to that conclusion. In my view equipment may be used for the purposes of a taxpayer's trade while, for example, an employee is being trained in its service. Under these circumstances the use to which the equipment is put is so closely incidental to the taxpayer's trade that it may legitimately be regarded as being used for the purposes of his trade. This construction fully accords with the obvious object of s 11(o).*
>
> *On a proper construction of the sub-section, it seems to be reasonably clear that the appellant used the helicopter for the purposes of his trade while F was undergoing a conversion course. The proper training of a pilot was directed towards the appellant using it for the purposes stated in his evidence. The training of F was, in the circumstances of his case, so closely related to the appellant's trade that it may be regarded as being used for the purposes of his trade.'*
>
> (My emphasis)

Melunsky made a valid point in that the word 'used' is qualified by the phrase 'for the purposes of the taxpayer's trade' and is further avoiding the trap that trade is limited to an 'income-test'[34].

It is further instructive that Melunsky J is not accepting a strict approach to the section 11(o) qualification, but employed the test that the equipment is so closely incidental to the taxpayer's trade that it may legitimately be regarded as being in used for such purpose.

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[32] *ibid* at 393

[33] To what other sections is Melunsky refering.

[34] Commenting on the Solaglass decision, Dennis Davis said: {1991 Annual Survey of South African Law at 573.}
"Effectively, the approach of the Appellate Division in the Solaglass case can be reduced to a profit test, namely that the absence of a profit motive means that the amount has not been expended wholly or exclusively for the purposes of trade. Section 23(g) employs the word "trade" not profit, yet the Appellate Division appears to consider the words as being synonymous."

The cases of Wijtenburg, Tayob and Griffiths employed a more expansive meaning to the word 'used'. Admittedly, none of the authorities cited dealt with the phrase 'to be used ... in the course of his trade', but deal with the word(s) 'used', for purposes of Schedule 4 of the Customs and Excise Act, and 'used for purposes of trade', in terms of section 11(o) of the Act.

The company uses the term 'safety equipment' to describe certain so-called spares that bring me to the point that these parts are kept for three reasons on board:

(i) Operational safety of the crew and of the ship;
(ii) Insurance purposes; and
(iii) For ordinary repair / trade purposes.

The first question is whether the first two reasons qualify as 'used'? The first two reasons are clearly abstract uses / purposes. It is not a physical use that the part is designed for.

The dictionary's reference to 'serve a purpose' or 'for some purpose' does not exclude abstract purposes. In the case of this company these abstract purposes are probably more important than any physical purpose.

The fact is that if the spare parts are not on board, fulfilling its insurance purpose, for instance, the company could jeopardize potential insurance claims.

The company did state that a ship would not leave a harbor without the necessary spare parts. The ship will not be used in the course of the company's trade without these spare parts on board.

The Act however determines that parts will remain spare until it is brought into use in the 'course of his trade'. The Legislature is clearly not of the intention that spare parts is only brought into use after such item has been used in the production of income. The language of the section does not lead to that conclusion. The 'course of his trade' is clearly wider than 'the production of income' and starts before such item is actively involve in producing income.

If, in the definition of 'trading stock', the Act applied the words 'for the purpose of producing income' instead of 'in the course of his trade', there might have been a good argument that such item is only brought into use once an actual repair is effected.

I am therefore of the opinion that because of the words 'in the course of his trade' the expansive meaning of the word 'used' is appropriate.

With permission, I think it is appropriate to amend Melunsky's test slightly to serve this purpose as well:

> *Under these circumstances, the question is whether the uses to which the spare parts are put are so closely incidental to the taxpayer's trade that it may legitimately be regarded as being used in the course of his trade?*

**THE MACHINERY OF SECTION 11(d) IN TANDEM WITH SECTION 22(1) & (2)**

The operation of the Act in general, but specifically the operation of section 22(1) and (2) in tandem with section 11(a) and (d), is fairly clumsy.

Section 11(d) of the Act is divided in three parts, namely:

- Expenditure actually incurred during the year of assessment on repairs of property occupied for the purpose of trade or in respect of which income is receivable.
- Including any expenditure so incurred on the treatment against attack by beetles of any timber forming part of such property.
- Sums expended for the repair of machinery, implements, utensils and other articles employed by the taxpayer for the purposes of his trade.

The third part is relevant to a ship, but why the legislature uses the words 'sums expended', as opposed to 'expenditure actually incurred' in respect of repairs to property, is not clear at all.

The abstract operation of this section is the fact that although an amount is spend on repairs, the repairs do not have to be carried out in order for the deduction to qualify. The adjustment takes partly place by way of the operation of section 22(1) and (2). In other instances, sums expended could be in

the form of advance payments to servicemen for work done in the following year of assessment in which case section 22 will have no bearing.

In the case of the company, sums are spent in obtaining spare parts whilst the ship is under construction and also subsequent, for replacement purposes.

Firstly, the latter; it is clear that sums expended on spare parts, which are earmarked for repairs qualify for a deduction in terms of section 11(d) of the Act. While it is not brought into use for physical repair purposes or any other manner, will it be added for taxable income purposes[35]. The amount that has been taken into account in the determination of taxable income, which represent the trading stock of such year of assessment, shall be allowed as a deduction in the following year of assessment[36].

Sums expended on spare parts while the ship is under construction will not serve as a deduction. Section 11(d) determines that the machinery etc. should be employed by the taxpayer for the purposes of his trade.

Section 11(d), read with section 23(g), of the Act determine that only expenditure, to the extent that it was laid out or expended for the purposes of trade, shall be considered for a deduction in determining the taxable income.

The expenditure is incurred in respect of a ship that is still under construction and that had not yet been brought into use in the company's trade. The company's trade is not that of a ship builder.

This expenditure is similar to pre-production interest, in that it is incurred before the asset is actually brought into use. Section 11(bA) makes provisions for interest, but there is no provision in the Act for spare parts.

Section 11(bA) of the Act determines the following:

> *'...any interest (including related finance charges) which is <u>not otherwise allowable as a deduction</u> under this Act, ... 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'* (my emphasis)

[35] Section 22(1) – closing stock
[36] Section 22(2) – opening stock

Pre-production interest would not have been deductible if it was not for this section. In CIR v Allied Building Society[37] Ogilvie Thompson JA held that the 'pre-production expenditure' relating to the non-revenue producing properties were more closely linked with the creation of a new source of income than with the income earning operations of the taxpayer. Steyn CJ's argument, in respect of the deductibility of the interest, is quite relevant. In his view the interest had been incurred in respect of an amount borrowed and used for the purpose of acquiring the non-revenue producing properties; and as these properties did not form part of the taxpayer's income producing concern, the interest in question was expenditure of a capital nature not wholly or exclusively laid out or expended for the purposes of the taxpayer's trade.

The court came to the conclusion in this case that the expenditure sought to be deducted does not pass due to the fact that it is of a capital nature and to an extent that it did not pass the trade-test.

In the company's case it does not make any difference whether it is seen as capital or non-trade. The effect will be the same.

Section 22(2) provides for two types of opening stock, namely; that which was trading stock at the end of the preceding year, and that which has become trading stock during the current year.

The spare parts will therefore become trading stock the moment the ship is brought into use and will serve as a deduction in terms of section 22(2)(b).

## RULING TO AIRLINE

The ruling furnished to the airline indicate that the Commissioner adopted a comprehensive approach to classification of assets and could therefore admit to the inconsistency of the description of assets in the Act.

The Commissioner could only have reach their decision in the ruling by:

i. applying the functional test to the aircraft;

ii. not limiting the cost of the assets in such a manner described by Trollip JA in the Eaton Hall case, and

iii. acknowledging the expansive meaning of the word 'used' in the definition of trading stock.

It appears prima facie that if a ruling of this nature was handed in respect of an airline, the Commissioner is not that strict with the application of the relevant sections of the Act. The Commissioner could therefore also furnish a favorable ruling to this company on request.

## CONCLUSION

I am of the opinion that although a ship is used in a particular way from a functional test point of view, regard should be paid to the manner in which spare parts are used. The spare parts serve a different function. In applying the functional test consciously it is clear that a ship might include a number of other things which are prima facie not part of the mechanical unit.

The cases cited have adopted a strict approach in classifying assets, but it would not be out of the ordinary to accept that the cost of the ship should not be limited to the cost of the mechanical unit and should include the cost of the spare parts.

I am also of the opinion that although section 14(2) refers to the cost 'of' a ship, the acceptance of the spare parts as part of the ship is not indicating that the ship should be construed as an abstract, gerundive concept.

The cost utilized in determining the allowances should therefore include the cost of the insurance spares, safety equipment and spare parts.

I am further of the opinion that the insurance spares and safety equipment on board is nothing else than spare parts, but are brought into use the moment the ship is brought into use or the moment subsequent spare parts are put on board, if the ship is in use.

It is ironic, but although these items have been brought into use, it is still 'held and not disposed of' for all practical purposes.

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[37] 1963 (4) SA 1 (A); (25 SATC 343)