URBAN RENEWAL TAX INCENTIVE

ABOUT THIS GUIDE

This guide contains a summary of the main features of the Urban Renewal Tax Incentive legislation (section 13*quat* of the Income Tax Act (Act No. 58 of 1962)). Although fairly comprehensive, this guide does not address all the legal detail associated with the tax incentive. It is not intended as a substitute legal interpretation but merely as a guide for potential investors. The relevant portions of the legislation are attached as an annexure.

For a more in-depth review of the legislation, we suggest that you consult the actual legislation and attached explanatory memorandum in the 2003 Revenue Laws Amendment Act (Act No. 45 of 2003). These items are available under the Local Government icon of the National Treasury website at "www.treasury.gov.za." Should you require additional information, contact:

- The Tax Policy Directorate within the National Treasury at lorraine.mashigo@treasury.gov.za; or
- The national office of the South African Revenue Service at smyburgh@sars.gov.za.

Prepared by:
The National Treasury
Economic Policy and International Financial Relations Division
Tax Policy Directorate

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INTRODUCTION: UNDERSTANDING THE BASICS

WHY HAVE A TAX INCENTIVE?

In 2003, the Minister of Finance, Mr. Trevor Manuel, announced the introduction of a tax incentive that will encourage investment for certain specified urban development zones. The core objectives of this incentive are:

- to respond to the problem of dereliction and dilapidation in South Africa's large cities; and
- to promote urban renewal and development through private sector investment in the construction and improvement of buildings.

This incentive, falling under section 13*quat* of the Income Tax Act (Act No. 58 of 1962), comes in the form of an accelerated depreciation allowance for the construction of new buildings and improvements in specified urban development zones. Without this incentive, these costs may not be depreciated or are generally entitled to depreciation of only 2 or 5 per cent per annum.

WHO IS ELIGIBLE FOR THE INCENTIVE?

Any investor (including individuals, companies, close corporations and trusts as well as partners in a partnership) is eligible for the incentive once the following three basic conditions are met:

Firstly, the investor must improve an existing building or erect or construct a new building within the urban development zone. Hence, an investor purchasing a pre-constructed building or improvement is ineligible for the incentive. In other words, the investor must add value to the zone.

Secondly, the investor must use the improved or new building solely for purposes of the investor's trade. The trade can be of any kind, either commercial, industrial or even as rental of a residential apartment. For instance, an investor constructing a building for lease would qualify for the incentive as well as an investor constructing premises to conduct a retail business. On the other hand, an investor living in a portion of a newly constructed building while leasing another portion would be ineligible because the building is not solely used for trade. This requirement applies on a per building basis. Thus, if an investor has two separate buildings on the same parcel of land, personal use of one building will generally not prevent the incentive from applying to the second building if that second building is used solely for trade.

Thirdly, the investor must receive a certificate of occupancy for that building along with a certificate from the relevant municipality confirming the building is located within its urban development zone. These items will be attached to the investor's return when claiming the urban development allowance.

WHERE MUST THE NEW BUILDING OR IMPROVEMENT BE MADE?

The urban development allowance applies only to buildings or improvements within an urban development zone selected by certain municipalities. In terms of the 2003 Budget proposals, 16 municipal areas were identified to benefit from the incentive. The following are the selected municipalities:

1. Buffalo City Municipality – Eastern Cape Municipality
2. Cape Town Municipality – Western Cape Province
3. Ekurhuleni Municipality (East Rand) – Gauteng Province
4. Emalahleni Municipality (Witbank) – Mpumalanga Province
5. Emfuleni Municipality (Vaal Triangle) – Gauteng Province
6. eThekwini Municipality (Durban) - Kwa Zulu Natal Province
7. Johannesburg Municipality – Gauteng Province
8. Mafikeng Municipality – North West Province
9. Mangaung Municipality (Bloemfontein) – Free State Province
10. Matjhabeng Municipality (Welkom) – Free State Province
11. Mbombela Municipality - (Nelspruit) – Mpumalanga Province
12. Msunduzi Municipality (Pietermaritzburg) – Kwa Zulu Natal Province
13. Nelson Mandela Municipality (Port Elizabeth) – Eastern Cape Province
14. Polokwane Municipality - Limpopo Province
15. Sol Plaatje Municipality – (Kimberley) – Northern Cape
16. Tshwane Municipality – Gauteng Province

In terms of the legislation, each of the above municipalities has the task of selecting one or possibly two urban renewal zones based on certain qualifying criteria. At this stage, only the urban development zones for Johannesburg and Cape Town have been finalised and gazetted. Applications from other municipalities are actively being reviewed and a further announcement will be made shortly.

CURRENTLY APPROVED ZONES

Johannesburg Municipality: www.joburg.org.za

- Johannesburg has selected one zone that forms the inner city totalling 1786 hectares. The Johannesburg UDZ includes the central business district, and also Newtown and Braamfontein, as well as the high-density and high-rise residential areas of Hillbrow, and Berea. Other lower-density residential areas surrounding the general Ellis Park area such as Bertrams Judith's Paarl, Doornfontein, and Troyeville, as well as Bellevue; Bellevue East and Yeoville form part of the approved UDZ. The manufacturing and industrial strip to the north of the M2 E/W from Benrose in the east to City West in the west is also included.

(Refer to the enclosed map or the municipality's website for more details).

Cape Town Municipality: www.capetown.gov.za

- Cape Town has selected two zones totalling 629 hectares, capturing part of the Cape Town CBD and the Bellville CBD.
- Most of the historic Cape Town CBD is included and properties adjacent to the Main Road and Klipfontein Road Corridors are included. This includes portions of the suburbs of Salt River, Woodstock, Observatoy, Maitland, Mowbray, Athlone and Gatesville.
- The second Cape Town UDZ includes the older part of the Bellville CBD, focussing on land adjacent to the Voortrekker Road Corridor and around Bellville Station. Some properties along Modderdam Road and Kasselsvlei Road are also included (Refer to attached maps). Both municipalities have proved that they meet the criteria as set out in the legislation.

(Refer to the enclosed map or the municipality's website for details).

The process of selection and gazetting is still underway in terms of the other 14 municipalities. Areas selected by each municipality will be included in this guide as each municipal application is approved and gazetted.

DATES THE INCENTIVE TAKES EFFECT

The incentive takes effect as each urban development zone is published. This means that for each municipality, the incentive will only be effective once the selected urban development zone is published in the Government Gazette. Johannesburg and Cape Town UDZ's take effect on Thursday 14th October 2004, Government Gazette No. 26866.

In more specific terms, the effective date is linked to the contract and to the construction. First, all the relevant parties must sign the construction contract on or after the date of gazetting. Second, the construction must also commence on or after that date. Projects commencing before these dates fall outside of the incentive.

WHAT IS THE NATURE OF THE INCENTIVE?

The incentive provides investors with a tax write-off for the cost of the improvement or building over time before actual sale (and without regard to the write off for accounting purposes). The tax write-off period depends on whether the construction relates to an improvement of an existing building (or part thereof) versus a new building (or extension or addition to a new building). As illustrated below, the incentive for improvements is more generous than for new buildings. The goal is to favour the refurbishment of existing sunken capital (rather than wholesale replacement).

Improvements

An investor who refurbishes or improves an existing building will receive a 20 percent straight-line depreciation write-off over a 5-year period once the building is brought into use. The purpose of this enhanced incentive (beyond the 17-year write-off above) is to maintain structures considered worthy of retention and to maximise the use of all the sunken capital of existing buildings. In order for the 5-year write-off, investors must preserve a substantial part of the building's existing structural or exterior framework (i.e., all the 4 walls or all the steel frameworks of the existing building). In addition, extensions or additions to an existing building may fall within the 5-year write-off (as opposed to the 17-year write-off) if merely incidental to the improvement.

> *Example 1. Facts.* An investor acquires a run-down shop for R8 million. The investor then refurbishes the shop in order to conduct a viable retail business. The refurbishment costs R100 million.
>
> *Result.* The investor can deduct 20 percent of the refurbishment cost over each of 5 years (i.e., R20 million over 5 years) once the building is brought into use. The R8 million falls outside of the UDZ incentive.

New Buildings (Plus Extensions and Additions)

Investors erecting a new building (or extending or adding to the expense of a building) receive a 17-year write-off period. This write-off allows for a deduction of 20 percent for the first year the building is brought into use and annual deductions of 5 percent for each the following 16 years.

> *Example 2. Facts.* An investor constructs a new commercial building in order to conduct a retail business after having purchased vacant land for R5 million. The new construction costs amount to R100 million.
>
> *Result.* The investor can deduct a maximum of 20 percent of the construction costs in the 1st year (i.e., R20 million) the building is brought into use. Thereafter, the investor can deduct 5 percent of these costs for each of the next 16 years (i.e., R5 million per annum for the next 16 years). The land may never be depreciated.

HOW DOES THE INCENTIVE REDUCE MY TAX?

If an investor qualifies for the tax incentive, any 5-year or 17-year write-off of costs incurred by the investor is deductible against the entire taxable income of the investor. No ring fencing applies. In other words, write-offs for one building can be setoff against any other income of the investor, regardless of whether that income relates to the building or the line of business to which that building relates. Any excess losses that cannot be fully setoff within a year are carried forward indefinitely. These excess losses can be setoff in later years until fully absorbed.

Example 3. Facts. An investor is a doctor that refurbishes a townhouse several kilometres from the Investor's home. The investor rents out the townhouse on a permanent basis. In 2005, the Investor generates R530 000 of income as a doctor. In terms of the townhouse, the investor also generates R36 000 of rental income, R34 000 of associated ongoing expenses, and a R50 000 urban development write-off.

Result: The R50 000 urban development write-off from the townhouse is fully deductible against the Investor's entire income, not just the net R2 000 annual profits of the townhouse.

Example 4. Facts: Company X is involved in a number of trades, including an IT business. Company X erects a building for R300 million for purposes of its IT trade. Company X is eligible for a R60 million urban development zone write-off during the first year of use. In that same year, no income is generated from the building, but R35 million of net income is generated from the overall IT business plus another R50 million from the other businesses.

Result: Company X can fully set off the R60 million of urban development zone write-offs against its other income. It makes no difference that the other income does not relate to the building constructed nor falls within the same line of business.

Example 5. Facts: The facts are the same as *Example 4*, except that Company X erects the same building for R600 million, thereby generating a R120 million capital allowance.

Results: Company X can fully utilise R85 million of the capital allowance in the current year to eliminate all of Company X's R85 million of net income. The remaining R35 million capital allowance can be used as a set off against income arising in later years.

WHAT HAPPENS WHEN THE BUILDING IS SOLD?

Investors receive the 5-year or 17-year write-offs only as long as the building is owned and used for purposes of trade. In addition, any sale may trigger ordinary revenue to the extent that any gain on the sale represents a recoupment of the prior write-off (with all excess gain being capital).

Example 6. Facts. An investor constructs a new commercial building in order to conduct a retail business. This new construction costs R100 million. The investor writes off 30 per cent of the building over 3 years (receiving a R20 million deduction in the first year and a R5 million deduction in each of the two following years). The investor then sells the building for R108 million.

Result. The investor has R38 million of gain on the sale (R108 million less the written down cost of R70 million). Of this amount, R30 million represents a recoupment of the prior write off. The net result is 30 million of ordinary revenue and R8 million of capital gain.

WHAT COSTS DOES THE ALLOWANCE COVER?

The urban development zone allowance covers all construction costs related to the erection, extension, addition or improvement of buildings. Finance and property acquisition costs do not fall within the incentive. These deductible costs include the following:

- Costs incurred by an investor in demolishing or destroying any existing building (or any part of a building)
- Costs incurred with respect to permanent fixtures lying near the site. These costs include provision for the following amenities:
  - water;
  - power;
  - sewage;
  - access or parking for the building;
  - drainage;
  - security for the building (including fences, cameras and surveillance equipment);
  - means of waste disposal;
  - sidewalks; and
  - landscaping (including earthworks, greenery and irrigation).

MUNICIPAL REGISTRATION

As part of the process of applying for the incentive, some municipalities will be creating a registration process at their respective municipal offices to facilitate interaction with the municipality and to provide early confirmation that the site is within the urban development zone. This registration (which will be voluntary will occur during the preliminary planning stage. It is recommended that investors register to ensure they receive support from their municipalities in tracking their various applications and approvals. Investors will then receive an official certificate (which is not conditional on registration) that the building is located within the demarcated zone when the municipality grants a certificate of occupancy. This certificate of location must be attached to the investor's annual return when claiming the urban development capital allowance along with a certificate of occupancy.

HOW DO I CLAIM THE INCENTIVE ON MY TAX RETURN?

Investors seeking a 5-year or 17-year write-off for a building within an urban development zone are subject to special tax reporting obligations. More specifically, investors must provide certain additional information when filing their income tax returns. This information must be filed yearly when claiming the allowance. Failure to submit the required information results in the allowance not being available for that specific year.

To satisfy this requirement, investors must firstly attach both a certificate of occupancy and a certificate from the municipality confirming that the building is located within the area chosen by the municipality. Secondly, investors must state the total actual and estimated costs incurred by them for the erection or refurbishment of the building. Lastly, investors must provide a breakdown of erection versus improvement costs if both the 5-year and 17-year write-offs are involved.

ANNEXURE

Selected Provisions of Urban Development Zone Legislation

13*quat*. Deductions in respect of erection or improvement of buildings in urban development zones. –(1) For the purposes of this section-

"certificate of occupancy" means a certificate contemplated in section 14 (1) of the National Building Regulations and Building Standards Act, 1977 (Act No.103 of 1977);

"cost" means the costs (other than borrowing or finance costs) actually incurred in erecting or extending, adding to or improving a building and includes any cost incurred-

(a) in demolishing any existing building or part thereof;

(b) in excavating the land for purposes of that erection, extension, addition or improvement; and

(c) in respect of structures or works directly adjoining the building so erected, extended, added to or improved, for purposes of providing-

(i) water, power or parking with respect to that building;

(ii) drainage or security for that building;

(iii) means of waste disposal for that building; or

(iv) access to that building, including the frontage thereof;

"urban development zone" means an area demarcated by a municipality in terms of subsection (6), the particulars of which were published in the *Gazette* in terms of section (8);

(2) There shall be allowed to be deducted from the income of the taxpayer an allowance determined in terms of subsection (3), in respect of the cost of the erection, extension, addition or improvement of any commercial or residential building within an urban development zone to be used solely for purposes of that taxpayer's trade-

(a) which was commenced by the taxpayer on or after the date of publication of the notice contemplated in subsection (8) in respect of that urban development zone, in terms of a contract formally and finally signed by all parties thereto on or after that date; and

(b) in respect of which a certificate of occupancy has been granted.

(3) The amount of the allowance contemplated in subsection (2) -

(a) in the case of the erection or any new building or the extension of or addition to any building (other than a building in respect of which paragraph (*b*) applies), is equal to-

(i) 20 per cent of the cost to the taxpayer of the erection or extension of or addition to that building, which is deductible in the year of assessment during which that building is brought into use by that taxpayer solely for the purposes of that taxpayer's trade; and

(ii) five per cent of that cost in each of the 16 succeeding years of assessment; or

(b) in the case of the improvement of any existing building or part of a building (including any extension or addition which is incidental to that improvement) where the existing structural or exterior framework thereof is preserved, is equal to-

(i) 20 percent of the cost to the taxpayer of the improvement, extension or addition which is deductible in the year of assessment during which the part of the building so improved, extended or added is brought into use by the taxpayer solely for the purposes of that investor's trade; and

(ii) 20 per cent of that cost in each of the 16 succeeding years of assessment.

(4) No deduction shall be allowed under this section, unless the taxpayer has together with the tax return for the year of assessment in which the deduction is claimed under subsection (3) (*a*) (i) or (*b*) (i), provided to the Commissioner -

(a) a certificate from the municipality confirming that the building is located within an urban development zone within that municipality;

(b) the total amount of the costs to the taxpayer of the erection, extension, addition or improvement and the extend that those cost relate to any portion of the building in respect of which a certificate of occupancy has been granted; and

(c) particulars as to whether the costs were incurred in respect of the erection of a building as contemplated in subsection (3) (*a*) or the extension, addition or improvement of a building as contemplated in subsection (3) (*b*).

(5) No deduction shall be allowed under this section in respect of any building-

(a) where that taxpayer ceased to use that building solely for purposes of that taxpayer's trade during any previous year of assessment; or

(b) which has been disposed of by the taxpayer during any previous year of assessment.