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Section 12C(1)(a) special depreciation allowance on landfill cells - Interpretation of s12C, s13 and s37B(1): The Enviroserv Supreme Court of Appeal of South Africa Case Perspective.

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“The landfill cells are not waste disposal assets in terms of S37B, neither are they buildings as envisaged by section 13. The landfill cells are assets used in the process of manufacture as envisaged by S12C and therefore accelerate depreciation allowance may be claimed in terms of S12C: Supreme Court of Appeal held in the Enviroserv case”

Section 12C of the Income Tax Allowance (ITA) provides for special depreciation allowances on new or used plant and machinery that a taxpayer uses directly in the process of manufacture or in a similar process and that the taxpayer has brought into use in the taxpayer’s trade for the first time. The special allowance is provided as 40 percent of the cost to the taxpayer for that machinery, plant, or improvement in respect of the year of assessment during which the plant, machinery or improvement was or is so brought into use for the first time and shall be 20 per cent in each of the three subsequent years of assessment. There is no requirement to apportion an allowance claim for an asset that was not in use for the full year a requirement present in other sections.

The purpose of this special allowance is to encourage growth in the manufacturing sector in order to create job opportunities in South Africa. One of the key requirements for the application of the section is that the asset must be used in a process of manufacture or in a similar process.

Section 13 of ITA provides for an allowance of 2% of the cost of a building used by the taxpayer in the process of manufacture. The building must be wholly or mainly used by the taxpayer or the lessee during the year of assessment for the purpose of carrying on, in the building, any process of manufacture, research and development or any process which is of a similar nature in the course of the taxpayer’s trade.

It was the court’s conclusion that the landfill cells are not buildings as envisaged by section 13 of ITA and therefore depreciation allowances may not be claimed based on this section.

Section 37B(2)(b) regulates depreciation allowance on environmental treatment and recycling assets, and environmental waste disposal assets of a permanent nature which are used by a taxpayer in a process that is ancillary to a process of manufacture or any process similar thereto. The assets that are similar to these are dams and reservoirs and the allowances on these, as provided in S37B, is 5% per annum. The Supreme Court concluded that the landfill cells are not ancillary to the process of manufacture as they are made for a specific purpose of extraction, collection and disposal of leachate. Therefore, the court’s position was that the depreciation allowance on the landfill cells may not be claimed in terms of the tax provisions under section 37B.

Regarding the interpretation of section 12C(1)(a) in respect of cells built in landfills, the Supreme Court of Appeal had to determine whether cells built into landfills and used for treatment and storage of waste qualify for allowances under this section.

The court contended that it is important, in terms of the landfill cells, to consider both the process of manufacture that produces the leachate and not only the final storage of the leachate. The storage in the cell of the produced leachate does not detract the fact that a cell was involved in a process of manufacture in terms of producing the leachate. The court found that SARS assertion that the principal activity of the landfill cells was for storage of the leachate was not supported by any provisions in section 12C. As a result, the court concluded that the landfill cells or disposal assets qualifies as a plant that is used in the process of manufacture or similar process and as result depreciation allowance may be claimed in terms of section 12C.

Consequently, it is important to note that, following this court case, a taxpayer who owns landfill cells or a waste disposal asset may be able to claim the accelerated depreciation allowance in terms of section 12C provided all the requirements of the that section are met.

The relevant facts of the Enviroserv case are as follows:

Enviroserv conducts a business of waste management services. This entails collection of pre-classified solid waste from clients in return for fees. The waste is taken to landfill sites located in Holfontein, Shongweni, and Chloorkop within the country, and in Mozambique and Uganda. There, the waste is treated, recycled and disposed of as defined in section 1 of the National Environment Management: Waste Act No 59 of 2008 (the Waste Act).

The first matter related to the interpretation of s12C(1)(a) concerns the process of converting hazardous solid waste material to waste material that is safe for disposal. At the landfill sites, the waste is weighed, its classification (per truck) is confirmed and it is taken into the 'workface' (the inside of a cell). The cells are constructed by a process of excavation on a landfill site, and installation in the cells of a subsoil and drainage system. Inside the cell, the waste is treated, prior to its disposal, to 'change its physical, biological, or chemical character or composition' to reduce its hazardous impact on the environment.

The dispute between SARS and Enviroserv emanated from claims made by Enviroserv of depreciation allowances in respect of the cells, for the 2015 and 2016 income tax assessment years. The amounts claimed were R48 947 694.61 in respect of 2015 and R41 306 206.93 for 2016. These amounts constituted 40% and 20% depreciation in respect of the cells for the years 2015 and 2016 respectively. SARS disallowed the claimed amounts, maintaining that the cells are waste disposal assets as defined in s 37B of the ITA, and that Enviroserv was only entitled to claim depreciation at 5% per year in respect of the cells. SARS then raised additional assessments in respect of the disallowed claims.

Legal issue

The process that occurs in the cells as described by Enviroserve is as follows:

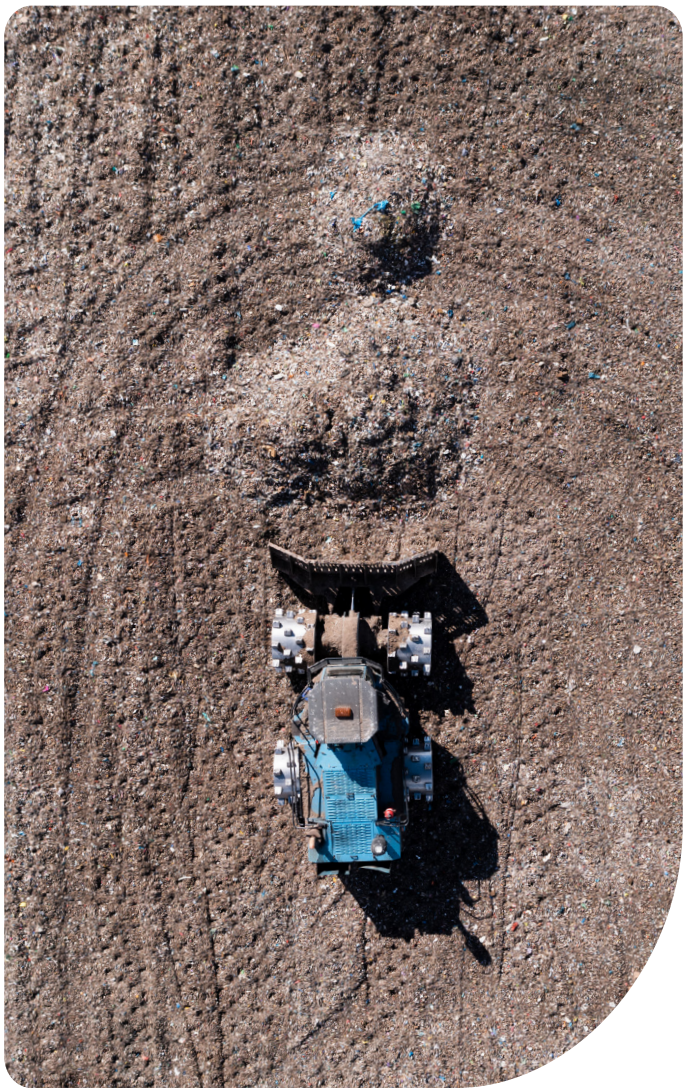
The waste that is collected contains organic or inorganic elements or compounds that may have a detrimental impact on the environment because of inherent physical, chemical or toxicological characteristics. The waste is therefore treated with chemicals, which include lime, cement, caustic soda, ferrous sulphate, hydrogen peroxide, sulphur, sodium metabisulphite, and other chemicals in order to remove the hazardous compounds. It is deposited into the cells where it gets broken down and decomposes, producing a liquid substance known as leachate (contaminated fluid). The cells are designed in such a manner that the toxin laden leachate is produced in the cells from decomposition and biodegradation of the hazardous solid waste in the cells. The leachate gathers at the bottom of the cell and is drained and pumped away to a storage dam or tank.

There, it is treated through processes such as reverse osmosis, nano filtration, freeze crystallisation, and evaporation or micro encapsulation, for further removal of toxins before it is disposed safely as prescribed in legislation. The remaining solid waste is stored in the cells indefinitely and the landfill is monitored for 30 years to ensure that no leakage of toxic substances occurs.

At issue was whether Enviroserv was engaged in the process of manufacture or similar process of which Enviroserv maintained that a process of manufacture occurs inside the cells and therefore argued that the cells constitute plant used directly in the process of its manufacturing activities or a process similar thereto as provided in s 12C(1)(a) of the ITA.

The Commissioner pleaded this in terms of rule 31 of Tax Court Rules that the cells are essentially used for storage of waste and not for a process similar to manufacture.

The Commissioner further argued that leachate is not manufactured but rather an ''unwanted'' product that happens when water enters the landfill.



In addition, the Commissioner contented that the cells are buildings and not plant due to the fact that they are: '… immovable property that has been structured to fulfil the purpose of disposal. The various layers constructed cannot be viewed as plant as these are not fixtures, implements, machinery or apparatus used in carrying on any industrial/ manufacturing process but permanent structures. The landfill is an asset used to handle resultant pollutants outside the ongoing process. Thus the landfill will be classified as an environmental waste disposal asset that is more akin to the longer useful life of a manufacturing building and is similar to the examples provided in the EM [Explanatory Memorandum], namely dams, reservoirs, evaporation ponds, etc.'

The approach followed by the Tax Court was to first determine whether the landfill and cells constituted a plant that qualifies as an environmental treatment and recycling plant or whether they were environmental waste disposal assets. The court found that the principle activity of the cells was the final disposal of the waste streams and thus concluded that the landfills are manufacturing buildings rather than plant and therefore they qualified as waste disposal assets provided for under s37B (2)(b) rather than manufacturing plant as provided under section 12C. The court then made adjustments to Enviroserv's returns for year of assessment 2015 and 2016 by adjusting depreciation claimed of 40% and 20% to 5%.

The Supreme Court of Appeal decision

As indicated above, Enviorserv was appealing the dismissal of the depreciation allowance under s12C.

The Supreme Court of Appeal made reference to SIR v Safranmark case in which the court acknowledged that there is no definition in the ITA for 'process' or 'manufacture' or 'process of manufacture. In that case, this court considered the meaning of 'process of manufacture' as used in s 12 of the ITA (the predecessor of s 12C).The Commissioner's predecessor, the Secretary for Inland Revenue, had disallowed Safranmark's claims for 'machinery initial allowance' and 'machine investment allowance' in respect of machinery used to cook Kentucky Fried Chicken.

In support of the Saframark's claims, the court contented that the word ''process of manufacture'' may be very difficult to assign meaning in a way that one is able to distinguish between all cases which falls within the scope of the phrase and those that falls outside its scope. The court also made reference to the McNicol v Finch (1906) 2 KB 352 at 361, case in which DARLING J stated that ''the essence of making or manufacturing is that what is made shall be a different thing from that out of which it is made''.

As noted above, the tax court had concluded that the cells are used for storage of waste and that the cells were ancillary to manufacture. However, the Supreme Court contented that in reaching the above conclusion, the tax court failed to consider the process of separation of the leachate from the waste in the cells before the leachate can be drained from the cells. It maintained that the tax court's omission to consider the process that occurs in the cells and consideration of only the final storage of the treated leachate in the cells was incorrect.

It is noteworthy that it was not in dispute that the purpose of treatment of the hazardous waste is essential in order to minimise its impact on the environment and the tax court accepted that the treatment of leachate and the production of leachate was a process similar to manufacture. However, the Supreme Court contented that the tax court's interpretation of the section, which was founded on the 'principal activity' of the cells, is not supported by the words used in s12C(1)(a) of ITA. Notably, the Supreme Court concluded that there was no reason why such principal activity should be based on the number of years of waste storage and not the process of manufacture which is essential for safe storage of the waste.

Based on the Supreme Court's arguments in the preceding paragraph, it is important to note that the bone of contention was whether the asset (landfill cells) was used for the process of manufacture or for storage of the leachate. This argument stemmed from the fact that section 12C does not contain provisions that address how an asset should be classified if it used for dual purposes, that is, used in the process of manufacture and also used for storage or other process. Therefore, it could have been helpful, in terms interpretation, if the section 12C had provisions addressing the tax treatment or classification of assets that are used for dual purposes.

The Supreme Court also argued that any dictionary definition of the process of manufacture should be supported by the words used in s12(C)(1)(a). It also argued that the Commissioner's interpretation of dictionary definition, that for a process of manufacture to have occurred there should have been 'a manual labour or mechanical process', is not supported by the words used in s12(C)(1)(a). The Supreme Court indicated that the dictionary definition of 'manufacture' as 'the act of producing something' is more consistent with the words used in the section, except that the end product must be different from the original material.

In addition, the Supreme Court contented that there is nothing in the section s12(1)(a) whose interpretation may mean that raw material is 'insufficient' as an end product of the process of manufacture as advanced by SARS. The court argued that the important test is to determine whether that which is made is different from that out of which it is made. In support of the point the court made reference to the court case, Secretary for Inland Revenue v Cape Lime Company Ltd in which the Supreme Court held that:

'…it does not offend against reason to say that the blasting operation at the quarry, whereby a portion of the raw material is removed from the rock face and fragmented in the process of doing so, is the commencement of a series of operations in which different techniques are employed at successive stages in order to manufacture lime from the natural deposits of limestone on the respondent's land. The first stage of change in the raw material takes place at the quarry as a result of the blasting operations which remove rock from the face of the quarry and breaks it up into smaller portions, some of which have to be subjected to further blasting in order to reduce them to a size suitable for feeding into crushers.'

The Supreme Court contented that the decomposition and biodegradation of waste that happens in the cells and which results in the formation of unhazardous waste and leachate (raw material) does not diminish the fact that the leachate is essentially different from the components that went into its production. In addition, the court indicated that there are no words in s12C(1)(a) support the interpretation that the end product must be useful or wanted.

In response to SARS assertion that the cells are akin to structures such as dumps and dams as provided in s37B and that they do not constitutes plant as envisaged in s12(C)(1)(a), the Supreme Court argued that the enquiry that should be made is whether the apparatus, fixtures or machinery is used in contacting the activities of the business, referred to as the functionality test: 'If it is, it does not matter that it consists of some structure attached to the soil'. The Supreme Court concluded that the utilisation of the cells by Enviroserv for extraction of leachate and for storage of non-hazardous waste is clearly in the conduct of its business.

Section 37(2)(b) provides for the depreciation allowance on environmental treatment and recycling assets, and environmental waste disposal assets of a permanent nature, which are used by a taxpayer in a process that is ancillary to a process of manufacture or any process similar thereto. Plant and equipment are depreciated at a rate of 40/20/20/20 per year. Permanent structures such as reservoirs and dumps are depreciated at the rate of 5% per year.

An ''environmental waste disposal asset" is defined in s37B as any air, water and solid waste disposal site, dam dump, reservoir, or other structure of a similar nature, or any improvement thereto, if the structure is –

(a) of a permanent nature,

(b) utilised in the course of a taxpayer's trade in a process that is ancillary to any process of manufacture, or any other process which, in the opinion of the Commissioner, is of a similar nature, and

(c) required by any law of the Republic for the purposes of complying with the measures that protect the environment.

The Supreme Court interpreted the definition of "environmental waste disposal asset" in s37B(1) by maintaining that where a disposal asset is not an indispensable part of the process of manufacture but it's used for ancillary purpose of compliance with legal requirements intended to protect the environment, then the provisions of this section are applicable. Put differently, where desired results can be achieved without the utilisation of the asset, then the asset is ancillary to process of manufacture or similar process. On the other hand, where, as in the case of Enviroserv, the asset is an indispensable part of manufacturing process, it cannot be ancillary to that process.

The Supreme Court further argued that the decomposition, biodegradation and extraction of the hazardous leachate is an indispensable part of the treatment of the hazardous solid waste. It also added that the 'unwanted' leachate is an intended or desired product of the processes performed by that business.

The Supreme Court therefore maintained that, as opposed to SARS assertion, the cells are not disposal assets nor are they buildings as envisaged by s13 of ITA. This is because the cells were constructed for a specific purpose in that they would be used as plant in which the extraction, collection and disposal of leachate would take place, with a drainage system installed for collection of leachate.

Conclusion

Evidently from the above, SARS clearly interpreted s12C and s37B, together with s13. The interpretation clearly indicates that when determining whether an asset is a plant or not, it is not important whether the asset is permanently fixed on the ground or not. What is important is whether it is used by the company in the conduct its business.

In addition, in determining whether an asset is an 'environmental disposal asset' it is clear that the important enquiry that need to be made is whether the asset is indispensable to the process of manufacture of the intended product or not. It is also evidence from Supreme Court's interpretation that the intended product produced from the manufacturing process does not need to be a product that can be used, it can be an unwanted product, for instance, leachate in this case.

One other important conclusion that came out from the interpretations made in this court case relates to the use of dictionary definition processes or anything. It noted that a dictionary definition, which one applies in interpreting the meaning of certain provisions in a particular section of ITA should be supported by words used in that specific section. In clarifying this point, the Supreme Court maintained that the dictionary definition stating that for a process of manufacture to have happened there should have been a manual labour or mechanical process is not in line with any of wording used in section 12C(1)(a).

Lastly, the court's interpretation of section 12C also clarified that the fact that an asset used in the process of manufacture is also used for another purpose does not detract that the asset is involved in a process of manufacture. The court maintained that it is not only the final stage of the process (storage of leachate) that is considered in determining the nature of the asset but it is all the processes that occur in the cells that need to be taken into account.

For any assistance regarding allowances related to environmental waste assets please do not hesitate to contact us.

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