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ANALYSIS OF THE GUIDELINES FOR CLASSIFICATION OF ADVERTISING COSTS IN TAXATION

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─Abstract ─

Advertising plays a distinct role in economies around the world. Previous studies have not resolved the question related to the classification of advertising as an expense or capital asset. Understanding the principles set out in The Income Tax Act 58 of 1962, with regard to the classification of advertising cost as capital or revenue of nature is important, since the incorrect interpretation of principles will have a direct impact on tax liability. The focus of this study is the classification of advertising costs for tax purposes. Research questions posed in this paper are answered through the development of a classification process that may assist with the classification of advertising costs for the purpose of taxation. Guidelines for the classification of advertising costs as capital or revenue of nature are needed to correctly classify advertising costs for tax purposes. Furthermore, the determination of when advertising costs will be regarded as capital of nature is also determined. A qualitative research approach is applied, including a literature review of case law and income tax acts. The contribution of this study is found in the guidelines set for the classification of advertising costs for tax purposes by using principles from national and international case law.

Key Words: *Advertising, Capital, Expense, Income Tax Acts, Revenue*

JEL Classification: G18, H21, H26, K34

1. INTRODUCTION

Consumers are enlightened with information through advertisements and advertisers are willing to spend a great deal of money on advertising their products (Backman, 1968). Advertising is commonly referred to as an endeavour to persuade consumers to feel a positive attitude towards a product or institution in order to ensure the purchase of such product, which will then have an increased sales effect or create loyalty to that institution (Shamdasani *et al.*, 2001; Solomon *et al.*, 2012). Advertising is, however, not a process by which trusting consumers are persuaded to buy goods and services they do not want (Backman, 1968).

Diederics (2015) illustrates through a seminal approach that the Commissioner of The South African Revenue Services v George Forest Timber Company Ltd (1924) court case is the principle on which this capital or revenue of nature is based. Telsa (1961) and Hirchey (1982) support this fact, however, Moodley (2011) proposes that guidelines are still lacking and further research is required.

The classification of advertising costs as capital or revenue of nature is crucial to determine whether the advertising costs will form part of the general deduction formula. In accordance with section 11(a) of The Income Tax Act 58 of 1962 (hereafter referred to as The Act), costs incurred that is capital of nature is a prohibited deduction. Moodley (2011) argues that the determination of the nature of costs incurred is therefore an important factor in determining taxable income. McCann and Holmes (2010) state that the classification of costs as capital of nature is complex. Several authors (Telser, 1961; Akanbi & Adeyeye, 2011; Moodley, 2011) argue that the notion of the intangible asset qualities that advertising costs may have, as well as the reasons for the classification of advertising as capital or revenue, are important. An intangible asset may be referred to as an identifiable non-monetary asset without physical substance that meets all other requirements of the definition of an asset as required by the International Financial Reporting Standards (IFRS). Williams (2011) identifies that The Act requires the classification of an amount as either capital or revenue for the purpose of income and expenditure or losses. The interpretation of The Act by Williams (2011) led to the conclusion that section 11(a) of The Act contains provisions related to the deduction of expenditure and losses; however, only if such expenditure or losses are capital of nature. Hence the requirements set out in section 11(a) lead to questions being asked related to the classification of advertising costs.

2. PROBLEM STATEMENT

Due to the gap in literature on the classification of advertising costs as either capital or revenue of nature, the aim of this study is to understand the differentiation between, and the classification of advertising expenditure of a capital nature and that of a revenue nature. This differentiation is crucial to establish when an expenditure, which is revenue related, will be deductible against income because this will not be the case if the expense is of a capital nature. Advertisers will therefore benefit from establishing classification guidelines.

3. OBJECTIVES OF THE STUDY

The objective of the study is to determine guidelines for when advertising costs for tax purposes may be classified as capital or revenue of nature.

4. RESEARCH DESIGN AND METHODOLOGY

Rajasekar *et al*. (2013) explain research methodology as a methodical technique to solve a problem and to achieve research objectives. In this study the classification of advertising costs as capital or revenue of nature are explored and a qualitative research method is followed.

Secondary data sources include applicable legislation, court cases, relevant textbooks, peer-reviewed journal articles and the Internet. These sources are used to briefly describe the development of advertising and the growth thereof. In addition, the literature review establishes guidelines for the process of classifying advertising as capital or revenue of nature.

The empirical review is conducted to determine the gap between literature, empirical literature reviews, legislation and court cases on advertising costs for tax purposes. Christie *et al*. (2000) explain that "the research methodology of qualitative case studies is process orientated and does not deal with cause and effect relations, but with underlying causal tendencies" and further state that case study research is a way of comprehending the dynamics present in a management situation. Burns (2000) is of the opinion that following a case study approach ensures an exploration that discovers the comprehensive and meaningful factors of real life phenomena. Case studies are used in this research study to establish the classification of advertising costs as capital or revenue of nature by uncovering similarities in court cases and the accounting legislation of various countries related to this topic.

5. FINDINGS FROM THE LITERATURE REVIEW AND COURT CASES

The classification of advertising costs may be described as a complex process that has to take a number of elements into consideration. These elements as per the general deduction formula include expenditure and losses, actually incurred, during the year of assessment, in the production of income, not of a capital nature but for the purpose of trade (Stigling *et al.*, 2013). The classification of advertising costs cannot be determined in isolation by considering just a few key factors.

5.1 Guidelines from national and international case law

South African case law, as well as international case law have an impact on how advertising costs should be classified for tax purposes. International case law is sourced from the BRICS countries as advertising is increasingly coming into the forefront, as a vital element of global economies, including Brazil, Russia, India and China as well as some of the Commonwealth Countries such as the United Kingdom and the United States of America. As such, drawing from the case analysis of the state laws of these countries, nine guidelines were identified for the purpose of the classification process and are set out in Table 1.

Table 1: Guidelines established from national and international case law

National and international case law	Guideline established	Court case
National	The term "capital" should not be used as a definite outcome. The term should rather be used to guide the classification of advertising as capital or revenue of nature.	The Commissioner for the South African Revenue Services v George Forest Timber Company Ltd (1924) Sub-Nigel Ltd v The Commissioner for the South African Revenue Services (1948)
National	The reference to fixed and floating capital should be used in line with the nature of the trade in which the asset is used. An expense may solely be classified as fixed or floating capital after the trade has been identified.	Bourke's Estate v The Commissioner for the South African Revenue Services (1991)

National and international case law	Guideline established	Court case
National	The type of transaction needs to be taken into account when deciding whether it qualifies as fixed or floating capital. After this has been ascertained, classifying advertising costs as either capital or revenue of nature can then be possible.	New State Areas Ltd v The Commissioner for the South African Revenue Services (1946)
National	Income earning activities and income earning concerns need to be identified before advertising costs may be classified for tax purposes.	The Commissioner for the South African Revenue Services v African Oxygen Ltd (1963)
National	Once-off payments may be regarded as capital of nature while costs that re-occur may be regarded as revenue of nature.	Vallambrosa Rubber Co Ltd v Farmer (1910)
International	An enduring benefit should be compared to fixed capital and not to revenue payments.	Anglo-Persian Oil Company Ltd v Dale (1931)
International	The length of the period in which the advertisement may be useful for the entity should be taken into account before deciding if the costs should be capital or revenue of nature.	Fuller Bay of Islands Ltd v Commissioner of Inland Revenue (2004)
International	The estimated amount of benefits that will be a result of the advertising campaign should be calculated if it is possible. In the case where the benefits are substantially larger than the costs that have been incurred, these may be regarded as capital of nature.	Commissioner of Inland Revenue v Adam (1990)
International	The costs incurred does not necessarily have to be a once-off payment in order for it to be classified as capital of nature.	Tucker v Granada Motor Way Services Ltd (1979) Lawson v Johnson Matthey Plc (1992)
International	The reason for the expense that has been incurred needs to be clearly understood. It is important to understand exactly why the advertising expense has been incurred and what it aims to achieve.	Heather v PE Consulting Group Ltd (1972) Anglo-Persian Oil Company Ltd v Dale (1931) The Commissioner of Inland Revenue v Carron Company (1931)

Source: Diederichs (2015)

The guidelines summarised in Table 1 contribute to the study by establishing principles that may be used to determine how advertising costs should be classified. These guidelines will help to ensure that advertising costs is classified as accurately as possible for tax purposes.

From the information provided in Table 1 , the term capital or capital of nature should not be used as a final outcome when determining whether the costs incurred for advertising qualifies as a fixed or floating capital item. . The realisation hereof is of great importance as practitioners, scholars and researcher shall now be able to classify advertising costs for tax purposes.

Therefore, when determining if the advertising costs in question is capital or revenue of nature, it is important to consider all the guidelines in order to achieve the most accurate outcome.

Two guidelines that should also be followed as set out in Table 1 are the length of the period during which the advertisement may prove useful for the entity and the amount of estimated benefits that it will yield as a result. The longer the period and the higher the benefits realised by the advertiser, the more likely it is that the costs may be classified as capital of nature.

Another guideline establish in Table 1 for classifying advertising costs relates to the clear understanding of why the cost has been incurred and exactly what is the aim of the cost.

From Table 1 it is evident that the South African court case decisions are in line with those from International court rulings.

5.2 Guidelines established from national and international income tax acts

Advertising costs, as stated by Stiglingh *et al*. (2013), qualifies as a transaction under the general deductions formula as per The Act. However, this eligibility presents some limitations and requirements. First, for advertising costs to qualify as a deduction it should to some degree, be connected to the advertising of a pre-existing business. Second, advertising costs has to meet all the requirements set out in the general deductions formula. In this regard, for a cost to be deductible, it should meet all the requirements of the general deductions formula. Stiglingh *et al*. (2013) add that as soon as an asset with an enduring benefit develops as a result of advertising, it will be regarded as capital of nature and will therefore, not be deductible as an expense, as made provision for by The Act, under the general deductions formula.

Clear guidelines and requirements are set out in the general deductions formula as to when certain expenses will qualify as a deduction. While this is so, the lack of detailed explanations regarding advertising deductions is evident in some of the tax textbooks most frequently used by university students and lecturers, two of these being “Silke: South African Income Tax” by Stiglingh *et al*. (2016) and “A Student's Approach to Income Tax” by Venter *et al*. (2011).

Section 11(a) and 23(g) of The Act states that advertising costs is not deductible under the general deductions formula as set out in The Act when it is of a capital nature. However, the factors that should be considered when classifying advertising as capital of nature are mostly absent and obscure. The fact that these factors or guidelines are unclear may cause a misinterpretation of The Act, which will consequently cause difficulties when calculating tax for an entity.

Countries from the Commonwealth organisation, the BRICS initiative as well as the United Kingdom and the United States of America are used to gather of information related to the tax treatment of advertising.

Table 2: Key points identified from international tax acts analysis

Key point	Popularity	South Africa
There is a deduction available for expenses that are in relation to trade; if this amount has been incurred in the production of taxable income it may be deducted for tax purposes.	This provision is made in all the tax acts that have been analysed.	Section 11(a) of The Act is similar to the provisions made in other international tax acts
Advertising is a specific deduction.	17 of the 41 tax acts that have been analysed contain sections that relate to the specific deduction of advertising costs.	Section 23(g) only give deductions to the extent of trade. There is no specific deductions for advertising in South Africa.
The possibility of advertising as capital of nature is addressed.	This possibility is addressed in 5 out of the 17 tax acts.	Section 11 (a) gives an indication that expenditure (in general, including advertising) may be of a capital nature. Section 23(g) only gives deductions to the extent of trade and no indication of capital nature.

Advertising that has a long-lasting benefit or is of a long-lasting nature will not be deductible.	The tax act of the United Kingdom eventuality makes provision for this.	There is no specific section of The Act that stipulates these circumstances.
A limitation on the deduction of advertising costs: 15% on the total income.	The tax act of China makes provision for the limitation of advertising costs.	The Act does not have any similar provision for advertising cost.

Source: Diederichs (2015)

It is evident from the research that not many tax acts provide specifically for the deduction of advertising costs. However, all of the tax acts have a provision for the deduction of expenses related to the income earning activities of advertising, which is in line with the provisions in section 11(a) and 23(g) of The Act. Section 23(g) provides for deductions to the extent of trade. There are no specific deductions for advertising in South Africa.

Most of the tax acts that have been analysed do not mention the possibility of advertising being capital of nature. Nevertheless, this does not mean that advertising is definitely not capital of nature. The omission of this possibility of advertising may be due to expenditure amounts that do not qualify as deductible expenditure with regard to expenses incurred for the production of income as being less easily identifiable.

6. GUIDELINES FOR THE ADVERTISING COSTS CLASSIFICATION PROCESS

From the research done in this study guidelines to assist in determining when advertising cost for tax purposes may be classified as capital or revenue of nature, are set out as follows:

Guideline one:

Determine whether advertising may be recognised as an intangible asset for accounting purposes. The definition of an intangible asset should be considered to determine how advertising may be recognised for accounting purposes. Another factor to keep in mind is the recognition criteria for an intangible asset.

Guideline two:

Apply the rules set out in section 11(a) together with section 23(g) of The Act to identify if advertising qualifies as a deduction. If there is uncertainty regarding advertising being capital of nature, guideline three should be applied.

Guideline three:

Apply the guidelines that have been established through national and international case law to the specific circumstances in order to gain a more accurate idea of the possibility of advertising cost being classified as capital of nature.

7. CONCLUSION AND LIMITATIONS OF THE STUDY

Both national and international case law related to the classification of advertising costs as capital or revenue of nature were investigated. The investigation of case law was a component of the qualitative part of the applied research methodology. The second element, involving a qualitative approach, was used to focus on the role of advertising in the economy as well as the development thereof in various countries. The guidelines established in this research study assist to provide a framework that may be used to assist in classifying advertising costs as either capital or revenue of nature.

8. FUTURE RESEARCH OPPORTUNITIES

Throughout the study, certain areas were identified that could be considered for future research. In the case where advertising costs is successfully identified as capital of nature, it may be necessary to determine if there should be a capital allowance for advertising. More research can be conducted on the long-term benefits of advertising for an entity. If these benefits could be identified or determined, this would result in a more simplified classification process. The impact of advertising on the South African economy would prove useful for tax purposes as well. Research on this topic is limited in South Africa and is therefore suggested for further research. Further research is recommended regarding the depreciation and capital allowance granted for advertising if it should be recognised as an asset for accounting purposes and classified as capital of nature for tax purposes.

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