Submission File

10 May 2018

South African Revenue Service
Private Bag X923
Pretoria
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BY E-MAIL: policycomments@sars.gov.za

Dear Sir/Madam

COMMENTS ON THE DRAFT INTERPRETATION NOTES OF LEASEHOLD IMPROVEMENTS AND LEASE PREMIUMS

1. We present herewith, on behalf of the South African Institute of Chartered Accountants' (SAICA) National Tax Committee, our comments on the respective Draft Interpretation Notes (Draft INs) on Leasehold Improvements and Leasehold Premiums, released by the South African Revenue Service (SARS).

2. Our submission includes a discussion of some of the most pertinent matters, which we believe require SARS' most urgent attention.

3. As always, we thank SARS for the ongoing opportunity to provide constructive comments in relation to draft interpretation notes. SAICA believes that a collaborative approach is best suited in seeking actual solutions to complex challenges.

4. Should you wish to clarify any of the above matters please do not hesitate to contact us.

Yours sincerely

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South African Institute of Chartered Accountants

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ANNEXURE A

Submissions on the Draft Interpretation Note on Leasehold Improvements

Paragraph 3.1.1 – Improvement definition

5. Paragraph 3.1.1 on page 4 of the Draft IN on Leasehold Improvements notes that *"Improvement is not defined in the Act"*.

6. Section 13(9) of the Income Tax Act, 58 of 1962 (the Act), however, defines improvements for purposes of that section to mean any extension, addition or improvements (other than repairs) to a building which is or are effected for the purpose of increasing or improving the industrial capacity of the building, in relation to any improvements commenced on or after the first day of April 1971.

7. Submission: The statement in the Draft IN on Leasehold Improvements should be amended to note that "improvement" is not defined for purposes of leasehold improvements, i.e. paragraph (h) of the gross income definition, section 11(g) and section 11(h) of the Act.

8. For purposes of clarity, it should be specified that a leasehold improvement will not include a repair.

9. Submission: We therefore submit that the following sentence in paragraph 3.1.1 on page 4 of the Draft IN on Leasehold Improvements is updated as follows (insert underlined text and delete **bold text** in square brackets):

*"Leasehold improvements may include, for example, items such as **[the]** shop fronts, doors, partitioning, carpets, tiles and light fittings to the extent that it does not represent a repair."*

Paragraph 3.1.2(a) read with paragraph 3.2.2(a) – Voluntary expenditure/Excess expenditure

10. Paragraph 3.1.2(a) on page 4 of the Draft IN on Leasehold Improvements notes that the excess above the stipulated amount in the lease agreement is voluntary expenditure, which is not part of the right to have improvements effected that accrued to the lessor under paragraph (h) of the gross income definition. In turn the lessee would therefore not be able to claim an allowance on the excess amount in terms of section 11(g) of the Act.

11. The lessee may, however, still qualify for a tax deduction given that the lessee incurred the voluntary expenditure/excess amount. For example, if such voluntary expenditure is an improvement in respect of a building used in a process of manufacturing, the lessee may still qualify for a deduction in terms of section 13 of the Act.

12. Submission: The Draft IN on Leasehold Improvements should clarify that if the voluntary expenditure/excess amount in terms of the lease agreement does not qualify for a section 11(g) allowance, the lessee may qualify for another deduction in terms of the Act.

13. Paragraph 3.1.2(a) on page 5 deals with the implications for the lessor when effecting a leasehold improvement and then suddenly also make reference to a leasehold improvement that qualifies for a deduction. This statement may confuse the reader of the Draft IN on Leasehold Improvements in that the reader may conclude that the lessor may qualify for a deduction rather than the lessee.

14. Submit: We therefore submit that the paragraph should be amended to provide clarity that the lessee may qualify for a potential leasehold improvement deduction and not the lessor.

Paragraph 3.1.2(a) – Minimum and maximum amounts

15. The sentence in the first bullet point in paragraph 3.1.2 on page 5 of the Draft IN on Leasehold Improvements is ambiguous as it refers to *"improvements up to a minimum amount"* but simultaneously indicates that the minimum amount may not be exceeded, which implies a situation where the contract stipulates a maximum value for the improvements.

16. Submission: We recommend that the sentence is updated as follows (insert underlined text and delete **bold text** in square brackets):

"If the obligation on the lessee is to effect improvements of ***[up to]*** *a stipulated minimum* ***amount [and no more, an amount which is expressed in the format of a stipulated]*** *that minimum amount constitutes an amount stipulated in an agreement* ***[. In this situation, the stipulated minimum amount is the amount]*** *which must be included in the lessor's gross income as a leasehold improvement under paragraph (h). This* ***[and]*** *is also the amount which potentially qualifies for a deduction under section 11(g) in calculating the lessee's taxable income."*

17. We submit furthermore that it should be clarified that the first bullet point refers to situations where the agreement solely provides a minimum value for the improvements without dictating that the improvements should meet certain specifications.

18. Guidance should also be provided in respect of the amount to be included in the gross income of the lessor under paragraph (h) where the contract does not require specific improvements, but merely stipulates a maximum value for the leasehold improvements.

19. Reference should be made to the situation where the lessee actually spends more than the maximum stipulated amount and where the lessee actually spends less than the maximum stipulated amount.

Paragraph 3.1.2(b) – Amounts not stipulated in the agreements

20. It is stated in paragraph 3.1.2(b) on page 6 of the Draft IN on Leasehold Improvements that the determination of the fair and reasonable value of an improvement depends on the facts and circumstances of the relevant case, but that *"in a number of cases"* the fair and reasonable value would represent the cost of the improvement.

21.	Submission: We submit that SARS should provide the reference to the number of cases or alternately provide examples of these specific number of cases.

Paragraph 3.1.3 – Date of accrual

22. Paragraph (h) of the gross income definition provides that a lessor must include in his/her gross income, any right which has accrued, to have improvements effected to land and/or buildings in terms of a lease agreement.

23. Paragraph 3.1.3 on page 6 of the Draft IN on Leasehold Improvements note that the amount of improvement stipulated in the lease agreement is generally included in the lessor's gross income in the year of assessment when the lease agreement is signed by all the parties.

24. It is, however, our understanding that SARS's practice is to include the amount into the lessor's gross income during the year of assessment in which the improvements are completed.

25.	Submission: The Draft IN on Leasehold Improvements should make reference to the SARS practice, while noting that a strict reading of the Act proposes that the amount should be included when the lease agreement is concluded and signed by all parties.

Paragraph 3.2.3 – Period to calculate the leasehold improvement allowance

26. Paragraph 3.2.3 on page 9 of the Draft IN on Leasehold Improvements provides guidance on the calculation of the leasehold improvement allowance, i.e. that the allowance is spread over the number of years for which the taxpayer is entitled to the use or occupation of the building, starting on the date on which the improvements are completed but limited to a maximum period of 25 years.

27.	Submission: We submit that clarity should be provided on how the possible renewal or extension periods of a lease agreement impact the calculation of the leasehold improvement allowance and whether it should be taken into account to determine the period of the lease.

Paragraph 3.2.3 – Example 2

28. Example 2 on page 11 of the Draft IN on Leasehold Improvements notes that the lessee cannot claim the excess amount (i.e. R50 000) actually spent over the amount stipulated in the contract in terms of section 11(g) of the Act.

29. The lessee may, however, still potentially qualify for a tax deduction given that the lessee actually incurred the excess amount. For example, the lessee may qualify for an allowance under section 13 of the Act if the lessee uses the building for qualifying purposes.

30.	Submission: We submit that reference should be made in the example that although the lessee will not qualify for a tax deduction of the excess amount in terms of section 11(g) of the Act, the lessee should consider other applicable sections in the Act, for example section 13.

Paragraph 3.3.1 – Special circumstances

31. Paragraph 3.3.1 on page 14 of the Draft IN on Leasehold Improvements refer to *"a very long delay"* between the time of including an amount in the gross income of the lessor under paragraph (h) and the time that the lessor receives the benefit of the related leasehold improvements, as a possible special circumstance to provide potential relief under section 11(h) of the Act.

32. Submission: We submit that SARS should provide more guidance as to what would constitute "a very long delay", as the term is open to interpretation.

33. Furthermore examples should be provided on the calculation of the section 11(h) allowance, which incorporates the relevant factors listed in paragraph 3.3.1 on page 15 of the Draft IN on Leasehold or give a short explanation on how these factors will impact the computation.

Paragraph 3.3.2 – Present value discount rate of 6%

34. The section 11(h) allowance is basically the difference between the amount included in gross income of the lessor under paragraph (h) and the present value of that amount. In practice a discounting rate of 6% is applied to determine the present value.

35. Submission: We submit that SARS should provide justification for the use of the 6% rate, i.e. whether it serves to approximate the inflation rate.

Paragraph 3.3.4 – Example 3

36. Example 3 on page 16 only makes reference to the applicable legislation without applying the facts within the example, which makes it difficult to follow.

37. Submission: We submit that it would be useful to have the following note at the end of this example:

"In terms of paragraph 35(3)(a) of the Eighth Schedule to the Act, the proceeds of Property B in the hands of Lessor A will be reduced by any amount that had been included in Lessor A's gross income, including the section 8(4)(a) recoupment.

In terms of paragraph 20(1)(a) of the Eighth Schedule to the Act, the base cost of Property B will be the expenditure actually incurred in acquiring the asset.

Furthermore in terms of paragraph 20(1)(h)(ii)(cc) of the Eighth Schedule to the Act, the base cost of Property B in the hands of Lessor A will also include the excess of the amount that had been included in Lessor A's gross income under paragraph (h) in respect of obligatory improvements affected by the lessee over the special allowance granted to Lessor A in terms of section 11(h).

Such an excess will therefore form part of the tax value of the asset when determining the section 8(4)(a) recoupment and will also form part of the base cost of the asset upon disposal".

Paragraph 3.3.4 – Example 4

38. It is noted in Example 4 on page 16 of the Draft IN on Leasehold Improvements that in calculating the recoupment the selling price of R600 000 was limited to R500 000.

39. Submission: We submit that if this is not an error, SARS should provide clarity as to why the R500 000 was utilised, instead of taking the total selling price of R600 000 into account.

Paragraph 4 – Conclusion on a recoupment

40. Paragraph 3.3.4 on page 16 of the Draft IN on Leasehold Improvements notes that under section 8(4)(a) a recoupment *"must"* be included where an allowance was previously granted. In turn paragraph 4 on page 17 of the Draft IN on Leasehold Improvements notes that depending on the facts, an allowance granted under sections 11(g) and 11(h) *"may"* be recouped under section 8(4)(a) of the Act, which is contradicting.

41. Submission: We submit that paragraph 4 of the Draft IN on Leasehold Improvements be amended to note that an allowance granted under sections 11(g) and 11(h) must/will be recouped under section 8(4)(a) of the Act.

General grammatical accuracy amendments

42. Submission: We propose that for ease of reading and grammatical accuracy, the following sentence should be updated as follows (insert underlined text and delete **bold text** in square brackets):

43. Paragraph 3.1.1 on page 4 - *"The improvements are normally affected according to the lessee's requirements **[as required by the lessee, and]** (as approved by the lessor)**[,]** for the purpose of preparing the land or building for the conduct of the lessee's business."*

44. Paragraph 3.1.2 on page 4 - *"The full amount must be included in **[the]** gross income (see 3.1.3 for the timing of the inclusion), subject to a possible deduction referred to in 3.3.".* Alternatively, reference can be made to *"…the gross income of the lessor…".*

45. Paragraph 3.1.2 on page 5 - *"The expenditure incurred by the lessee in effecting the specific improvements will potentially qualify for a deduction under section 11(g) of up to a maximum **[equal to]** equalling the fair and reasonable value of the specific improvements required under the agreement."*

46. Paragraph 3.1.2 on page 6 - *"Whether a lessee is obligated to effect improvements of a **[to the]** minimum stipulated amount…".*

47. Paragraph 3.1.4 on page 7 - *"In contrast, if the agreement is only altered after the improvement is completed **[, and]** (hence after the expenditure was incurred by the lessee), it will not impact on the lessee's obligation and the lessor's rights under the agreement and**[,]** the amount of the increase will therefore not be included **[therefore, the inclusion]** in the lessor's gross income".*

48. Paragraph 3.2.6 on page 13 - *"In this case, proviso vii of section 11(g) will not apply and the lessee will only be entitled to a proportion of the annual allowance…".*

49. Footnote 24 on page 13 - "Assuming the land or building was used in the production of income or if income was derived from it up until this date."

Submissions on the Draft Interpretation Note on Lease Premiums

Paragraph 3.2.4

50. Submission: We submit that the following statement is not entirely correct, and as a result needs to be updated for the carve-out in respect of a line or cable used for the transmission of electronic communications as contained in proviso (dd) of section 11(f): "*No deduction will be allowed if the "income" is exempt income or "income" which is not included in gross income. For example, for a person who is not a resident, "income" from a non-South African source."*

51. We further propose that this paragraph must be cross-referenced to paragraph 3.2.7.

Paragraph 3.2.7

52. Binding General Ruling 20 (the BGR) states that SARS will accept a percentage of not less than 85% as representing "substantially the whole".

53. Submission: We propose that the Draft IN on Lease Premiums is aligned to be consistent with the BGR.

Paragraph 4

54. The Conclusion indicates that the allowance may be recouped.

55. Submission: We submit that the allowance must or will be recouped where section 8(4)(a) applies the BGR and accordingly we propose that the Draft IN on Lease Premiums is aligned with this interpretation.