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Improvements made to land held under 99 year lease agreements

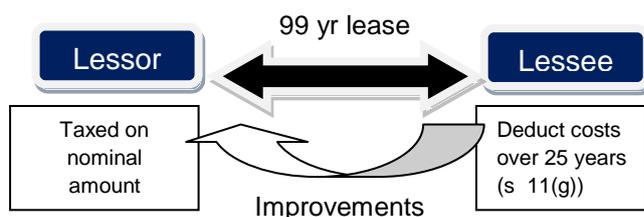
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Property held under a 99-year lease agreement often result in some interesting questions from a tax perspective. These questions often arise from the fact that the practical effect of such an agreement may be similar to obtaining ownership, yet legal ownership remains with the lessor.

Binding Private Ruling 135, which was issued by SARS on 7 February 2013, deals with the question as to which allowances a lessee who obtained the right to use property for a period of 99 years would be entitled to if improvements (in this case, the construction of a commercial property) were made to the property. The agreement between the parties involved in the particular lease stated that the lessee is obliged to make improvements to the property, but did not state an amount for these improvements.

It is important to note that section 13quin, which provides an allowance in respect of commercial buildings, only allows a deduction in respect of "the cost to the taxpayer of any new and unused building owned by the taxpayer". As the land leased to the lessee in terms of a 99 year lease is owned by the lessor and ownership of any improvements to the land accedes to the owner (lessor), no allowances is available to the lessor in terms of section 13quin in respect of commercial property constructed on leased land (irrespective of the duration of the lease).

The ruling states that the lessee is entitled to a section 11(g) deduction in respect of the cost of the improvements (over a period of 25 years). The lessor will be taxed on the value of the improvements (par (h) of the definition of gross income), but is entitled to a deduction in terms of section 11(h), which effectively only includes the present value of the improvements discounted at 6% per annum over the lease period (99 years), in its taxable income. This amount is likely to be nominal amount in comparison to the amount of the improvements. The diagram shows the effect:



If the 6% discount rate is applied, the inclusion in gross income in the hands of the lessor over a 50 year lease term would be 5% of the value of the leasehold improvements (and even less over a 99 year period).

Despite a general tendency of lessors to resist including an obligation to effect leasehold improvements in lease agreements to avoid being taxed on the value of the improvement in terms of par (h) of the definition of gross income (especially if the property is of such a nature that improvements are implicitly required for the lessee to be able to use it, for example, an empty piece of land which is of no use to a lessee if no building is constructed), this diagram shows that an obligation to make leasehold improvements can in some instances be used in favour of the two taxpayers where the lease period is relatively long.

This may structure may provide a useful section 11(g) deduction in cases where the construction of a building on a taxpayer's own land would otherwise not qualify for an allowance or deduction, for example, where a taxpayers constructing less than 5 units of residential property would not qualify for an allowances in terms of either section 13quin or 13sex.

BPR78, which dealt with a very similar transaction to BPR135, however clearly indicates that SARS is conscious of the risk of manipulation as it considered the reason of the transaction as one of the conditions for granting the ruling. Structuring such a transaction without paying careful attention to the general anti-avoidance provisions in section 80A to 80K may prove to be foolish. In addition, section 11(h), which provides a large element of the benefit in the transaction, allows a deduction for the lessor "as the Commissioner may deem reasonable having regard to any special circumstances of the case". This discretion may not be exercised when a section 11(h) deduction is claimed as part of a scheme to manufacture a deduction that would otherwise not have been available.

In addition, other possible tax implications of 99 year leases must also be considered when structuring such a transaction; for example, the part-disposal of the property by the lessor for CGT purposes, to name only one.

If you require technical tax or IFRS assistance or an inhouse seminar please feel free to contact Pieter van der Zwan at 083 417 5904 or pieter@pvdz.co.za or to visit www.pvdz.co.za and submit a request on the relevant page.

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Tax Update