

**INTERPRETATION NOTE 110**

DATE: 7 February 2019

**ACT : INCOME TAX ACT 58 OF 1962**  
**SECTION : PARAGRAPH (h) OF THE DEFINITION OF “GROSS INCOME” AND SECTION 11(g) AND (h)**  
**SUBJECT : LEASEHOLD IMPROVEMENTS**

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### **Preamble**

In this Note unless the context indicates otherwise –

- “**paragraph**” means a paragraph of the definition of “gross income” in section 1(1);
- “**section**” means a section of the Act;
- “**the Act**” means the Income Tax Act 58 of 1962; and
- any other word or expression bears the meaning ascribed to it in the Act.

All guides and interpretation notes referred to in this Note are available on the SARS website at [www.sars.gov.za](http://www.sars.gov.za). Unless indicated otherwise, the latest issue of these documents should be consulted.

## **1. Purpose**

This Note provides guidance on the application of paragraph (h) and the related deductions under section 11(g) and (h).

The capital gains tax consequences of leasehold improvements are not dealt with in this Note. See the *Comprehensive Guide to Capital Gains Tax* for detail in this regard.

## **2. Background**

A lessee that incurred rent as an expense for the use of an asset will be entitled to claim a deduction for income tax purposes under section 11(a) provided the expenditure meets the requirements of that section. The lessor, on the other hand, who receives the rent or to whom it accrues, must declare the rent as gross income.

The lease agreement may stipulate that the lessee is obliged to effect improvements to the lessor’s land or buildings. This expense, in the case of the lessee, and receipt or accrual, in the case of the lessor, are subject to specific provisions in the Act which are discussed in this Note.

### 3. The law and its application

#### 3.1 The lessor's position – section 1(1) paragraph (h) of the definition of “gross income”

Paragraph (h) of the definition of “gross income” reads as follows:

- (h) in the case of any person to whom, in terms of any agreement relating to the grant to any other person of the right of use or occupation of land or buildings, or by virtue of the cession of any rights under any such agreement, there has accrued in any such year or period the right to have improvements effected on the land or to the buildings by any other person—
- (i) the amount stipulated in the agreement as the value of the improvements or as the amount to be expended on the improvements; or
  - (ii) if no amount is so stipulated, an amount representing the fair and reasonable value of the improvements;

##### 3.1.1 The right to have improvements effected under the agreement granting the right of use or occupation

Paragraph (h) applies when a right to have improvements effected on land or to buildings by a lessee accrues to the lessor under an agreement granting the right of use or occupation of such land or buildings. It also applies if a person obtains such a right under such agreement through the cession of the right. It does not apply if the right to have such improvements effected does not accrue to the lessor. For example, paragraph (h) does not apply if the lessee pays the lessor an amount of cash towards improvements that the lessor will effect to the property.

The question whether the lessee has a legal and enforceable obligation to effect the improvements under an agreement granting the right of use or occupation, and therefore whether the lessor has a right to have the improvements effected, is a question of fact. Generally, the obligation to effect leasehold improvements is specified in the lease agreement which is the same document that records the granting of the right of use or occupation of the land and buildings. However, there may be cases in which the right of use or occupation is recorded in one document, namely, the lease agreement, and the obligation to effect improvements is recorded in another document, but the facts clearly indicate that the lessor and lessee had only one transaction and that the two documents must be read together to determine what was agreed in that transaction. In a case like this the court will consider the true intention of the parties rather than just the form of two separate documents.<sup>1</sup> The onus is on the parties to the agreement to prove that an agreement granting the right of use or occupation exists and that the obligation to effect improvements is contained in that agreement. In *Relier (Pty) Ltd v CIR*<sup>2</sup> the parties entered into a series of agreements under which the right to have improvements effected *prima facie* accrued to the sub-lessor, a tax exempt entity, and not the lessor. However, on the facts of that case the court held that the agreements did not reflect the parties' true intentions, that the arrangement contained simulated elements or unexpressed terms and that the lessor had an enforceable right to have the improvements

<sup>1</sup> *CIR v Carletonville Motors (Pty) Ltd* 1964 (3) SA 581 (A), 26 SATC 195.

<sup>2</sup> [1998] 1 All SA 183 (A), 60 SATC 1.

effected.<sup>3</sup> In most cases the obligation to effect improvements will be documented clearly and unambiguously in the lease agreement.

Improvements effected voluntarily by a lessee do not result in a right to have improvements effected which will accrue to the lessor and are not included in the lessor's gross income under paragraph (h). An agreement which gives a lessee the right but not the obligation to effect improvements does not fall within the ambit of paragraph (h) even if those improvements are subject to the lessee obtaining the lessor's approval or both parties anticipate that improvements will be effected.

The word "improvement" is not defined in the Act for purposes of paragraph (h) or section 11(g).<sup>4</sup> The *Concise Oxford English Dictionary*<sup>5</sup> defines "improvement" as –

"[a]n addition or alteration which increases the quality or value of something".

In general, leasehold improvements include the construction of a building on vacant land, the construction of a new part of an existing building or the alteration of an existing building, if they result in an increase in the quality or value of the land or existing building. In preparing land or buildings for the conduct of a lessee's business, any improvements to such land or buildings are normally made in accordance with the lessee's requirements after obtaining the lessor's approval. Leasehold improvements may include, for example, items such as shop fronts, doors, partitioning, carpets, tiles and light fittings. Reference must be made to the facts of each case in determining whether something constitutes an improvement. An improvement must be distinguished from a repair.<sup>6</sup> Parties that agree to specific improvements should attach the specifications or approved plans to the lease agreement (see 3.1.2).

### **3.1.2 The amount to be included in gross income**

The amount which must be included in the lessor's gross income depends on whether an amount for the value or the cost of the improvements to be effected has been stipulated in the agreement.

The lessor is not entitled to spread the accrual over the period of the lease agreement. The full amount must be included in the lessor's gross income (see 3.1.3 for the timing of the inclusion), subject to a possible deduction referred to in 3.3.

#### **(a) Amount stipulated in the agreement**

If the value of the improvements or the amount to be expended on the improvements is stipulated in the agreement, the amount stipulated is the amount which must be included in the lessor's gross income.

The amount included in the lessor's gross income is limited to the amount stipulated in the agreement and is not increased if a lessee spends more than the stipulated amount. The excess above the stipulated amount is voluntary expenditure which is

<sup>3</sup> See also *Erf 3183/1 Ladysmith (Pty) Ltd and Another v CIR* 1996(3) SA 942 (A), 58 SATC 229.

<sup>4</sup> The word "improvements" is defined in section 13(9) for the purposes of section 13 only. It is not defined under section 11(g) nor under section 1(1).

<sup>5</sup> 11ed (2006) Oxford University Press.

<sup>6</sup> See Interpretation Note 74 "Deduction and Recoupment of Expenditure on Repairs" for the distinction between repairs and improvements.

not part of the right to have improvements effected that accrued to the lessor under paragraph (h).<sup>7</sup>

If the lessee spends less than the amount stipulated in the agreement, the stipulated amount must still be included in the lessor's gross income under paragraph (h). The lessor may be able to sue the lessee for non-performance under the agreement. The courts have been called upon to consider whether an amount expressed in the form of a minimum amount, for example, a building of not less than R50 million, is an amount stipulated in the agreement<sup>8</sup> and whether the lessee qualifies for a deduction of a leasehold improvement for any excess above that amount.<sup>9</sup> The general principles which can be extracted from those cases<sup>10</sup> are as follows:

- If the obligation on the lessee is to effect improvements equal to a stipulated minimum amount and no more,<sup>11</sup> an amount which is expressed in the format of a stipulated 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) and is also the amount which potentially qualifies for a deduction under section 11(g) in calculating the lessee's taxable income. Any expenditure in excess of the stipulated minimum amount is voluntary expenditure which is not included in the lessor's gross income and does not qualify for a deduction from the lessee's perspective.
- If the obligation on the lessee is to effect specific improvements even if that requires the lessee to incur costs which exceed the stipulated minimum amount, the stipulated minimum amount will not be considered to be an amount which has been stipulated in an agreement and the fair and reasonable value of the specific improvements to be effected under the agreement (see **3.1.2(b)**) must be included in the lessor's gross income. The reason is that the lessee's obligation is to deliver specific improvements, not a specific cost or value of improvements, and the lessor has a contractual right to demand those specific improvements even if it means the lessee's costs will exceed the stipulated minimum amount. The expenditure incurred by the lessee in effecting the specific improvements will potentially qualify for a deduction under section 11(g) to a maximum equal to the fair and reasonable value of the specific improvements required under the agreement. Depending on the facts, the fair and reasonable value of the specific

<sup>7</sup> ITC 456 (1939) 11 SATC 171 (U). Although this case dealt with the inclusion of lease premiums under a previous Income Tax Act, the principle is similar because in that case the voluntary expenditure was not held to be part of the premium or consideration in the nature of a premium which accrued to the lessor for the use or right of occupation of premises, and, in the context of leasehold improvements, voluntary expenditure is not part of the right which accrues to the lessor.

<sup>8</sup> The alternative is that the amount is not stipulated in the agreement which means the fair and reasonable value of the improvements is relevant – see **3.1.2(b)**.

<sup>9</sup> The cases considered the amount in respect of which the lessee qualified for a deduction. However, the principle applies equally when considering the amount which must be included in the lessor's gross income because in order to qualify for a deduction under section 11(g) the amount must be included in the lessor's income.

<sup>10</sup> ITC 456 (1939) 11 SATC 171(U); *Professional Suites Ltd v COT* 24 SATC 573, 1960 (NR); *COT v Ridgeway Hotel Ltd* 24 SATC 616, 1961 (FC) and ITC 1036 (1963) 26 SATC 84 (N). See also BPR 135.

<sup>11</sup> “[E]qual to a stipulated minimum and no more” means there is no obligation on the lessee to effect improvements in excess of that amount. If the stipulated minimum is exceeded, it is done so voluntarily and not in terms of an obligation.

improvements required under the agreement could be less than or greater than the actual costs incurred by the lessee and different to the fair and reasonable value of the improvements actually effected.

Whether a lessee is required to effect improvements equal to the minimum stipulated amount or to effect specific improvements, even if the stipulated minimum amount is exceeded, depends on the facts of each case. The determination of a lessee's obligations and a lessor's rights will include a detailed analysis of all the clauses and schedules to a lease agreement.

The taxpayer bears the onus of proving the value of the improvements agreed to under the lease agreement.

#### **(b) Amount not stipulated in the agreement**

An amount representing the fair and reasonable value of the improvements must be included in the lessor's gross income if no amount is stipulated in the agreement for the value of or the amount to be spent on the improvements.

The fair and reasonable value of improvements must be objectively determined having regard to all the relevant facts and circumstances of the case.<sup>12</sup> Although the determination depends on the facts and circumstances of the particular case, in a number of cases the fair and reasonable value of the improvements may be equal to the cost of the improvements.

#### **3.1.3 Date of accrual**

Leasehold improvements must be included in the lessor's gross income on the date of accrual. The right to have improvements effected generally accrues when the lessor acquires the right to have the improvements effected. The date of accrual is normally the date on which the lease agreement is signed by all the parties to the lease agreement. Therefore, if the amount of the improvement is stipulated in the lease agreement, the amount is generally included in the lessor's gross income in the year of assessment when the lease agreement is signed by all the parties. However, if the amount of the improvements is not stipulated in the lease agreement, the date of completion of the improvement is generally regarded as the date of accrual because the amount can only be determined at this point in time.

#### **3.1.4 Variation of the lease agreement**

The effect of a variation to the amount to be incurred in respect of leasehold improvements will depend on the facts of each case. Generally, if the variation is limited to increasing only the amount of the obligation it will be regarded as part of the obligation under the agreement in terms of which the right of use or occupation was granted and not as a new obligation under a new agreement.

In the context of paragraph (h) the issue, as noted above, is whether the lessor has a right to demand performance and, correspondingly, whether the lessee has an obligation to perform under the agreement. Therefore, it is submitted that a variation to the amount of the improvement before the expenditure is incurred by the lessee will impact on the lessee's obligation to effect the improvement and the lessor's right

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<sup>12</sup> D Davis *et al Juta's Tax Library* [online] (Jutastat e-publications: 30 November 2017) in Commentary on Income Tax – 'gross income' paragraph (h).

to demand performance.<sup>13</sup> As a result it will impact on the amount to be included in the lessor's gross income. In circumstances in which the amount is increased in a year of assessment after that in which the right accrued to the lessor and was originally included in gross income but before the expenditure was incurred by the lessee, the amount of the increase will be viewed as the accrual of an additional right and included in the lessor's gross income in the year of the increase.

In contrast, if the agreement is altered only 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, therefore, will not be included in the lessor's gross income. In *Professional Suites Ltd v COT*,<sup>14</sup> the lessor and the lessee agreed to amend the agreement and increase the minimum value stipulated for the specified improvements after the building had been completed. On the facts of that case the court held that the obligation was to erect a specified building irrespective of the fact that the agreement included a minimum value, and therefore the reasonable value of the improvements and not the stipulated minimum amount was relevant. The court, however, noted that the expenditure was not incurred in pursuance of an obligation under the agreement granting the right of use because the agreement was varied only afterwards. As a result the lessee did not qualify for a deduction under the equivalent of section 11(g) and, it is submitted, the lessor would not have been required to include the amount of the increase in gross income under paragraph (h).

### 3.2 The lessee's position [section 11(g)]

Section 11(g) reads as follows:

- (g) an allowance in respect of any expenditure actually incurred by the taxpayer, in pursuance of an obligation to effect improvements on land or to buildings, incurred under an agreement whereby the right of use or occupation of the land or buildings is granted by any other person, where the land or buildings are used or occupied for the production of income or income is derived therefrom: Provided that—
- (i) the aggregate of the allowances under this paragraph shall not exceed the amount stipulated in the agreement as the value of the improvements or as the amount to be expended on the improvements or, if no amount is so stipulated, an amount representing the fair and reasonable value of the improvements;
  - (ii) any such allowance shall not exceed for any one year such portion of the aggregate of the allowances under this paragraph as is equal to the said aggregate divided by the number of years (calculated from the date on which the improvements are completed, but not more than 25 years) for which the taxpayer is entitled to the use or occupation;
  - (iii) if—
    - (aa) the taxpayer is entitled to such use or occupation for an indefinite period; or
    - (bb) the taxpayer or the person by whom such right of use or occupation was granted holds a right or option to extend or renew the original period of such use or occupation,

<sup>13</sup> *COT v Ridgeway Hotel (Pty) Ltd* 24 SATC 616, 1961 (FC).

<sup>14</sup> 24 SATC 573, 1960 (NR).

the taxpayer shall for the purposes of this paragraph be deemed to be entitled to such use or occupation for such period as represents the probable duration of such use or occupation;

- (iv) the aggregate of the allowances under this paragraph in respect of any building or improvements referred to in section 13(1) or 27(2)(b) shall not exceed the cost (after the deduction of any amount which has been set off against the cost of such building or improvements under section 13 (3) or section 27 (4)) to the taxpayer of such building or improvements less the aggregate of the allowances in respect of such building or improvements made to the taxpayer under the said section 13(1) or 27(2)(b) or the corresponding provisions of any previous Income Tax Act;
- (v) . . . . .
- (vi) the provisions of this paragraph shall not apply in relation to any such expenditure incurred if the value of such improvements or the amount to be expended on such improvements, as contemplated in paragraph (h) of the definition of "gross income" in section 1, does not for the purposes of this Act constitute income of the person to whom the right to have such improvements effected has accrued;
- (vii) if during any year of assessment the agreement whereby the right of use or occupation of the land or buildings is granted is terminated before expiry of the period to which that taxpayer was entitled to the use or occupation, as contemplated in paragraph (ii) or (iii), so much of the allowance which may be allowed under this paragraph, which has not yet been allowed in that year or any previous year of assessment, shall be allowable as a deduction in that year of assessment;

### 3.2.1 Obligation to effect improvements under the agreement granting the right of use or occupation

Paragraph (h) and section 11(g) are complementary to each other. Section 11(g) provides for the deduction of an allowance for the expenditure actually incurred by the lessee in meeting an obligation under an agreement, which grants the right of use or occupation of the land or buildings, to effect improvements on such land or to such buildings used or occupied for the production of income or from which income is derived.

A lessee who voluntarily effects improvements to a leased property will not be allowed to deduct any of the expenses incurred under section 11(g).<sup>15</sup> Section 11(g) requires that the lessee must have an obligation under the agreement granting the right of use or occupation to effect improvements to potentially qualify for an allowance. This requirement also means the lessor must have a legally enforceable right to demand the improvements. It should be apparent from the lease agreement that there is a clear and unambiguous obligation on the lessee. In *ITC 1188*<sup>16</sup> there was no enforceable obligation to build and the court held that the fact that the lessor was entitled to terminate the right of occupation if the building was not erected did not create a legally enforceable obligation to erect the building. The lessee was not therefore entitled to an allowance under section 11(g).

<sup>15</sup> The lessee may qualify for a deduction under another section - see Example 2.

<sup>16</sup> (1972) 35 SATC 150 (T).



See **3.1.1** for a discussion on the right and obligation to have improvements effected under the agreement granting the right of use or occupation.

### **3.2.2 The amount allowed as a deduction**

The amount of the allowance is based on the expenditure actually incurred by the lessee. However, if that expenditure incurred exceeds, as appropriate, the amount stipulated in the agreement or the fair and reasonable value of the improvements [see **(a)** and **(b)** below], the amount of the allowance will be limited.

#### **(a) Amount stipulated in the agreement**

As noted above, the lessee may claim an allowance based on the amount of expenditure actually incurred.

If an amount is stipulated in the agreement granting the right of use or occupation as the value of the improvements to be effected or as the amount to be expended on the improvements, the aggregate of the allowances under section 11(*g*) may not exceed the amount stipulated in the lease agreement.<sup>17</sup> The amount stipulated in the agreement is the same as the amount included in the lessor's gross income under paragraph (*h*) – see **3.1.2(a)**.<sup>18</sup> If the expenditure actually incurred is less than the amount stipulated in the agreement the lessee may claim an allowance based only on the expenditure actually incurred.

The amount stipulated in the lease agreement may be in the form of a minimum amount. Depending on the facts of the particular case [see the discussion in **3.1.2(a)**], the amount may be treated as an amount stipulated in the agreement or as an amount not stipulated in an agreement. In the former case, **3.2.2(a)** is relevant and in the latter case, see **3.2.2(b)**.

See the examples in **3.2.3**.

#### **(b) Amount not stipulated in the agreement**

As noted above, the lessee may claim an allowance based on the amount of expenditure actually incurred.

If no amount is stipulated in the agreement as discussed in **3.2.2(a)**, the aggregate of the allowances under section 11(*g*) may not exceed an amount representing the fair and reasonable value of the improvements effected. The fair and reasonable value of the improvements must be objectively determined having regard to all the relevant facts and circumstances of the case. Although the determination will depend on the facts and circumstances of the particular case, in a number of cases the fair and reasonable value of the improvements will be equal to the actual cost of the improvements. The fair and reasonable value of the improvements is the same as the amount included in the lessor's gross income under paragraph (*h*) – see **3.1.2(b)**.<sup>19</sup>

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<sup>17</sup> Section 11(*g*) proviso (i).

<sup>18</sup> Section 11(*g*) proviso (i) and (vi).

<sup>19</sup> Section 11(*g*) proviso (i) and (vi).

### 3.2.3 Calculation of the allowance permitted in a year of assessment

The expenditure incurred is not deductible in full in the year of assessment in which it is incurred or in which the improvements are completed. The allowance is spread over the number of years for which the taxpayer is entitled to the use or occupation of the land or building, starting on the date on which the improvements are completed but limited to a maximum period of 25 years.<sup>20</sup> The number of years may include a portion of a year, for example, if the improvements are completed when the lessee has 2½ years of use remaining, the period over which the allowance must be spread is 2½ years.

In order to qualify for the allowance the lessee must use or occupy the land or buildings for the production of income or derive income from it.<sup>21</sup> The lessee will not be entitled to a full deduction in the year of assessment during which the improvements are completed; the allowance must be proportionately reduced in that year to take into account only the period from the date of completion until the end of the year of assessment. In addition, if this requirement is met for only part of any year of assessment, for example because the lessee terminates the lease or stops using the land or buildings, the allowance available for that year of assessment must be proportionately reduced.<sup>22</sup>

The lessee is deemed to be entitled to the use or occupation for a period that represents the probable duration of use or occupation if –<sup>23</sup>

- the lessee or lessor has a right or option to extend or renew the original period of use or occupation; or
- the lessee is entitled to the use or occupation for an indefinite period.

The probable duration of a lease is determined on a case-by-case basis. Factors such as the initial period of use or occupation, the period of possible renewal or extension, commercial circumstances and any other aspects which may affect the duration of the lease must be taken into account. The probable duration of use or occupation is also subject to the maximum of 25 years referred to above.

#### **Example 1 – Leasehold improvements if costs are less than the stipulated amount**

*Facts:*

Taxpayer A is obliged under a lease agreement to erect a building to a value of R600 000 within a period of 18 months from the date of commencement of the lease on 1 March year 1. The lease is for a period of 20 years. The building was completed on 28 February Year 2 at a cost of R550 000 and is used in the production of income.

Taxpayer A's year of assessment ends on 28 or 29 February, as appropriate.

<sup>20</sup> Section 11(g) proviso (ii).

<sup>21</sup> Section 11(g) includes “where the land or buildings are used or occupied for the production of income or income is derived therefrom”.

<sup>22</sup> ITC 971 (1962) 24 SATC 791 (F). See also **3.2.6** for detail on the additional deduction which is available if the lease is terminated early.

<sup>23</sup> Section 11(g) proviso (iii).

*Result:*

Year of assessment ended 28 February year 2

Taxpayer A is not entitled to an allowance under section 11(g) because the building was completed only on the last day of the year of assessment.

Year of assessment ended 29 February year 3 to year 21

The building was completed on the last day of the previous year of assessment and Taxpayer A is therefore entitled to an allowance under section 11(g) for the first time in year 3. The allowance is calculated and deducted over the remaining period of the lease after the completion of the improvements which is 19 years. The allowance is based on expenditure of R550 000. Although allowances under section 11(g) are limited to the amount stipulated in the agreement of R600 000, the limitation does not apply as it exceeds the expenditure incurred.

The amount of the allowance is equal to R28 947 (R550 000 / 19 years) per year.

**Note:** The allowance would no longer be available if Taxpayer A stopped using the land and buildings in the production of income.

**Example 2 – Leasehold improvements if costs are greater than the stipulated amount**

*Facts:*

Taxpayer A is obliged under a lease agreement to erect a building to a value of R600 000 within a period of 18 months from the date of commencement of the lease on 1 March year 1. The lease is for a period of 20 years. The building was completed on 31 August year 2 at a cost of R650 000 and is used in the production of income.

Taxpayer A's year of assessment ends on 28 or 29 February, as appropriate.

*Result:*

Year of assessment ended 28 February year 2

Taxpayer A is not entitled to an allowance under section 11(g) because the building was not completed during the year of assessment.

Year of assessment ended 29 February year 3

The building was completed during the year of assessment and Taxpayer A is therefore entitled to an allowance under section 11(g). The allowance is calculated and deducted over the remaining period of the lease after the completion of the improvements which is 18 years and 6 months. The allowance must be proportionately reduced as the improvements were completed during the year of assessment. Although actual expenditure totalled R650 000, the aggregate of allowances under section 11(g) is limited to the amount of R600 000 stipulated in the lease agreement. The allowance is therefore calculated on a base of R600 000, not R650 000.

The amount of the allowance is equal to R16 216 (R600 000 / 18½ years × 6 / 12).

Years of assessment ended February year 4 to February Year 20

The amount of the allowance under section 11(g) in each of the above years of assessment is R32 432 (R600 000 / 18½ years).

Year of assessment ended 28 February year 21

The allowance allowable as a deduction during this year of assessment amounts to the remaining balance of R32 440, calculated as R600 000 – [R16 216 + (17 × R32 432)].

**Note:** The allowance would no longer be available if Taxpayer A stopped using the land and buildings in the production of income. The excess of R50 000 may qualify for a deduction under another section if the requirements of that section are met, for example, section 13 or section 13*bis*.

**3.2.4 Limitation on the deduction**

The aggregate of the allowances under section 11(g) in respect of any building or improvements referred to in section 13(1)<sup>24</sup> or 27(2)(b)<sup>25</sup> may not exceed the cost [after the deduction of any amount which has been set off against the cost of such building or improvements under section 13(3) or 27(4)] to the lessee of such building or improvement less the aggregate of the allowances in respect of such building or improvements made to the lessee under section 13(1) or 27(2)(b) or the corresponding provisions of any previous Income Tax Act.<sup>26</sup>

In addition, for agreements entered into before 2 November 2010, the aggregate of the allowance under section 11(g) for the cost of improvements (excluding improvements qualifying for a deduction under sections 13(1), 27(2)(b), 13*bis* (hotel buildings) or any residential units referred to in section 13*ter*) may not exceed the net of –<sup>27</sup>

- the amount stipulated in the agreement as the value of the improvement or the cost to be expended, or, if not so stipulated, the fair and reasonable value of the improvements; and
- the aggregate of any amounts that qualified or may qualify for deduction from the lessee's income under any other provision of the Act.

The reference to “qualified or may qualify” means it is not necessary that these deductions must have been claimed by the lessee. This limitation applies if the expenditure qualified for a deduction in the current, preceding or any subsequent year of assessment.

To the extent the above limitations do not apply to prevent a deduction in excess of expenditure actually incurred, section 23B contains a general prohibition against double deductions.

<sup>24</sup> Deductions in respect of buildings used in a process of manufacture.

<sup>25</sup> Buildings and improvements to buildings used by a co-operative as storage buildings.

<sup>26</sup> Section 11(g) proviso (iv). See section 13(1) and section 27 for detail on the allowances permitted under those sections and when not permitted because of section 11(g).

<sup>27</sup> Section 11(g) proviso (v). Note that this proviso does not apply to agreements entered into on or after 2 November 2010.

### 3.2.5 Exclusion from deduction

Section 11(g) does not apply to expenditure incurred if the value of such improvements or the amount to be expended on such improvements, as contemplated in paragraph (h), does not constitute income for the lessor. For example, the lessee will not be entitled to an allowance under section 11(g) if the lessor is a tax-exempt entity.

Exceptions to this exclusion apply for agreements entered into before 2 November 2010 if the expenditure was incurred under an obligation to effect improvements on the land or the building in terms of – <sup>28</sup>

- a Public Private Partnership, or
- an agreement in terms of which the right of use or occupation of land or a building had a duration of 20 years or more and was owned by –
  - the Government of the Republic in the national, provincial or local sphere, or
  - any entity, the receipts and accruals of which are exempt under section 10(1)(cA) or 10(1)(t).

### 3.2.6 Termination of the lease before the expiry date of the lease agreement

The lessee may deduct the balance of the expenditure that qualifies for the allowance and which was not previously deducted if the agreement granting the right of use is terminated before the period of use or occupation to which the lessee is entitled has expired.<sup>29</sup> This ensures that the lessee may fully write off the remaining expenditure not yet deducted in the year of assessment in which the lease agreement is terminated.

If a lessee cedes a lease agreement to another party, the agreement granting the right of use is generally transferred but not terminated. In this case, proviso vii of section 11(g) will not apply and the lessee will be entitled to only a proportion of the annual allowance up to the date of the cession<sup>30</sup> and not in respect of the period covered by future years of assessment.

### 3.2.7 Variation of the lease agreement

The effect of a variation to the amount to be incurred in respect of leasehold improvements will depend on the facts of each case. Generally, if a lease agreement stipulates that improvements of a specified value or amount are to be effected and the amount is subsequently varied before the expenditure is incurred, it will impact on the lessee's obligation to effect the improvements and, as a result, may impact on the amount that the lessee may claim as a deduction.

If the amount is varied after the lessee has incurred the expenditure, it will generally not impact on the amount which the lessee may claim as a deduction.

<sup>28</sup> Section 11(g) proviso (vi) as it was before amendment by the Taxation Laws Amendment Act 7 of 2010. This Act also introduced section 12N to deal with, amongst others, the situations no longer covered as a result of the deletion of these exceptions.

<sup>29</sup> Section 11(g) proviso (vii).

<sup>30</sup> Assuming the land or building was used in the production of income or income was derived from it up until this date.

See 3.1.4 for a detailed discussion.

### 3.2.8 Recoupment of the allowances allowed

Under section 8(4)(a), a lessee must include in income any amount received or accrued to the extent to which such amount represents a recovery or recoupment of allowances previously granted under, amongst others, section 11(g). For example, depending on the facts, an amount received from a third party in respect of a cession of the lessee's rights under a lease or a reimbursement from the lessor for some of the expenditure incurred may constitute a recoupment.

### 3.3 A lessor's special allowance [section 11(h)]

Section 11(h) reads as follows:

- (h) such allowance in respect of amounts included in the taxpayer's gross income under paragraph (g) or paragraph (h) of the definition of "gross income" in section 1 as the Commissioner may deem reasonable having regard to any special circumstances of the case and, in the case of an amount so included under the said paragraph (h), to the original period for which the right of use or occupation was granted or, in the case of any amount so included under the said paragraph (h) in consequence of an agreement concluded on or after 1 July 1983, to the number of years taken into account in the determination of the relevant allowance granted to any other person under the provisions of paragraph (g) of this section: Provided that where there has on or after the twenty-ninth day of March, 1972, accrued to the taxpayer the right to have improvements effected on land or to buildings by any other person and an amount is required to be included in the taxpayer's gross income under the said paragraph (h) with respect to such improvements, no allowance shall be made to the taxpayer under this paragraph in respect of such amount, if—
- (i) the taxpayer or such other person is a company and such other person or the taxpayer, as the case may be, is interested in more than 50 per cent of any class of shares issued by such company, whether directly as a holder of shares in that company or indirectly as a holder of shares in any other company; or
  - (ii) both the taxpayer and such other person are companies and any third person is interested in more than 50 per cent of any class of shares issued by one of those companies and in more than 50 per cent of any class of shares issued by the other company, whether directly as a holder of shares in the company by which the shares in question were issued or indirectly as a holder of shares in any other company;

Section 11(h) provides for the deduction of an allowance in respect of amounts included in the taxpayer's gross income under paragraph (g) or paragraph (h) as the Commissioner may deem reasonable having regard to any special circumstances of the case.

#### 3.3.1 Special circumstances

No hard and fast rules can be laid down as to what constitutes special circumstances. It is a factual issue which depends on the circumstances of each case. In this regard the onus is on the taxpayer to satisfy the Commissioner that there are special circumstances which justify an allowance.

*Paragraph (g)*

The application of section 11(*h*) in the context of paragraph (*g*) is discussed in the Interpretation Note 109 “Lease Premiums”.

*Paragraph (h)*

In the case of leasehold improvements a long delay between the time when the value or cost of the improvements is included in the lessor’s gross income under paragraph (*h*) and when the lessor receives the benefit of the improvements at the expiry of the lease agreement, if there is any benefit at all, will generally constitute a special circumstance entitling a lessor to the deduction of an allowance under section 11(*h*). See, for example, Example 3 and Example 4 under **3.3.4**.

The following factors are examples of special circumstances which are relevant when determining the quantum of the allowance:

- The period of the lease and the period between the inclusion in gross income and when the lessor receives the benefit.
- Whether the lessee has to leave the property in the condition it was at the commencement of the lease upon termination of the lease.
- If applicable, the value of the compensation to which the lessee is entitled at the termination of the lease.
- The value of the building or improvements to the lessor at the end of the lease.

### **3.3.2 Calculation of the allowance in respect of leasehold improvements included under paragraph (*h*)**

The allowance is generally calculated as being equal to the difference between the amount included in gross income under paragraph (*h*) and the present value of that amount. The present value of the amount included in the lessor’s gross income is generally determined by discounting that amount<sup>31</sup> to its present value at 6% over the original period for which the right of use or occupation was granted or, in the case of an agreement concluded on or after 1 July 1983, the same period as that in which the lessee is granted a deduction under section 11(*g*) (see **3.2.3**). This period would include renewal periods. In addition, the special factors mentioned in **3.3.1** must be appropriately taken into account. Therefore, although the maximum period for a deduction under section 11(*g*) is 25 years, there could be special circumstances which justify determining the present value over a longer period. For example, in the case of a 99 year lease it may be appropriate to use a longer discounting period. The Commissioner’s decision is not subject to objection and appeal.<sup>32</sup>

<sup>31</sup> See **3.1.2(a)** and **3.1.2(b)** – in some cases the amount included in gross income will be the fair and reasonable value of the improvements and that may equate to the cost of the improvements.

<sup>32</sup> Section 3(4).

### 3.3.3 Exclusion from the allowance

No allowance is permitted under section 11(h) when the right to have improvements effected accrued to the lessor on or after 29 March 1972 and –

- either the lessor or lessee is a company and the lessee or the lessor, as appropriate, has an interest in more than 50% of any class of shares issued by that company, whether directly as a holder of shares in that company or indirectly as a holder of shares in any other company; or
- both the lessor and lessee are companies and any third person has an interest in more than 50% of any class of shares issued by one of these companies and in more than 50% of any class of shares issued by the other company, whether directly as a holder of shares in the company by which the shares were issued or indirectly as a holder of shares in any other company.

An indirect holding is determined by ascertaining the effective interest of the holder of shares, namely, by multiplying the respective percentage holdings in the chain of companies. For example, if Individual X owns 90% of Company A and Company A owns 65% of Company B, Individual X has an indirect interest of  $90\% \times 65\% = 58,54\%$  in Company B. There is no limitation on the number of companies through which the shareholding must be traced.

### 3.3.4 Recoupment of the allowances allowed

Under section 8(4)(a), a lessor must include in income any amount received or accrued to the extent to which such amount represents a recovery or recoupment of allowances previously granted under, amongst others, section 11(h).

#### **Example 3 – Recoupment**

*Facts:*

Property B cost Lessor A R100 000. Under the lease agreement between Lessor A and Lessee B, Lessee B was required to erect improvements to the value of R400 000 over the 99-year period of the lease.

Lessor A was previously required to include R400 000 in gross income and was granted an allowance of R325 000 under section 11(h).

During the current year of assessment Lessor A sold Property B subject to the lease to C for R375 000, R100 000 related to the purchased portion of Property B and R275 000 related to the leasehold improvement.

*Result:*

Lessor A must include R200 000 [ $R375\ 000^* - \{(Purchased\ Property\ B: R100\ 000 - Rnil) + (Leasehold\ improvement: R400\ 000 - R325\ 000^*)\}$ ] in income under section 8(4)(a).



\* Section 8(4)(a) is a section which recoups allowances or set-offs previously deducted under the specified sections. Although not specified in the Act, the following formula calculates the amount of the recoupment that can arise under section 8(4)(a): Selling price (up to a maximum of original cost) less tax value. In the context of a recoupment of an allowance granted under section 11(h), the same principles are applicable even if the terminology is not accurate, "original cost" is equivalent to the amount included in the lessor's gross income and "tax value" is equivalent to the amount included in the lessor's gross income less any deduction claimed by the lessor. The sale of Property B includes the purchased Property B and the leasehold improvement and both of these components must be taken into account when calculating the recoupment. The calculations in this example include both components; separate calculations would yield the same result. For example, the full selling price of R375 000 is included in the formula because it does not exceed "original cost" of R500 000 (R100 000 purchased building B + R400 000 amount included in the lessor's gross income).

Lessor A's capital gain is calculated as follows:

- Proceeds = R375 000 – R200 000 under paragraph 35(3)(a) of the Eighth Schedule (Note 1) = R175 000
- Base Cost = (R100 000 Property B under paragraph 20(1)(a) of the Eighth Schedule (Note 2) + R75 000 under paragraph 20(1)(h)(ii)(cc) of the Eighth Schedule (Note 3)) = R175 000
- Capital gain = Proceeds of R175 000 – Base cost of R175 000 = Rnil

**Note:**

- 1) Under 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 namely, the section 8(4)(a) recoupment.
- 2) Under paragraph 20(1)(a) the base cost of Property B will be the expenditure actually incurred in acquiring the asset.
- 3) Under paragraph 20(1)(h)(ii)(cc), the base cost of Property B in the hands of Lessor A will 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).

**Example 4 – Recoupment**

*Facts:*

Property B cost Lessor A R100 000. Under the lease agreement between Lessor A and Lessee B, Lessee B was required to erect improvements to the value of R400 000 over the 99-year period of the lease.

Lessor A was previously required to include R400 000 in gross income and was granted an allowance of R325 000 under section 11(h).

During the current year of assessment Lessor A sold Property B subject to the lease to C for R600 000, R100 000 related to the purchased portion of Property B and R500 000 related to the leasehold improvement.

**Result:**

Lessor A must include R325 000 [R500 000\* – {(Purchased Property B: R100 000 – Rnil) + (Leasehold improvement: R400 000 – R325 000\*)}] in income under section 8(4)(a).

- \* Section 8(4)(a) is a section which recoups allowances or set-offs previously deducted under the specified sections. Although not specified in the Act, the following formula calculates the amount of the recoupment that can arise under section 8(4)(a): Selling price (up to a maximum of original cost) less tax value. In the context of a recoupment of an allowance granted under section 11(h), the same principles are applicable even if the terminology is not accurate, “original cost” is equivalent to the amount included in the lessor’s gross income and “tax value” is equivalent to the amount included in the lessor’s gross income less any deduction claimed by the lessor. The sale of Property B includes the purchased Property B and the leasehold improvement and both of these components must be taken into account when calculating the recoupment. The calculations in this example include both components; separate calculations would yield the same result. For example, selling price is limited to R500 000 (R100 000 purchased building B + R400 000 amount included in the lessor’s gross income).

Lessor A’s capital gain is calculated as follows:

- Proceeds = R600 000 – R325 000 under paragraph 35(3)(a) of the Eighth Schedule (Note 1) = R275 000
- Base Cost = (R100 000 Property B under paragraph 20(1)(a) of the Eighth Schedule (Note 2) + R75 000 under paragraph 20(1)(h)(ii)(cc) of the Eighth Schedule (Note 3)) = R175 000
- Capital gain = Proceeds of R275 000 – Base cost of R175 000 = R100 000

**Note:**

- 1) Under 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 namely, the section 8(4)(a) recoupment.
- 2) Under paragraph 20(1)(a) the base cost of Property B will be the expenditure actually incurred in acquiring the asset.
- 3) Under paragraph 20(1)(h)(ii)(cc), the base cost of Property B in the hands of Lessor A will include the excess of the amount that had been included in Lessor A’s gross income under paragraph (h) in respect of obligatory improvements effected by the lessee over the special allowance granted to Lessor A in terms of section 11(h).

#### **4. Conclusion**

This Note deals with the tax treatment of leasehold improvements for lessors and lessees.

Paragraph (*h*) applies when a right to have improvements effected on land or to buildings by a lessee accrues to the lessor under an agreement. Depending on the facts, the amount included in the agreement as the value or cost of the improvements or the fair and reasonable value of the improvements will be included in the lessor's gross income in the year the right to have the improvements effected accrues to the lessor. Under section 11(*g*) the lessee, who is obliged to effect improvements under the lease agreement, may, subject to certain limitations, deduct the expenditure actually incurred over the remaining period of the lease calculated from the date of completion of the improvements.

In limited circumstances a lessor may be entitled to a special allowance under section 11(*h*) in respect of leasehold improvements included in gross income under paragraph (*h*). The amount of the allowance, if it applies, is equal to such amount as the Commissioner deems reasonable, taking into account the special circumstances of the case and the length of the lease. For example, an allowance may be granted when there is a significant delay for the lessor between the time of accrual of the leasehold improvement under paragraph (*h*) and the time when the lessor physically receives the benefit of the improvement.

Depending on the facts, an allowance granted under sections 11(*g*) and 11(*h*) must be recouped under section 8(4)(*a*).

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