SARS South African Revenue Service

BINDING PRIVATE RULING: BPR 079

DATE: 12 March 2010

ACT	**:**	**INCOME TAX ACT, NO. 58 OF 1962 (the Act)**
SECTION	**:**	**SECTION 1, PARAGRAPH (*h*) OF THE DEFINITION OF "GROSS INCOME" AND SECTIONS 11(*a*), 22 AND 11(*h*)**
SUBJECT	**:**	**INCOME TAX IMPLICATIONS FOR THE LAND OWNER AND THE DEVELOPER RELATING TO THE ESTABLISHMENT OF A RESIDENTIAL TOWNSHIP DEVELOPMENT IN TERMS OF LEASE AGREEMENTS**

1. Summary

This ruling deals with the income tax implications for the land owner and the developer relating to the establishment of a residential township development (improvements) in terms of lease agreements.

2. Relevant tax laws

This is a binding private ruling issued in accordance with section 76Q of the Act

In this ruling legislative references to sections are to sections of the Act applicable as at 31 July 2007 and unless the context indicates otherwise, any word or expression in this ruling bears the meaning ascribed to it in the Act.

This ruling has been requested under the provisions of –

- section 1, paragraph (*h*) of the definition of "gross income";
- section 11(*h*);
- section 11(*a*); and
- section 22.

3. Parties to the proposed transaction

The Applicants:	Property Owning Company (Propco)
	Property Development Company (Devco)
	Holding company of Propco (Holdco)
	Fellow subsidiary of Propco (Subco)

4. Description of the proposed transaction

The transaction entails the development of a portion of a farm for the purposes of establishing the development. This development encompasses the installation of infrastructure, completion of the common facilities and buildings on the township land and the disposal of serviced stands to End Lessees, including the conclusion of a Residential Building Construction Agreement (RBC Agreement) by each End Lessee to construct a residential building on the serviced stand.

Transaction Details

Step 1: The farm is leased by Subco to Holdco in perpetuity. The farm will be subdivided into various distinct portions or subdivisions.

Step 2: A subdivided portion will, while it is still subject to the Notarial Deed of Lease/Perpetual Lease, be sold to Propco. The amount payable for the subdivided portion will be minimal due to the fact that the farm is burdened with the Perpetual Lease in favour of Holdco and the *bare dominium* which is held by Subco will therefore hold minimal value. The selling price for the subdivided portion will be debited and credited to loan accounts in the books of Subco and Propco respectively (that is, debit to the loan account – Propco and credit to the loan account – Subco).

Step 3: The Perpetual Lease will be cancelled in respect of the subdivision sold to Propco. Propco will pay an amount to Holdco for the release of the rights in terms of the Perpetual Lease.

Step 4: Propco will enter into a Main Lease with Devco, whereby Propco will lease the subdivided portion to Devco at a nominal rental of R100 per annum to provide security to Devco in respect of Devco's development costs. In terms of the Main Lease Devco is under obligation to effect the development.

Step 5: Propco will enter into a Construction and Development Agreement (C&D Agreement) with Devco for the purpose of the development, including a further division (of the subdivision) into serviced stands.

Step 6: Propco will, in terms of the Lease Agreement (herein after referred to as the End Lease) lease the serviced stands to End Lessees after Devco agreed to release the relevant stands from operation of the Main Lease, for a period of 99 years renewable at the option of the End Lessee. The proceeds received by Propco in terms of each End Lease shall accrue to Propco and Devco in the agreed ratio set out in the C&D

Agreement and will become payable to Propco and Devco upon registration of an End Lease. The End Lease is subject to the End Lessee concluding a separate RBC Agreement with Devco or an approved developer, to erect a residential building on the serviced stand. Devco will facilitate the conclusion of the End Lease, on behalf of Propco.

Step 7: Once the End Leases and RBC Agreements are concluded, the Main Lease will be cancelled.

Step 8: Devco or the approved developer chosen by the End Lessee will erect a residential building on the serviced stand in terms of the RBC Agreement entered into with the End Lessee. In terms of common law of accession, the residential buildings will accede to the stands and Propco will become the owner of the residential buildings. No amount is payable to the End Lessees by Propco in respect of the accession.

Step 9: The proceeds from the disposal will accrue to each party according to the agreed ratio and will become payable to Propco and Devco upon registration of an End Lease. Development costs plus a margin will be recovered by Devco through receiving a portion of the disposal price of serviced stands (effectively as a fee for developing the property) from Propco.

Renewal options available to End Lessees:

- The End Lessee can elect to extend the End Lease without effecting a cancellation, as envisaged in the End Lease, in which case the End Lessee is required to pay an amount equal to 5% of the fair market value of the serviced stand (including improvements thereon) plus VAT. The End Lessee will be required to enter into an agreement recording such extension, which agreement is to be notarially executed and registered in the office of the Registrar of Deeds.

- The End Lessee can also elect to extend the End Lease by cancelling the End Lease and entering into a proposed Replacement End Lease (Replacement End Lease) with Propco, as envisaged in the Replacement End Lease.

Disposal of leasehold rights by the End Lessee:

- The End Lessee can further elect to dispose of the leasehold rights by ceding and delegating the rights and obligations to a Third Party, as envisaged in the Agreement in respect of the Cession of Rights and Delegation of Obligations under a lease agreement (Cession Agreement). No amount is payable by the Third Party to Propco if the

Third Party elects to register the new End Lease for the balance of the term of the initial End Lease (that is, no cancellation of the End Lease).

- The Third Party, in buying the End Lease, can elect to cancel the End Lease and a Replacement End Lease will be granted by Propco to the Third Party, as envisaged in the Replacement End Lease. The Third Party will not have to pay any amount to Propco, where the End Lease is cancelled within three (3) years after the date of the first registration. The Third Party will have to pay an amount equal to 5% of the greater of the disposal price or fair market value of the serviced stand (including improvements thereon), plus an amount equal to the VAT payable by Propco in terms of section 18(1) of the Value-Added Tax Act, No. 89 of 1991.

5. Conditions and assumptions

This ruling is made subject to the conditions and assumptions that –

- the proposed transaction, in its entirety, is not part of or connected with any other transaction, operation or scheme; and
- the rights acquired under the Main Lease entered into between Propco and Devco will only be regarded as trading stock in the hands of Devco to the extent that Devco will acquire the rights for the purpose of subdivision, development and subsequent disposal to End Lessees by means of 99 year leases.

6. Ruling

The ruling made in connection with the proposed transaction is as follows:

Propco

- Propco acquired a legal right to have improvements effected in terms of the C&D Agreement entered into with Devco in respect of the proposed transaction and Devco is under a legal obligation to effect the improvements.
- Propco must include in its gross income the value of all improvements effected by Devco in terms of paragraph (*h*) of the definition of “gross income” in section 1.
- Propco must further include in its gross income the value of all improvements effected by End Lessees in terms of paragraph (*h*) of the definition of “gross income” in section 1.
- Having regard to the special circumstances of this transaction, Propco will be allowed as a deduction from its income an allowance in terms of section 11(*h*) in respect of amounts included under paragraph (*h*) of the definition of “gross income” in section 1. The allowance will be

determined by using the present value of the development cost discounted at 6% over a 99 year period.

- Any amount received by or accrued to Propco in respect of a renewal or extension of an End Lease must be included in its "gross income" as defined in section 1.

Devco

- The rights acquired under the Main Lease constitute trading stock in the hands of Devco. It follows that Devco will be entitled to a deduction under section 11(*a*) read with section 22 in respect of its development costs incurred.

7. Period for which this ruling is valid

This binding private ruling is valid for a period of five (5) years as from 11 May 2007 or until the end of the Applicants' year of assessment during which the development is completed, as contemplated in the C&D Agreement, whichever is the earlier.

Issued by:

Legal and Policy Division: Advance Tax Rulings
SOUTH AFRICAN REVENUE SERVICE