INCOME TAX NATURE OF REIMBURSEMENTS RELATING TO LEASEHOLD IMPROVEMENTS

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Summary

It is becoming increasingly common for lessees to receive contributions from lessors towards leasehold improvements costs. A lessee will be entitled to claim an allowance in terms of section 11(g), where expenditure has actually been incurred in pursuance of an obligation in terms of a lease agreement, and the property is used for the production of income. Obstacles arise where the lessee either receives a payment or benefit, in cash or otherwise from the lessor, either as consideration for the lessee to effect the improvements or as inducement for the lessee to enter into the lease agreement. The nature of these payments or benefits received by the lessee for income tax purposes needs to be assessed with reference to the general principles laid down by the South African courts in respect of the “gross income” definition and international case law dealing with the income tax treatment of similar payments made by the lessor to the lessee. Factors also need to be identified, which should be taken into account to assess the income tax nature of these payments or benefits. The terms of the agreement in terms of which such payments or benefits are made should clearly state the purpose thereof, and a conclusive answer will depend on the particular circumstances and facts of each case. The interaction between a payment or benefit received by a lessee and the availability of a leasehold improvements allowance in terms of section 11(g) is a complex matter and it remains to be seen how South African courts will deal with these issues.

Die inkomstebelastingaard van bydraes ontvang deur die huurder met betrekking tot huurverbeteringe

Dit raak toenemend algemeen dat huurders ’n bydrae tot huur verbetering koste vanaf verhuurders ontvang. ’n Huurder sal geregtig wees om ’n artikel 11(g) toelaag te eis, waar onkostes werklik aangegaan is ter voldoening aan ’n verpligting ingevolge die huurooreenkoms en die eiendom word gebruik vir die voortbrenging van inkomste. Struikelblokke ontstaan waar die huurder ’n bedrag of voordeel, in kontant of andersins ontvang vanaf die verhuurder, as vergoeding vir die aanbring van verbeteringe of as beweegrede om die huurooreenkoms te sluit. Die inkomstebelastingaard van hierdie bedrae of voordele ontvang moet beoordeel word met verwysing na die algemene beginsels ontwikkel deur die Suid-Afrikaanse howe met betrekking tot die “bruto inkomste” definisie en internasionale hofsake wat handel met die inkomstebelastinghantering van soortgelyke betalings vanaf die verhuurder aan die huurder. Faktore moet ook identifiseer word wat inag geneem moet word ten einde die aard van hierdie bedrae of voordele vas te stel. Die terme van die ooreenkoms ingevolge waarvan die bedrag of voordeel ontvang word, moet duidelik die doel daarvan uiteensit. ’n Beslissende antwoord sal afhang van die spesifieke omstandighede en feite van elke geval. Die interaksie tussen ’n betaling of voordeel ontvang deur die huurder en die beskikbaarheid van ’n huurverbeteringe toelaag ingevolge artikel 11(g) is ’n komplekse onderwerp en daar sal nog gesien moet word hoe die Suid-Afrikaanse howe hierdie kwessies sal hanteer.

1. Introduction

Taxpayers are often faced with the choice of buying or leasing property to carry on their business operations. Many factors may influence this decision and each option has its own benefits and disadvantages. Where a taxpayer decides to lease property, such property is often not suitable and improvements are required to convert and equip the property to a suitable condition prior to commencing business operations. Depending on the

financial position of the lessee and lessor and the nature of the improvements, the parties will decide who will be responsible for effecting the improvements and incurring the related costs.

There is an increasing tendency that lease agreements place contractual obligations on lessors to make payments or grant benefits to lessees, either as reimbursement for the improvements effected or as inducement for entering into the lease agreement. This article will focus on instances where a lessee is responsible for effecting improvements to the leased property, and will consider the circumstances where the lessor remunerates the lessee in cash or otherwise.

The amounts payable to the lessee may be in the form of:

- A rent inducement payment;

- Reimbursement of the leasehold improvements expenditure through a tenant installation allowance; and

- Granting of the free right of use of the leased property until all the leasehold improvements expenditure have been recovered by the lessee.

These payments and benefits cause many uncertainties, not only with regard to the income tax nature thereof, but also with regard to the availability of the leasehold improvements allowance in terms of section 11(g).

The writer could not find any South African case law that deals with these issues simultaneously, nor could South African case law be found that deals with the income tax treatment of these payments or benefits in the hands of the lessee. There is however international case law which deals with the nature of rent inducement payments in the hands of the lessee.

Not many commentators and tax experts have expressed their views on the potential income tax implications of these payments or benefits receivable by a lessee. There are however articles by, amongst others, Clegg, D., Meyerowitz, S.C. and Croome, B.

2. Objective and scope of the paper

The problem statements to be examined in this article are as follows:

- Whether the lessee will be entitled to claim a leasehold improvements allowance, where the lessor makes a payment or grants a benefit to the lessee, either as reimbursement of the leasehold improvements expenditure or as inducement for entering into the lease agreement?

- What is the nature of these payments or benefits in the hands of the lessee?

3. Research method

The research method to be adopted consists of a literature review and application through case studies. South African income tax legislation, South African case law, international case law, opinions expressed in articles as written by South African tax experts and commentators and textbooks are referred to in order to analyse the interaction between section 11(g) and payments or benefits received by a lessee.

4. Requirements of section 11(g)

Leasehold improvements generally constitute construction or improvements effected to a building or premises, which are required by the lessee, subsequent to the approval from the lessor.[1] A need for leasehold

[1] Cornelissen, C. *De Rebus – SA Attorneys' Journal.* Taxation and lease agreements. March 2010.

improvements typically arise where vacant land or a building is leased, which requires specific buildings or items to customise the land or building according to the requirements of the lessee. The need for leasehold improvements may also arise where the lessor does not want to incur costs upfront or is not financially capable of incurring such costs. Section 11(g) was introduced to clarify the income tax position for the lessee. Conversely, paragraph (h) was inserted into the gross income definition in section 1 to deal with the income tax consequences for the lessor.[2]

Section 11(g) reads as follow:

> 11...For the purpose of determining the taxable income derived by any person...shall be allowed as deductions from the income of such person so derived…
>
> (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… (Emphasis added)

The following key requirements can be identified, which all need to be complied with in order for the lessee to claim a section 11(g) leasehold improvements allowance:

- There must be a lease agreement;
- There must be an obligation to effect improvements in terms of the lease agreement;

[2] Paragraph (h) of the gross income definition in section 1 will only be briefly mentioned, in the context of the requirements of section 11(g) (refer to section 11(g)(vi) of the ITA.

- There must be expenditure actually incurred in pursuance of such obligation; and

- The land or building must be used or occupied for the production of income or income must be derived there from.

A further requirement is that the value of the leasehold improvements or the amount to be expended on such improvements should constitute income in the hands of the lessor.

The requirements of section 11(g) are clear and unambiguous, but the practical application thereof may be problematic in certain instances.

4.1 Lease agreement

It is possible in terms of law of contract principles to conclude an enforceable oral lease agreement, but it is submitted that for purposes of claiming a section 11(g) leasehold improvements allowance, that the lease agreement should be reduced to writing. This will ease the burden of proof for the lessee, if the deduction thereof is ever be challenged.

4.2 In pursuance of an obligation in terms of the lease agreement

The Natal Special Court had to specifically decide on whether this requirement was met in *ITC 1615.*[3] The lease agreement in this case contained the following provision:[4]

> …the lessee undertakes and agrees and shall be obliged...to erect such new buildings and/or effect such improvements...upon the leased property...at its own sole cost and expense… (Emphasis added)

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[3] (1990) 59 SATC 264.
[4] At 268.

The CIR contended that:

- the obligation contained in the lease agreement was void for vagueness;

- there was no obligation on the lessee to effect the improvements, nor did the lessee incur expenditure in pursuance of an obligation; and

- the phrase "shall be obliged" did not relate to the improvements but to the costs that the lessee was obliged to bear.[5]

Galgut J, President of the Special Court stated that the determination of an obligation depends on the correct interpretation of the provision in the lease agreement, and that an obligation can only exist if the provision does not leave it to the discretion of the lessee to effect the improvements or not.[6] The following test was laid down in this case:[7]

> It is only if it gives the lessor the right to demand the improvements that it can be said that the lessee is burdened with an obligation to effect them. The test, so the cases say, is whether upon refusal by the lessee to effect the improvements the lessor will have the right to approach a court for an order for specific performance or for damages in lieu thereof. (Emphasis added)

It was held that "shall be obliged" referred to the need to effect improvements, and once it is clear that the lessor has a need that improvements should be effected, an obligation for the lessee is created and the lessor may demand that the improvements are effected. Upon failure by the lessee to effect such improvement, the lessor may sue for specific performance.[8]

In *ITC 1188,*[9] Margo J, President of the Transvaal Special Court had to decide whether an obligation to effect improvements arose where the right of

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[5] At 270.
[6] At 270.
[7] At 270.
[8] At 271.
[9] (1972) 35 SATC 150.

occupation was conditional upon the lessee effecting such improvements, as the lease agreement did not contain an express obligation for the lessee.[10] The SIR contended that it was essential that the obligation to effect improvements in terms of section 11(g), should be legally enforceable and that its breach should entitle the lessor to sue for specific performance or damages.[11] The court held as follow with regard to this contention:[12]

> I doubt whether it was intended in either of these cases to lay down that it was an essential characteristic of an obligation to effect improvements...that the breach thereof should found a claim for specific performance or damages. The reference to these remedies seems to me to have been merely descriptive of the requirement of enforceability. It is certainly a fundamental characteristic of an obligation in the present case that it should be legally enforceable.

The court held that the lessee may have an obligation to effect improvements even in the absence of a right of the lessor to sue for specific performance or damages. The lessee does however have to establish that a legally enforceable obligation to effect the improvements was incurred. The court concluded that the fact that a lease agreement can be terminated upon failure by the lessee to effect improvements does not create a legally enforceable obligation.[13]

There should however be a clear and unambiguous obligation on the lessee in terms of the lease agreement, to effect the leasehold improvements.[14] It also not required that the obligation should be an expressed or explicit term of the lease agreement, and it may therefore be an implied or tacit term of the lease agreement.[15]

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[10] At 153 and 154.
[11] At 154.
[12] At 154.
[13] At 155.
[14] *ITC 1464* (1986) 51 SATC 205.
[15] De Koker, A.P. *Silke on South African Income Tax.* Electronic version. Updated January 2010. At § 8.71. *ITC 1611* (1995) 59 SATC 126 at 150.

If the lessee does not have an obligation to effect the leasehold improvements, it will be regarded as being voluntarily undertaken, and the lessee will not be entitled to claim a leasehold improvements allowance in terms of section 11(g).

Compliance with this requirement is a question of fact. It is however submitted that where there is a breach of contract where the lessee does not effect the improvements and the lessor is entitled to sue for specific performance or damages, this may be indicative that this requirement has been met. In order to determine whether there is an obligation on the lessee, it will be helpful to establish whether the lessor has any legal mechanism to force the lessee to effect the improvements.

The intention of the lessee and lessor at the time when the lease agreement was concluded is an essential factor in establishing whether there is an obligation on the lessee to effect improvements. This will be relevant where there is no express obligation in the lease agreement or where an oral lease agreement was concluded. If the intention of the parties and their subsequent behaviour indicates that there is an obligation on the lessee to effect the improvements, then value should be attached to this intention.

Bearing in mind the contradictory decisions in *ITC 1615* (1996) and *ITC 1188* (1972), it is submitted that the prudent approach should be followed and that a clear and unambiguous obligation on the lessee to effect the improvements, should be evident from the terms of a written lease agreement.

4.3 Expenditure actually incurred

The third requirement of section 11(g) that should be met is that the lessee should actually incur expenditure for leasehold improvements, in pursuance of an obligation in terms of the lease agreement.

The term “expenditure actually incurred” has been dealt with in a number of cases in the context of section 11(a). In order to determine the meaning of this

phrase for purposes of section 11(g), the principles laid down by South African courts in the context of section 11(a) will be applied, as case law dealing with this term in the context of section 11(g) could not be found.

The meaning that should therefore be afforded to the term “expenditure actually incurred” is “expenditure really incurred” or “expenditure for which the taxpayer has in fact become liable for”. Therefore, as long as the lessee has an unconditional liability to incur leasehold improvements expenditure, or the lessee has in fact incurred leasehold improvements costs, in pursuance of an obligation in terms of the lease agreement, this requirement of section 11(g) should be met.

4.4 For the production of income or income is derived there from

The fourth requirement of section 11(g), is that the expenditure actually incurred for the leasehold improvements, in pursuance of an obligation in terms of the lease agreement, should be for the production of the lessee’s income or the lessee should derive income there from.

As noted above in the context of “expenditure actually incurred”, the meaning of “for the production of income” should be considered in the context of case law dealing with section 11(a). The general deduction formula in section 11(a) contains a similar requirement, i.e. “in the production of income”, and it is submitted that these cases would be equally relevant in the context of section 11(g).

The only difference between the section 11(g) and the section 11(a) requirements being, the use of the word “for” instead of the word “in”. In the writer’s view this difference relate to expenses being <u>incurred in the furtherance of the business operations</u> of a taxpayer and such operations produces income (section 11(a)), in comparison to expenses (normally capital in nature) incurred for purposes of the income earning structure of the taxpayer and such structure is <u>utilised for the production of income</u> (section 11(g)) (Emphasis added).

It is submitted that for purposes of section 11(g), that this requirement will be met, as long as the leased property is used by the lessee for purposes of producing income, this requirement should be met.

The alternative requirement of "*income is derived therefrom*", in the writer's view refers to instances where the lessee derives income in the form of rental, from the leased building or land to which the improvements were effected.

4.5 Value of leasehold improvements or amount to be expended should be included in the income of the lessor

The final requirement of section 11(g) that should be met is that the value of the improvements, or the amount to be expended on such improvements should constitute income in the hands of the lessor.[16] To the extent that the lessor's income is exempt from income tax in terms of section 10, or where the lessor is a non-resident that does not derive any income or deemed source income from South Africa, the value of the leasehold improvements or the amount to be expended thereon will not constitute income in the lessor's hands, and the lessee will not be entitled to claim a leasehold improvements allowance.

The following amounts will be included in the gross income of the lessor in terms of paragraph (h) of the gross income definition in section 1:

- Where an amount is stipulated in the lease agreement, the value of the improvements or the amount to be expended on the improvements; or

- Where no amount is stipulated in the lease agreement, an amount representing the fair and reasonable value of the improvements.

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[16] Section 11(g)(vi) of the ITA.

It is the practice of SARS to include the relevant amount in the gross income of the lessor in the year of assessment in which the improvements have been completed, but on a strict reading of paragraph (h) of the gross income definition in terms of section 1, the lessor should be taxed upon conclusion of the lease agreement.[17] The amount included in the lessor's gross income will be deemed to form part of the base cost of its property.[18]

In order to ensure that this requirement is met, it is submitted that written confirmation of the income tax status of the parties to the lease agreement should be obtained, prior to concluding the lease agreement.

4.6 Deduction of leasehold improvements expenditure in terms of section 11(g)

Once all of the above requirements of section 11(g) have been met, the lessee will be allowed to claim a leasehold improvements allowance, in the manner set out below:

- The allowance is limited to the amount stipulated in the lease agreement as the value of such improvements or the amount to be expended on the improvements.[19]

- Where no amount is stipulated in the lease agreement, the allowance may not exceed an amount which in the opinion of the C:SARS represents the fair and reasonable value of such improvements.[20]

- The allowance is calculated as equal annual instalments over the period of the lease agreement, but is limited to 25 years.[21]

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[17] Huxham&Haupt, *Notes on South African Income Tax* [29th Edition] at 201.
[18] Paragraph 20 of the Eight Schedule to the ITA.
[19] Expenses incurred in excess of the amount stipulated in the lease agreement, will be regarded as being voluntarily incurred, and the lessee will not be entitled to claim such excess portion in terms of section 11(g).
[20] Section 11(g)(i) of the ITA.

- Where the property is not used by the lessee for the full year, the allowance is proportionately reduced by the C:SARS,[22] but is not proportionately reduced where the property does not produce income for the full year, due to the termination of the lease agreement.[23]

- The lessee may also be entitled to a building allowance in terms of section 13, in addition to the leasehold improvements allowance.[24]

5 Nature of amount received by or accruing to a lessee

5.1 Gross Income definition

Gross income is defined in section 1 of the ITA as follows:

> "gross income", in relation to any year or period of assessment, means –
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> (i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
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> (ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within the Republic,
>
> during such year or period of assessment, excluding receipts or accruals of a capital nature...

The writer will deal with the following elements of the gross income definition, separately below:

- There must be an amount, in cash or otherwise;

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[21] Section 11(g)(ii) of the ITA. The number of years is calculated from the date on which the improvements have been completed, and it is the practice of SARS not to take into account any extended period of the lease.

[22] De Koker, A.P. *Silke on South African Income Tax.* Electronic version. Updated January 2010. At § 8.71.

[23] Section 11(g)(vii) of the ITA.

[24] The section 11(g) allowance will be limited to the cost of the building or improvements, reduced by any untaxed recoupment set off against such costs and the total allowances claimed in terms of section 13 (section 11(g)(iv) of the ITA).

- Received by or accrued to or in favour of the recipient; and

- It must not be of a capital nature.

All of these elements should be present before an amount may be treated as gross income in the hands of the recipient thereof.

For non-residents, only receipts and accruals derived from a source within or deemed to be within South Africa will be included in gross income (i.e. source principle). It is submitted that the source of the payments or benefits received by the lessee, will not affect the nature thereof.

5.1.1 An amount in cash or otherwise

It has been held that "amount" should be given a wider meaning and must include money and the value of every form of property earned by a taxpayer, whether corporeal or incorporeal, which has a money value.[25] The onus of proving that there is an "amount" for purposes of the gross income definition is on the C:SARS, and the mere fact that an amount is difficult to determine does not mean that there is not an amount.[26]

In *CIR v Delfos*[27] it was held that an asset should have ascertainable money value and should be able to be converted into money.[28] The SCA held in *C:SARS v Brummeria Renaissance (Pty) Ltd and others*[29] that the right to retain and use an interest-free loan had a money value, and that the value of such right should be included in the gross income of the taxpayer for the years in which such rights accrued.[30] The *Delfos* – principle was further expanded in the *Brummeria* – case, and in the *obiter dicta* it was said that an

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[25] *WH Lategan v CIR* (1926) 2 SATC 16 at 19. Confirmed by Hefer JA. in *CIR v People's Stores (Walvis Bay) (Pty) Ltd* (1990) 52 SATC 9 at 19.
[26] *CIR v Butcher Bros (Pty) Ltd* (1945) 13 SATC 21.
[27] (1933) 6 SATC 92.
[28] At 99.
[29] (2007) 69 SATC 205.
[30] At 212.

amount did not have to be turned into money, but merely had to be in the form of an asset which objectively could be turned into money should it be sold.[31]

5.1.2 Received by or accrued to or in favour of

In *Geldenhuys v CIR*[32] it was held that "received by" means to be received by the taxpayer on his own behalf for his own benefit.[33] The courts accepted the principle that an amount "accrued to" a taxpayer when he has become entitled to such amount in *WH Lategan v CIR*[34]*.* In a later case, the court was divided with regards to the meaning of this phrase, but the majority confirmed the principle laid down in the *Lategan* – case.[35] De Villiers JA. and Stratford JA. were however of the view that "accrued to" meant to become "due and payable". The Appellate Division of the Supreme Court finally concluded on this uncertainty and held that the meaning which should be afforded to "accrued to" is when an amount has become unconditionally due and the taxpayer has become entitled to it, thereby confirming the *Lategan* – principle.[36]

It should be noted that the presence of a benefit is not a test for determining whether an amount should be included in gross income.[37]

5.1.3 Capital versus revenue

The courts have over the years given guidance and a variety of tests or guidelines have been developed to determine whether a particular receipt or accrual is of a capital or revenue nature.

In *Lace Proprietary Mines Ltd v CIR*[38]*,* the court held that income is the result of the productive use of capital employed to earn profits.[39] Generally it is

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[31] At 214.
[32] (1947) 14 SATC 419.
[33] At 431.
[34] *WH Lategan v CIR* (supra) at 20.
[35] *CIR v Delfos* (supra) at 99 and 100.
[36] *CIR v People's Stores (Walvis Bay) (Pty) Ltd* (supra) at 22.
[37] *Ochberg v CIR* (1931) 5 SATC 93.

found that “income” is produced through the employment of “capital”, or it is something in the nature of interest (fruit) arising from the principal (tree).[40]

The intention of the taxpayer is of importance in determining the capital or revenue nature of a receipt or accrual.[41] The taxpayer’s intention in this context means the aim or actual purpose of the taxpayer with regard to the amount received or accrued.[42] It was held by Smalberger JA. in the Appellate Division of the Supreme Court, in *CIR v Pick ‘n Pay Employee Share Purchase Trust* that:[43]

> Contemplation is not to be confused with intention in the above sense. In a tax case one is not concerned with what possibilities, apart from his actual purpose, the taxpayer foresaw and with which he reconciled himself. One is solely concerned with his object, his aim, his actual purpose.

The test for determining the intention of the taxpayer is subjective, and involves an enquiry into the taxpayer’s *ipse dixit*, i.e. what the taxpayer professes his/her/its intention to be.[44] The courts will not merely accept the taxpayer’s view of what his/her/its intention was, but will infer the taxpayer’s intention from all the surrounding circumstances relating to the specific transaction.[45] In *CIR v Middelman*[46] the court held that although due consideration and weight must be given to the taxpayer’s *ipse dixit,* it must be considered against the probabilities and objective facts.

The application of another test, the “scheme of profit making test”, also requires an enquiry into the intention of the taxpayer. This test has two characteristics, i.e. the activities must qualify as a business activity and it must

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[38] (1938) 9 SATC 349.
[39] At 358 and 359.
[40] *CIR v Visser* (1937) 8 SATC 271.
[41] *CIR v Stott* (1928) 3 SATC 253.
[42] *CIR v Pick ‘n Pay Employee Share Purchase Trust* (1992) 54 SATC 271 at 281.
[43] (supra) at 281.
[44] *ITC 1185* (1972) 35 SATC 122.
[45] *ITC 1185* (supra) at 124.
[46] (1989) 52 SATC 323 at 327, with reference to *Malan v Kommissaris van Binnelandse Inkomste* 1981 (2) SA 91 (C).

be performed in carrying out a scheme of profit making.[47] It was held in the *Pick 'n Pay Employee Share Purchase Trust* – case that both of these elements should be present before this test can be applied and income can be classified as being revenue in nature. In *C:SARS v Wyner*[48] the Supreme Court of Appeal emphasized that the scheme of profit making element should be considered in isolation, and that a business activity includes a single transaction, not invoked in the carrying out of a business, but of a business or commercial nature. An activity can be ascertained as qualifying as a business activity by applying reasonable and business standards.[49] Therefore, to the extent that it is the intention of a taxpayer that amounts earned should form part of a scheme of profit-making, such amounts will normally be regarded as being revenue in nature and taxable in the hands of the taxpayer.

It is submitted that the recurrence of a receipt or accrual may be an indication that the amount, in cash or otherwise, is not fortuitous and that it is designedly sought for and worked for.[50]

5.1.4 Conclusion on section 1 gross income definition

The essential elements of the gross income definition that should be met in the context of payments or benefits made by a lessor to a lessee are whether such amounts have been received by or accrued to the lessee and whether it is capital or revenue in nature. The additional element that should be met where the lessor agrees to receive reduced or no rental payments from the lessee, is whether such benefit constitutes "an amount in cash or otherwise".

The writer could not find any South African case law that deals with the nature of payments received by a lessee from a lessor as inducement for entering into a lease agreement. This is surprising, as these types of payments are becoming regular occurrences in practice, specifically in the context of new

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[47] *CIR v Pick 'n Pay Employee Share Purchase Trust* (supra) at 279, with reference to *Californian Copper Syndicate v Inland Revenue* 41 SCLR.
[48] (2003) 66 SATC 1.
[49] *CIR v Pick 'n Pay Employee Share Purchase Trust* (supra) at 280.
[50] *CIR v Pick 'n Pay Employee Share Purchase Trust* (supra) at 280.

developments where lessors need to attract anchor tenants. Leading Australian and New Zealand case law will be discussed below, that specifically dealt with rent inducement payments received by a lessee from a lessor. Although international case law has no binding effect in South Africa, they may be valuable and very well influence South African courts. International case law should nevertheless be cautiously approached due to the differences in the basis of taxation in countries.[51]

5.2 Section 8(4)(a) – Recoupment of allowances previously claimed

Section 8(4)(a) provides as follows:

> There shall be included in the taxpayer's income all amounts allowed to be deducted or set off under the provisions of sections 11 to 20...<u>whether in the current or any previous year of assessment which have been recovered or recouped</u> during the <u>current year</u> of assessment... (Emphasis added)

Taxability in terms of section 8(4)(a) is only to recovery or recoupment and these words should be given a wide meaning.[52] It has been held that the word "recoup" means to recover or get back what has been expended, lost or paid, or to compensate.[53] The purpose of section 8(4)(a) is to ensure that a deduction of expenditure was allowed once, and that a taxpayer should not escape taxation if such expenditure was not expensed at all (as a result of it being recouped), whether or not the liability to pay was legally terminated or not.[54] It is also not necessary that the amount included in income, should be revenue in nature, as this is not a requirement of section 8(4)(a).[55] It will therefore not matter whether the payments or benefits received from the lessor is capital or revenue in nature in the hands of the lessee.[56] The mere fact that the lessee will be reimbursed for expenditure incurred will result in a

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[51] De Koker, A.P. *Silke on South African Income Tax.* Electronic version. Updated January 2010. At § 25.4.
[52] *Omnia Fertilizer Ltd v C:SARS* (2003) 65 SATC 159 at 162. *ITC 1704* (1997) 63 SATC 258 at 262.
[53] *Omnia Fertilizer Ltd v C:SARS* (supra) at 163.
[54] *Omnia Fertilizer Ltd v C:SARS* (supra) at 163.
[55] *ITC 1704* (supra) at 262.
[56] De Koker, A.P. *Silke on South African Income Tax.* Electronic version. Updated January 2010. At § 4.58.

recoupment for income tax purposes. There should thus be a link between the receipt and expenditure incurred to determine whether there is indeed a recoupment for purposes of section 8(4)(a), i.e. there must have been a reduction in the expenditure claimed. The lessee should therefore be compensated for expenditure incurred and a deduction in respect of such expenditure should be claimed.

Section 8(4)(a) does not address the situation where an upfront tenant installation allowance or rent inducement payment is received by the lessee, prior to any expenditure being incurred and prior to any leasehold improvements allowances being claimed. On a strict reading of section 8(4)(a), it only provides for a recoupment of allowances claimed during the current and previous years of assessment, and not for any future allowances. It is therefore submitted that there can be no recoupment in terms of section 8(4)(a) where the payment or benefit is received from the lessor prior to the lessee incurring expenditure and claiming an allowance.

6 Types of amounts receivable by the lessee

6.1 Rent inducement payments

As noted above, no South African case law could be found that deals with rent inducement payments and the nature of rent inducement payments will thus be discussed with reference to international case law.

In *Federal Commissioner of Taxation v Cooling*[57] the Federal Court of Australia had to decide whether an incentive payment made by a lessor to a lessee, should be included in the taxable income of the lessee. This case involved a firm of solicitors who received an offer from a lessor to relocate its practice to new premises. The firm was not required to, but expensed the cash payment on leasehold improvements. Cooling, one of the partners of the

[57] [1990] 94 ALR 121.

firm disclosed his share of the incentive payment in his return as not taxable. The court concluded that the payment constituted income and is accordingly taxable in the hands of the taxpayer.[58]

Hill J. held as follows:[59]

> Where a taxpayer operates from leased premises, the move from one premises to another and the leasing of the premises occupied are acts of the taxpayer in the course of its business activity just as much as the trading activities that give rise more directly to the taxpayer's assessable income.
>
> ...Why then should a profit received during the course of business where the making of such a profit was an ordinary incident of part of the business activity of the firm not be seen to be income in ordinary concepts? (Emphasis added)

It was also held that it is possible to have a scheme of profit-making even if the sole or dominant purpose of entering into a transaction was not to make profit.[60] A common sense approach was applied and it was held that the firm entered into a commercial transaction (conclusion of the lease agreement) that formed part its business activities, and the obtaining of a commercial profit by way of the incentive payment was a significant purpose of this transaction.[61]

The New Zealand Privy Council also had to assess the income tax nature of a similar receipt for the first time in *CIR v Wattie.*[62] The taxpayers were representatives of an accounting firm and negotiated new leased premises during the early 1990's, when owners and developers of buildings were anxious to secure anchor tenants, and were prepared to enter into negotiations to attract such tenants. The firm was aware that it could be an

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[58] The principles laid down in *Federal Commissioner of Taxation v Myer Emporium Ltd* (1987) 163 CLR 199; 71 ALR 29 were applied.
[59] At 135 and 136.
[60] At 136.
[61] At 136.
[62] [1999] 1 NZLR 529.

anchor tenant and that it had bargaining power and could expect significant incentive offers from lessors. It was offered a substantial lump sum inducement payment of $5 million, which effectively reduced its rental payments. In the partnership's income tax return, the $5 million inducement payment was disclosed as a capital receipt.

The Commissioner disputed the income tax treatment of the $5 million inducement payment. The Privy Council held that the $5 million receipt did not arise from the firm's normal business operations,[63] and that the payment could not be regarded as arising from an ordinary incident of firm's business. The *Cooling* – decision was rejected and it was held that this decision should not be followed in New Zealand.[64]

The Privy Council agreed with the submission by the firm that the inducement payment was of the same nature as a lease premium which is normally capital, except that a lease premium is a payment made by a lessee to a lessor.[65] The Privy Council continued that the inducement payment was in this case paid by the lessor to the lessee as consideration for undertaking an onerous lease for a substantial period, and that the payment was a "mirror image" of a lease premium (also referred to as "a negative lease premium").[66]

On an appeal from the Full Federal Court of Australia to the High Court of Australia, the nature of an inducement payment was again the subject under review in *Federal Commissioner of Taxation v Montgomery*[67]*.* This case also involved a firm of solicitors of which the taxpayer was a partner. The firm initially leased two buildings and effected extensive improvements to one of the leased buildings. Shortly thereafter, the lessor informed the firm that it intended to clear all of its buildings from asbestos and that it was envisaged that this operation could extend over three or more years. The firm could not occupy the buildings while the work was carried out and therefore had to

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[63] At 535.
[64] At 535 and 536.
[65] At 539.
[66] At 539.
[67] [1999] 198 CLR 639.

relocate. Various options were considered and the firm ultimately accepted an offer to enter into a new lease agreement for a period of 12 years. Another agreement was entered into that provided for an inducement payment of approximately $30 million payable to the firm over a three year period, as consideration for the firm entering into the lease agreement. The firm applied the first tranche of payment towards "fit-out" costs for the new premises, and also incurred substantial costs for the termination of its earlier lease and relocation to the new premises.

The Federal Court of Australia[68] found that the inducement payment was revenue in nature and subject to income tax. The *ratio decidendi* of the decision by Jenkinson J. was that the payment was consideration for the firm entering into the new lease agreement and that it was received by the firm in the course of carrying on its business.[69] The court *a quo* therefore confirmed the earlier *Cooling* – decision.

The taxpayer appealed to the Full Federal Court of Australia[70] who held in separate judgements that the inducement payments did not constitute ordinary business income of the firm, and was therefore not taxable.[71] Heerey J. rejected the *Cooling* – decision[72] and concurred with the principle laid down in the *Wattie* – case. The distinction drawn between a lease premium and inducement payment was however rejected and it was held that the inducement payment is a payment made by the lessor to the lessee, and that such payment is capital in nature. Davies J. held that the conclusion of the lease agreement was an activity relating to the structure of the firm's business, and that the inducement payment was a once and for all amount that arose from a capital transaction involving the lease.[73] He went on to say that there was no evidence that the firm was involved in a scheme of profit making, and if the substantial costs of terminating the earlier lease and

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[68] Reported as *Montgomery v Federal Commissioner of Taxation* 97 ATC 4287.
[69] Under paragraph 17 at 647 and 648.
[70] Reported as *Montgomery v Federal Commissioner of Taxation* 98 ATC 4120.
[71] Under paragraph 18 at 648.
[72] Based thereon that there was no profit or gain, by taking the whole transaction into account.
[73] Referring to the *British Insulated and Helsby Cables Ltd v Atherton (HM Inspector of Taxes)*-case (supra).

relocation were taken into account, the firm did not make any profit. Lockhart J. distinguished the facts of the present case from the *Cooling* – case in that the firm in the present case was required to relocate due to a statement made by the lessor (clearing all of its buildings from asbestos), and that such relocation was not initiated by the lessee as in *Cooling.*

The Commissioner appealed to the High Court of Australia, where a four to three majority, found that the inducement payment was revenue in nature and subject to income tax. The court confirmed the conclusion reached in the *Cooling* – case, but based its decision on a more general approach by applying basic capital versus revenue principles. It was held that the receipts did not add to the firm's "profit-yielding structure", and that the lease was acquired as part of their "profit-yielding structure", while the inducement payment was not. The court also rejected the analogy between an inducement payment and lease premium, by making the following distinction between these concepts:[74]

> A lessee who pays a premium for a lease obtains the advantage of the lease and that lease may well form part of the profit-yielding structure of the lessee's business. The amount outlaid as premium would, in those circumstances, be outlaid on capital account. But an amount received by a lessee on agreeing to take a lease is not necessarily of the same character even if the lease is properly regarded as being part of the profit-yielding structure of the lessee's business.

It is interesting to note that the majority of the court agreed with the taxpayer's contention that the lease agreement which gave rise to the inducement payment, did not form part of the firm's ordinary course of business.[75] This conclusion was reached by looking into previous leases and sub-leases entered into by the firm and the fact that no inducement payments were

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[74] Under paragraph 97 at 670 to 671.
[75] Under paragraph 102 at 672.

previously received by the firm (something that was not considered in the *Cooling* – case[76]).

As the purpose of a rent inducement payment is to attract a lessee to enter into a lease agreement, it is submitted that there is no link between the rent inducement payment received by the lessee and any improvements costs incurred. To the extent that there is a link between the receipt and the expenditure incurred, it is submitted that the receipt would be more in the nature of a tenant installation allowance (refer to discussion in 6.2). Where the lessee thus incurs improvements costs, it will be entitled to claim a leasehold improvements allowance in terms of section 11(g). Furthermore, as there is no reimbursement of the improvements costs incurred, there should be no recoupment for purposes of section 8(4)(a), when a rent inducement payment is received by a lessee.

The rent inducement payment will also not have any CGT implications, as a disposal[77] is required to trigger a CGT event, and it is submitted that there is no disposal for CGT purposes upon receipt of the rent inducement payment, although there may be proceeds[78] for CGT purposes with no base cost[79].

6.2 Reimbursement of improvements costs incurred by the lessee (tenant installation allowance)

The lessor can reimburse the lessee for improvements costs incurred either by way of an upfront lump-sum tenant installation allowance or upon completion of the improvements, or by making direct payments to third party contractors when the improvements are effected.

Where the lessee receives a tenant installation allowance from the lessor and is contractually obliged to utilise the amount for purposes of effecting the

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[76] Maples, A. *Journal of Australian Taxation.* "Are Lease Incentives Taxable?" – A Trans-Tasman Comparison. [2000] JIA Tax Volume 14. At 4.4.1.
[77] Paragraph 11 of the Eight Schedule of the ITA.
[78] Paragraph 35 of the Eight Schedule of the ITA.
[79] Paragraph 20 of the Eight Schedule of the ITA.

improvements, there is an amount in cash, for purposes of the gross income definition. It will however have to be determined whether the cash amount is received by or accrued to the lessee, and whether it is capital or revenue in nature.

It is uncertain whether the lessee will "receive" a tenant installation allowance on its own behalf and for its own benefit, as the amount was provided for a specific purpose, i.e. to effect improvements. It would however still need to be considered whether the cash amount "accrued to" the lessee. It was held that "accrued to" means that the taxpayer should be unconditionally entitled to the amount,[80] which will be the case when a tenant installation allowance is paid by the lessor, based thereon that the lessee will become unconditionally entitled to the cash amount as soon as it incurs the improvements costs.

In order to determine the capital or revenue nature of the amount, due consideration should be given to the intention of the lessee against the probabilities and objective facts.[81] A further test which may assist in determining the intention of the lessee is the scheme of profit making test. Firstly, it would have to be considered whether the tenant installation allowance qualifies as a business activity, and secondly whether the amount was acquired as part of a scheme of profit making.[82] The recurrence of the tenant installation allowance is not a decisive factor, but may be an important factor. It would also need to be considered whether the tenant installation allowance was designedly sought for and worked for by the lessee or whether it was merely a fortuitous receipt.[83] A conclusive answer regarding the nature of a tenant installation allowance can only be provided once the terms of the (lease) agreement and the intention of the lessee have been considered. (Refer to Case Study 2 for the application of these guidelines to facts.)

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[80] *WH Lategan v CIR* (supra).
[81] *CIR v Middelman* (supra).
[82] *CIR v Pick 'n Pay Employee Share Purchase Trust* (supra).
[83] *CIR v Pick 'n Pay Employee Share Purchase Trust* (supra).

The lessee will be entitled to claim a leasehold improvements allowance in terms of section 11(g), to the extent that all the requirements have been met. Where the lessee enters into agreements with third party contractors in its own name, it will have an unconditional liability for payment, as these contractors can legally demand payment of their accounts. The fact that the lessee will utilise the tenant installation allowance to incur the improvements costs, will not change the fact that expenditure has been incurred, as the tenant installation allowance is merely a method of settlement.[84] It is therefore submitted that the lessee will be entitled to claim a leasehold improvements allowance in terms of section 11(g), to the extent that the other requirements of section 11(g) are met.

The final matter for consideration is whether the tenant installation allowance will result in a recoupment of section 11(g) allowances claimed. The writer's findings are set out below:

- Upfront tenant installation allowance or direct payments to service providers – There is an anomaly between section 11(g) and section 8(4)(a), where an upfront lump-sum tenant installation allowance is received by or accrues to the lessee. Say, the tenant installation allowance is received in year 1. A section 11(g) allowance may only be claimed during the year of assessment in which the leasehold improvements have been completed, e.g. year 3. During year 1 when there is a reimbursement of the improvements costs, no allowance have been claimed and section 8(4)(a) does not refer to allowances claimed in future years of assessment. It is therefore submitted that there can be no recoupment of section 11(g) leasehold improvements allowances, for purposes of section 8(4)(a).

- Tenant installation allowance upon completion of improvements – The applicability of section 8(4)(a) will depend on the timing of the receipt or

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[84] *ITC 1801* (supra).

accrual, i.e. whether it is received before or after section 11(g) allowances have been claimed. To the extent that it is received before any allowances have been claimed, the same principles discussed above will apply, and there will be no recoupment in terms of section 8(4)(a). Where the tenant installation allowance is however received after the lessee has commenced with the claiming of section 11(g) leasehold improvements allowances, the allowances claimed in the year of such receipt and any previous years of assessments, would have to be included in the lessee's taxable income. The section 11(g) leasehold improvements allowances claimed in the future years of assessment will in the writer's view not fall within the ambit of section 8(4)(a), as the wording of this provision does not make provision for such circumstances.

6.3 Reduced or no rental payments

There may also be instances where the lessor agrees to receive reduced rental payments or no rental payments from the lessee, either as reimbursement of improvements costs incurred by the lessee or as inducement for the lessee for entering into the lease agreement.

Although the lessee does not receive a tangible asset or cash, it will receive a benefit. The presence of a benefit is however not a test for determining whether an amount should be included in the lessee's gross income.[85] It is submitted that there is an "amount in cash or otherwise", as an "amount" includes every form of corporeal or incorporeal property, which has a money value.[86] It was further held that where a right has a money value, then the value of such right should be included in the gross income of a taxpayer.[87] The benefit will also accrue to the lessee as it will become unconditional entitled thereto in terms of the lease agreement, upon incurring the leasehold improvements costs. The only issue for consideration is therefore whether such benefit is capital or revenue in nature. It is submitted that the intention of

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[85] *Ochberg v CIR* (supra).
[86] *WH Lategan v CIR* (supra). *CIR v People's Stores (Walvis Bay) (Pty) Ltd* (supra).
[87] *C:SARS v Brummeria Renaissance (Pty) Ltd and others* (supra).

the lessee upon accrual of the benefit should be assessed, by looking at the purpose with which the lessor grants the benefit.

If the purpose of the concession in rental payments is to induce the lessee to enter into the lease agreement, it is submitted that the benefit will be in the nature of a rent inducement payment (refer to discussion in 6.1). To the extent that the concession in rental payments is however to reimburse the lessee for incurring leasehold improvements costs, the benefit will assume the nature of a tenant installation allowance (refer to discussion in 6.2). In this instance, it is however important to consider the legal principle of "set-off", i.e. can the rental payments legally be set-off against the improvements costs? Set-off legally means that one debt is cancelled by another and it can only take place when debts are mutually owed by two persons, i.e. each person is simultaneously the debtor and creditor.[88] There can however be no set-off of the rental payments against the improvements costs, as both obligations[89] will be due by the lessee. In the absence of corresponding obligations by the lessee and lessor, the concession granted by the lessor for rental payments will not affect the availability of a leasehold improvements allowance in terms of section 11(g) for the lessee. The lessee will therefore actually have incurred expenditure, and provided the expenditure is incurred in pursuance of an obligation in terms of the lease agreement and the property is used for the production of income, the lessee will qualify for an allowance in terms of section 11(g).

It is further submitted that the lessor's waiver of the claim for rental payments, resulting in the lessee being relieved from the obligation to make rental payments, will result in a recoupment in terms of section 8(4)(m). The lessee will be entitled to a deduction of the rental payments in terms of section 11(a) as expenditure will be actually incurred due to the unconditional liability to make rental payments in terms of the lease agreements. In terms of section 8(4)(m), the lessee will be deemed to have recovered an amount equal to the

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[88] Joubert, W.A. Obligations. *The Law of South Africa*. Volume 19. Second Reissue at 243.
[89] Firstly, the obligation to make rental payments to the lessor, and secondly the obligation to effect leasehold improvements to the lessor's property.

obligation from which it was relieved during the year of assessment, i.e. the amount of the rental payments that was not paid[90] and claimed as a deduction[91] in terms of section 11(a).

6.4 South African authorities

According to Clegg, D, the principle that can be extracted from the *Cooling* – case is that the act of entering into a new lease agreement is an unavoidable consequence of carrying on a trade, and any related receipt will therefore be revenue in nature and subject to income tax.[92] Clegg, D.[93] is further of the view that the basic principles laid down by courts over the years with regards to the "gross income" definition should be considered, i.e. the essence of trading operations,[94] the fortuitous receipt test[95] and asking the question of which hole is being filled[96]. Clegg, D. concludes that each individual case should be looked at on its own merits by considering whether the lessee has attempted to induce the inducement payment and actively intervened or suggested such payment. A noteworthy point mentioned by Clegg, D. is that it does not matter if the taxpayer received a number of inducement payments from different lessors on different occasions, as long as the offer of payment is made by the lessor, the receipt should be capital in nature.[97]

Meyerowitz[98] is of the view that a South African court would follow the Privy Council's approach in the event that it is faced with similar facts as in the *Wattie* – case, and that an inducement payment would be regarded capital in nature for South African income tax purposes. Meyerowitz goes further by

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[90] Section 8(4)(m)(ii).
[91] Section 8(4)(m)(iii).
[92] Clegg, D. *Property Law Digest.* Shall a lease in any other place be so sweet? Volume 12. Part 2. April 1997.
[93] Clegg, D. *Property Law Digest.* Shall a lease in any other place be so sweet? Volume 12. Part 2. April 1997.
[94] Referring to *SA Marine Corporation Limited v CIR* (1955) 20 SATC 15.
[95] Referring to *CIR v Pick 'n Pay Employee Share Purchase Trust* (supra).
[96] Referring to *Burmah Steamship Company Limited v IRC* 1931 SC 156, 16 TC 67 and *ITC 1435* 50 SATC 117.
[97] Clegg, D. does however note that a pattern of receiving various inducement payments on different occasions may affect the credibility of the lessee's claim that they were not sought after.
[98] *The Taxpayer*. Editorial – Inducements to lessees to enter into leases. Volume 48. October 1999 at 190.

stating that a portion of the rental payments would not have been deductible in terms of section 11(a) and 23(g), based thereon that a portion of the rental payable would not have been incurred in the production of income or laid out for purposes of trade, but for purposes of obtaining a capital amount.

Croome, B.[99] disagrees with Meyerowitz's view by confirming that the South African income tax is rooted in the New South Wales legislation, and that a South African court is therefore more likely to rely on the Australian decision. He goes further to say that the income tax treatment of an inducement payment is not free from doubt and careful consideration should be given as to how a lease agreement is drafted and the true nature of such payment. According to Croome, B.[100] the likely outcome in South African courts is that inducement payments received by a lessee from a lessor will be a revenue receipt that would be fully taxable, as the lessee is receiving the amount for exploiting its goodwill and is not sterilising or disposing of a part of its business. In a subsequent article by Croome, B.[101] the decision handed down by the Federal Court of Australia in *O'Connell v Federal Commission of Taxation*[102] is analysed. The court confirmed the decisions in *Cooling* and *Montgomery,* i.e. that the inducement payment was revenue in nature and consequently subject to income tax. The court took the view that the lessee exploited its goodwill in obtaining the inducement payment and that the payment formed part of its trading activities. The court also held that the fact that the transaction was isolated did not preclude the receipt from being revenue in nature, as the taxpayer intended to make a profit or gain from the transaction.

The writer is firstly of the view that South African courts will not draw an analogy between a rent inducement payment and a lease premium, as it is a well established principle in South African tax law that a lease premium is

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[99] Croome, B. *Property Law Digest.* The fiscal considerations in lease inducements. Volume 3. October 2001.
[100] Croome, B. *Property Law Digest.* The fiscal considerations in lease inducements. Volume 3. October 2001.
[101] Croome, B. *Property Law Digest.* Lease inducements and income tax: an update. Volume 27. December 2002.
[102] 50 ATR 331.

"consideration passing from a lessee to a lessor, whether in cash or otherwise, distinct from and in addition tom or in lieu of rent"[103]. Secondly, although the writer agrees that a single transaction is not a decisive factor in determining the nature of an inducement payment, it is submitted that a South African court will attach more weight to this consideration, as it may be indicative of the lessee's intention. Furthermore, in terms of the "gross income" definition principles, an amount will be regarded as revenue in nature to the extent that it was designedly sought for and worked for, is not merely a fortuitous receipt and is part of a scheme of profit making, and these tests should be applied to the facts of each case.[104]

The writer is of the view that if a similar set of facts as noted in the cases above would come before a South African court, the relevant circumstances that led to the rent inducement payment as well as the structuring of the lease agreement would have to be carefully considered to assess the treatment of such amount for income tax purposes. There is no definite answer regarding the revenue or capital nature of such receipt, notwithstanding the international case law noted above. The test should be whether the lessee would still have entered into the lease agreement, notwithstanding the rent inducement payment, i.e. the intention of the lessee. The receipt will in the writer's view be regarded as part of the lessee's scheme of profit making where, for example, a large retailer leases property in a new development knowing that it will receive a rent inducement payment due to its name and brand, or where a retailer concludes the lease agreement for purposes of receiving the rent inducement payment and immediately sub-leases the property.

6.5 Conclusion

The nature of the payment or benefit from a lessor to a lessee is important to determine whether a lessee will be entitled to claim a leasehold improvements allowance in terms of section 11(g), and whether there will be a recoupment

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[103] *CIR v Myerson* (1947) 14 SATC 300 at 308.
[104] *CIR v Pick 'n Pay Employee Share Purchase Trust* (supra).

of such allowance in terms of section 8(4)(a). The distinction between a rent inducement payment and tenant installation allowance will depend on the specific circumstances of each case, how these receipts are defined in the (lease) agreement, and whether the agreement draws a clear link between the receipt and improvements costs incurred. Where the lessor agrees to receive reduced rental payments or no rental payments, the purpose of such concession should be determined in order to assess whether the benefit will be in the nature of a tenant installation allowance or rent inducement payment in the hands of the lessee.

Where there is a clear link between the leasehold improvements costs incurred by the lessee and the payment or benefit paid by the lessor, which indicates that the receipt constitutes a reimbursement of the costs incurred, the lessee will in the writer's view be entitled to claim a section 11(g) allowance, provided that all the requirements of section 11(g) are met. It will however need to be considered whether there is a recoupment for income tax purposes. Where there is no link between the payment or benefit paid by the lessor, and the leasehold improvements costs incurred by the lessee, the lessee will also be entitled to a leasehold improvements allowance in terms of section 11(g), and there can be no recoupment for income tax purposes in terms of section 8(4)(a), due to the absence of a link between the payment received and the costs incurred.

In light of the above, the writer is of the view that the following factors should be considered when assessing the income tax treatment of the receipt in the hands of the lessee, as well as the availability of the leasehold improvements allowance in terms of section 11(g):

- Was the negotiating of the payment or benefit, in cash or otherwise, at the insistence of the lessee or lessor?

- If at the instance of the lessee, was it a once-off occurrence or does it form part of the lessee's standard lease agreement negotiations?

- The intention of the lessee when receiving the payment or benefit from the lessor (the purpose with which the lessor makes the payment to the lessee may be indicative of the lessee's intention).

- Are there any conditions attached to the payment or benefit from the lessor, or is the lessee free to utilise the amount for any purpose?

- Can a link be established between the payment or benefit, and the costs incurred in respect of the leasehold improvements, in terms of the lease- or other agreement?

- Where the cash amount or benefit is specifically paid by the lessor for purposes of effecting leasehold improvements to the leased property, are the agreements with the contractors in the name of the lessee or lessor, and does the lessee or lessor make the payments to the contractors?

The writer reiterates that there are no hard and fast rules and no definitive answer regarding the nature of these types of payments or benefits in the hands of the lessee. All of the surrounding circumstances and facts would need to be assessed, and it is recommended that the parties ensure that the terms of the (lease) agreement clearly state the purpose of the payment. It is also recommended that the parties clearly record their negotiations leading to the conclusion of the lease agreement (and other relevant agreement).

7 Case studies

7.1 Case study 1: Lessee receives a cash rent inducement payment

7.1.1 Background information

ABC (Pty) Ltd ("ABC" or "the lessee") is a large clothing retailer in South Africa, and concludes a lease agreement with XYZ Developments (Pty) Ltd

("XYZ" or "the lessor"). ABC is given the right to use floor space in a new shopping mall owned by XYZ for a period of 5 years with an option to renew the lease for a further 5 years.

Prior to concluding the lease agreement, XYZ approached ABC and offered it an amount of R8 million to enter into the lease agreement. ABC has never received such a rent inducement payment. Prior to XYZ approaching ABC, ABC was planning to expand its business operations to the area in which the new shopping mall was erected.

XYZ is aware that ABC would have to customize the floor space in the shopping mall to comply with its brand standards, but XYZ does not have the upfront cash to do this itself. The lease agreement provides that ABC is obliged to effect the leasehold improvements at its own cost. No amount is stipulated in the lease agreement. ABC and XYZ are both taxpaying entities.

The following matters should be considered:

- Will the rent inducement payment received by ABC be taxable in its hands?

- Will ABC be entitled to claim a leasehold improvements allowance in terms of section 11(g)?

7.1.2 Income tax treatment of the rent inducement payment[105]

The first two elements of the gross income definition have been met, as ABC received a cash amount from XYZ. The only matter for consideration is therefore whether the receipt is capital or revenue in nature. The nature of the rent inducement payment should be determined by considering the intention of ABC, as inferred from the surrounding circumstances and facts relating to

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[105] Refer to the detailed discussion of the gross income definition in 5.1 and rent inducement payments in 6.1.

this specific transaction. It was not ABC's intention to enter into the lease agreement, only to receive the rent inducement payment. The rent inducement payment was offered by XYZ and was not paid at the insistence of ABC. This indicates that the receipt was not designedly sought for and worked for and was merely a fortuitous receipt. Although not a decisive factor, the fact that it is the first time that ABC received this type of payment is indicative that the receipt is revenue in nature. It is also submitted that the rent inducement payment does not form part of ABC's scheme of profit making, as the receipt thereof was not the sole or main consideration for entering into the lease agreement. It was ABC's intention to commence business operations in that specific area, i.e. the lease agreement would have been concluded with or without the rent inducement payment.

Based on the above circumstances, the rent inducement payment is capital in nature, and the amount will not be subject to income tax in the hands of ABC. There will also not be any CGT consequences for ABC upon receipt of the rent inducement payment as there is no disposal for CGT purposes.

Note: The rent inducement payment would have been revenue in nature and subject to income tax in the hands of ABC where it actively sought lessors who offer rent inducement payments to large traders with reputable names. A further factor that would have made the rent inducement payment revenue in nature and part of ABC's scheme of profit making is where ABC enters into the lease agreement only to obtain the rent inducement payment, and subsequently sub-leases the property.

7.1.3 Entitlement to leasehold improvements allowance[106]

The rent inducement payment was paid by XYZ to ABC, independently from ABC's obligation to effect leasehold improvements. The purpose of the payment was to induce ABC as large clothing retailer to be a tenant in the

[106] Refer to 4 for a detailed discussion on the requirements of section 11(g), and to 6.1 for a discussion on the interaction between the rent inducement payment, section 11(g) and section 8(4)(a).

new shopping mall. The conclusion of the lease agreement was to the advantage of XYZ and it was therefore prepared to make the rent inducement payment. In order for ABC to claim a leasehold improvements allowance in terms of section 11(g), there should be expenditure actually incurred in pursuance of an obligation to effect improvements to the leased property in terms of the lease agreement, and property should be used or occupied for the production of income.

It is submitted that all the requirements of section 11(g) have been met, in that:

- There is a lease agreement between ABC and XYZ;

- There is an obligation on ABC to effect the improvements in terms of the lease agreement;

- ABC actually incurred expenditure in pursuance of the obligation in terms of the lease agreement;

- The leased property will be used and is occupied for the production of ABC's income; and

- The value of the improvements will be included in the income of XYZ.

As the rent inducement payment and the leasehold improvements are not linked to each other in terms of the lease agreement, the rent inducement payment does not constitute a reimbursement of the improvement costs incurred by ABC. There will thus be no recoupment of section 11(g) allowances claimed, in terms of section 8(4)(a). To the extent that there is a link between the receipt and improvements costs, the receipt will assume the nature of a tenant installation allowance (refer to Case Study 2 below).

ABC will be entitled to claim the fair and reasonable value of the leasehold improvements over the initial 5 year lease period (no amount specified in the lease agreement). The first section 11(g) allowance will be granted in the year of assessment during which the improvements are completed.

7.2 Case study 2: Lessee is reimbursed for the leasehold improvements expenditure

7.2.1 Background information

JJ (Pty) Ltd ("JJ" or "the lessor") concluded a lease agreement with EE (Pty) Ltd ("EE" or "the lessee"), in terms of which EE leases the property from JJ for a period of 10 years. Both JJ and EE are taxpaying entities. EE operates as a motor vehicle workshop and requires a specific layout and equipment prior to commencing its business. The buildings are in a satisfactory condition and there are no signs of damage or deterioration to the building, but they are not equipped for EE's business operations.

The lease agreement explicitly provides that the lease of the property is subject to specific improvements and alterations being effected by EE to the buildings. No amount is stated in the lease agreement as the value of the improvements. The lease agreement makes provision for improvements undertaken by EE at its own costs, subject to approval by JJ and towards which JJ contributes R15 million. EE received a tenant installation allowance once before, when its previous lessor granted such an allowance. The tenant installation allowance was however at the insistence of the lessors at both times.

The lease agreement defines the contribution of R15 million from JJ to EE as a upfront lump-sum "tenant installation allowance" and states that this contribution should specifically be utilised by EE for purposes of effecting the required improvements. EE should therefore not use the tenant installation allowance for any other purposes. To the extent that the tenant installation allowance is not utilised for the improvements, EE should repay the full

amount to JJ. Where a portion of the tenant installation allowance remains after all the required improvements have been effected, EE should repay the balance to JJ. EE enters into the contracts with the respective contractors in its own name.

The following matters should be considered:

- Will the R15 million tenant installation allowance received by EE be taxable in its hands?

- Will the improvements costs incurred by EE qualify for a leasehold improvements allowance in terms of section 11(g), in light of the fact that JJ paid a tenant installation allowance to EE?

- Will EE be entitled to a section 11(g) leasehold improvements allowance to the extent that the improvements costs are for its own costs without any contributions from JJ (where the improvements costs are in excess of R15 million)?

7.2.2 Income tax treatment of tenant installation allowance[107]

The first element of the gross income definition has been met. The last two elements of the definition should thus be considered further, i.e. whether the amount was received by or accrued to EE and whether it is capital or revenue in nature.

It appears that JJ is effectively paying for the improvements to the leased property through the tenant installation allowance. EE receives a benefit from the tenant installation allowance through the improvements to the leased property, which will enable it to commence its business operations. The presence of a benefit is however not a test for determining whether an amount

[107] Refer to the detailed discussion of the gross income definition in 5.1 and 6.2 for a discussion on the nature of a tenant installation allowance.

should be included in gross income. The tenant installation allowance has been received by EE on its own behalf and for its own benefit. This element of the gross income definition has therefore been satisfied. The requirement is that the amount should be "received by or accrued to" (emphasis added) the taxpayer and it is therefore submitted that it is not necessary to consider whether the amount accrued to EE. EE will however become unconditionally entitled to the amount upon incurring the improvements costs.

It is further submitted that the tenant installation allowance received by EE is capital in nature, based on the intention of EE, in light of the surrounding circumstances and objective facts relating to this transaction. EE received the tenant installation allowance as reimbursement for the improvements costs incurred. The tenant installation allowance was paid at the insistence of JJ, and was therefore a fortuitous receipt for EE. Although EE received a tenant installation allowance once before, it was offered by different lessors on different occasions. The receipt of the tenant installation allowance also does not form part of EE's scheme of profit making, and it was not designedly sought for and worked for in the course of EE's normal business operations. It is submitted that the main object of the receipt was to reimburse the lessee for the cost incurred in effecting the leasehold improvements, and not for the lessee to make a profit.

Note: To the extent that it can be proved that the tenant installation allowance was paid at the instance of EE and EE regularly negotiates for these types of benefits, then such receipts will be regarded as being revenue in nature.

7.2.3 Entitlement to leasehold improvements allowance[108]

EE has an explicit obligation in terms of the lease agreement to effect the improvements to the leased building. The fact that the lessee is reimbursed for the improvements costs incurred, will not affect its obligation to effect the

[108] Refer to 4 for a detailed discussion on the requirements of section 11(g), as well as 6.2 for a detailed discussion regarding the interaction between a tenant installation allowance, section 11(g) and section 8(4)(a).

leasehold improvements in terms of the lease agreement. The only issue remaining is whether the leasehold improvement expenditure has been actually incurred by EE.

To the extent that EE incurs expenditure relating to the improvements, and is reimbursed through the tenant installation allowance, it is submitted that JJ is effectively paying for the improvements. There is however a difference between incurring expenditure and the settlement thereof. EE contracts directly with the contractors and is therefore unconditional liable for payment to the extent that the work are performed, and the fact that EE settles the costs by utilising the tenant installation allowance received from JJ, will not change this. Expenditure has therefore been actually incurred by EE for purposes of section 11(g). It will need to be considered whether there is a recoupment of the section 11(g) allowances claimed, to the extent that the tenant installation allowance is utilised to fund the improvements costs. The relevant consideration is whether there will be a recoupment for purposes of section 8(4)(a) where an upfront tenant installation allowance is received before any section 11(g) leasehold improvements allowances are claimed. EE will only be entitled to claim the first leasehold improvements allowance in terms of section 11(g) in the first year of assessment when the improvements are completed, and the recoupment of the expenditure (tenant installation allowance) will occur in an earlier year of assessment. On a strict reading of section 8(4)(a) there will be no recoupment of section 11(g) allowances.

Where the leasehold improvements expenses exceed the tenant installation allowance of R15 million and EE effects that leasehold improvements at its own expense, EE will also have actually incurred expenses for purposes of section 11(g). Such expenditure will be incurred by EE is in pursuance of an obligation in terms of the lease agreement and the property will be used for the production of income. As JJ is a taxpaying entity, it will be taxed on the value of the leasehold improvements or the amount to be expended by EE, in

the year of assessment in which the improvements have been completed.[109] EE will therefore be entitled to claim a leasehold improvements allowance in terms of section 11(g).

The section 11(g) allowance will be calculated as equal annual instalments over the 10 year lease period of the lease agreement. The amount that EE may claim is limited to the amount specified in the lease agreement, as the value of the improvements. As no amount is stipulated in the lease agreement, the allowance will be based on an amount which in the opinion of the C:SARS represents the fair and reasonable value of the improvements. It is submitted that the tenant installation allowance of R15 million is not sufficient support for an amount stipulated in the lease agreement, to be expended by EE, for purposes of section 11(g). The leasehold improvements allowance will thus be based on the fair and reasonable value of the improvements.

7.3 Case study 3: Lessee receives free use of the lease building for a specific period

7.3.1 Background information

Alpha (Pty) Ltd ("Alpha" or "the lessor") concluded a lease agreement with Omega (Pty) Ltd ("Omega" or "the lessee"), in terms of which three buildings are leased to Omega for a period of 15 years. The lease agreement provides that Omega is under an obligation to refurbish and restore the leased buildings. Both parties are taxpaying entities. The agreement provides that the value of the improvements should be R10 million, which are for Omega's own costs.

The lease agreement provides for monthly rental payments, payable by Omega to Alpha as follow:

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[109] A special allowance in terms of section 11(h) of the Act will however be available to JJ.

- Building A – R25 000;

- Building B – R35 000;

- Building C – R20 000

The lease agreement provides that Omega will be liable for payment of the rental in respect of all the buildings, but that the rental payments will be set off against the improvements costs incurred by Omega. In terms of the lease agreement, this arrangement will continue until Omega has recovered all the improvements costs from Alpha.

The following matters should be considered:

- How should the concession in rental payments provided for in the lease agreement be treated in the hands of Omega, for income tax purposes?

- Will Omega be entitled to deduct the rental payments in terms of section 11(a)?

- Will Omega be entitled to claim a leasehold improvements allowance in terms of section 11(g), in light of the fact that Alpha is agreeing to suspend all rental payments until all improvements costs have been reimbursed?

7.3.2 Income tax treatment of benefit and the deductibility of rental payments[110]

It is submitted that the first element of the gross income definition has met, as the benefit in the form of relief from the payment of rental payments, can be valued. The benefit in the present case is that Alpha waived its right to receive

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[110] Refer to the detailed discussion of the gross income definition in 5.1 and 6.3 for a discussion regarding the benefit received by a lessee through concessions in rental payments.

rental payments, and it is submitted that this benefit can be valued at R80 000. Although the presence of a benefit is not a test for determining whether an “amount” should be included in Omega’s gross income, the “amount” in the form of relief from rental payment has accrued to Omega, and Omega became unconditionally entitled to the benefit in terms of the lease agreement.

Finally, it will need to be considered whether the benefit is capital or revenue in nature. The concession in rental payment is granted by Alpha to reimburse Omega for the leasehold improvements costs that it incurs. It therefore appears that the benefit is rather in the nature of a recoupment for income tax purposes. For this reason, Omega’s entitlement to deduct the rental payments will first be considered.

Omega will have an absolute and unconditional liability for payment of the rental payments of R80 000 during the year of assessment, as the lease agreement explicitly provides that Omega shall be liable for payment of rental for all the buildings. The lease agreement provides Omega as lessee with two distinct obligations, namely an obligation to make rental payments in the amount of R80 000 and an obligation to incur leasehold improvements expenditure. These obligations cannot legally be set-off against each other, as there are no corresponding obligations, i.e. both obligations are the obligations of Omega. As Alpha does not owe any debt to Omega, there can legally be no set-off of Omega’s obligations. The incurral of expenditure should not be confused with the settlement thereof, therefore once Omega incurred the rental payments, the fact that it chose to settle the payments by way of effecting the leasehold improvements, does not change this.

Omega has thus actually incurred expenditure for purposes of section 11(a), and it is submitted that the rental payments were incurred in the production of income and rental payments are normally regarded as revenue in nature. The waiver by Alpha of the claim for rental payment will result in a recoupment of the section 11(a) deductions for rental payments in terms of section 8(4)(m).

7.3.3 Entitlement to leasehold improvements allowance[111]

The lease agreement places an obligation on Omega to effect the leasehold improvements at its own costs. Alpha is a taxpaying entity and the amount to be expended on the improvements as stipulated in the lease agreement (i.e. R10 million) will therefore be included in Alpha's income.

The only issue remaining is whether Omega will be regarded as having actually incurred the leasehold improvements in pursuance of an obligation in terms the lease agreement, as Alpha is agreeing to waive its claim to the rental payments, in order for Omega to recover all improvement costs. Alpha may therefore be regarded as effectively incurring the improvements costs through the waiver of rental payments. Omega has however incurred the leasehold improvements costs, based thereon that the costs are for its own costs, and the contractors rendering the services will be entitled to demand payment from Omega. Omega should therefore qualify for a leasehold improvements allowance in terms of section 11(g).

The section 11(g) allowance will be calculated over the lease period of 15 years, and is limited to the amount stipulated in the lease agreement as the value of the improvements, i.e. R10 million. The first allowance can only be claimed in the year of assessment during which the improvements have been completed.

Due to the fact that there are two distinct obligations, namely to incur rental payments and to effect the leasehold improvements, it is submitted that the waiver of the rental payments by Alpha should be viewed separately from the obligation on Omega to incur leasehold improvements expenditure. The waiver of Alpha's claim for rental payments does not constitute a reimbursement of the improvements costs incurred by Omega, and Omega

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[111] Refer to 4 for a detailed discussion on the requirements of section 11(g), as well as Chapter 6.3 for a detailed discussion regarding the interaction between the benefit of reduced or no rental payment, section 11(g) and section 8(4)(m).

will not have to include any recoupment in its taxable income in terms of section 8(4)(a).

8 Conclusion

The objectives of this paper were to consider the requirements of section 11(g) and the income tax consequences for the lessee where the lessor pays a cash amount or grants a benefit to the lessee, in cash or otherwise. The objectives were limited to the income tax consequences for the lessee.

From the wording of section 11(g), the requirements are clear. It is however submitted that the practical application of section 11(g) may be problematic. Two conflicting cases dealing with the determination of a lessee's obligation for purposes of section 11(g) were cited, and it is not clear whether or not the lessee's obligation should be determined with reference to the lessor's right to legally demand that the improvements be effected by the lessee. The conclusion reached was that the parties should explicitly provide for a clear and unambiguous obligation for the lessee to effect the leasehold improvements in a written lease agreement.

The last objective was to conclude on the income tax treatment of payments or benefits, in cash or otherwise, paid or granted by the lessor to the lessee. This objective was reached by performing extensive research into the general principles and guidelines laid down by the South African courts in respect of the interpretation of the gross income definition, as well as section 8(4)(a). The research continued into a detailed consideration of leading international case law dealing with the nature of rent inducement payments and was complemented with comments from South African authors. The aforementioned principles and case law were applied to the scenarios identified, and various of factors were identified which should be taken into account when assessing the interaction between the income tax treatment of such amounts and benefits and improvement costs incurred by the lessee. The writer did not commit herself to a conclusive answer regarding this

interaction due to the various factors which should be taken into account, including the structuring of the lease- or other agreement.

In the final instance, this objective was illustrated by way of practical examples in case studies illustrating the interaction between section 11(g), the gross income definition and the recoupment provisions in section 8(4)(a)..

It remains to be seen how South African courts will deal with, firstly the income tax nature of a rent inducement payment, tenant installation allowance or concession in rental payments received by or accrued to a lessee, and secondly the interaction between such receipt or accrual and a leasehold improvements allowance in terms of section 11(g).