

INTERPRETATION NOTE 109

DATE: 7 February 2019

ACT : INCOME TAX ACT 58 OF 1962
SECTION : PARAGRAPH (g) OF THE DEFINITION OF “GROSS INCOME” AND SECTION 11(f) AND (h)
SUBJECT : LEASE PREMIUMS

CONTENTS

	PAGE
Preamble	2
1. Purpose.....	2
2. Background	2
3. The law and its application	3
3.1 Position of the lessor [paragraph (g) of the definition of “gross income” in section 1(1)].....	3
3.1.1 The meaning of “premium or consideration in the nature of a premium”	4
3.1.2 The meaning of “use or occupation or the right of use or occupation”	8
3.2 Position of the lessee [section 11(f)].....	9
3.2.1 Deduction of a lease premium	11
3.2.2 Actually paid by the lessee	11
3.2.3 The meaning of “the right of use or occupation”.....	11
3.2.4 Used or occupied for the production of income or income is derived from it	12
3.2.5 Amount of the allowance - maximum annual allowance.....	12
3.2.6 Amount of the allowance - maximum annual allowance (linked to know-how)	16
3.2.7 Exclusion from deduction.....	17
3.2.8 Recoupment of the allowances allowed.....	18
3.3 A lessor’s special allowance [section 11(h)].....	18
3.3.1 Special circumstances.....	19
4. Conclusion	19

Preamble

In this Note unless the context indicates otherwise –

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

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

1. Purpose

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

A number of the court cases that considered whether an amount fell within the scope of the above-mentioned paragraph and sections dealt with leases of land and buildings. The use of the words “rent”, “lease”, “lease period”, “lease premium”, “lessor” and “lessee”, and “sub-lessor” and “sub-lessee” is therefore common in this Note. The use of these words is not intended to imply that the scope of the above-mentioned paragraph and sections is always limited to situations involving the use or occupation or right of use or occupation of land and buildings. The above-mentioned paragraph and sections are wider than land and buildings and cover other property, for example, machinery, motion picture films, patents and trademarks. The specific paragraph or section must be referred to in order to determine the specific property covered. Although other terminology may be used in the context of the other types of property, if the same principles apply, the requirements of the above-mentioned paragraph and sections may be met and hence require an inclusion in gross income or entitle the taxpayer to a deduction. For example, under an agreement of use a licensee may pay a patent owner a monthly royalty for the use of the patent as well as an up-front lump sum for entering into the agreement of use. The up-front lump sum is an amount that is paid for the use of the patent and it is distinct from and in addition to the royalty (see 3.1.1). It therefore falls within the scope of a premium for the right of use of a patent under paragraph (g)(iii) and requires a full inclusion in gross income.

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

2. Background

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

The parties to a lease agreement may agree that the lessee must pay an amount in addition to or in lieu of the rent, known as a lease premium. This expense, in the case of the lessee, and the receipt or accrual, in the case of the lessor, are subject to specific provisions in the Act which are discussed in this Note.

3. The law and its application

3.1 Position of the lessor [paragraph (g) of the definition of “gross income” in section 1(1)]

Paragraph (g) reads as follows:

<p>“gross income”, in relation to any year or period of assessment, means—</p> <ul style="list-style-type: none"> (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 (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 the Republic, <p>during such year or period of assessment, excluding receipts or accruals of a capital nature, but including, without in any way limiting the scope of this definition, such amounts (whether of a capital nature or not) so received or accrued as are described hereunder, namely—</p> <p>.....</p> <ul style="list-style-type: none"> (g) any amount received or accrued from another person, as a premium or consideration in the nature of a premium— <ul style="list-style-type: none"> (i) for the use or occupation or the right of use or occupation of land or buildings; or (ii) for the use or the right of use of plant or machinery; or (ii) <i>bis</i> for the use or the right of use of any motion picture film or any film or video tape or disc for use in connection with television or any sound recording or advertising matter connected with such motion picture film, film or video tape or disc; or (iii) for the use or right of use of any patent as defined in the Patents Act or any design as defined in the Designs Act or any trade mark as defined in the Trade Marks Act or any copyright as defined in the Copyright Act or any model, pattern, plan, formula or process or any other property or right of a similar nature;

Paragraph (g) requires a lessor to include the full amount of a lease premium in gross income in the earlier of the year of assessment in which it is received by or accrues to the lessor. The inclusion of the lease premium in gross income may not be spread over the period of the lease. However, in special circumstances the Commissioner may allow the lessor a deduction in the form of an allowance under section 11(h) (see 3.3).

Paragraph (g) was introduced to prevent taxpayers from trying to avoid paying income tax by artificially labelling rental income a premium, claiming it was of a capital nature and thus excluding it from gross income. The introduction of paragraph (g) eliminated the argument that the payment of a premium is of a capital

nature and therefore falls outside the definition of “gross income”¹ because the items in the various paragraphs are included in gross income irrespective of whether the amount is of a capital or revenue nature. Central to the application of paragraph (g) is the meaning of “premium or consideration in the nature of a premium” and the “use or occupation or right of use or occupation”. These concepts are considered below.

3.1.1 The meaning of “premium or consideration in the nature of a premium”

The words “premium or like consideration” were replaced by “premium or consideration in the nature of a premium” with effect from 1 April 2012 in order to bring paragraph (h) in line with the wording used in section 11(f). It is a technical correction and does not result in the increase or decrease in the ambit of lease premium inclusions in gross income. It is considered that the meaning of the words “premium or consideration in the nature of a premium” will generally have the same meaning when used under paragraph (g) and section 11(f).

This view received judicial support in *Turnbull v CIR*² where Centlivres CJ stated the following:

“The words ‘premium or like consideration’ in section 7(d)³ have *prima facie* the same meaning as the word “premium or consideration in the nature of a premium” in section 11(2)(e) ... In the present case, however, I can see no reason for giving one meaning to the word “premium” in section 7(d) and another meaning to the same word in section 11(2)(e).”

This means that court cases which considered the meaning of “premium or like consideration” for gross income purposes and cases which considered the meaning of “premium or consideration in the nature of a premium” for expenditure purposes are both relevant in determining whether a particular amount constitutes a premium or consideration in the nature of a premium for purposes of paragraph (g). In addition, when determining whether an amount constitutes a premium for purposes of section 11(f) (see 3.2) the cases discussed in this section of the Note are relevant.

The words “premium or consideration in the nature of a premium” are not defined in the Act. The meaning of “premium or like consideration” was interpreted in the context of relations between a lessor and lessee by the court in *CIR v Butcher Brothers (Pty) Ltd* as follows:⁴

“Consideration passing from a lessee to a lessor, whether in cash or otherwise, distinct from and in addition to, or in lieu of, rent.’

... I would insert ‘having an ascertainable money value’ after the word ‘consideration’ in the above suggested definition. ...

Certain obligations frequently accepted by a lessee in respect of matters normally incidental to relations between landlord and tenant such as undertakings to pay all rates and taxes imposed on or in respect of property leased, to maintain buildings in good repair, and to insure buildings ...should not be so regarded, and that such consideration should be excluded from the suggested definition.”

¹ D Davis *et al Juta’s Tax Library* [online] (Jutastat e-publications: 30 November 2017) in Commentary on Income Tax – ‘gross income’ paragraph (g).

² 1953 (2) SA 573 (A), 18 SATC 336 at 343.

³ Section 7(d) of Act 31 of 1941 is similar to para (g) and section 11(2)(e) of that Act is similar to section 11(f).

⁴ 1945 AD 301, 13 SATC 21 at 34.

In *Rex Tea Room Cinema (Pty) Ltd v CIR* the court adopted the finding in the *Butcher Bros* case and stated that:⁵

“The Appellate Division held that the words ‘premium or like consideration’ in sec 7(1)(d) of Act 40 of 1925, in so far as they refer to relations between lessor and lessee[,] mean consideration having an ascertainable money value passing from a lessee to a lessor, whether in cash or otherwise distinct from and in addition to or in lieu [of] rent, excluding any obligation accepted by a lessee in respect of matter[s] normally incidental to leases such as undertakings to pay rates and maintain buildings.”

Therefore, in summary, a lease premium is consideration having an ascertainable money value paid by a lessee to a lessor for the use or occupation or right of use or occupation of, amongst others, land and buildings but which is distinct from and in addition to or instead of rent. A lease premium is usually, but not necessarily, received as a cash lump sum at the commencement of the lease and is not refundable.

A lease premium must be distinguished from a rental deposit and an up-front rental which may be received by or accrue to the lessor.⁶ A rental deposit is generally also received up front, but its purpose is to cover potential damages which may occur during the period of the lease and as such it is not for the use or occupation or the right of use or occupation. In addition, to the extent it is not required to cover damages or the costs specified in the lease agreement, it is normally refundable to a lessee at the end of the lease period. In contrast, an upfront rental receipt, often called a bullet rental, is for the use or occupation or right of use or occupation but it is not in addition to or in lieu of rent, it remains rent in nature. A rental deposit or upfront rental with these features is not a lease premium or consideration in the nature of a premium.

No hard and fast rule can be formulated to determine whether the receipt of an amount constitutes a lease premium, a rental deposit or an up-front rental. All the facts and circumstances of a particular case must be considered in making that determination.

Example 1 – Lease premiums and rental deposits

Facts:

A (Pty) Ltd agreed to let B (Pty) Ltd a building it owned in the Western Cape for a period of 24 months with an option to extend by 12 months. Under the lease agreement B (Pty) Ltd was required to pay A (Pty) Ltd the following amounts:

- An up-front lump sum payable on signature of the lease agreement.
- A monthly rental of R15 000 per month payable on or before the 5th of each month.
- A deposit of R30 000 payable before taking occupation to cover possible damages arising during the period the building is occupied by B (Pty) Ltd.

⁵ 1946 TPD 338, 14 SATC 76 at 81 and 82.

⁶ Special Board Decision 74 (2 SASBDR 93) held that the initial rental was fully deductible as it could not otherwise be described as an incentive to the initiation of the relationship between lessee and lessor. See also TC 14189 (J) (20 December 2018).

The agreement was concluded on 1 July year 1. B (Pty) Ltd paid the up-front lump sum and the deposit and took occupation on 1 July year 1. The deposit is held in a trust account.

A (Pty) Ltd has a December year end.

Result:

The up-front lump sum is an amount that is payable for the use of the building but which is distinct from and in addition to the monthly rental of R15 000. It therefore constitutes a premium that is payable for the right of use or occupation of the building under paragraph (g) and A (Pty) Ltd must include it in gross income for the year of assessment ending 31 December year 1. In addition, A (Pty) Ltd must include the monthly rental of R90 000 ($R15\ 000 \times 6$) in gross income for the year of assessment ending 31 December year 1.

The deposit of R30 000 does not constitute a premium under paragraph (g) because it was paid to cover damages which may arise during the lease and was not paid for the right of use or occupation of the building. Therefore, even though it is distinct from and in addition to the rent, it does not fall within the ambit of paragraph (g). In addition, it does not meet the other requirements of gross income because it is held in a trust account and has not been "received by or accrued to or in favour of" A (Pty) Ltd. It is not included in gross income for the year of assessment ending 31 December year 1.

Example 2 – Up-front rentals

Facts:

A (Pty) Ltd agreed to lease B (Pty) Ltd a building it owned in the Western Cape for a period of 36 months with an option to extend by 3 months. Under the lease agreement B (Pty) Ltd was required to pay A (Pty) Ltd the rental of R10 000 per month for the 36-month period before taking occupation.

The agreement was concluded on 1 July year 1 and B (Pty) Ltd paid A (Pty) Ltd R360 000 on the same day.

A (Pty) Ltd has a December year end.

Result:

Although the upfront receipt of R360 000 is an amount for the use of the building, it is not a premium that falls within the ambit of paragraph (g) because it is not an amount which is distinct from and in addition to rent. The R360 000 is rent which is paid in advance. The amount is of a revenue nature and must be included in A (Pty) Ltd's gross income for the year of assessment ending 31 December year 1.

Paragraph (g) refers to a "premium or consideration in the nature of a premium ... for the use or occupation or right of use or occupation of land and buildings ..." and as such includes a payment by a lessee to a lessor which meets those requirements. Paragraph (g) is not, however, limited to payments by lessees to lessors and provided those requirements are met, also applies, for example, to a premium paid by a sub-lessee to a sub-lessor. In addition, although a payment between a lessee and lessor will often meet the requirements of being a premium under paragraph (g),

this is not necessarily always the case. The detailed facts of each case must be considered in assessing a particular payment.

An amount paid by a lessor to a lessee for the premature vacation of business premises has been held by the court not to be a premium or consideration in the nature of a premium, which is in the nature of rent passing from a lessee to a lessor.⁷ Although this case considered whether the expenditure constituted a lease premium from the lessor's perspective, as noted above, the same principles are relevant in assessing whether the receipt would constitute a lease premium from the lessee's perspective.

In ITC 670⁸ a lessor agreed to make alterations to the leased property on behalf of the lessee and the lessee agreed to reimburse the lessor for the cost of the alterations in monthly instalments added to the rent. The court held that the monthly instalments were a reimbursement of the expenditure incurred on the lessee's behalf and were not a payment of rent or an additional payment over and above rent for the right of use or occupation of the property concerned. As such, the monthly instalments did not constitute a premium or like consideration.

In order to constitute a "premium or consideration in the nature of a premium" the amount must be in the nature of rent and in addition to or instead of rent. It must, therefore, be paid to the person granting the right of use or occupation. In ITC 731⁹ the payment of commission to an auctioneer on the acquisition of the lease of a farm was not regarded as a lease premium or consideration in the nature of a premium paid for the right of use or occupation of land or buildings because it was not made to the person granting the right of use or occupation, but another.

A premium under paragraph (g) does not include an amount received by or accrued to a cedent from a cessionary for the cession of rights held under a lease. The amount received or accrued is not a premium as it is not received, in the case of lease rights, in addition to or instead of rent, it is simply the purchase price for the right of use.¹⁰ After the cession the cedent no longer holds the right under the lease and is not entitled to any rent.

Similarly, the amount received or accrued for the sale of an asset (that is, all the rights associated with ownership of the asset) does not fall within the ambit of paragraph (g). The purchase price does not constitute a premium because it is not received or accrued in addition to or instead of rent, it is simply the purchase price for the asset. After the sale, the seller no longer holds any rights in respect of the asset and is not entitled to rent. The nature of the receipt or accrual (whether it is revenue or capital) will depend on the facts of the case.

Although the discussion above focussed on leases of land and buildings, the principals apply to other types of property listed in paragraph (g)(ii) to (iii). For example, in the case of royalties, a premium or consideration in the nature of a premium will include a consideration passing from the grantee to the grantor of the right of use of a patent, trade mark or other such item, which is distinct from and in addition to the royalty that is payable.

⁷ ITC 819 (1955) 21 SATC 71 (C).

⁸ (1948) 16 SATC 220 (U).

⁹ (1951) 18 SATC 106 (C).

¹⁰ *CIR v Myerson* 1947 (2) SA 1243 (A), 14 SATC 300.

3.1.2 The meaning of “use or occupation or the right of use or occupation”

Paragraph (g) applies only to lease premiums in respect of –

- the use or occupation or the right of use or occupation of land or buildings;
- the use or the right of use of plant or machinery;
- the use or the right of use of any motion picture film or any film or video tape or disc for use in connection with television or any sound recording or advertising matter connected with such motion picture film, film or video tape or disc; or
- the use or right of use of any patent as defined in the Patents Act, or any design as defined in the Designs Act, or any trade mark as defined in the Trade Marks Act, or any model, pattern, plan, formula or process or any other property or right of a similar nature.

An amount received by or accrued to a lessor from a lessee in consideration for the cancellation of a lease is paid to terminate the right of use earlier than previously agreed. It is not paid for the right of use or occupation of the property. Therefore, it does not fall within the ambit of paragraph (g). However, it must still be included in the lessor’s gross income as it will meet the general requirements of gross income.¹¹

In ITC 745¹² a business was sold as a going concern and the buyer leased the premises from the seller. The parties agreed that part of the purchase price would represent consideration for the goodwill of the business. The Commissioner was of the opinion that approximately 73% of the purchase price for the business, which included the goodwill, represented a premium for the right to use and occupy the business premises. The court held that the amount payable for goodwill was not a disguised payment for the use or occupation of the business premises and evidence of this fact was that a very high rental in excess of an estimated fair rental was payable under the lease agreement. Therefore, no portion of the goodwill could be regarded as a disguised payment for the right of use or occupation of the business premises. Accordingly, the payment for goodwill did not constitute an additional payment for the right of use of the business premises and did not fall within the ambit of a premium under paragraph (g). If the facts had been different such that the amount allocated to goodwill had represented the value of the goodwill of the business as a going concern and a premium for the right of use of the premises subsequently leased by the buyer, a portion of the goodwill would have constituted a premium for the right of use of the premises.

In ITC1231¹³ the taxpayer relocated its business to a new location and sub-let its previous premises to the sub-lessee for a monthly rental and a lump sum amount for goodwill and for vacating the premises. The sub-lessor claimed the lump sum was of a capital nature. Evidence revealed that the lump sum represented the consideration that was required from the sub-lessee for the occupation of the premises. As such, despite being described as goodwill, the lump sum constituted a premium paid for the use and occupation of land and buildings.

¹¹ ITC 312 (1934) 8 SATC 154 (U).

¹² (1952) 18 SATC 307 (T).

¹³ (1975) 37 SATC 141(R).

These cases demonstrate that it is important to look behind a label given to an amount in order to determine whether it is in truth in respect of a right of use or occupation being granted or something else.

The question whether an amount paid for the right to mine (that is, to extract, remove and dispose of the minerals) can fall within the ambit of a premium for “the use or occupation or the right of use or occupation”, has been considered by the court.¹⁴ The court held that, in the context of the section dealing with lease premiums, an amount for the right to dig for diamonds which, if sold, would constitute income, was different to and did not constitute a payment for the right of use or occupation. If the holder of a right to mine, who is not the owner of the land, allows another person the “use” of that right in return for a premium, it is submitted that it would constitute a right of use and paragraph (g) would apply.¹⁵

3.2 Position of the lessee [section 11(f)]

Section 11(f) reads as follows:

11. General deductions allowed in determination of taxable income.—For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived—

(f) an allowance in respect of any premium or consideration in the nature of a premium paid by a taxpayer for—

- (i) the right of use or occupation of land or buildings used or occupied for the production of income or from which income is derived; or
- (ii) the right of use of any plant or machinery used for the production of income or from which income is derived; or
- (ii)bis the right of use of any motion picture film or any sound recording or advertising matter connected with such film, if such film, sound recording or advertising matter is used for the production of income or income is derived therefrom; or
- (iii) the right of use of any patent as defined in the Patents Act or any design as defined in the Designs Act or any trade mark as defined in the Trade Marks Act or any copyright as defined in the Copyright Act or of any other property which is of a similar nature, if such patent, design, trade mark, copyright or other property is used for the production of income or income is derived therefrom; or
- (iv) the imparting of or the undertaking to impart any knowledge directly or indirectly connected with the use of such film, sound recording, advertising matter, patent, design, trade mark, copyright or other property as aforesaid; or
- (v) the right of use of any pipeline, transmission line or cable or railway line contemplated in the definition of “affected asset” in section 12D, *other than an asset contemplated in paragraph (c) of that definition*;¹⁶

¹⁴ ITC 990 (1962) 25 SATC 125 (T).

¹⁵ D Clegg & R Stretch *Income Tax in South Africa* [online] (My LexisNexis: August 2016) in Chapter 6.7 and AP de Koker & RC Williams *Silke on South African Income Tax* [online] (My LexisNexis: September 2016) in § 4.56.

¹⁶ Italicised amendment effective 1 April 2019 and applicable in respect of assets brought into use on or after that date.

- (vi) the right of use of any line or cable used for the transmission of electronic communications contemplated in paragraph (c) of the definition of "affected asset" in section 12D;¹⁷

Provided that—

- (aa) the allowance under sub-paragraph (i), (ii), (ii)*bis*, (iii) or (v) shall not exceed for any one year such portion of the amount of the premium or consideration so paid as is equal to the said amount divided by the number of years for which the taxpayer is entitled to the use or occupation, or one twenty-fifth of the said amount, whichever is the greater;
- (bb) if the taxpayer is entitled to such use or occupation for an indefinite period, or if, in the case of any such right of use or occupation granted under an agreement concluded on or after 1 July 1983, the taxpayer or the person by whom such right of use or occupation was granted holds a right or option to extend or renew the original period of such use or occupation, he shall be deemed, for the purposes of this paragraph, to be entitled to such use or occupation for the period of the probable duration of such use or occupation; and
- (cc) the allowance under sub-paragraph (iv) shall not exceed for any one year such portion (not being less than one twenty-fifth) of the amount of the premium or consideration so paid as may be determined having regard to the period during which the taxpayer will enjoy the right to use such film, sound recording, advertising matter, patent, design, trade mark, copyright or other property as aforesaid and any other circumstances which are relevant;
- (dd) the provisions of this paragraph shall not apply in relation to any such premium or consideration paid by the taxpayer which does not for the purposes of this Act constitute income of the person to whom it is paid, unless such premium or consideration is paid in respect of a right of use of a line or cable—
- (A) used for the transmission of electronic communications; and
- (B) substantially the whole of which is located outside the territorial waters of the Republic,
- where the term of the right of use is 15¹⁸ years or more;
- (ee) the allowance under subparagraph (vi) shall not exceed for any one year such portion of the amount of the premium or consideration so paid as is equal to the said amount divided by the number of years for which the taxpayer is entitled to the use or occupation, or one tenth of the said amount, whichever is the greater;¹⁹

¹⁷ Effective 17 January 2019.

¹⁸ With effect from 1 April 2019, 15 years or more will be reduced to 10 years or more.

¹⁹ Effective 1 April 2019.

3.2.1 Deduction of a lease premium

Section 11(f) provides for the deduction of an allowance in respect of any premium or consideration in the nature of a premium paid by a lessee.

As noted in 3.1.1 the meaning of the words “premium or consideration in the nature of a premium” as referred to in section 11(f) and in paragraph (g) is generally the same. See 3.1.1 for detail. Therefore, to the extent the type of property (for example, land and buildings, plant and machinery, or trademark) overlaps, payments that are not considered to be a premium or consideration in the nature of a premium under paragraph (g) from the lessor’s perspective would similarly not constitute a premium from the lessee’s perspective and would not qualify for a deduction of an allowance under section 11(f). For example, a lessee will not be entitled to an allowance under section 11(f) for rental deposits and up-front rentals.²⁰

The scope of property included in paragraph (g) and section 11(f) differs slightly, for example, section 11(f) includes pipelines, transmission lines and knowledge transfer which are not included in paragraph (g). However, the principles related to what constitutes a premium still apply.

In order to qualify for a deduction under section 11(f) the payment of a premium or consideration in the nature of a premium must meet certain requirements. These are discussed below. A payment that does not qualify for a deduction under section 11(f) may qualify for a deduction under section 11(a) if all the requirements of that section are met. In the latter case the full amount will be deductible in the year during which the expenditure was incurred, subject to potential spreading required under section 23H.

3.2.2 Actually paid by the lessee

The lessee will be entitled to a deduction of the allowance under section 11(f) only if the expenditure was paid and not if it was incurred but not yet paid by the lessee. The deduction of the allowance under section 11(f) therefore commences only in the year of assessment in which the premium is paid assuming the other requirements of the section are met.

A lessee that agrees to pay a lease premium or consideration in the nature of a premium at the end of the lease period, or that incurs a liability to pay it, but has not made the payment, will not be entitled to the deduction of the said premium over the period of the lease.

3.2.3 The meaning of “the right of use or occupation”

The words “the right of use or occupation” referred to in section 11(f) have the same meaning as the words “use or occupation or the right of use or occupation” referred to in paragraph (g).²¹

²⁰ In *C: SARS v BP South Africa (Pty) Ltd* 2006 (5) SA 559 (SCA), 68 SATC 229 the parties agreed and the court ordered that the upfront rental be deducted under section 11(f). However, the court did not rule on whether the up-front rental constituted a lease premium.

²¹ See 3.1.2.

3.2.4 Used or occupied for the production of income or income is derived from it

An allowance under section 11(f) will be granted to the lessee only if the property as specified in section 11(f)(i) to (v) is used or occupied for the production of income²² or income is derived from it.²³

No deduction will be allowed if the lessee's "income" is exempt income or "income" which is not included in gross income. For example, for a person who is not a resident, "income" from a non-South African source would be excluded from gross income.²⁴

The deduction must be apportioned if the property is used only for a part of the year of assessment because the section requires that the property must be used or occupied or income must be derived from it in order to qualify for a deduction.²⁵ For example, if the commencement of the lease does not correspond with the commencement of the year of assessment or the lessee stops using the property concerned during the year of assessment, the allowance will be apportioned. This requirement also means that if the lease is terminated early or the lessee simply stops using the asset in the production of income or deriving income from it, the balance of a lease premium not yet deducted will not qualify for deduction under section 11(f).

See examples under **3.2.5**.

3.2.5 Amount of the allowance - maximum annual allowance²⁶

Subject to the exception below, the allowance under section 11(f) must be spread over the number of years the lessee is entitled to the use or occupation of the asset. The deduction for a year of assessment is equal to the greater of –

- the premium or consideration in the nature of a premium that was paid divided by the number of years the lessee is entitled to the use or occupation of the asset; or
- one twenty-fifth of the premium or consideration in the nature of a premium that was paid.²⁷

The maximum period over which the deduction is calculated is therefore limited to 25 years.

²² *Port Elizabeth Tramway Company Ltd v CIR* 1936 CPD 241, 8 SATC 13.

²³ The requirement that the property detailed in section 11(f)(v) must be used is found through the linkage to an affected asset as defined in section 12D. See also wording of section 11(f)(i)-(v) and section 23(f).

²⁴ See **3.2.7** for the circumstances in which, notwithstanding that this requirement has been met, the deduction will be denied if the lease premium does not constitute income from the lessor's perspective.

²⁵ See ITC 971 (1962) 24 SATC 791 (F) for a comparable principle.

²⁶ Excluding a premium paid for imparting or undertaking to impart knowledge of specified asset – see **3.2.6** for these types of premiums.

²⁷ Section 11(f) proviso (aa). This proviso also applies to assets specified in section 11(f)(i), (ii), (ii)bis, (iii) or (v).

With effect from 1 April 2019 a different deduction was introduced for the premium or consideration in the nature of a premium paid by a taxpayer for the right of use of any line or cable used for the transmission of electronic communications contemplated in paragraph (c) of the definition of “affected asset” in section 12D.²⁸ The allowance must still be spread over the number of years the lessee is entitled to the use or occupation of the asset. However, the deduction for a year of assessment is equal to the greater of –

- the premium or consideration in the nature of a premium that was paid divided by the number of years the lessee is entitled to the use or occupation of the asset; or
- one tenth of the premium or consideration in the nature of a premium that was paid.²⁹

Therefore for a premium or consideration in the nature of a premium paid by a taxpayer for the right of use of any line or cable used for the transmission of electronic communications contemplated in paragraph (c) of the definition of “affected asset” in section 12D, the maximum period over which the deduction is calculated is limited to 10 years.

If the lessee is entitled to the use or occupation for an indefinite period, or if the right of use or occupation was granted under an agreement concluded on or after 1 July 1983 and the lessee or lessor has the right or option to extend or renew the original period of such use or occupation, the lessee shall be deemed for purposes of section 11(f) to be entitled to the use or occupation for the period of probable duration of such use or occupation.³⁰ The period of the lease and, in the case of lease agreements entered into on or after 1 July 1983, all probable renewal periods, are relevant and must be taken into account when determining the probable duration of such use or occupation.

Example 3 – Treatment of lease premiums and rental deposits for a lessee

Facts:

A (Pty) Ltd agreed to let B (Pty) Ltd a building it owned in the Western Cape for a period of 24 months with an option to extend by 12 months. Based on the facts of the case it was unlikely that B (Pty) Ltd would exercise the option to extend the lease. Under the lease agreement B (Pty) Ltd was required to pay A (Pty) Ltd the following amounts:

- An up-front lump sum of R20 000 payable on signature of the lease agreement.
- A monthly rental of R15 000 per month payable on or before the 5th of each month.
- A deposit of R30 000 payable before taking occupation to cover possible damages arising during the period the building is occupied by B (Pty) Ltd.

²⁸ Section 11(f)(vi).

²⁹ Section 11(f) proviso (ee). This proviso applies to assets specified in section 11(f)(vi) and is effective 1 April 2019.

³⁰ Section 11(f) proviso (bb).

The agreement was concluded on 1 July year 1. B (Pty) Ltd paid the up-front lump sum and the deposit and took occupation on 1 July year 1. The monthly rental was paid on the 5th of each month. The building was used in the production of income. The deposit is held in a trust account.

B (Pty) Ltd has a December year end.

Result:

The up-front lump sum is an amount that was payable for the use of the building but which is distinct from and in addition to the monthly rental of R15 000. It therefore constitutes a premium that is payable for the right of use or occupation of the building under section 11(f) and B (Pty) Ltd may deduct an allowance of R5 000 ($R20\,000 / 2 \text{ years} \times 6 / 12$) under section 11(f) in the year of assessment ending 31 December year 1. In addition, B (Pty) Ltd may deduct the monthly rental of R90 000 ($R15\,000 \times 6$) under section 11(a) for the year of assessment ending 31 December year 1.

The deposit of R30 000 does not constitute a premium under section 11(f) because it was paid to cover damages which may arise during the lease and was not paid for the right of use or occupation of the building. Therefore, even though it is distinct from and in addition to the rent, it does not fall within the ambit of section 11(f). In addition, as a refundable deposit it does not meet the requirements for deduction under section 11(a).

Example 4 – Treatment of lease premiums for the lessee in cases of early termination of the lease

Facts:

A (Pty) Ltd agreed to let B (Pty) Ltd a building it owned in the Western Cape for a period of 60 months with an option to extend by 12 months. Based on the facts of the case it was likely that B (Pty) Ltd would exercise the option to extend the lease. Under the lease agreement B (Pty) Ltd was required to pay A (Pty) Ltd the following amounts:

- An up-front lump sum of R50 000 payable on signature of the lease agreement.
- A monthly rental of R15 000 per month payable on or before the 5th of each month.

The agreement was concluded on 1 July year 1. B (Pty) Ltd paid the up-front lump sum and took occupation on 1 July year 1. The monthly rental was paid on the 5th of each month up to and including 5 August year 2. The building was used in the production of income.

On 31 August year 2 A (Pty) Ltd and B (Pty) Ltd agreed to cancel the lease. A (Pty) Ltd was not required to repay any portion of the up-front lump sum and B (Pty) Ltd was not required to pay any further monthly rentals.

B (Pty) Ltd has a December year end.

Result:

The up-front lump sum is an amount that was payable for the use of the building and which is distinct from and in addition to the monthly rental of R15 000. It therefore constitutes a premium that is payable for the right of use or occupation of the building under section 11(f). B (Pty) Ltd must deduct an allowance of R4 167 ($R50\,000 / 6 \text{ years} \times 6 / 12$) and R5 556 ($R50\,000 / 6 \text{ years} \times 8 / 12$) under section 11(f) in the year of assessment ending 31 December year 1 and year 2, respectively.

A deduction is not available under section 11(f) for the premium which would otherwise have been deductible under section 11(f) in year 2 and subsequent years of assessment had the lease not been cancelled and the property been used in the production of income. Therefore, the remaining balance of R40 277 ($R50\,000 - R4\,167 - R5\,556$) will not qualify for a deduction.

B (Pty) Ltd may deduct the rental of R90 000 ($R15\,000 \times 6$ for the period 1 July to 31 December year 1) and R120 000 ($R15\,000 \times 8$ for the period 1 January year 2 to 31 August year 2) under section 11(a) in the year of assessment ending 31 December year 1 and year 2, respectively.

Example 5 – Lease premiums*Facts:*

Taxpayer A, the lessor, entered into a lease agreement on 1 July year 1 for a period of 20 years. Taxpayer B, the lessee, paid taxpayer A a lease premium of R150 000. Both taxpayers have a year end of 28 February.

Assume:

1. The lease is terminated after 20 years.
2. The lease is terminated on 30 June year 6.

*Result 1:***Taxpayer A: Lessor**Year of assessment ended 28 February year 2

The full amount of R150 000 is included in gross income under paragraph (g).

Taxpayer B: LesseeYear of assessment ended 28 February year 2

An allowance of R5 000 ($R150\,000 / 20 \text{ years} \times 8 / 12^*$) is allowed as a deduction under section 11(f).

- * The apportionment of 8 / 12 is necessary as the lease commenced during the year of assessment.

Years of assessment ended 28 February year 3 to 28 February year 20

An allowance of R7 500 ($R150\,000 / 20 \text{ years}$) will be allowed as a deduction under section 11(f) each year.

Year of assessment ended 28 February year 21

An allowance of R2 500 ($R150\,000 / 20 \text{ years} \times 4 / 12^{**}$) will be allowed as a deduction under section 11(f).

** The apportionment of 4 / 12 is necessary because the lease expired during the year, that is, on 30 June year 20.

Result: 2

Taxpayer A: LessorYear of assessment ended 28 February year 2

The full amount of R150 000 is included in gross income under paragraph (g).

Taxpayer B: LesseeYear of assessment ended 28 February year 2

An allowance of R5 000 ($R150\,000 / 20 \text{ years} \times 8 / 12^*$) is allowed as a deduction under section 11(f).

* The apportionment of 8 / 12 is necessary as the lease commenced during the year of assessment.

Year of assessment ended 28 February year 3 to 28 February year 6

An allowance of R7 500 ($R150\,000 / 20 \text{ years}$) will be allowed as a deduction under section 11(f) in each year.

Year of assessment ended 28 February year 7

An allowance of R2 500 ($R150\,000 / 20 \text{ years} \times 4 / 12$) is allowed as a deduction under section 11(f). R112 500 [$R150\,000 - (R5\,000 + R7\,500 \times 4 + R2\,500)$] is not deductible as the lease is prematurely terminated.

3.2.6 Amount of the allowance - maximum annual allowance (linked to know-how)

The allowance for a premium or consideration in the nature of a premium paid for the imparting of or the undertaking to impart knowledge directly or indirectly connected with the use of a film, sound recording, advertising matter, patent, design, trade mark, copyright or property of a similar nature which is used in the production of income or from which income is derived is dealt with under section 11(f)(iv).

Paragraph (cc) of the proviso provides that the allowance shall not exceed for any one year of assessment such portion (not being less than one twenty-fifth) of the amount of the premium or consideration paid, having regard to the period during which the lessee will enjoy the right to use the film, sound recording, advertising matter, patent, design, trade mark, copyright or other property and any other circumstances which are relevant.³¹ This requirement means that the allowance must be spread over the number of years the lessee is entitled to the use or occupation of the asset to which such knowledge relates or 25 years, whichever is the lesser. The maximum period over which the deduction is calculated is therefore 25 years.

³¹ Section 11(f) proviso (cc).

Example 6 – Treatment of lease premiums for imparting knowledge relating to the use of a registered patent

Facts:

A (Pty) Ltd granted B (Pty) Ltd the right of use of a registered patent for a period of 30 years. A (Pty) Ltd also undertook to impart knowledge relevant to using the patent in B (Pty) Ltd's income-producing business for a premium of R100 000.

The agreement was concluded on 1 January year 1. B (Pty) Ltd paid the premium and commenced using the patent on 1 January year 1.

B (Pty) Ltd has a March year end.

Result:

A deduction is available under section 11(f)(iv) for the premium paid by B (Pty) Ltd to A (Pty) Ltd for undertaking to impart the relevant knowledge to B (Pty) Ltd. The maximum amount of the deduction for a year of assessment is equal to the greater of –

- Premium / period of entitlement to use the patent = R100 000 / 30 years = R3 334 per year; and
- Premium / 25 years = R100 000 / 25 years = R4 000 per year.

Therefore the maximum amount of the allowance for the year 1 year of assessment is R4 000. However, B (Pty) Ltd used the asset only for 3 months during the year of assessment and therefore the allowance claimed must be apportioned. B (Pty) Ltd is therefore entitled to an allowance of R1 000 ($R4\ 000 \times 3 / 12$) in the year 1 year of assessment.

3.2.7 Exclusion from deduction

A lessee is not entitled to a deduction under section 11(f) if the premium or consideration paid does not constitute income for the lessor for the purposes of the Act, unless the term of the right of use is 15 years or more³² and the premium or consideration is paid in respect of a right of use of a line or cable –

- used for the transmission of electronic communications;
- substantially the whole of which is located outside the territorial waters of the Republic; and
- which was brought into use for the first time after 1 January 2009.³³

The term “substantially the whole” is regarded by SARS to mean 90% or more. The percentage must be determined using a method appropriate to the circumstances.

³² With effect from 1 April 2019, 15 years or more will be reduced to 10 years or more. Before 1 April 2016, proviso (dd) of section 11(f) referred to a period of 20 years or more.

³³ Effective date of section 14(1)(e) of the Taxation Laws Amendment Act 25 of 2015.

3.2.8 Recoupment of the allowances allowed

Under section 8(4)(a) an amount previously allowed as a deduction under, amongst others, section 11(f) that has been recouped must be included in the lessee's income in the year in which it is recouped.

Example 7 – Recoupment of the allowances allowed

Facts:

Taxpayer A entered into a 10 year lease agreement on 1 January year 1 and paid the lessor a premium of R40 000 for granting the lease. On 1 January year 4 Taxpayer A ceded all its rights under the lease to Taxpayer B for R70 000. Taxpayer A has a December year end.

Result:

Taxpayer A claimed an allowance of R4 000 per year under section 11(f) in year 1, year 2 and year 3. A taxable recoupment arises under section 8(4)(a) when Taxpayer A ceded the lease for R80 000. R12 000 (3 years of allowances) must be included in Taxpayer A's income under section 8(4)(a) in its year 4 year of assessment.

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

Section 11(h) reads as follows:

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

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

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

3.3.1 Special circumstances

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

Paragraph (g)

Under paragraph (*g*) a lessor who derives a lease premium must include the full premium in gross income in the earlier of the year of assessment in which the amount is received by or accrues to the lessor. The fact that the lessor's tax liability will be higher in that year or that the lessor, if a natural person, may be subject to tax at a higher marginal rate than usual as a result of the inclusion of the lease premium is not sufficient to constitute special circumstances which entitle the lessor to an allowance under section 11(*h*).

Paragraph (h)

The application of section 11(*h*) in the context of paragraph (*h*) is discussed in the Interpretation Note 110 "Leasehold Improvements".

4. Conclusion

This Note deals with the tax treatment of lease premiums for lessors and lessees.

Lessors that receive lease premiums are obliged under paragraph (*g*) to include the full amount of the premium in their gross income in the earlier of the year of assessment of receipt or accrual. Lessees who pay the premium to a lessor for the right of use or occupation are generally allowed an allowance under section 11(*f*) over the period of the lease. Although there are differences, paragraph (*g*) and section 11(*f*) are complementary.

In limited circumstances a lessor may be entitled to a special allowance under section 11(*h*) in respect of lease premiums included in gross income under paragraph (*g*). The amount of the allowance, if it applies, is equal to such amount as the Commissioner deems reasonable, taking into account the special circumstances of the case and the length of the lease.

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