South African Revenue Service

INTERPRETATION NOTE 135

DATE: 22 October 2024

ACT : INCOME TAX ACT 58 OF 1962
SECTION : SECTIONS 23D AND 23G
SUBJECT : SALE AND LEASEBACK ARRANGEMENTS

Contents

Preamble

In this Note unless the context indicates otherwise –

- **"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 interpretation notes referred to in this Note are available on the SARS website at **www.sars.gov.za**. Unless indicated otherwise, the latest issues of these documents should be consulted.

1. Purpose

This Note provides guidance on the application of sections 23D and 23G to certain sale and leaseback arrangements. The Note does not address sale and leaseback arrangements in general.

2. Background

Taxpayers in need of financing, generally for business equipment and assets, can structure the financing arrangement in different ways. The taxpayer could either obtain loan funding from a financial institution or alternatively could enter into a sale and leaseback arrangement. A sale and leaseback arrangement is a transaction in which the owner of an asset sells the asset to the financier and then enters into a use agreement under which the asset is hired back from the financier. In this way the taxpayer raises the required funding through the proceeds on the sale of the asset and the repayment of the financing takes the form of rent.

The perceived benefits of entering into a sale and leaseback arrangement are that one party is generally entitled to deduct the full rental expenditure associated with the lease (both interest and capital portions), while the second party, usually a financial institution, is entitled to claim an allowances on the asset, and so shield the gross income arising from the receipt of the rentals. Financial institutions may in some cases utilise this "tax benefit" created through the claiming of the capital allowances to offer a lower interest rate, reflected in the rentals to the client, on the funding made available.[1] By contrast, under a loan, only the interest is deductible by the borrower and only the interest is taxable in the hands of the financier.

In *CIR v Conhage (Pty) Ltd*[2] the taxpayer had entered into two sale and leaseback transactions in respect of some of its manufacturing plant and equipment with a bank. The taxpayer had required capital to expand its business and the bank was prepared to make the funds available. Both parties had been aware of the tax advantages of sale and leaseback arrangements. The Commissioner had refused to allow the rental payments as deductions on the basis that the true nature of the transactions was a loan and alternatively that the transactions fell foul of the general anti-avoidance provisions of section 103. Hefer JA noted the following:[3]

> "Within the bounds of any anti-avoidance provisions in the relevant legislation, a taxpayer may minimise his tax liability by arranging his affairs in a suitable manner. If *eg* the same commercial result can be achieved in different ways, he may enter into the type of transaction which does not attract tax or attracts less tax. But, when it comes to considering whether by doing so he has succeeded in avoiding or reducing the tax, the court will give effect to the true nature and substance of the transaction and will not be deceived by its form (*Erf 3183/1 Ladysmith (Pty) Ltd and Another v Commissioner for Inland Revenue* 1996 (3) SA 942 (A) at 950I-952C)."

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1 Emil Brincker *Taxation Principles of Interest and Other Financing Transactions* (2004) LexisNexis Butterworths at GG-2.

2 1999 (4) SA 1149 (SCA), 61 SATC 391.

3 At SATC 393.

In the result, the court held that the transactions made perfectly good business sense and their true nature and substance were those of authentic sale and leaseback agreements. The court was also not persuaded that section 103 applied. This case highlighted the need for specific anti avoidance legislation to address sale and leaseback arrangements.

The Act contains two sections that deal with specified sale and leaseback arrangements, namely, sections 23D and 23G.

Section 23D is aimed at arrangements in which an asset, which has substantially increased in value owing to currency depreciation or inflation, is sold at market value to another party, such as a financial institution, which then in turn lets or licences the asset back to the seller. In this way, the seller is able to claim a deduction for the lease rentals determined on the increased value of the asset. Section 23D[4] is aimed at restricting the allowance which the lessor may claim on the leased asset.

Section 23G[5] treats specified sale and leaseback transactions as financial arrangements. The objective of section 23G is to prevent one entity from using the tax base of another to obtain a tax benefit.[6] This situation can arise, for example, when a tax-exempt person or institution is introduced as lessor or lessee.

Sections 23D and 23G are applicable to genuine sale and leaseback transactions that meet the requirements of those sections and, if applicable, alter the tax treatment of transactions that would otherwise have applied under other provisions of the Act. There are many genuine sale and leaseback transactions. However, there may be certain transactions which take the legal form of a sale and leaseback but that form is not genuine and was undertaken to conceal or disguise the real character of a transaction, or vice versa. If that is the case, the ostensible form of the stimulated transaction[7] is disregarded and effect is given to the real transaction with the appropriate provisions of the Act being applied to the real transaction. If the real transaction is not a genuine sale and leaseback, the provisions of section 23D and section 23G will not apply.

3. The law

The relevant sections of the Act are quoted in the **Annexure**.

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4 The section came into effect on 21 June 1993.

5 The section was introduced with effect from 5 June 1997.

6 Section 1(1) broadly defines a tax benefit to include any avoidance, postponement or reduction of any liability for tax.

7 Various principles laid down in case law have determined that the transaction must be examined as a whole, including all surrounding circumstances, any unusual features of the transaction, the income tax consequences and the manner in which the parties intend to implement it, before determining whether a *bona fide* sale and leaseback arrangement has been entered into or whether it should be considered a simulated transaction.

4. Application of the law

4.1 Leased assets previously held by the lessee or sublessee or a connected person to the lessee or sublessee (section 23D)

Section 23D was introduced as an anti-avoidance measure to limit specified allowances available to a lessor on certain assets acquired under a sale and leaseback arrangement. As mentioned briefly above, before the introduction of section 23D, transactions of this nature effectively allowed a taxpayer to claim increased capital allowances on assets that had increased in value.[8]

Section 23D applies when a depreciable asset, which is let or licenced by a taxpayer to a lessee or licensee, was held within a period of two years before the start of the lease or licence –

- by the lessee or licensee, or by any sublessee or sublicensee in relation to the asset; or
- by a person who was at any time during that period a connected person in relation to the lessee, licensee, sublessee or sublicensee.[9]

"Depreciable asset" is defined in section 1(1) as meaning –

> "an asset as defined in paragraph 1 of the Eighth Schedule (other than any trading stock and any debt), in respect of which a deduction or allowance determined wholly or partly with reference to the cost or value of that asset is allowable in terms of this Act for purposes other than the determination of any capital gain or capital loss;".

Under section 23D the amount on which allowances and deductions can be claimed by the lessor or licensor is limited to the sum of –

- the cost of the asset to the most recent lessee or licensee, sublessee or sublicensee or connected person (as referred to above), that previously held the asset, less the sum of all deductions allowed to that person on that asset and all deductions deemed[10] to have been allowed to that person on that asset under section 11(*e*)(ix),[11] 12B(4B),[12] 12C(4A),[13] 12D(3A),[14] 12DA(4),[15] 12F(3A),[16] 13(1A),[17] 13*bis*(3A),[18] 13*ter*(6A),[19] 13*quin*(3)[20] or 37B(4);[21]

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8 *Explanatory Memorandum on the Income Tax Bill, 1993.*

9 Section 23D(2).

10 A special deeming rule, depending on the section, would deem a taxpayer to have been allowed a deduction in previous years if in those previous years the receipts and accruals from its trade were not included in income and therefore no deduction on an asset used in that trade had actually been allowed.

11 The wear-and-tear or depreciation allowance.

12 Deduction in respect of certain machinery, plant, implements, utensils and articles used in farming or production of renewable energy.

13 Deduction in respect of assets used by manufacturers or hotel keepers and in respect of aircraft and ships, and in respect of assets used for storage and packaging of agricultural products.

14 Deduction in respect of certain pipelines, transmission lines and railway lines.

15 Deduction in respect of rolling stock.

16 Deduction in respect of airport and port assets.

17 Annual allowance on buildings and improvements.

18 Deduction in respect of buildings used by hotel keepers.

19 Deduction in respect of residential buildings.

20 Deduction in respect of commercial buildings.

21 Deduction in respect of environmental expenditure.

- any recoupment included in the income of such lessee, licensee, sublessee, sublicensee or connected person as a result of the disposal of the asset; and
- the applicable percentage[22] of any capital gain of such lessee, licensee, sublessee, sublicensee or connected person that arises on the disposal.[23]

Example 1 – Sale and leaseback (section 23D)

Facts:

Company X sold a machine (a depreciable asset) costing R1,5 million to Company Y for R2 million. The machine qualified for a wear-and-tear or depreciation allowance of 20% a year under section 11(*e*). Before disposing of the machine to Company Y, Company X had claimed an allowance of R300 000 on the machine. Company Y then let the machine to Company Z, a wholly owned subsidiary of Company X, for three years. Company Y was entitled to claim an allowance under section 11(*e*) of 20% a year on the machine.

Result:

Cost on which Company Y can claim an allowance

Section 23D applies as Company X held the machine within the two-year period preceding the commencement of the lease between Company Z and Company Y, and Company Z was a connected person in relation to Company X during that period under paragraph (d)(*i*) of the definition of "connected person" in section 1(1).

Calculation under section 23D:

		R
Cost to Company X		1 500 000
Less: Deductions previously allowed or deemed to have been allowed (section 11(*e*) allowance claimed by Company X)		(300 000)
		1 200 000
Add: Section 11(*e*) allowance recouped by Company X under section 8(4)(*a*) (selling price limited to cost R1,5m – tax value of R1,2m)		300 000
Add: Applicable percentage of the capital gain made by Company X		
Capital gain *[Proceeds (selling price R2m - recoupment R0,3m) – Base cost (Cost R1,5m – allowanced previously claimed R0,3m)]*	500 000	
Inclusion rate	80%	
Taxable capital gain (R500 000 × 80%)		400 000
Portion of cost subject to section 11(*e*)		1 900 000

Calculation of the allowance under section 11(e):

Section 11(*e*) allowance granted to Company Y for a year of assessment (R1 900 000 × 20%)	380 000

[22] In terms of paragraph 10 of the Eighth Schedule of the Act.
[23] Section 23D(2A).

Both section 23A and section 23D can apply to the same leased asset. Section 23A ring-fences specified capital allowances granted to a lessor for certain aircraft, ships, machinery, plant, implements, utensils and articles.[24] Section 23D can, for example, limit the amount of an allowance available under section 11(*e*). Section 23A can further limit the amount of that allowance to taxable income derived from rental income.

Depending on the facts of the particular case, paragraph 38 of the Eighth Schedule may apply to the disposal of the asset in a sale and leaseback transaction. If paragraph 38 applies, it would impact on the proceeds and base cost of the asset for the seller and purchaser respectively for capital gains tax purposes. Generally, in determining if actual cost is deemed to be equal to market value for a section of the Act, it is necessary to look at that particular section. Section 23D refers to actual cost and not market value. Therefore, even if paragraph 38 applies, and deems, for capital gains tax purposes, the seller to have disposed of and the purchaser to have incurred expenditure in acquiring the asset equal to market value, it will not impact section 23D. Paragraph 38 applies only for purposes of the Eighth Schedule.

4.2 Sale and leaseback arrangements in which the lessee or lessor is exempt from tax (section 23G)

Despite the limitations of section 23D introduced in 1993, arrangements were still structured so that one entity could use the tax base of another to obtain a tax benefit. This result was achieved by, for example, introducing a lessee, sublessee or lessor whose receipts and accruals are exempt from tax. Section 23G was therefore introduced to address a sale and leaseback arrangement relating to an asset in which either the lessee or the lessor is a tax-exempt person.

Under section 23G, specified sale and leaseback transactions will in substance be treated on the same basis as a loan arrangement. If the lessor is tax-exempt, the effect of section 23G is that the deduction available to a lessee or sublessee relating to any lease payments due under an affected sale and leaseback arrangement will be limited to the interest element of such lease payments. Alternatively, if the lessee or sublessee is tax-exempt under such an arrangement, the lessor will be taxed only on the interest element of the lease payments and will not be entitled to any depreciation allowances on the relevant asset under the Act.[25]

Effectively, the underlying asset is ignored, no tax allowances are granted on the cost of the asset, and the finance component of the arrangement is dealt with under section 24J. Section 24J was amended so that such sale and leaseback arrangements could be included in the definition of "instrument". This result was achieved by deeming the absolute value of the difference between the amounts receivable and payable by a person under such an arrangement to be "interest" for the purposes of that section.[26]

Section 23G(1) defines a "sale and leaseback arrangement". For purposes of the section, it is any arrangement in which –

- the seller disposes of any asset, directly or indirectly, to the purchaser; and

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[24] For commentary on section 23A, see Interpretation Note 53 "Limitation of Allowances Granted to Lessors of Affected Assets".

[25] *Explanatory Memorandum on the Income Tax Bill, 1997.*

[26] *Explanatory Memorandum on the Income Tax Bill, 1997.*

- the seller or any connected person[27] in relation to the seller leases, directly or indirectly, the asset from the purchaser.

An asset can be movable or immovable, corporeal or incorporeal.[28]

Arrangement

The word "arrangement" is not defined in the section. It is not a term of great technical complexity and its ordinary grammatical use may apply. *Dictionary.com* defines "arrangement" and "arrange" respectively as –

> "1. an act of arranging; state of being arranged"[29]

> " 2. to come to an agreement or understanding regarding: *The two sides arranged the sale of the property.* … 3. To prepare or plan: *to arrange the details of a meeting*".[30]

Disposes

The context of the section points to a transfer of ownership.

The transfer of ownership must be distinguished from the granting of a limited real right such as mortgage, pledge, and servitude, which confer only limited and clearly defined powers on the holder of the real right.[31] By granting third parties these limited real rights, the owner's power to exercise his or her ownership is merely limited and does not amount to a disposal of an asset. Once these limited real rights are extinguished, the person's ownership automatically becomes unencumbered again.[32]

Directly or indirectly

The word "directly" bears its ordinary meaning, and is defined by *Dictionary.com* as –[33]

> 1. in a direct line, way, or manner; straight".

Similarly, "indirectly" is defined in *Dictionary.com* as –[34]

> "1. in a roundabout way; not by the shortest or straightest path; 2.by a connection that is not immediate; 3. in a way that is veiled or not straightforward; obliquely".

In assessing whether there is an indirect disposal, it is always necessary to consider the facts and circumstances of a particular case. For example, in the sale of an asset by A to B, followed by a sale of that asset from B to C, it is necessary to assess whether the sale between A and B was a contributing factor to the sale between B and C, and, if so, whether that link was sufficiently close as to be "indirect" or whether it was too remote. If the sale between B and C was totally unrelated to the sale between A and B, then it would not give rise to an indirect disposal of that asset from A to C as the link

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27 See the definition of "connected person" in section 1(1). For commentary on the definition, see Interpretation Note 67 "Connected Persons".

28 Definition of "asset" in section 23G(1).

29 **www.dictionary.com/browse/arrangement** [Accessed 22 October 2024].

30 **www.dictionary.com/browse/arrange** [Accessed 22 October 2024].

31 CG van der Merwe Things / Ownership / Nature / Definition 27 (Second Edition) *LAWSA* [online] (My LexisNexis: 31 January 2014) in paragraph 134.

32 CG van der Merwe Things / Ownership / Nature / Content 27 (Second Edition) *LAWSA* [online] (My LexisNexis: 31 January 2014) in paragraph 135.

33 **www.dictionary.com/browse/directly** [Accessed 22 October 2024].

34 **www.dictionary.com/browse/indirectly** [Accessed 22 October 2024].

is too remote.[35] However, if A sold the asset to B with an agreement or requirement, that is with the intention, that B would sell the asset to C then the link would be sufficiently close such that the disposal would be an "indirect disposal" between A and C.

Leases

A lease includes any arrangement that can be legally classified as a lease. The Law of South Africa (LAWSA)[36] states that a contract of lease is entered into when, within the limits laid down by law, parties agree that the one party, called the lessor, shall give the use and enjoyment of property to the other, called the lessee, in return for the payment of rent. An agreement that permits a party to consume or destroy the subject matter of the contract is not a lease even if the parties are referred to as lessor and lessee or one of them is said to be obliged to pay "rent". A lease contemplates the return of the property to the lessor at the end of the lease. A person who acquires an asset under an agreement contemplated in paragraph (*a*) of the definition of "instalment credit agreement" in section 1(1) of the Value-Added Tax Act, 1991 is regarded as the owner of the asset for the purposes of claiming the various depreciation allowances under the Act. Such an asset is not acquired by the person under a lease agreement for the purposes of section 23G.

4.2.1 Receipts and accruals of a lessee or sublessee do not constitute income [section 23G(2)]

(a) Receipts and accruals of a lessee or sublessee do not constitute income

Section 23G(2) seeks to regulate sale and leaseback transactions in which a tax-exempt body[37] is used to obtain a tax benefit. It applies when all the potential receipts or accruals of a lessee or a sublessee do not constitute income[38] of that person. Section 23G(2) is not applicable if only a particular source of income of the lessee or sublessee is exempt from tax. Thus, if an institution or body that is a lessee or sublessee in a sale and leaseback transaction is only partially exempt (for example, a public benefit organisation), section 23G(2) does not apply. Similarly, if the lessee or sublessee is a non-exempt company but all of its receipts or accruals for a particular year of assessment happen to comprise exempt local dividends, section 23G(2) will not apply because all its receipts and accruals of whatever nature are not exempt from normal tax. A typical example of a fully exempt body is a municipality.

Section 23G(2) refers to a lessee or a sublessee in relation to a sale and leaseback arrangement. If a head lease and a number of sub-leases are entered into, section 23G(2) would apply even if the ultimate user of the asset were not exempt as long as the lessee's or one of the sublessee's receipts and accruals were exempt.

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35 D Davis, L Olivier, G Urquhart, R Engels-van Zyl, J Roeleveld, O Mollagee & M Benetello *Juta's Tax Library* [online] (Jutastat e-publications: 30 November 2017) in Commentary on Income Tax – section 23G.

36 GB Bradfield Lease / Introduction / Definition 26 (Third Edition) *LAWSA* [online] (My LexisNexis: 31 December 2020) in paragraph 75.

37 *Explanatory Memorandum on the Income Tax Bill, 1997*.

38 "Income" is defined in section 1 as the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax under Part I of Chapter II.

Under these circumstances section 23G(2) would apply and the lessor would be impacted.

See **4.2.3** for consideration of the further impact on a lessor who is both a lessor and lessee in a sale and leaseback transaction during the year of assessment.

(b) Impact of section 23G(2) on lessee and lessor

If applicable, section 23G(2) amends the tax consequences that otherwise apply to the lessor. The tax consequences that apply to the lessee or sublessee are not amended under section 23G(2).

Under section 23G(2) the lessor will –

- have to account for any amount received or accrued in relation to the sale and leaseback arrangement to the extent that it constitutes interest for the purposes of section 24J; and
- not be entitled to any allowances on the asset to which the sale and leaseback applies under sections 11(*e*),[39] 11(*f*),[40] 11(*g*A), 11(*g*C),[41] 12B, 12BA, 12C, 12DA,[42] 13[43] or 13*quin*.[44]

For the purposes of section 23G, "interest" is defined with reference to the definition of that term in section 24J, namely, the absolute value of the difference between all amounts receivable and payable by a person in terms of the sale and leaseback arrangement throughout the full term of the arrangement. This determination applies irrespective of whether the amount is calculated with reference to a fixed or variable rate of interest or is payable or receivable as a lump sum or in unequal instalments during the term of the financial arrangement.[45]

The interest is calculated for the period of the lease and spread over its term on a yield to maturity basis. When an asset is leased for only part of the financial year, the interest amount for the relevant accrual period will be apportioned on a day-to-day basis over the period.

Example 2 – Tax-exempt lessee or sublessee

Facts:

All the receipts or accruals of Company X are exempt from normal tax under section 10. Company X sold an asset to Company Y for R100 000 on the first day of the year of assessment. On the same day Company Y let the asset to Company X for five years at an annual rental of R30 000.

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39 The wear-and-tear or depreciation allowance.
40 The allowance for lease premiums.
41 The allowance for patents and similar rights.
42 Depreciation allowances for machinery and similar assets.
43 The allowance for industrial buildings.
44 The allowance for commercial buildings.
45 Paragraph (*c*) of the definition of "interest" in section 24J(1).

Result:

The arrangement is a sale and leaseback arrangement since Company X sold the asset to Company Y and leased it back from Company Y. Section 23G(2) applies as Company X, the lessee in this arrangement, is exempt from tax. Company Y will not be allowed to claim any capital allowances on the asset under section 23G(2)(*b*), read with the relevant allowance section. Further, under section 23G(2)(*a*), Company Y's income from this arrangement is limited to an amount which constitutes interest under section 24J.

	R
Amount receivable under the lease R30 000 × 5	150 000
Less: Amount paid for the asset	(100 000)
Interest	50 000

The interest of R50 000 accrues to Company Y on a yield to maturity basis over the period of the lease under section 24J. Instead of recognising the annual lease rentals of R30 000 as income, Company Y must include total interest of R50 000 over five years in its income on the yield to maturity basis under section 24J.

4.2.2 Lessor's receipts and accruals arising under the agreement are not income [section 23G(3)]

(a) Receipts and accruals of the lessor arising under the sale and leaseback are not income

As noted above, section 23G(2) requires that all the receipts or accruals of whatever nature of the lessee or sublessee be exempt from tax. By contrast, section 23G(3) requires that only the lessor's receipts and accruals arising from the sale and leaseback arrangement do not constitute income. It is likely that in most situations a lessor that is exempt from tax on the receipts and accruals from a sale and leaseback arrangement would be a fully exempt person such as a municipality. However, there could be situations in which a partially taxable entity could be exempt from tax on such receipts or accruals. For example, a public benefit organisation, which is subject to partial taxation under section 10(1)(*c*N), may potentially be taxable on some of its receipts or accruals but its receipts and accruals from a sale and leaseback arrangement may be exempt from tax in a particular year of assessment if its receipts or accruals for that year are below the threshold exemption (greater of 5% of all receipts and accruals and R200 000).

(b) Impact of section 23G(3) on lessee and lessor

If the receipts and accruals of a lessor arising from a sale and leaseback arrangement do not constitute income, a lessee or sublessee may not deduct the full lease rentals for tax purposes. Instead, the deduction is limited to an amount that constitutes interest under section 24J. The tax consequences that apply for the lessor are not amended under section 23G(3).

Depending on the facts of a particular sale and leaseback arrangement, the targeted "interest element" may arise in a lessee, a sub-lessee or a combination of a lessee and sub-lessees to the arrangement. In targeting the "interest element", section 23G(3) is wide and, depending on the facts, can be applied a lessee, a sub-lessee, or a combination of the lessee and sub-lessees to a sale and leaseback arrangement.

Example 3 – Tax-exempt lessor

Facts:

Company Y, a subsidiary of Company X, sold an asset to Company Z, a tax-exempt institution, for R80 000 on the first day of the year of assessment. On the same day, Company Z leased the asset to Company X for five years at R18 000 a year, and Company X in turn sublet it to Company Y for five years at R19 200 a year.

Result:

The arrangement is a sale and leaseback arrangement since Company Y sold the asset to Company Z, and indirectly leased it back from Company Z.

Company X

The rental income received from Company Y of R19 200 a year is taxed in full, since both Company X and Company Y are subject to tax.

In the facts of this arrangement as there is no interest element from Company X's perspective, the total rental expense of R90 000 (R18 000 × 5) paid by Company X qualifies for a deduction and is left unaffected by section 23G(3). If the facts were different such that the interest element was in Company X or split between Company Y and Company X, section 23G(3) would, as appropriate, be applied to Company X, or Company Y and Company X.

Company Y

Company Y, the sub lessee, is a party to the sale and leaseback arrangement.

Company Y does not have income from the sale and leaseback arrangement but will have income from its business operations.

The total rental expense of R96 000 (R19 200 × 5) paid by Company Y to Company X is limited to an amount equal to the absolute amount of interest determined under section 24J of R16 000.* The amount of R16 000 must be spread over the five years in accordance with the yield to maturity method.

	R
Rentals payable by Company Y under the agreement (R19 200 × 5)	96 000
Less: Amount received on sale of asset by Company Y	(80 000)
Deductible rentals to be spread in the same manner as interest	16 000*

Treatment of lease premiums by the lessee

Section 23G(3) provides that the section is subject to section 11(*f*),[46] which provides an allowance for lease premiums. Section 11(*f*) denies the lessee the right to claim an allowance in respect of a lease premium or similar consideration if the lessor is a tax-exempt body.[47] Since section 11(*f*) takes precedence in denying a deduction for a lease premium paid to a tax-exempt body, no portion of such a premium is dealt with by section 23G(3), and it must be excluded from the calculation of the amount of

[46] See Interpretation Note 109 "Lease Premiums".
[47] Paragraph (*dd*) of the proviso to section 11(f).

interest as contemplated in section 24J. Accordingly, it will not qualify for a deduction under section 11(*a*), section 11(*f*), or section 24J.[48]

Example 4 – Tax-exempt lessor and section 11(*f*) applicable to lessee

Facts:

Company X sold a machine to Company Y, a tax-exempt institution, for R100 000 on the first day of the year of assessment. On the same day, Company Y let the machine to Company X for R25 000 a year for five years subject to the payment of an up-front lease premium of R20 000.

Result:

The arrangement is a sale and leaseback arrangement since Company X sold the machine to Company Y and leased it back from Company Y.

The rentals payable by Company X of R125 000 (R25 000 × 5) to tax-exempt Company Y are subject to section 23G(3) since all Company Y's receipts or accruals are exempt and do not constitute income. The deductions for the rentals paid are limited to interest of R25 000 payable over the period of five years on a yield to maturity basis under section 24J:

	R
Rentals payable under the lease agreement R25 000 × 5	125 000
Less: Amount received on sale of asset by Company X	(100 000)
Deductible interest	25 000

The up-front lease premium of R20 000 is an amount that was payable for the use of the machine and is distinct from and in addition to the annual rental of R25 000. It therefore constitutes a premium payable for the right of use of the machine under section 11(*f*), and Company X will not be allowed to claim the premium as a deduction over the period of the lease by virtue of paragraph (*dd*) of the proviso to section 11(*f*). The latter proviso makes section 11(*f*) inapplicable when the premium or like consideration does not constitute income of the person to whom it is paid, subject to an exception for qualifying communication cables not relevant to the present example. Since section 11(*f*) takes precedence over section 23G(3), the amount of the premium is not dealt with by section 23G(3), and must be excluded from the calculation of the amount of interest as contemplated in section 24J.

4.2.3 Taxpayer is both lessor and lessee [section 23G(4)]

Section 23G(4) provides that section 23G(2)(*a*) does not apply to any person that is both a lessor and a lessee in relation to the same sale and leaseback arrangement during any year of assessment. Section 23G(2) applies when the lessee or sublessee is a tax-exempt person. Section 23G(2)(*a*) limits the receipts or accruals of the lessor to an equivalent amount of interest determined under section 24J.

However, since section 23G(4) "turns off" section 23G(2)(*a*), the limitation of receipts and accruals of the lessor to an amount of interest does not apply if the lessor is also a lessee in relation to the same sale and leaseback arrangement during the year of assessment. The lessor, being a party to the sale and leaseback transaction, is still subject to section 23G(2)(*b*), and, if the requirements for an allowance had been met,

[48] Section 23B(3).

would not be permitted to deduct any allowances under section 11(*e*), (*f*) or (*g*A), (*g*C), 12B, 12BA, 12C, 12DA, 13 or 13*quin.*[49] The effect of section 23G(4) is that the lease receipts will be taxed in full and not limited to the interest element only but that, if applicable, no deduction for depreciation allowances on the relevant asset will be allowed against such income.

Since a person cannot let an asset to itself, it follows that section 23G(4) envisages, for example, a tripartite arrangement in which Company A sells the asset to Company B, Company B leases the asset to Company C, and Company C leases the asset to Company A.

Section 23G(4) applies only for that period of the year during which the person concerned is both lessor and lessee, and not for the entire year.[50]

Example 5 – Person both a lessor and lessee in relation to the same sale and leaseback arrangement

Facts:

Municipality sold a machine to Company X for R100 000 on the first day of the year of assessment of Company X. Company X in turn immediately let the machine to its wholly owned subsidiary Company Y at R25 000 a year over five years, and Company Y in turn sublet the machine to the municipality at R30 000 a year over five years. The machine would normally qualify for a wear-and-tear or depreciation allowance under section 11(*e*) at 20% a year on the straight-line basis.

Result:

The arrangement is a sale and leaseback arrangement since the municipality sold the machine to Company X and indirectly leased it back from Company X.

Company Y

Section 23G(4) applies to Company Y because it is both a lessor (in relation to the municipality) and a lessee (in relation to Company X) under the sale and leaseback arrangement.

Consequently, Company Y must include the full lease rentals of R30 000 a year in its income because section 23G(4) suspends the application of section 23G(2)(*a*). In other words, Company Y is not permitted to reduce its rental income to an equivalent amount of interest under section 24J.

Company Y may deduct the rentals of R25 000 a year it paid to Company X under section 11(*a*), since Company X is a fully taxable entity, and section 23G(3) does not apply to this leg of the arrangement.

Company X

The municipality is a sublessee in relation to the sale and leaseback arrangement and its receipts or accruals are exempt from tax.

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[49] The application of section 23G(2)(*b*) is not excluded by section 23G(4).

[50] In agreement with the view held by D Davis *et al Juta's Tax Library* [online] (Jutastat e-publications: 30 November 2017) in Commentary on Income Tax – section 23G.

Company X is a lessor in relation to Company Y and a party to the sale and leaseback transaction because it is indirectly leasing the machine to the municipality through Company Y. Under section 23G(2)(*a*), any amount which is received by or accrues to Company X ("any lessor") in relation to the sale and leaseback arrangement, is limited to an amount which constitutes interest as contemplated in section 24J.

	R
Amount receivable under the lease (R25 000 × 5)	125 000
Less: Amount paid for the asset	(100 000)
Interest	25 000

Instead of recognising the annual lease rentals of R25 000 as income, Company X must include total interest of R25 000 over five years in its income on the yield to maturity basis under section 24J.

Company X will not be allowed to claim any capital allowances on the asset under section 23G(2)(*b*).

In summary: Over the five-year lease term, Company Y will have taxable income of R25 000 [(R30 000 − R25 000) × 5]. Company X will have taxable income of R25 000 (rental reduced to R25 000 less zero wear-and-tear or depreciation allowances). The total taxable income of Company X and Company Y is thus R50 000, which is equal to the difference between the rentals paid by the municipality of R150 000 (R30 000 × 5) and the cost of the machine of R100 000.

5. Conclusion

Section 23D limits the allowances that a lessor may claim under a sale and leaseback arrangement should the asset be held within a two-year period before the commencement of the lease or licence by the lessee or licensee or by any sublessee or sublicensee in relation to that asset or by a person that was a connected person in that time period to the lessee, licensee, sublessee, or sublicensee.

Before the introduction of section 23G, parties to a sale and leaseback arrangement made use of the tax benefit that arose should one party be tax exempt. For example, since the lessor buying an asset from a tax-exempt lessee was entitled to allowances on the asset purchased, the lessor could effectively provide financing at a lower rate to the lessee. As these arrangements are effectively financing arrangements, section 23G serves to treat them as loan arrangements with no tax allowances granted on the asset and the finance component covered under section 24J. Section 23G(2) applies when the receipts and accruals of whatever nature received by or accrued to a lessee or sublessee do not constitute income, while section 23G(3) applies when the receipts and accruals of any lessor arising from the sale and leaseback arrangement do not constitute income.

Annexure – The law

Section 23D

23D. Limitation of allowances granted in respect of certain assets.—(1) . . . . . .

(2) Where any depreciable asset which is let or licensed by a taxpayer to a lessee or licensee was held within a period of two years preceding the commencement of the lease or licence—

(*a*) by the lessee or licensee, or by any sublessee or sublicensee in relation to the asset; or

(*b*) by a person who was at any time during that period a connected person in relation to the lessee, licensee, sublessee or sublicensee,

the cost or value of the depreciable asset for the purpose of this section and any deduction or allowance claimed by the taxpayer in respect of the asset shall not exceed the amount determined in accordance with subsection (2A).

(2A) The amount to be determined for purposes of subsection (2) is the sum of—

(*a*) the cost of the asset to the most recent lessee, licensee, sublessee, sublicensee or connected person contemplated in subsection (2) that previously held that asset, less the sum of—

(i) all deductions which have been allowed to the lessee, licensee, sublessee, sublicensee or connected person in respect of the asset; and

(ii) all deductions that are deemed to have been allowed to the lessee, licensee, sublessee, sublicensee or connected person in respect of the asset in terms of section 11(*e*)(ix), 12B(4B), 12C(4A), 12D(3A), 12DA(4), 12F(3A), 13(1A), 13*bis*(3A), 13*ter*(6A), 13*quin*(3) or 37B(4);

(*b*) any amount contemplated in paragraph (*n*) of the definition of "gross income" in section 1 that is required to be included in the income of the lessee, licensee, sublessee, sublicensee or connected person that arises as a result of the disposal of the asset; and

(*c*) the applicable percentage in paragraph 10 of the Eighth Schedule, of the capital gain of the lessee, licensee, sublessee, sublicensee or connected person that arises as a result of the disposal.

(3) . . . . . .

Section 23G

23G. Sale and leaseback arrangements.—(1) For the purposes of this section—

"asset" means any asset, whether movable or immovable, or corporeal or incorporeal;

"sale and leaseback arrangement" means any arrangement whereby—

(*a*) any person disposes of any asset (whether directly or indirectly) to any other person; and

(*b*) such person or any connected person in relation to such person leases (whether directly or indirectly) such asset from such other person.

(2) Where the receipts or accruals of any person, who is a lessee or sublessee in relation to a sale and leaseback arrangement, do not for the purposes of this Act constitute income of such person—

(*a*) any amount which is received by or accrues to any lessor in relation to such sale and leaseback arrangement, shall be limited to an amount which constitutes interest as contemplated in section 24J; and

(*b*) such lessor shall, notwithstanding the provisions of this Act, not be entitled to any deduction in terms of section 11 (*e*), (*f*) or (*g*A), (*g*C), 12B, 12BA, 12C, 12DA, 13 or 13*quin* in respect of an asset which is the subject matter of such sale and leaseback arrangement.

(3) Where the receipts or accruals of any person, who is a lessor in relation to a sale and leaseback arrangement, arising from such arrangement do not for the purposes of this Act constitute income of such person, any deduction to which a lessee or sublessee in relation to such sale and leaseback arrangement is entitled under the provisions of this Act shall, subject to the provisions of section 11 (*f*), be limited to an amount which constitutes interest as contemplated in section 24J.

(4) The provisions of subsection (2) (*a*) shall not apply to any person who is both a lessor and a lessee in relation to the same sale and leaseback arrangement during any year of assessment.