

BINDING PRIVATE RULING: BPR 401

DATE: 14 December 2023

ACT : INCOME TAX ACT 58 OF 1962 (the Act)
SECTION : SECTION 11(h)
SUBJECT : LEASEHOLD IMPROVEMENT ALLOWANCE

Preamble

This binding private ruling is published with the consent of the Applicant(s) to which it has been issued. It is binding between SARS, the Applicant and any Co-Applicant(s) only and published for general information. It does not constitute a practice generally prevailing.

1. Summary

This ruling determines the tax consequences for a lessor in respect of improvements effected by a lessee.

2. Relevant tax laws

In this ruling references to sections are to sections of the Act applicable as at 11 September 2023. Unless the context indicates otherwise any word or expression in this ruling bears the meaning ascribed to it in the Act.

This is a ruling on the interpretation and application of section 11(h).

3. Parties to the proposed transaction

The Lessor: A resident company

The Lessee: A resident company, which is independent of the Lessor

4. Description of the proposed transaction

The Lessor, a company that is a member of an international group, wishes to upgrade its current warehouse to a facility that can accommodate its required capacity and maximize its distribution efficiencies. To achieve this, the Lessor considered various options, bearing in mind its business strategy, operational needs, and the transactional implications of each option.

The Lessor's corporate philosophy is driven by the group's global strategy and approach to capital expenditure, being to focus its capital expenditure on its main business, by spending its allocated capital budget on machinery and equipment to manufacture its product and not to build or acquire buildings. The reason for choosing the proposed structure is, therefore, driven by global guidance, business and capital investment strategy.

The proposed transaction entails the Lessor leasing the lease area to the Lessee under a ground lease and the Lessee subletting the lease area back to the Lessor under a sub-lease. The intention of the parties is that the Lessee should act as landlord of the lease area.

In terms of the provisions in the ground lease read with the sub-lease the Lessee will have the obligation to erect a warehouse on the lease area.

The following are the salient terms of both lease agreements:

- The lease area is to be leased by the Lessor to the Lessee in terms of the ground lease, for a period of 50 years for a nominal rental amount.
- One of the conditions precedent to the ground lease, is that the sub-lease is concluded simultaneously between the Lessor and Lessee.
- When read together, the ground lease and the sub-lease provide that the Lessee will erect, at its own cost, certain improvements upon the lease area, being a warehouse. As such the Lessee will procure the construction, installation, and completion of a warehouse.
- The lease area, along with the warehouse, are to be sublet by the Lessee to the Lessor in terms of the sub-lease for an initial period, which may be extended on three occasions for 5-year periods each, at the option of the Lessor.
- The sub-lease is subject to the suspensive condition that the ground lease becomes unconditional and that the site development plan of the warehouse is approved by the relevant authorities.
- The Lessor is entitled to terminate the ground lease prior to the end of the 50-year period, either at the end of the initial period of the sub-lease or at the end of an applicable renewal period.
- Should the ground lease be so terminated, the Lessor will be obliged to pay the Lessee an amount equal to the market value of the lease area and warehouse.
- Should the Lessor not exercise its early termination right but elect not to renew the sub-lease, the ground lease will continue to operate for the balance of the 50-year lease period and the Lessee will be entitled to sublet the lease area to third parties.
- Should the ground lease be terminated for any reason the sub-lease will also be terminated.
- Should the ground lease be terminated prior to the expiry of the initial period of the sub-lease resulting from a material breach:
 - by the Lessee, then the Lessee will be entitled to claim an amount equal to the balance of the monthly rental payable in terms of the sub-lease which would have been payable up to the expiry of the initial period of the sub-lease, from the Lessor; or
 - by the Lessor, then the Lessee will be entitled to claim an amount equal to the market value of the lease area and the warehouse erected thereon from the Lessor, plus an amount equal to the net present value of the monthly rental payable in terms of the sub-lease,

which would have been payable up to the expiry of the initial period of the sub-lease.

- Should the ground lease terminate prior to the expiry of the relevant renewal period but after the initial period of the sub-lease as a result of a material breach by either party, then the Lessee will be entitled to claim an amount equal to the balance of the monthly rental payable in terms of the sub-lease, which would have been payable up to the expiry of the relevant renewal period of the sub-lease, from the Lessor.

5. Conditions and assumptions

This binding private ruling is subject to the following additional conditions and assumptions:

- a) The Lessee will be granted a deduction under the provisions of section 11(g) over 25 years; and
- b) The value of the improvements will be included in the Lessor's "gross income" (Inclusion Amount) under paragraph (g) or paragraph (h) of the definition of "gross income" in section 1(1).

6. Ruling

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

- a) In respect of the Inclusion Amount, the Lessor may deduct from its income an allowance under section 11(h), equal to the difference between the Inclusion Amount and the present value of the Inclusion Amount, which present value is determined by discounting the Inclusion Amount at 6% over the number of years taken into account in the determination of the relevant allowance granted to the Lessee under the provisions of section 11(g).

7. Period for which this ruling is valid

This binding private ruling is valid for a period of three years from 11 September 2023.