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LEASEHOLD IMPROVEMENTS: DEVELOPING A FRAMEWORK FOR THE TAX DEDUCTIONS APPLICABLE TO LESSEES

by

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Dedicated to my daughter, Anje Theart, who was born during the completion of this work.

I would also like to express my appreciation to the following people who have supported me throughout this study:

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ABSTRACT

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Taxpayers who operate from leased premises often incur significant costs in order to make the premises suitable for their specific trade. For accounting purposes such costs are generally capitalised as leasehold improvements and depreciated over the lease term. In practice many taxpayers proceed to follow the same approach for tax purposes by claiming an allowance for wear and tear on leasehold expenditure over the term of the lease. However, such expenditure is far more complex and taxpayers often do not properly understand the appropriate tax treatment of such costs.

The tax treatment of expenditure incurred on leased premises is determined by a number of legislative sections, each with its own provisos and requirements. The applicable section under which a taxpayer should claim a deduction for expenditure on leased premises depends on the type of expenditure incurred by the taxpayer.

In this study a framework was developed for determining the correct tax treatment of expenditure incurred by lessees on leased premises. Different types of expenditure that lessees had incurred were identified in three case studies. The framework was evaluated by applying it to these types of expenditure identified, and was found to be of considerable practical use.

Keywords:

Leasehold improvements

Leasehold expenditure

Tax deductions for lessees

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OPSOMMING

HUURVERBETERINGE: ONTWIKKELING VAN ’N RAAMWERK VIR BELASTINGAFTREKKINGS VAN TOEPASSING OP HUURDERS

deur

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Belastingpligtiges wat hul besighede vanuit gehuurde persele bedryf, moet dikwels aansienlike uitgawes aangaan ten einde die perseel geskik te maak vir hul spesifieke tipe besigheid. Vir rekenkundige doeleindes word hierdie uitgawes oor die algemeen as huurverbeteringe gekapitaliseer en oor die huurtermyn gedepresiëer. Vir belastingdoeleindes volg belastingpligtiges in die praktyk dikwels dieselfde benadering, deur ’n waardeverminderingstoelaag op huuruitgawes oor die huurtermyn te eis. Die toepaslike belastinghantering van sulke uitgawes is egter meer gekompliseerd en belastingpligtiges verstaan dit dikwels nie.

Die belastinghantering van uitgawes aangegaan by huurpersele word bepaal deur ’n aantal wetsartikels, elk met sy eie voorwaardes en vereistes. Die toepaslike artikel waaronder ’n belastingpligtige ’n aftrekking vir uitgawes op huurpersele kan eis, hang af van die tipe uitgawe wat aangegaan is.

In hierdie studie is ’n raamwerk ontwikkel wat huurders gebruik om die korrekte belastinghantering van uitgawes op huurpersele aangegaan, te bepaal. Verskillende tipes uitgawes wat huurders aangegaan het, is in drie gevallestudies geïdentifiseer. Die raamwerk is geëvalueer deur dit op die geïdentifiseerde tipes uitgawes toe te pas, en daar is gevind dat dit heelwat praktiese waarde het.

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Sleutelwoorde:

Huurverbeteringe

Uitgawes op huureiendom

Belastingaftrekkings vir huurders

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CHAPTER 1

INTRODUCTION

1.1 BACKGROUND

The taxation of property and property improvements is relevant for most taxpayers, as most businesses require premises from which to operate. In many instances these premises are leased from a third party. Lessees often spend significant amounts on effecting improvements or alterations to leased property and the correct tax treatment of such expenditure is in many instances unclear. Such expenditure is commonly referred to in South Africa as “leasehold improvements”. For accounting purposes leasehold improvements are generally capitalised and written off over the period of the lease. Taxpayers commonly treat these expenses similarly for tax purposes by claiming a wear-and-tear allowance over the period of the lease, without proper regard to the terms of the lease agreement and the provisions of the Income Tax Act of South Africa (58/1962) (hereafter referred to as the Act) (Walne, 2011).

Section 11(g) of the Act contains a provision for a tax deduction specifically for leasehold improvements incurred by the lessee. The requirements of this section are, however, very strict in that it requires the lessor to be taxed on the value of such improvements. Moreover the lessee must have had an obligation under the lease agreement to effect the improvements in order to qualify for the deduction.

Two previous studies addressed the tax treatment of leasehold improvements from different perspectives. The first study aimed at developing a framework to reduce tax liabilities arising from property leases for both lessee and lessor (Du Preez, 2001), while the second study focused on the tax treatment of reimbursements made by the lessor to

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the lessee in respect of leasehold improvements effected by the lessee. (Esterhuizen, 2011).

To date no study has been done in South Africa which focuses on the deductions available to lessees with regard to expenditure incurred on leased premises. The main focus of this study is to analyse which other deductions are available to the lessee in instances where the section 11(g) deduction may not be claimed, and to develop a framework based on this analysis that will be of practical assistance to lessees.

1.2 PROBLEM STATEMENT

Many lessees who incur expenditure on leasehold improvements do not qualify for the section 11(g) tax deduction. The nature of the lessee's expenditure should be analysed to determine if all or any of it actually relates to *improvements* to the leased premises. In cases where no section 11(g) deduction is available, the lessee may qualify for another tax deduction in respect of the expenditure incurred on the leased premises, for example section 11(e) which allows for a wear and tear deduction on certain assets. The capital gains tax (CGT) implications of expenditure incurred by the lessee should also be considered.

1.3 PURPOSE STATEMENT

The main focus of this study is to analyse deductions that are available to the lessee in instances where no section 11(g) deduction may be claimed. This analysis is then used to develop a framework that will be of practical assistance to lessees with regard to determining the correct tax deductions available in respect of leasehold improvements.

Previous studies and existing literature focus mainly on the requirements of section 11(g) when reviewing the tax deductions available to the lessee in respect of leasehold improvements. From a theoretical perspective this study should therefore make a valuable contribution to the existing body of knowledge as it will focus on the options available to the lessee where no section 11(g) allowance is permitted.

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From a practical perspective, the framework developed during this study could assist lessees in evaluating the nature of expenditure incurred in respect of leased premises and determining the correct tax treatment. Such a framework should also be of benefit to employees of the South African Revenue Service (SARS), tax practitioners in South Africa and researchers in other countries.

1.4 RESEARCH OBJECTIVES

This study is guided by the following research objectives:

- To identify and critically analyse the different tax deductions that may be applicable to expenditure incurred by lessees, in respect of leased premises, in instances where section 11(g) will not apply.
- To identify the type of expenditure that taxpayers typically include in leasehold improvements by analysing the expenditures in three practical cases.
- To develop a framework which will assist the lessee in determining the correct tax treatment of expenditure incurred in respect of leased premises.
- To evaluate the usefulness of the framework in a number of scenarios.

1.5 DELIMITATIONS AND ASSUMPTIONS

The study has a number of delimitations relating to context and perspective. Firstly the study was done in a South African context, hence only South African tax legislation was considered. Furthermore the study focuses only on leases of immovable property from the lessee's perspective.

The literature review briefly touches on the requirements of section 11(g) and focuses on alternative deductions available to the lessee. Deductions relating to lease premiums under section 11(f) of the Act, as well as the section 11(o) allowance on depreciable assets disposed of are not included in the scope of this study.

Lessees in agreements with Public Private Partnerships can, under section 12N of the Act, in certain instances qualify for a tax deduction on improvements of property owned by

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another party. Situations in which section 12N could apply were not included in the scope of this study.

Special capital allowances or deductions provided for in the Act applicable to hotel buildings, industrial buildings, ship-building structures or farmland have not been considered. Provisions in the Act that apply to property developers also fall outside the scope of this study.

This study was done on the assumption that a lease agreement is between two parties only, namely the lessor and the lessee. Situations where a lessee subleases a property to a third party were not analysed. Also, lease agreements that form part of a sale and leaseback arrangement were not considered.

Furthermore it was assumed in all instances that the lessee occupies the leased premises for the purposes of trade.

Finally the study focuses on the income tax implications for the lessee, and any other applicable taxes such as value added tax (VAT) were not considered.

1.6 DEFINITION OF KEY TERMS

There are a number of key terms or concepts that are relevant to this study. The definitions of these terms are listed below. These definitions are not meant to serve as general definitions, *and have been formulated for purposes of this study only*, after a review of existing literature and relevant case law.

Improvements: Reconstruction of the whole or a substantial part of the premises, or reconstruction resulting in an increase in the income earning capacity of the premises. (see section 2.2.1 of chapter 2).

Lease: A contract whereby one person grants another person the use and enjoyment of an asset and, in the context of leased premises, “an agreement granting the right of use or

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occupation of property" (Kruger, Stein, Dachs & Davey, 2012:97, 102) (see section 2.2.2 of chapter 2).

Leased premises: The property that forms the subject of a lease, which is the property owned by the lessor of which the right of use is granted to the lessee in terms of the lease (see section 2.2.2 of chapter 2).

Leasehold improvements: Improvements that are fixed to the leased premises, which improvements become the property of the lessor once effected (see section 2.2.2 of chapter 2).

Lessee: "A person who holds the lease of a property; a tenant." (Oxford Dictionaries, Not dated.)

Lessor: "A person who leases or lets a property to another; a landlord." (Oxford Dictionaries, Not dated.)

Repairs: Restoration, renewal or replacement of a subsidiary part or parts of the premises due to impairment, damage or deterioration to such part or parts, in order to restore the premises to a state in which they will continue to earn income as before. (see section 2.2.1 of chapter 2).

1.7 ABBREVIATIONS USED

The abbreviations used in this document are listed in Table 1 below.

Table 1: Abbreviations used in this document

Abbreviation	Meaning
AC	Appeal Cases (English Law Reports)
CGT	Capital Gains Tax
CIR	Commissioner for Inland Revenue
COT	Commissioner of Taxes
FC	Federal Supreme Court of the Federation of Rhodesia and Nyasaland
ITC	Income Tax Case

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Abbreviation	Meaning
NR	Northern Rhodesia
SA	South African Law Reports
SARS	South African Revenue Service
SATC	South African Tax Cases
TC	Tax Cases (United Kingdom)
UK	United Kingdom

1.8 RESEARCH DESIGN

This study seeks to formulate a framework which will assist lessees in determining the correct tax treatment of expenditure incurred on leased premises. In order to achieve this, the relevant tax legislation and case law must be analysed in detail to ensure a correct understanding of the tax treatment applicable to such expenditure.

The inquiry strategy for the study consequently is in the form of a literature review. A literature review is described as a study that provides an overview of scholarly work in a certain discipline (Mouton, 2001:179). In a literature review study (also known as a conceptual study) a critical evaluation of the current knowledge available on a particular topic is performed without collecting or analysing data (University of Pretoria, 2013:4). A critical evaluation of existing literature provides a thorough understanding of the issues and debates surrounding the research topic (Mouton, 2001:180).

A clear and thorough understanding of the concepts of *improvements* versus *repairs,* and assets owned by the *lessee* versus assets owned by the *lessor*, is required, as well as an understanding of the current tax legislation relevant to these concepts. Such a thorough understanding is best achieved by performing a critical review of existing literature.

Literature review or conceptual analysis studies are classified as non-empirical research, with the core characteristic being that no new data is collected, nor is existing data re-analysed. (University of Pretoria, 2013:3-4).

The study further analysed the type of expenditure that taxpayers typically include in leasehold improvements and a case study methodology was used for this purpose. A case study is a form of qualitative research, and explores a research topic in real life context

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(Sauders, Lewis & Thornhill, 2012:179). The purpose of a case study is to understand a situation in great depth (Leedy & Ormrod, 2013:150). The purpose of the case study aspect of this study was to obtain an understanding of the type of expenditure that lessees typically incur, and to evaluate the effectiveness of the preliminary framework developed by applying it to a number of real-life situations.

The case study component of the study was done by selecting and approaching three companies that have incurred significant expenditure on leased premises in recent years, as identified from audited financial statements. The relevant information that was required for evaluating the framework was obtained from the companies' detailed fixed-asset registers and interviews with the appropriate persons in each company to determine the nature of expenditure incurred on leased premises. Copies of the lease agreements were also obtained to consider the lease terms.

1.9 CHAPTER OVERVIEW

This study consists of five chapters, and the content of each chapter is briefly described below.

Chapter one contains the introduction to the study by first providing some background on the topic. It then sets out the problem statement, purpose statement and the specific research objectives applicable to the study. This is followed by the delimitations, assumptions made and definitions ascribed to key terms of the study. The chapter further provides a table of all abbreviations used and concludes with a description of the research design and methods used.

Chapter two covers the literature review of this study. It first aims to determine the meaning of the term "leasehold improvements" as contemplated in the Act. Thereafter a brief overview is given of the tax treatment of leasehold improvement expenditure incurred by lessees and lessors. This is followed by a more detailed discussion of the different tax deductions that could apply to expenditure incurred by a lessee. The chapter concludes with a suggested framework that could be applied in determining the correct tax treatment of costs incurred by lessees on leased premises.

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The case study element of this study is contained in chapter three in which the typical expenditure incurred by lessees on leased premises is identified. The tax treatment of each of the types of expenditure identified is then determined using the suggested framework of chapter two.

In chapter four the final framework to be used by lessees in determining the correct tax deductions for expenditure incurred on leased premises is set out.

The study concludes with chapter five, in which the outcomes of the research objectives set out in chapter one are summarised and recommendations for future research are made.

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CHAPTER 2

LITERATURE REVIEW

2.1 INTRODUCTION

In this chapter the meaning of the term *"leasehold improvements"* as contemplated in the Act is discussed. This is done by analysing firstly what an improvement is, and secondly when an improvement would constitute a *leasehold* improvement.

A brief overview of the tax deductions applicable to expenditure incurred on leased premises, both by the lessor and by the lessee, is then provided. Thereafter the different tax deductions that could apply to expenditure incurred by a lessee are discussed in some detail. Normal income tax deductions as well as capital gains tax (CGT) implications for the lessee are discussed.

At the end of this chapter a preliminary framework is suggested, which will form the foundation of the final framework.

2.2 DETERMINING WHAT CONSTITUTES LEASEHOLD IMPROVEMENTS

In order to understand the tax treatment of leasehold improvements, one first needs to understand what constitutes a leasehold improvement in the context of the Act. By implication it is an improvement to property under lease. Cornelissen (2010) describes leasehold improvements as improvements made to a building or premises as required by the lessee, in order to prepare the building or premises in such a way that the lessee can conduct its business there. The term refers to two key aspects; firstly to an *improvement*, and secondly an improvement made *to the leased premises*.

The Act refers to term *improvement* on numerous occasions but nowhere in the Act is a definition ascribed to it. (Sections 13*quin*, 12C, 12S, 12P, 36, 12B and paragraph 20(1)(e)

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of the Eighth Schedule to the Act). Section 12C(1)(h) refers to "improvements (other than repairs)" indicating that a repair must be distinguished from an improvement.

2.2.1 Improvements *versus* repairs

The distinction between improvements and repairs is a complicated one, and has often been the topic of case law in South Africa. These cases have over the years set out the guidelines and principles to be used in determining whether expenditure relates to repairs or to improvements.

In income tax case (*ITC) 238*, 1932 (6 South African tax cases [SATC] 353) it was said that the word *repairs* must be understood in its ordinary natural sense, as the Act does not provide a definition for it. The Oxford English Dictionary (2009) provides the following meanings for the word *repair*:

> "To restore (a damaged, worn, or faulty object or structure) to good or proper condition by replacing or fixing parts; to mend, fix"; or
>
> "To restore (a material thing, esp. a body or body part) to good or proper condition by compensating for waste, decay, exhaustion, etc.; to renew."

In *ITC 617*, 1946 (14 SATC 474) the principles laid down by the courts in defining repairs over the years were summarised, and have been cited by several authors since (Kruger et al., 2012:123, De Koker & Williams, 2012:§ 8.93, Emslie SC, Davis, Hutton & Olivier, 2001:673). The principles enunciated in ITC 617 are as follows:

> "1. Repair is restoration by renewal or replacement of subsidiary parts of the whole. Renewal as distinguished from repair is reconstruction of the entirety, meaning by the entirety not necessarily the whole but substantially the whole subject matter under discussion.
>
> 2. In the case of repairs effected by renewal it is not necessary that the materials used should be identical with the materials replaced.
>
> 3. Repairs are to be distinguished from improvements. The test for this purpose is – has a new asset been created resulting in an increase in the income earning capacity or does the work undertaken merely represent the cost of restoring the asset to a state in which it will continue to earn income as before?"

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The words "restoration by renewal or replacement" used above imply that the original structure must have become impaired. What follows is that, unless a part of the original structure has been damaged or has deteriorated, a renewal or replacement cannot be regarded as a repair (De Koker & Williams, 2012:§ 8.93).

In *ITC 1264,* 1977 (39 SATC 133) the distinction between an improvement and a repair was formulated on the grounds of whether a new asset had been created that increased the income earning capacity, or whether the asset was merely restored to a state in which it would continue to earn income as before. The fact that new materials were used was held to be irrelevant in drawing the distinction.

Following from the above, the following meanings will be ascribed to repairs and improvements for the purposes of this study:

- *Repairs:* Restoration, renewal or replacement of a subsidiary part or parts of the premises due to impairment, damage or deterioration to such part or parts, in order to restore the premises to a state in which they will continue to earn income as before.
- *Improvements:* Reconstruction of the whole or a substantial part of the premises, or reconstruction resulting in an increase in the income earning capacity of the premises.

2.2.2 Improvements to the leased premises

Kruger et al. (2012:97, 102) describe a lease of a tangible asset as a contract whereby one person grants another person the use and enjoyment of an asset and, in the context of leased premises, as "an agreement granting the right of use or occupation of property". Hence the *leased premises* refer to the property that forms the subject of a lease, which is the property owned by the lessor of which the right of use is granted to the lessee in terms of the lease.

Improvements to the leased premises are thus improvements to a property under lease. Such improvements would, by their very nature, increase the value of the property (Cornelissen, 2010). Furthermore, such improvements will become the property of the

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lessor in terms of the Roman-Dutch law principle of *superficies solo credit* (owner by accession) (National Treasury, 2013:50). It follows that improvements to the leased premises become the property of the lessor, whether it was affected by the lessor or the lessee.

Leasehold improvements in the theoretical sense therefore mean *improvements* that are fixed to the leased premises, which improvements become the property of the lessor once effected.

2.2.3 Improvements not fixed to the leased premises

A lessee may incur expenditure in respect of leased premises which, upon closer examination, does not constitute an improvement to the premises but rather a separate asset that has been created or acquired by the lessee.

In *CIR v Le Sueur*, 1960 (2) SA 708 (A) (23 SATC 261) the court held that the test of whether something formed part of a building was "whether it had become part of the fabric of the building", and that the taxpayer's intention was irrelevant in determining the character of fixtures as moveable or immovable. Judge Botha A.J.A. further held the following:

> "Assistance could be derived from inquiring whether or not the movable had by actual physical incorporation in the immovable been deprived of its separate identity, or been so securely attached to the immovable that separation would involve substantial injury either to the immovable or to the accessory".

The case *SIR v Charkay Properties (Pty) Ltd*, 1976 (4) SA 872 (A) (38 SATC 159) dealt with the question of whether demountable partitions constituted articles as contemplated in section 11(e) or whether they formed part of the building. The following was held:

> "Because of the nature of the partitions, the way in which they were mounted and the intention of the taxpayer in mounting them, they had not been structurally integrated or otherwise physically incorporated into the building permanently in such a way as to have lost their own separate identity and become part of the building."

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De Koker and Williams (2012:§ 8.119) are also of the opinion that wear and tear may be claimed on movable partitions.

Although the two cases cited above provide conflicting views regarding the importance of the taxpayer's intention, they both emphasise that in order to determine whether something is a separate article or part of the building, one should consider the following:

- Is the item structurally integrated or physically incorporated into the immovable (i.e. the building); and
- Has the item lost its separate identity in such a way that it becomes part of the building, as separating the item from the building would cause substantial damage to either the building or to the item?

Expenditure incurred by lessees that result in items that have a separate identity from the building should consequently not be confused with improvements to the premises and classified as such, and should be treated as assets separate from the premises.

2.3 OVERVIEW OF INCOME TAX DEDUCTIONS FOR ALL EXPENDITURE INCURRED ON LEASED PREMISES

The tax treatment of expenditure incurred on leased premises is governed by different sections of the Act. These sections can apply to the lessor, the lessee or both, depending on which party incurred the relevant expenditure. The tax deductions applicable to expenditure incurred on leased premises, both in hands of the lessor and in the hands of the lessee, are for that reason briefly discussed.

2.3.1 Expenditure incurred by the lessor

The tax consequences of expenditure incurred by lessors are briefly discussed below for an overall view of the income tax implications pertaining to expenditure incurred in respect of leased premises.

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Expenditure incurred by a lessor in respect of leased premises will be deductible in terms of section 11(a) of the Act if it is incurred in the production of income, not of a capital nature and laid out for the purposes of the lessor's trade (Kruger et al., 2012:119).

Expenditure relating to repairing or improving a building is inherently of a capital nature (Kruger et al., 2012:123), and therefore not deductible under section 11(a) of the Act. However section 11(d) of the Act provides for a special deduction in respect of "repairs of property occupied for the purpose of trade or in respect of which income is receivable". A lessor can thus deduct expenditure relating to repairs of leased premises under section 11(d), as the lessor will receive income in the form of rent paid by the lessee. Improvements effected by the lessor to the property will not qualify for a normal income tax deduction; however it may qualify for a capital deduction when the lessor disposes of the property and triggers a CGT event.

CGT is dealt with in the Eighth Schedule of the Act (hereafter referred to as the Eighth Schedule). In broad terms, a capital gain or loss is created when an asset is disposed of by a taxpayer. The gain or loss is calculated as the proceeds received on disposal less the base cost of the asset. Par 20 of the Eighth Schedule deals with expenditure which may be included in the base cost of an asset upon its disposal. More specifically, par 20(1)(e) allows expenditure incurred in effecting an "improvement or enhancement to the value of [an] asset if that improvement or enhancement is still reflected in the state or nature of that asset at the time of its disposal". Therefore the lessor only receives a tax benefit for expenditure incurred on improvements to a property at the time such property is disposed of, which undoubtedly could be years after the expenditure was actually incurred. Such a tax benefit is also not guaranteed at the time of incurring the expenditure, as par 20(1)(e) requires the improvement to still be reflected in the state of the asset at the time of disposal.

Similarly to the lessor, there are also provisions for expenditure incurred by the lessee to leased premises.

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2.3.2 Expenditure incurred by the lessee

The lessee may incur expenditure in respect of leased premises, either voluntarily or in terms of an obligation imposed on the lessee in terms of the lease agreement (Kruger et al., 2012:126). Obligatory expenditure incurred by the lessee will qualify for a tax deduction if the requirements of section 11(g) of the Act are met. Voluntary expenditure relating to improvements will be regarded as expenditure of a capital nature and thus will not qualify for an income tax deduction (Kruger et al., 2012:127).

In so far as the expenditure relates to repairs, the lessee may qualify for a section 11(d) deduction (Kruger et al., 2012:127) provided of course that the lessee occupies the premises for the purpose of trade. Expenditure that result in a separate asset of which ownership vests in the lessee, may qualify for a wear-and-tear allowance under section 11(e).

Section 11(g) of the Act provides for a special deduction in respect of expenditure incurred by a lessee "*in pursuance of an obligation* to effect improvements to land or to buildings, *incurred under an agreement* whereby the right of use or occupation of the land or buildings is granted by any other person…" (own emphasis). Therefore voluntary expenditure (i.e. no obligation is placed on the lessee in terms of the lease agreement) incurred by a lessee to effect improvements will not qualify for this deduction.

2.4 NORMAL TAX DEDUCTIONS RELATING TO THE LESSEE'S EXPENDITURE

The tax treatment of expenditure incurred by a lessee in respect of a leased premises depend mainly on whether such expenditure was incurred voluntarily or in terms of an obligation stipulated in the lease agreement. Section 11(g) will apply in the latter case, and consequently its requirements must be analysed in order to determine under which circumstances the lessee will qualify for this deduction.

Relevant sections that could apply in instances where the requirements of section 11(g) are not met must be analysed in order to determine under which circumstances they could

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apply. These are section 11(d) deduction for repairs and section 11(e) deduction for wear and tear on certain assets.

2.4.1 Improvements to the leased premises – section 11(g)

Section 11(g) of the Act provides for a special deduction in respect of expenditure incurred by a lessee "in pursuance of an obligation to effect improvements to land or to buildings, incurred under an agreement whereby the right of use or occupation of the land or buildings is granted by any other person …" The deduction takes the form of an annual allowance spread over the shorter of the lease term or 25 years. Proviso (i) to this section states that the allowance must be calculated based on the amount stipulated in the agreement as the value of the improvements or the amount to be expended, or if no amount is stipulated in the agreement, the fair value of the improvements effected.

Proviso (vi) to section 11(g) further requires that no allowance may be claimed by the lessee unless the value of or amount expended on the improvements is included in the lessor's gross income under par (h) of the definition of gross income in section 1. Lease agreements are normally the product of negotiations between lessor and lessee, and it is understandable that lessors may be inclined to structure lease agreements in such a way that the lessor is not taxed on improvements which benefit the lessee.

The courts have been very strict in applying the requirements of section 11(g). This is particularly so with regard to the requirement that improvements effected by a lessee must have been done so in pursuance of an obligation imposed upon the lessee in terms of a lease. Improvements undertaken voluntarily or by the lessee's choice will not qualify for the section 11(g) allowance (De Koker & Williams, 2012:§ 8.71).

The obligation to effect improvements must be contained in the original lease agreement in order to qualify for the section 11(g) allowance (Kruger et al., 2012:102). In the case of *Professional Suites Ltd v COT*, 1960 (NR) (24 SATC 573) the court held that a deed of variation to the original lease, increasing the amount of the lessee's obligation to improve the leased premises, was irrelevant and only the terms of the original lease could be considered. However in *COT v Ridgeway Hotel Ltd,* 1961 (FC) (24 SATC 616) the court

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decided to give effect to a deed of variation which increased the amount of improvements to be effected as per the original lease agreement.

The difference in the above two cases is purely factual, in that in the *Ridgeway Hotel* case the deed of variation was entered into while improvements were still in the course of construction whereas in the *Professional Suites* case it was done after the improvements had been effected. De Koker and Williams (2012:§ 8.71) are of the opinion that an amendment to the original lease agreement would enable the lessee to base the section 11(g) allowance on the terms as per the deed of variation, as long as the deed of variation was concluded before improvements were completed. Kruger et al. (2012:103) however caution against this approach on the basis that the principles in the two cases are irreconcilable, and that it is doubtful whether South African tax courts would follow the principle laid down in the *Ridgeway Hotel* decision.

Be that as it may, it is clear that the requirements of section 11(g) are very strict, and in many cases the lessee would not qualify for a deduction under this section. The focus of this study is to analyse the alternative tax deductions available to the lessee.

2.4.2 Repairs to the leased premises – section 11(d)

Section 11(d) of the Act permits a deduction for expenditure incurred on "repairs of property occupied for the purposes of trade or in respect of which income is receivable". A lessee would for that reason qualify for this deduction in respect of repairs to leased premises, provided the lessee occupies the premises for the purposes of trade.

The question arises whether repairs done by the lessee prior to occupying the premises (i.e. repairs made after the lessee obtains the right of use under the lease agreement, but before physically moving into the premises) will be deductible under section 11(d). It has been held that the phrase "for the purpose of trade" means "for the purpose of enabling a person to carry on and earn profits in the trade" (*Strong and Co of Romsey Ltd v Woodifield [Surveyor of Taxes]*, 1906, AC 448 [5 TC 215] as quoted by De Koker and Williams (2012: § 8.100)). It is therefore submitted that repairs incurred by the lessee prior to physically moving into the leased premises constitute repairs incurred for the purpose of

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enabling the lessee to occupy the premises to carry on a trade, and should thus qualify for the section 11(d) deduction.

Taxpayers often incur repairs as part of an overall reconstruction or refurbishment of premises. In many cases one inclusive contract would be entered into which would include the cost of repairs as part of the overall cost, or the costs of "essential repairs may become submerged in the overall cost of reconstruction" (Kruger et al., 2012:124). Alternatively a repair can be done in the process of creating an improvement where only a portion of the premises has deteriorated (De Koker & Williams, 2012:§ 8.98). In such cases the cost of repairs would only be deductible if it can be separated from the costs of reconstruction. The cost of notional repairs will however not be deductible (Emslie SC et al., 2001:674). This is based on the decision by the court in *ITC 1457*, 1988 (51 SATC 131). In this case it was held that only the portion of costs which the taxpayer could prove related to separately identifiable repairs could be deducted. A similar decision was reached in *ITC 238.* In this case it was held that it was impossible to *ex post facto* separate the costs of repairs included in the overall refurbishment, even though estimated values were attached to such repairs by an architect. The court disallowed the cost of notional repairs as a deduction, but the portion of costs that was identifiable relating to actual repairs was held to be deductible.

2.4.3 Expenditure resulting in assets owned by the lessee – section 11(e)

Improvements effected by a lessee that are not fixed to the lease premises will result in a separate asset of which the lessee has the ownership. Such an asset or article may qualify for a wear-and-tear allowance under section 11(e) of the Act. This section permits the deduction of this allowance for "implements, utensils and articles … owned by the taxpayer … and used by the taxpayer for the purposes of his or her trade …" The allowance is subject to a number of provisions, of which only the provisions relevant to this study are discussed below.

In terms of proviso (ii) to section 11(e) no allowance is permitted for "buildings or other structures or works of a permanent nature". Section 11(e) further requires that the item or article must be owned by the taxpayer (or acquired by the taxpayer under an instalment

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sale agreement) in order to qualify for the wear-and-tear allowance. In *ITC 840*, 1957 (21 SATC 424) a lessor acquired fixtures that would, in terms of the lease agreement, become the property of the lessee when the lease expired (Kruger et al., 2012:123). The court held that the ownership of the fixtures remained vested in the lessor until such time that the lease expired, and as a result the lessor was entitled to deduct an allowance for wear and tear in respect of the fixtures.

The terms of the lease agreement will determine whether fixtures or similar items acquired by the lessee will become the property of the lessor or remain the property of the lessee at the end of the lease term. Based on the decision in *ITC 840* the lessee would none the less be entitled to a wear-and-tear allowance on such items acquired by the lessee for the duration of the lease, as the ownership will vest in the lessee until such time that the lease expires.

The amount of the allowance is “such a sum as the Commissioner may think just and reasonable as representing the amount by which the value of any … utensils and articles … has been diminished by reason of wear and tear or depreciation” (section 11(e) of the Act). SARS issued Interpretation Note 47 (2012) to provide guidance on how the allowance must be calculated. The general rule as discussed in Interpretation Note 47 is that the allowance is calculated on the cash cost of the item (excluding finance charges) over the useful life of the item. Annexure A to Interpretation Note 47 contains a list of items with their proposed write-off periods as deemed acceptable by SARS, some of which are set out in Table 2 below. The cost of the item includes moving costs directly linked to the item (according to proviso (v) to section 11(e) as well as any direct installation costs (proviso (vii) to section 11(e).

Table 2: Extract of acceptable write-off periods set out in Interpretation Note 47

Asset	Proposed write-off period (in years)
Air conditioners:	
Window type	6
Room unit	10
Air conditioning assets (excluding pipes, ducting and vents):	
Air handling units	20
Cooling towers	15

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Asset	Proposed write-off period (in years)
Condensing sets	15
Carports	5
Communication systems	5
Curtains	5
Demountable partitions	6
Escalators	20
Fire detection systems	3
Fitted carpets	6
Furniture and fittings	6
Neon signs and advertising boards	10
Refrigeration equipment and refrigerators	6
Security systems (removable)	5
Shop fittings	6
Telephone equipment	5
Warehouse racking	10

Source: South African Revenue Service: Interpretation note: no. 47 (issue 3), 2012:19-22

2.5 OTHER DEDUCTIONS AND CGT CONSIDERATIONS FOR THE LESSEE

It is possible that a lessee may incur expenditure on leased premises which do not qualify for any of the specific deductions discussed above. In such a case one must consider if a deduction is available under the general deduction formula in section 11(a) of the Act. Should no deduction be available under section 11(a), one must consider the possible CGT implications for the lessee.

2.5.1 Section 11(a) deduction

Section 11(a) permits a deduction of "expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature". The objective of this study is not to provide an in-depth analysis of the general deduction formula in section 11(a); however, in order to provide a complete overview of the deductions that a lessee must consider in respect of expenditure incurred on leased premises, one must consider its application. Section 11(a) should be considered in instances to which no other specific deduction such as section 11(e), 11(d) or 11(g) applies.

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The main restriction imposed by section 11(a) that is relevant to this study is that it prohibits the deduction of amounts that are of a capital nature. The Act does not define the term "of a capital nature"; as a result the principles that have been laid down by the courts must be applied.

The principal test that should be applied in determining whether expenditure is of a capital nature or not is the question of whether it is regarded as a part of the cost of performing the income earning operations of the taxpayer, or whether it is part of the cost of creating or improving the taxpayer's income earning structure (Emslie SC et al., 2001:349). This test was laid down in the case of *New State Areas Ltd v CIR*, 1946 AD 610 (14 SATC 155). In this case it was held that expenditure which related to the creating or improving of the taxpayer's income-earning structure was of a capital nature. A similar view was held in the case of *CIR v George Forest Timber Co Ltd*, 1924 AD 516 (1 SATC 20) where it was also stated that expenditure incurred in the acquisition of a revenue producing source was of a capital nature, in contrast to money spent on working that source which is revenue expenditure.

In instances where the lessee's expenditure on leased premises do not qualify for any deduction, that is the specific deductions of sections 11(e), 11(d) or 11(g), or the general deduction in section 11(a), one must consider whether there are any CGT implications for the lessee.

2.5.2 The lessee's asset: the lease agreement

A CGT event will occur when an asset is disposed of. Paragraph 1 of the Eighth Schedule defines what constitutes an asset for CGT purposes, and it includes property of whatever nature, movable or immovable, and particularly "a right or interest of whatever nature in such property". McAllister (2011:34) lists a contractual right as an example of an asset. A lessee's contractual right under a lease agreement to use the premises is therefore an asset of the lessee for purposes of CGT. Kruger et al. (2012:109) very simply state that "the lease is a capital asset for the lessee …"

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2.5.3 Base cost of the lessee's asset

Improvements to leased premises effected by the lessee constitute improvements to the lease, as the lessee enjoys the right of use of such improvements until the lease expires (Kruger et al., 2012:109). Such improvements will be included in the base cost of the lessee's asset in terms of par 20(1)(e) of the Eighth Schedule, if the improvement is still reflected in the state of the asset upon its disposal. However if the lessee was allowed to claim a section 11(g) deduction for such an improvement, it will be excluded from the base cost in order to avoid a double deduction according to par 20(3)(a) of the Eighth Schedule.

2.5.4 Disposal of the lessee's asset

As discussed above, the lessee will be entitled to a capital deduction for improvements effected to the leased premises if no section 11(g) deduction was permitted. However such a capital deduction will only be available once the asset is disposed of, as part of the base cost of the asset.

Under the normal time of disposal rules as set out in par 13 of the Eighth Schedule a disposal will occur when there is a change of ownership (par 13(1)(a)(ix)). McAllister (2011:245-246) states that improvements made by a lessee to the leased premises accede to the property under common law, and therefore the lessee loses the ownership of the asset (the improvements) when it is affixed to the property. The result is a disposal of the bare *dominium* of the asset.

The implication of the above is that the lessee would have a disposal as soon as improvements effected by the lessee are affixed to the property. Assuming the lessor does not compensate the lessee for such improvements, a capital loss would result in the hands of the lessee at the time that the improvements are completed. Par 33(3)(c) of the Eight Schedule was consequently inserted to prevent such a premature triggering of a capital loss while the lessee still enjoys the right of use of the improvements (McAllister, 2011:246). In terms of par 33(3)(c) there is deemed to be no part disposal of an asset by the lessee in respect of improvements to the leased premises. The disposal will only occur when the lease expires and the lessee no longer enjoys the right of use of the

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improvements. At this time the cost of improvements effected by the lessee will be brought into account as part of the base cost of the lessee's asset (McAllister, 2011:246). Since the lessee will not usually receive any amount that constitutes proceeds when the lease expires, the cost of the improvements will constitute a capital loss in the lessee's hands on completion of the lease (Kruger et al., 2012:109).

2.6 PRELIMINARY FRAMEWORK

A preliminary framework was created based on the literature discussed in this chapter. This framework will be used as the basis of creating a final framework which will assist lessees in determining the correct tax treatment of expenditure incurred in respect of leased premises. The preliminary framework is set out in Table 3 on the next page.

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Table 3: Preliminary framework for determining the correct tax treatment of expenditure incurred by lessees

Step	Description		Test		Outcome
Step 1	Lease agreement stipulates obligation on lessee to effect specified improvements	Yes	Fair value of improvements included in lessor's gross income	Yes	Section 11(g) deduction
				No	Proceed to step 2
		No	Proceed to step 2		
Step 2	Determine whether expenditure relates to repairs	(a)	Restoration, renewal or replacement of part or parts of the premises	Yes	Proceed to step 2(b)
				No	Proceed to step 4
		(b)	Due to impairment, damage or deterioration to such parts	Yes	Proceed to step 2(c)
				No	Proceed to step 4
		(c)	In order to restore the premises to a state in which it will continue to earn income as before	Yes	Expenditure = Repairs Proceed to step 3
				No	Proceed to step 4
Step 3	Determine whether repairs qualify for a section 11(d) deduction	(a)	Did the repairs form part of an overall reconstruction or refurbishment	Yes	Proceed to step 3(b)
				No	Section 11(d) deduction
		(b)	Can the costs relating to repairs be identified and separated from the costs of reconstruction	Yes	Section 11(d) deduction
				No	Proceed to step 4
Step 4	Determine whether expenditure resulted in separately identifiable articles which qualify for a section 11(e) wear-and-tear deduction	(a)	Expenditure relates to an item or article that is separately identifiable	Yes	Proceed to step 4(b)
				No	Proceed to step 5
		(b)	The item is structurally integrated or incorporated into the building, or separating it would cause substantial damage to the item or the building	Yes	Proceed to step 5
				No	Section 11(e) deduction
Step 5	Determine whether expenditure is of a capital nature or not	Expenditure relates to creating or improving the taxpayer's income earning structure, or relates to acquisition of a revenue producing source		Yes	Proceed to step 6
				No	Section 11(a) to be further considered
Step 6	Expenditure relates to improvements to the leased premises	Include in base cost for CGT purposes		Time of disposal for CGT will be when lease expires	

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2.7 SUMMARY

The literature review commenced by determining the meaning of the term *"leasehold improvements"* as contemplated in the Act. This was done by analysing what an *"improvement"* is and also how it must be distinguished from *"repairs"*. Thereafter it was determined that expenditure incurred by a lessee that constitutes improvements to the leased premises should be differentiated from expenditure that results in separately identifiable assets of which the lessee retains the ownership.

The second part of the literature review provided a brief overview of the relevant tax deductions applicable to leasehold expenditure for lessors and lessees. This was followed by a more detailed discussion of the different tax deductions applicable to the lessee's expenditure. Normal income tax deductions as well as CGT implications for the lessee were discussed.

The chapter concluded with a preliminary framework to be used in determining the correct tax treatment of expenditure incurred by lessees.

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CHAPTER 3

ANALYSING LESSEES' EXPENDITURE ON LEASED PREMISES

3.1 INTRODUCTION

Three companies were selected that operate in different industries and had incurred significant expenditure on leased premises in recent years. The relevant lease agreement and a detailed breakdown of expenditure incurred on leased premises were obtained for each company selected. Interviews were held with the appropriate person in each company to obtain additional information regarding the type and nature of expenditure incurred. The expenditure incurred by each of the three companies selected was analysed using the preliminary framework compiled in the previous chapter in order to determine the correct tax treatment for each type of expenditure identified.

The information obtained from the three companies is discussed in scenarios one to three below. Where applicable, names of persons and entities have been changed in order to protect their identities.

3.2 SCENARIO 1

This scenario involves Company ABC (Proprietary) Limited (hereafter referred to as ABC), which operates in the advertising industry and entered into a lease agreement with Trust X (the lessor) to lease part of a block of offices owned by the lessor. ABC is therefore the lessee in this scenario.

3.2.1 Background

The block of offices which forms the subject of this lease agreement was in a dire state when purchased by the lessor, and was to be completely refurbished before any tenants took occupation. ABC is the main tenant, leasing three floors of the six-storey building. The relevant terms of the lease agreement can be summarised as follows:

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- ABC was granted beneficial occupation of the premises for the purposes of fitting and furnishing them in terms of the agreement with the lessor. The beneficial occupation date was 1 December 2008. The lease commencement date was on 1 February 2009, after the refurbishment had been completed.
- The initial lease term was 10 years from the commencement date, with the option of renewing it thereafter. ABC was liable for rental payments from the commencement date of 1 February 2009.
- The lessor agreed to undertake and implement the internal fit-out of the premises before the commencement date. ABC had to provide the lessor with its written plans and requirements for the internal partitioning and layout of the building, its interior design and finishes preference. Any costs arising from changes to the internal design subsequently required by ABC would be for ABC's own account.
- ABC was liable for its share of the cost of the internal fit-out, and this amount was payable to the lessor. (This amount is referred to as the "tenant installation allowance" in ABC's accounting records.)
- ABC was obliged to maintain and repair the premises together with all fixtures, fittings and appurtenances for the duration of the lease. ABC was entitled, but not obliged, to enter into maintenance contracts with third parties to supply maintenance of, inter alia, electrical installations and central air-conditioning systems.
- ABC was allowed to make internal changes and alterations which did not affect the structure of the building without prior consent of the lessor. The lessor had the right to require that such alterations be removed by ABC at the end of the lease and the premises be reinstated at ABC's cost. If the lessor did not exercise his right, the alterations would become the property of the lessor and no compensation would be payable to ABC.
- ABC waived any right it may had to enrichment lien for improvements made to the premises, whether or not such improvements were made with the lessor's prior consent.

ABC took occupation of the premises in February 2009 after the initial refurbishment of the building had been completed. During 2012 and 2013 the layout of the office space occupied by ABC was changed drastically, in order to allow for more people to be accommodated in the premises. ABC moved some of its subsidiaries into the same

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building, thereby decreasing the overall rental expense incurred by the group. The costs for these subsequent alterations in 2012 and 2013 were all incurred by ABC.

ABC had a 31 December financial year-end and reflected significant costs incurred on "leasehold improvements" in its annual financial statements for 2009, 2012 and 2013. For accounting purposes these costs were capitalised and depreciated over 5 years.

3.2.2 Expenditure incurred on the leased premises

ABC's detailed fixed-asset register for the category "leasehold improvements" was obtained. The register reflected 35 items with a total cost of R6 153 573 classified as "leasehold improvements" for accounting purposes and incurred during the 2009 to 2013 financial years. Of this amount, R700 554 related to improvements effected by subtenants of ABC and paid for by ABC, and were excluded from the analysis. The 10 highest value items were selected from the register for analysis, but items relating to subtenant costs were excluded. The total cost of the 10 items selected amounted to R5 145 229, which accounts for 94% of the total expenditure, excluding subtenant costs, incurred on "leasehold improvements".

The detail of the 10 items selected from ABC's fixed asset register is summarised in Table 4 below.

Table 4: Expenditure relating to leased premises incurred by ABC

Item no.	Description in fixed asset register	Detailed description obtained from supporting invoices and interview with ABC representative	Invoice Date	Amount
1	Tenant installation	Tenant installation allowance. This relates to ABC's portion of the costs incurred by the lessor for the internal fit-out of the building, as stipulated in lease agreement.	Jun 2009	R 4 000 000
2	Space planning 4th to 6th	Project management, design and drafting of plans for office space planning to increase number of offices.	Sep 2012	R 310 175
3	5th floor alterations	Demolition of existing drywall partitioning and erecting new as per design, supply and installation of cabling, new doors, painting of new partitions and ceilings, replacing carpet tiles, and installation of 7 new glass doors fitted in aluminium frames. Alterations were made to increase number of offices in order to accommodate staff from subsidiary companies.	May 2013	R 241 650

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Item no.	Description in fixed asset register	Detailed description obtained from supporting invoices and interview with ABC representative	Invoice Date	Amount
4	5th,6th &ground floor electrical	Electrical installations done as a result of alterations made to increase the number of offices, in order to accommodate staff from subsidiary companies. Includes moving existing and installing new cables, plug points, light fittings and related items.	Jun 2013	R 99 982
5	5th floor alterations	Alterations made to increase the number of offices. Includes installing and painting of new dry walling and doors, as well as new carpets laid.	May 2012	R 91 301
6	Recording booth	Construction of recording booth: double brick walls, double glazed window, doors, ceiling and acoustic treatment thereof, including paint and labour.	Mar 2009	R 89 851
7	Phase1 ground/5/6 floor data points	Data network costs incurred as a result of alterations made to increase the number of offices, in order to accommodate staff from subsidiary companies. Includes moving existing and installing new data cables, network points and related items.	Jul 2013	R 89 122
8	5th & ground floor alterations	Alterations made to increase the number of offices. Includes installing of new and moving existing dry walling and doors and painting thereof.	May 2013	R 88 000
9	6th floor alterations	Alterations made to increase the number of offices. Includes installing of new and moving existing dry walling and doors and painting thereof.	May 2013	R 85 400
10	Storeroom basement	Construction of new storeroom consisting of dry walls in basement area, as result of subsidiary companies moving into the premises.	Mar 2013	R 49 748
Total				**R 5 145 229**

From the items selected and described in Table 4 various different types of expenditure have been identified. Each type of expenditure identified must be analysed separately, using the preliminary framework set out in the previous chapter (Table 3), in order to determine the correct tax treatment thereof.

3.2.3 Tax deductions applicable to the expenditure incurred

The expenditure incurred by ABC as set out in Table 4 is analysed below and the steps as set out in the preliminary framework in Table 3 were followed in order to determine the correct tax deduction, if any, for each type of expenditure.

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Step one of the framework considers whether the lease agreement stipulates an obligation on the lessee to effect improvements and is applied once-off for all the items in Table 4. The lease agreement in this scenario did not stipulate an obligation for ABC to effect any improvements to the premises; it merely catered for the recovery of costs incurred by the lessor. Section 11(g) of the Act is thus considered not to be applicable and the remaining steps of the framework are applied to each type of expense identified in Table 4.

- *Tenant installation allowance (item 1 in Table 4)*

The first type of expenditure incurred by ABC was a once-off payment to the lessor referred to as the "tenant installation allowance". The tenant installation allowance was the amount paid by ABC in terms of the lease agreement, in respect of ABC's portion of the costs incurred by the lessor for the internal fit-out of the building prior to the commencement of the lease. Using the relevant steps in the preliminary framework as set out in Table 5 below it is concluded that the tenant installation allowance paid by ABC does not qualify for any tax deduction and must be included in the base cost of the lease.

Table 5: Applying framework to tenant installation allowance paid by ABC

<table>
<tr><td rowspan="2">Step 2</td><td rowspan="2">Determine whether expenditure relates to repairs</td><td rowspan="2">(a)</td><td rowspan="2">Restoration, renewal or replacement of part or parts of the premises</td><td>No</td><td>Proceed to step 4</td></tr>
<tr><td colspan="2">The entire building was completely refurbished by the lessor</td></tr>
<tr><td rowspan="2">Step 4</td><td rowspan="2">Determine whether expenditure resulted in separately identifiable articles which qualify for a section 11(e) wear-and-tear deduction</td><td rowspan="2">(a)</td><td rowspan="2">Expenditure relates to an item or article that is separately identifiable</td><td>No</td><td>Proceed to step 5</td></tr>
<tr><td colspan="2">The costs recovered by the lessor comprised the overall interior fit-out of the building and cannot be allocated to separate assets</td></tr>
<tr><td rowspan="2">Step 5</td><td rowspan="2">Determine whether expenditure is of a capital nature or not</td><td colspan="2" rowspan="2">Expenditure relates to creating or improving the taxpayer's income earning structure, or relates to acquisition of a revenue producing source</td><td>Yes</td><td>Proceed to step 6</td></tr>
<tr><td colspan="2">Related to construction costs of a newly leased premises, which is an income earning structure for ABC</td></tr>
<tr><td>Step 6</td><td>Expenditure relates to improvements to the leased premises</td><td colspan="2">Include in base cost for CGT purposes</td><td colspan="2">Time of disposal for CGT will be when lease expires</td></tr>
</table>

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- *Project management and design fee (item 2 in Table 4)*

This expenditure was incurred two years after the lease commenced, and related to the re-design of the internal office space and the drafting of plans for the new lay-out. The new lay-out was required in order to increase the number of offices to accommodate additional staff of subsidiary companies of ABC. Applying the framework in Table 6 below it is concluded that the project management fee paid by ABC does not qualify for any tax deduction and must be included in the base cost of the lease.

Table 6: Applying framework to project management fee paid by ABC

Step 2	Determine whether expenditure relates to repairs	(a)	Restoration, renewal or replacement of part or parts of the premises	No	Proceed to step 4
				A project management and design fee clearly does not relate to repairs	
Step 4	Determine whether expenditure resulted in separately identifiable articles which qualify for a section 11(e) wear-and-tear deduction	(a)	Expenditure relates to an item or article that is separately identifiable	No	Proceed to step 5
				The project management fee did not result in any identifiable item or article	
Step 5	Determine whether expenditure is of a capital nature or not	Expenditure relates to creating or improving the taxpayer's income earning structure, or relates to acquisition of a revenue producing source		Yes	Proceed to step 6
				The project management fee related to enhancing the space leased by ABC	
Step 6	Expenditure relates to improvements to the leased premises	Include in base cost for CGT purposes		Time of disposal for CGT will be when lease expires	

- *Drywalls, doors and carpets (items 3, 5, 8, 9 and 10 in Table 4)*

ABC incurred expenditure on alterations to the interior of the building approximately two years after it first took occupation of the premises. The reason for the alternations was to change the lay-out of the offices in order to accommodate additional staff from subsidiary companies in the same premises. These subsidiary companies previously operated from different leased premises, and when the leases of the subsidiary companies expired, their staff and operations were moved to the premises leased by ABC. The move for that reason resulted in a significant decrease in the overall rental expense of the group.

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The alterations involved changes to the layout of the offices by way of removing some of the existing drywalls and installing new ones, as well as installing new custom-made glass entrance doors which in turn resulted in portions of the carpet tiles being replaced. The framework is used as set out in Table 7 below to determine the correct tax deduction for the drywall partitions, the carpets and the glass doors.

Table 7: Applying framework to drywalls, doors and carpets installed by ABC

Step 2	Determine whether expenditure relates to repairs	(a)	Restoration, renewal or replacement of part or parts of the premises	Yes	Proceed to step 2(b)
				Existing partitions, doors and carpets were replaced	
		(b)	Due to impairment, damage to or deterioration of such parts	No	Proceed to step 4
				Alterations were made to use office space more efficiently, not because any parts of the premises were damaged	
Drywall partitions:					
Step 4	Determine whether expenditure resulted in separately identifiable articles which qualify for a section 11(e) wear-and-tear deduction	(a)	Expenditure relates to an item or article that is separately identifiable	Yes	Proceed to step 4(b)
				The drywall partitions can be separately identified	
		(b)	The item is structurally integrated or incorporated into the building, or separating it would cause substantial damage to the item or the building	No	Section 11(e) deduction
				The drywall partitions can be removed without causing substantial damage to the building or to partitions themselves	
Carpets:					
Step 4	Determine whether expenditure resulted in separately identifiable articles which qualify for a section 11(e) wear-and-tear deduction	(a)	Expenditure relates to an item or article that is separately identifiable	Yes	Proceed to step 4(b)
				The carpets can be separately identified	
		(b)	The item is structurally integrated or incorporated into the building, or separating it would cause substantial damage to the item or the building	No	Section 11(e) deduction
				The carpets can be removed without causing substantial damage to the building or the carpets	

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<table>
<tr><td colspan="6">Glass doors:</td></tr>
<tr><td rowspan="4">Step 4</td><td rowspan="4">Determine whether expenditure resulted in separately identifiable articles which qualify for a section 11(e) wear-and-tear deduction</td><td rowspan="2">(a)</td><td rowspan="2">Expenditure relates to an item or article that is separately identifiable</td><td>Yes</td><td>Proceed to step 4(b)</td></tr>
<tr><td colspan="2">The doors can be separately identified</td></tr>
<tr><td rowspan="2">(b)</td><td rowspan="2">The item is structurally integrated or incorporated into the building, or separating it would cause substantial damage to the item or the building</td><td>Yes</td><td>Proceed to step 5</td></tr>
<tr><td colspan="2">The glass doors cannot be removed without causing substantial damage to them</td></tr>
<tr><td>Step 5</td><td>Expenditure relates to improvements to the leased premises</td><td colspan="2">Include in base cost for CGT purposes</td><td colspan="2">Time of disposal for CGT will be when lease expires</td></tr>
</table>

Section 11(e) requires that an article must be owned by the taxpayer in order to claim the allowance. In terms of the lease agreement the alterations installed by ABC will become the property of the lessor at the end of the lease. However, applying the same principles as those set out in the *ITC 840* decision, the drywall partitions and carpets installed by ABC will be owned by ABC for the duration of the lease. ABC may therefore deduct a section 11(e) allowance on these items. The allowance must be calculated over the useful life of the item. In terms of Annexure A to Interpretation Note 47, SARS accepts a write-off period of six years for both demountable partitions and fitted carpets.

- *Electrical and data network fittings (items 4 and 7 in Table 4)*

ABC incurred costs relating to the data network and electrical works as a result of the change in the internal layout of the offices. These costs involved the moving and installation of electrical and data network fittings which included cables, plug points, network points, light switches etcetera, all of which were fixed to the drywall partitions discussed above. By applying the framework as set out in Table 8 below, it is submitted that the electrical and data network fittings in this scenario will qualify for a wear-and-tear allowance. The write-off period of the fittings should be equal to that of the partitions on which they are mounted.

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Table 8: Applying framework to electrical and data network costs incurred by ABC

<table>
<tr><td rowspan="4">Step 2</td><td rowspan="4">Determine whether expenditure relates to repairs</td><td rowspan="2">(a)</td><td rowspan="2">Restoration, renewal or replacement of part or parts of the premises</td><td>Yes</td><td>Proceed to step 2(b)</td></tr>
<tr><td colspan="2">Existing cables and fittings were moved and new ones installed</td></tr>
<tr><td rowspan="2">(b)</td><td rowspan="2">Due to impairment, damage to or deterioration of such parts</td><td>No</td><td>Proceed to step 4</td></tr>
<tr><td colspan="2">Alterations were made to use office space more efficiently, not because any parts of or items were damaged</td></tr>
<tr><td rowspan="4">Step 4</td><td rowspan="4">Determine whether expenditure resulted in separately identifiable articles which qualify for a section 11(e) wear-and-tear deduction</td><td rowspan="2">(a)</td><td rowspan="2">Expenditure relates to an item or article that is separately identifiable</td><td>Yes</td><td>Proceed to step 4(b)</td></tr>
<tr><td colspan="2">The electrical and data network fittings were mounted on the drywall partitions which are separately identifiable assets (Refer Table 7)</td></tr>
<tr><td rowspan="2">(b)</td><td rowspan="2">The item is structurally integrated or incorporated into the building, or separating it would cause substantial damage to the item or the building</td><td>No</td><td>Section 11(e) deduction</td></tr>
<tr><td colspan="2">The fittings can be removed without causing damage to them, and removal thereof would not cause damage to the building as they are mounted on the drywall partitions.</td></tr>
</table>

- *Construction of a brick wall structure (item 6 in Table 4)*

ABC incurred some costs in constructing a recording booth consisting of sound-proofed brick walls. Applying the framework in Table 9 below it is concluded that these costs must be included in the base cost of the lease.

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Table 9: Applying framework to brick wall structure put up by ABC

<table>
<tr><td rowspan="2">Step 2</td><td rowspan="2">Determine whether expenditure relates to repairs</td><td rowspan="2">(a)</td><td rowspan="2">Restoration, renewal or replacement of part or parts of the premises</td><td>No</td><td>Proceed to step 4</td></tr>
<tr><td colspan="2">A new recording booth was constructed</td></tr>
<tr><td rowspan="4">Step 4</td><td rowspan="4">Determine whether expenditure resulted in separately identifiable articles which qualify for a section 11(e) wear–and-tear deduction</td><td rowspan="2">(a)</td><td rowspan="2">Expenditure relates to an item or article that is separately identifiable</td><td>Yes</td><td>Proceed to step 4(b)</td></tr>
<tr><td colspan="2">The recording booth can be separately identified</td></tr>
<tr><td rowspan="2">(b)</td><td rowspan="2">The item is structurally integrated or incorporated into the building, or separating it would cause substantial damage to the item or the building</td><td>Yes</td><td>Proceed to step 5</td></tr>
<tr><td colspan="2">The recording booth has brick walls which are structurally integrated into the building</td></tr>
<tr><td rowspan="2">Step 5</td><td rowspan="2">Determine whether expenditure is of a capital nature or not</td><td colspan="2" rowspan="2">Expenditure relates to creating or improving the taxpayer's income earning structure, or relates to acquisition of a revenue producing source</td><td>Yes</td><td>Proceed to step 6</td></tr>
<tr><td colspan="2">The recording booth is used in ABC's business of advertising and relates to an improvement to the income-earning structure</td></tr>
<tr><td>Step 6</td><td>Expenditure relates to improvements to the leased premises</td><td colspan="2">Include in base cost for CGT purposes</td><td colspan="2">Time of disposal for CGT will be when lease expires</td></tr>
</table>

ABC incurred significant costs on its leased premises which have all been classified as leasehold improvements for accounting purposes. None of the costs incurred by ABC qualify for a section 11(g) allowance as the lease agreement does not comply with the requirements of that section. However, it is evident from the analysis of expenditure above that many of the items included in the category “leasehold improvements” would qualify for a section 11(e) wear-and-tear allowance, as they relate to assets that are separately identifiable from the leased premises.

3.3 SCENARIO 2

The second scenario involves company DEF (Proprietary) Limited (hereafter referred to as DEF) which operates in the microlending industry through various branches across South Africa. At the end of its 2013 financial year DEF had 125 branches across South Africa.

All of the branches trade from leased premises with a typical lease period of three to five years and an option to renew the lease for a further period. DEF incurs expenditure on the leased premises every time a new branch is opened and during the lease term in order to

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maintain the premises in a good condition. The type of expenditure incurred is similar for all branches; hence only one branch was selected for analysis. DEF discloses the expenditure incurred on the leased premises as “shop fittings” in its annual financial statements and its accounting policy is to write it off over a period of ten years. For the year ended February 2013 the total cost capitalised to shop fittings amounted to R4 980 647.

3.3.1 Background

The branch selected for analysing the expenditure incurred by DEF in respect of leased premises is a new branch that was opened during the 2013 financial year. The branch is located in a shopping centre owned by Trust Y. DEF entered into a lease agreement with Trust Y (the lessor) to lease a portion of the interior of the shopping centre. The relevant terms of the lease agreement can be summarised as follows:

- The lease commences on 1 June 2012 for a period of three years, with a renewal period of a further three years at the option of DEF.
- The lessor does not warrant that the premises are fit for the purposes for which they are let to DEF, and the lessor will not incur any liability to make alterations or repairs to the premises that DEF may require in order to conduct its business there.
- DEF is required to keep and maintain the interior and surrounds of the leased premises in good order. The lease agreement specifically includes the maintenance of paintwork, windows, window fittings, electrical fittings, doors, plate glass, walls, ceilings, floors and carpets.
- DEF may install fixtures and fittings if approved by the lessor in writing. DEF may upon termination of the lease remove such fixtures and fittings, provided that it repairs any damage caused to the premises by the installation or removal thereof before handing the premises back to the lessor.
- DEF may not make any alterations or additions to the premises without the prior written consent of the lessor. Should the lessor give his consent, the lessor will be entitled to call upon DEF at the end of the lease to hand over the premises without compensating DEF for such alterations or additions. Alternatively, the lessor may require that DEF restore the premises to their original condition at its own cost.

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- The lease contains a generic clause which states that the lessor is entitled to require that alterations or additions be effected and paid for by the lessee. The lessor may further require that, if applicable, such alterations or additions be removed at DEF's expense at the end of the lease term, subject to the reasonable approval of an architect.

3.3.2 Expenditure incurred on the leased premises

DEF's detailed asset register for "shop fittings" pertaining to the new branch was obtained. The register reflected 12 items with a total cost incurred of R107 606. The ten items with the highest value were selected for further analysis. These ten items comprised R101 415 or 94% of the total amount incurred on "shop fittings" for the branch.

The detail of the ten items selected from DEF's fixed asset register for the selected branch is summarised in Table 10 below.

Table 10: Expenditure relating to leased premises incurred by DEF

Item no.	Description in fixed asset register	Detailed description obtained from supporting invoices and interview with DEF representative	Invoice Date	Amount
1	Supply/Fit Paint 75MM Skirting/16.74 Dry Wall/Lock/Door	Supply, fitting and painting of new dry walls and doors	04/07/2012	R 21 422
2	Supply/Fit 12 x D/Plugs/Trunking/Fluorescent Tubes/Switch	Supply and fitting of electrical fixtures (lights, switches, plugs)	04/07/2012	R 15 308
3	Sign - Chromadek Vinyl D/Tinted 4200 x 1225MM	Design, manufacture and installation of signage	21/08/2012	R 11 939
4	Supply/Fit Drywall/Skirting/Rails/Rubble/Travel	Supply and fitting of new dry walling, plugs and skirting boards.	06/07/2012	R 11 003
5	Demolish Walls/Rubble/Travel/Cleaning	Demolition of existing walls and rubble removal. (Service supplied by the same contractor who installed the new dry walls)	04/07/2012	R 9 914
6	Tiles120sq M/Spacers/Progrip/Adhesive	New tiles to replace existing (materials only)	14/06/2012	R 8 080

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Item no.	Description in fixed asset register	Detailed description obtained from supporting invoices and interview with DEF representative	Invoice Date	Amount
7	Painting-Ceiling 150SQ M/40L PVA	Painting of existing ceilings	04/07/2012	R 7 186
8	Tiling 30SQ M/Delivery	Laying new tiles	04/07/2012	R 6 299
9	Sign-Chromadek D/Sided D/Printed 1200 x 500MM/Travel	Design, manufacture and installation of signage	21/08/2012	R 5 611
10	Supply/Fit Rails/Counters/Brackets /Supports/Bins	Supply and fitting of new counter tops	04/07/2012	R 4 652
TOTAL				**R 101 415**

Using the preliminary framework set out in the previous chapter (Table 3), each type of expenditure described in Table 10 was analysed separately in order to determine the correct tax treatment thereof.

3.3.3 Tax deductions applicable to the expenditure incurred

Step one of the framework starts off by considering whether the lease agreement stipulates an obligation on the lessee to effect improvements to the leased property. The lease agreement entered into by DEF for the branch selected does not stipulate that DEF is obliged to effect any improvements to the leased premises. As a result DEF will not qualify for a section 11(g) allowance. The remaining steps of the framework are therefore applied to each type of expense identified in Table 10.

- *Drywalls and electrical fixtures (items 1, 2, 4 and 5 of Table 10)*

DEF made changes to the interior of the premises before it took occupation in order to make the premises suitable for its trade. As a result DEF incurred costs relating to the removal of the existing internal drywall partitions and installing new ones, as well as fitting electrical fixtures. The facts pertaining to these costs are very similar to those described in Table 7 of Scenario 2 above; thus the result is no different. The costs incurred on the drywalls and electrical fixtures relate to separately identifiable items that qualify for a section 11(e) wear-and-tear allowance.

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The acceptable write-off period for movable partitions as per Annexure A of Interpretation Note 47 is six years (*South African Revenue Service: Interpretation note: no. 47 (issue 3)*, 2012:20). The lease term in this scenario is however only three years with an option to renew it for a further three years. The view of SARS is that assets which are let for a period that is longer than the accepted write-off period listed in Annexure A of Interpretation Note 47 must be written off over the lease term (*South African Revenue Service: Interpretation note: no. 47 (issue 3)*, 2012:13). In contrast, assets which are let for a shorter period must be written off over the period set out by SARS, unless the taxpayer submits an application for a shorter write-off period. The factors which SARS consider relevant in determining whether a shorter write-off period will be allowed include “the environment in which the asset operates and the intensity with which the asset is used” (*South African Revenue Service: Interpretation note: no. 47 (issue 3)*, 2012:13). The lease term in itself will therefore not be reason enough for a claiming a shorter write-off period.

- *Signage and counter tops (items 3, 9 and 10 of Table 10)*

DEF installed new signage and counter tops in the leased premises in order to make the premises suitable for its trade. By applying the framework in Table 11 below it is concluded that these items qualify for a section 11(e) allowance.

Table 11: Applying framework to signage and countertops installed by DEF

Step 2	Determine whether expenditure relates to repairs	(a)	Restoration, renewal or replacement of part or parts of the premises	No	Proceed to step 4
				DEF installed new signage and counter tops as there were none in the premises before the lease commenced	
Step 4	Determine whether expenditure resulted in separately identifiable articles which qualify for a section 11(e) wear-and-tear deduction	(a)	Expenditure relates to an item or article that is separately identifiable	Yes	Proceed to step 4(b)
				The signage and countertops are clearly separately identifiable	
		(b)	The item is structurally integrated or incorporated into the building, or separating it would cause substantial damage to the item or the building	No	Section 11(e) deduction
				The signage and countertops can be removed without causing damage to the items themselves or to the building	

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In terms of Annexure A to Interpretation Note 47, SARS will accept a ten year write-off period for signage and six years for shop fittings (*South African Revenue Service: Interpretation note: no. 47 (issue 3)*, 2012:21). It is submitted that the counter tops fall within the category “shop fittings”.

As with the drywalls and electrical fixtures discussed above, the write-off periods permitted by SARS is longer than the term of the lease, which is three years with the option of renewal for a further three years. As discussed above, SARS’s view is that assets which are let for a period shorter than the acceptable write-off period listed in Annexure A of Interpretation Note 47 must be written off over the period listed in the annexure, and not over the lease term (*South African Revenue Service: Interpretation note: no. 47 (issue 3)*, 2012:13).

- *Replacing tiles and painting ceilings (items 6, 7 and 8 of Table 10)*

DEF incurred costs to replace the floor tiles and paint the ceilings of the premises in the month that the lease commenced. This was done as the floors and ceilings were somewhat deteriorated, and DEF had to maintain the interior of the premises in good order in terms of the lease agreement. The work was done before DEF physically occupied the premises for trading, but after the lease commenced. By applying the framework in Table 12 below it can be seen that these costs qualify for a section 11(d) deduction for repairs and maintenance.

Table 12: Applying framework to tiles and ceilings replaced by DEF

<table>
<tr><td rowspan="6">Step 2</td><td rowspan="6">Determine whether expenditure relates to repairs</td><td rowspan="2">(a)</td><td rowspan="2">Restoration, renewal or replacement of part or parts of the premises</td><td>Yes</td><td>Proceed to step 2(b)</td></tr>
<tr><td colspan="2">The tiles and ceilings of the premises were replaced</td></tr>
<tr><td rowspan="2">(b)</td><td rowspan="2">Due to impairment, damage to or deterioration of such parts</td><td>Yes</td><td>Proceed to step 2(c)</td></tr>
<tr><td colspan="2">The previous tiles and ceilings were somewhat deteriorated</td></tr>
<tr><td rowspan="2">(c)</td><td rowspan="2">In order to restore the premises to a state in which it will continue to earn income as before</td><td>Yes</td><td>Expenditure = Repairs
Proceed to step 3</td></tr>
<tr><td colspan="2">Even though DEF did not occupy the premises before, the replacing of the tiles and ceilings did not in itself increase the income earning capacity of the premises</td></tr>
</table>

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Step 3	Determine whether repairs qualify for a section 11(d) deduction	(a)	Did the repairs form part of an overall reconstruction or refurbishment	Yes	Proceed to step 3(b)
				The tiles and ceilings were replaced as part of an overall refurbishment of the premises before DEF commenced trading from them.	
		(b)	Can the costs relating to repairs be identified and separated from the costs of reconstruction	Yes	Section 11(d) deduction
				The repair costs were separately invoiced	

DEF cannot claim a section 11(g) allowance for costs incurred in respect of the premises they lease, as the lease agreement does not specify an obligation for DEF to effect improvements. A closer look at the expenditure incurred by DEF revealed that none of it actually related to improvements and qualified for tax deductions under sections 11(d) and 11(e).

3.4 SCENARIO 3

This scenario involves a company GHI (Proprietary) Limited (hereafter referred to as GHI) which owns a chain of furniture stores, all operating from leased premises. GHI is owned by a company listed on the Johannesburg Stock Exchange.

GHI incurred considerable expenditure on revamping leased premises, the most significant and most recent of which was in respect of a branch which operated from the same premises for many years, and was revamped during the 2011 financial year. GHI classifies such expenditure as leasehold improvements for accounting purposes, and depreciates it over five years or over the lease term, whichever is shorter. GHI has a March yearend.

3.4.1 Background

The expenditure incurred on the branch revamped during the 2011 financial year was selected for further analysis as it was incurred most recently. The branch is located in a shopping centre, owned by an individual, Mr. Z (the lessor).

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GHI had leased the premises from Mr. Z for some time when they were refurbished in October 2010. A new lease agreement was signed in November 2009 before the refurbishment took place; however the lease period in terms of the new lease commenced only on 1 July 2011. The initial lease agreement commenced on 1 July 2001 and remained in force for a period of ten years until 30 June 2011. The terms of both lease agreements were considered in this scenario.

The terms of the initial lease agreement which was in force at the time the refurbishment took place are summarised below:

- The lease period is from 1 July 2001 to 30 June 2011. GHI has the option to renew the lease for a further period after 30 June 2011 and, except for clauses dealing with the amount of rent payable, the terms of the initial lease shall continue to apply during the renewal period.
- The lessor does not warrant that the premises are suitable for the purposes of GHI's business and is not liable to do any repairs, or make any changes to the premises to render them suitable for use by GHI.
- GHI is responsible for maintaining the premises in good order during the lease period, and shall carry out at its own cost any painting, repairs or replacements necessary for that purpose.
- GHI may not make any structural alterations or additions to the premises without the lessor's prior written consent. Any alterations so made must be carried out at GHI's own cost.
- GHI will not be entitled to remove any alteration or additions which it has made, and on termination of the lease they will remain the property of the lessor.
- GHI may install fixtures and fittings necessary to conduct its business. At the end of the lease term GHI must remove all fixtures and fittings installed and repair any damage caused by their removal. Any fixtures and fittings not removed on termination of the lease will become the property of the lessor without compensation.
- On termination of the lease GHI will be required to hand over the premises in the same good order as at the inception of the lease, with allowance for reasonable wear and tear.

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The new lease signed in November 2009 is effective from 1 July 2011 for a period of three years, terminating on 30 June 2014 where after it can be renewed again. The terms of the new lease are similar to those of the initial lease agreement.

3.4.2 Expenditure incurred on the leased premises

GHI's detailed fixed asset register for the category "leasehold improvements" was obtained. In total R466 789 was spent on the branch selected, consisting of only five items. All five items were selected for further analysis. The details of the items classified as "leasehold improvements" by GHI in respect of the selected branch are summarised in Table 13 below.

Table 13: Expenditure relating to leased premises incurred by GHI

Item no.	Description in fixed asset register	Detailed description obtained from supporting invoices and interview with GHI representative	Invoice Date	Amount
1	Revamp Makhado as per plan (deposit paid)	The revamp included paint work, removal of existing drywalls and replacing with new, replacing existing tiles and carpets with new, installing new cabinets, desks and countertops, repairing damaged ceilings and some electrical work. All work was done by one contractor who provided a detailed plan of work to be done, but the total cost was not allocated to the various items as per the plan. It is unclear how the breakdown of costs in the fixed-asset register was determined, as the contractor issued one invoice with the total amount charged for the entire revamp.	29/08/2010	R 368 000
2	Repair and plaster of wall		12/08/2010	R 6 200
3	Removal and laying of tiles		12/08/2010	R 8 211
4	Revamp outside shop		28/08/2010	R 14 957
5	Revamp outside shop		29/10/2010	R 69 422
TOTAL				**R 466 789**

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The expenditure incurred by GHI on the revamp of the shop premises must be analysed using the preliminary framework set out in the previous chapter (Table 3) in order to determine the correct tax treatment thereof.

3.4.3 Tax deductions applicable to the expenditure incurred

The premises leased by GHI underwent an overall revamp which was done by one contractor. The revamp included repairing some items that had deteriorated and were damaged, as well as refurbishing the premises in general. The contractor invoiced for the costs incurred in one invoice, not specifying how the total amount invoiced was determined. No other documentation was available to support the allocation of costs to different items as per the fixed asset register in Table 13. The framework is thus applied to the total costs incurred by GHI as set out in Table 14 below.

Table 14: Analysing premises revamp costs incurred by GHI

<table>
<tr><td rowspan="2">Step 1</td><td rowspan="2">Lease agreement stipulates obligation on lessee to effect specified improvements</td><td>No</td><td colspan="3">Proceed to step 2</td></tr>
<tr><td colspan="4">The lease agreement do not stipulate an obligation on GHI to effect any improvements</td></tr>
<tr><td rowspan="6">Step 2</td><td rowspan="6">Determine whether expenditure relates to repairs</td><td rowspan="2">(a)</td><td rowspan="2">Restoration, renewal or replacement of part or parts of the premises</td><td>Yes</td><td>Proceed to step 2(b)</td></tr>
<tr><td colspan="2">Some of the work done related to repairs to the walls and ceilings</td></tr>
<tr><td rowspan="2">(b)</td><td rowspan="2">Due to impairment, damage to or deterioration of such parts</td><td>Yes</td><td>Proceed to step 2(c)</td></tr>
<tr><td colspan="2">Parts of the walls and ceilings were damaged</td></tr>
<tr><td rowspan="2">(c)</td><td rowspan="2">In order to restore the premises to a state in which it will continue to earn income as before</td><td>Yes</td><td>Expenditure = Repairs
Proceed to step 3</td></tr>
<tr><td colspan="2">The repairs did not increase the income earning capacity of the premises</td></tr>
<tr><td rowspan="4">Step 3</td><td rowspan="4">Determine whether repairs qualify for a section 11(d) deduction</td><td rowspan="2">(a)</td><td rowspan="2">Did the repairs form part of an overall reconstruction or refurbishment</td><td>Yes</td><td>Proceed to step 3(b)</td></tr>
<tr><td colspan="2">The repairs were done by the same contractor and at the same time as the overall shop revamp</td></tr>
<tr><td rowspan="2">(b)</td><td rowspan="2">Can the costs relating to repairs be identified and separated from the costs of reconstruction</td><td>No</td><td>Proceed to step 4</td></tr>
<tr><td colspan="2">The contractor did not separate the cost of repairs from the overall cost of the revamp in his invoice, and no other documentation is available to provide basis of allocating costs to the repairs</td></tr>
</table>

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<table>
<tr><td rowspan="4">Step 4</td><td rowspan="4">Determine whether expenditure resulted in separately identifiable articles which qualify for a section 11(e) wear-and-tear deduction</td><td rowspan="2">(a)</td><td rowspan="2">Expenditure relates to an item or article that is separately identifiable</td><td>Yes</td><td>Proceed to step 4(b)</td></tr>
<tr><td colspan="2">New cabinets, desks and countertops were installed as part of the refurbishment</td></tr>
<tr><td rowspan="2">(b)</td><td rowspan="2">The item is structurally integrated or incorporated into the building, or separating it would cause substantial damage to the item or the building</td><td>No</td><td>Section 11(e) deduction</td></tr>
<tr><td colspan="2">The cabinets, desks and countertops can be removed without causing damage to the items or the building. (Refer also to the discussion below)</td></tr>
<tr><td colspan="6">Remaining refurbishment costs, excluding costs qualifying for a section 11(e) allowance:</td></tr>
<tr><td rowspan="2">Step 5</td><td rowspan="2">Determine whether expenditure is of a capital nature or not</td><td colspan="2" rowspan="2">Expenditure relates to creating or improving the taxpayer's income earning structure, or relates to acquisition of a revenue producing source</td><td>Yes</td><td>Proceed to step 6</td></tr>
<tr><td colspan="2">The revamp of the shop will improve GHI's income earning structure</td></tr>
<tr><td>Step 6</td><td>Expenditure relates to improvements to the leased premises</td><td colspan="2">Include in base cost for CGT purposes</td><td colspan="2">Time of disposal for CGT will be when lease expires</td></tr>
</table>

The refurbishment undertaken by GHI resulted in some separately identifiable assets being created, for example the new cabinets, desks and countertops installed (Refer step 4 of Table 14 above). These fixtures qualify for a section 11(e) allowance; however the costs relating to these fixtures cannot be identified as they are included in the contractor's overall cost for the entire refurbishment. The section 11(e) allowance must be calculated as the amount by which the value of an article has diminished or depreciated during the year of assessment. The section does not define what the "value" of an article is but in practice SARS has always regarded the cost of acquisition, excluding any finance charges, as the value of the asset for purposes of determining the section 11(e) allowance (*South African Revenue Service: Interpretation note: no. 47 (issue 3)*, 2012:6). In terms of paragraph (vii) of the proviso to section 11(e), the cost of acquisition to be used in determining the value of an asset must be the cost that a person would incur if the asset was acquired in a cash transaction concluded at arm's length, or in other words the market value of the asset (*South African Revenue Service: Interpretation note: no. 47 (issue 3)*, 2012:7). If a taxpayer acquired an asset at no cost, the practice of SARS has been to allow the taxpayer to place a reasonable value on the assets for the purpose of calculating the section 11(e) allowance (De Koker & Williams, 2012:§ 8.117). In this scenario GHI did incur costs for the acquisition of certain furniture and fixtures, but the exact amount of such costs incurred cannot be identified. It is submitted that a section 11(e) wear-and-tear

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allowance may be claimed based on the reasonable value of the furniture and fixtures acquired.

In step 5 and 6 of Table 14 above it is concluded that the refurbishment costs incurred by GHI should be added to the base cost of the lease agreement. In terms of par 20(3) of the Eighth Schedule, the base cost must be reduced by any amount which was allowed as a deduction from taxable income. For that reason the base cost of GHI's improvements to the lease must be reduced by any amounts claimed under section 11(e) relating to fixtures of which the cost was included in the overall refurbishment cost.

GHI incurred significant costs for revamping premises which it has leased for some years. None of the costs incurred by GHI qualify for a section 11(g) allowance as the lease agreement does not comply with the requirements of that section. An analysis of the expenditure incurred by GHI revealed that it consisted of a combination of repairs, fixtures and improvements. The allocation of costs between these items could however not be supported by documentary proof, which resulted in the section 11(d) allowance not being available for the repair costs incurred.

3.5 CONCLUSION

In this chapter three companies of different sizes and operating in different industries were selected. The expenditure incurred by them on leased premises were analysed. This was done in order to determine the type of expenditure typically incurred by lessees in respect of the premises they lease. Thereafter the different types of expenditure incurred by each company were analysed using the preliminary framework of the previous chapter.

Some of the expenditure incurred by the lessees in the three scenarios was similar, although the reasons for incurring such expenditure were different. In scenario one for instance, the lessee effected certain alterations to the internal design and layout of the premises in order to accommodate staff from subsidiary companies, while in scenario two similar types of expenditure were incurred in order to make the premises suitable for the lessee's trade. In scenario three, expenditure was incurred to revamp the premises from

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which the lessee had traded for ten years. The overall revamp included elements of repair as it was the first revamp done in ten years, as well as installation of certain fixtures. However, the supporting documents that were available could not provide a basis for allocating the overall cost between repairs, fixtures and improvements.

In the three scenarios analysed not one company qualified for a section 11(g) allowance on improvements made to the leased premises as none of the lease agreements inspected complied with the requirements of that section. All three companies incurred expenditure that qualified for a section 11(e) allowance for wear and tear, as it related to articles that were separately identifiable and not of a permanent nature. Two of the companies incurred costs that related to repairs rather than improvements; however a section 11(d) deduction could only be claimed where the costs relating to repairs could be identified and separated from the overall costs incurred by the lessee. Expenditure which did not qualify for a specific deduction had to be evaluated in terms of the general deduction formula of section 11(a) before a final decision could be made as to whether the cost should be added to the base cost of the lease.

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CHAPTER 4

THE FINAL FRAMEWORK

4.1 INTRODUCTION

A preliminary framework was developed based on an analysis of the different tax deductions that may apply to costs incurred by lessees on leased premises. Thereafter the preliminary framework was applied to determine the correct tax treatment of specific costs incurred by three selected lessee companies. In this chapter the preliminary framework is slightly adjusted in order to incorporate issues that previously had to be dealt with outside of the framework.

4.2 FRAMEWORK

The typical expenditure incurred by lessees on leased premises were identified and analysed using the preliminary framework. The preliminary framework however did not provide sufficient guidance towards determining the quantum of the section 11(e) wear-and-tear allowance in instances where expenditure incurred by the lessee resulted in separately identifiable assets. The quantum of the section 11(e) allowance is dependent on firstly, the cost of the asset, and secondly, the period over which the asset is written off. Furthermore, the preliminary framework did not consider whether the lessee had ownership of such assets in terms of the lease agreement, which is crucial as ownership of the asset is a prerequisite for claiming the section 11(e) allowance.

The framework was therefore adjusted in order to address the inadequacies described above. This was done by inserting a step to consider whether ownership of the separately identifiable assets vests in the lessee in terms of the lease agreement, as set out in Step 4(c) of Table 15 below. Thereafter two steps were inserted firstly, to address the amount on which the section 11(e) allowance must be based and secondly, to address the period over which the allowance must be calculated, as can be seen in Steps 5(a) and 5(b) of Table 15 below.

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Table 15: Final framework for determining the correct tax treatment of expenditure incurred by lessees

Step 1	Lease agreement stipulates obligation on lessee to effect specified improvements	Yes	Fair value of improvements included in lessor's gross income	Yes	Section 11(g) deduction
				No	Proceed to step 2
		No	Proceed to step 2		
Step 2	Determine whether expenditure relates to repairs	(a)	Restoration, renewal or replacement of part or parts of the premises	Yes	Proceed to step 2(b)
				No	Proceed to step 4
		(b)	Due to impairment, damage to or deterioration of such parts	Yes	Proceed to step 2(c)
				No	Proceed to step 4
		(c)	In order to restore the premises to a state in which it will continue to earn income as before	Yes	Expenditure = Repairs Proceed to step 3
				No	Proceed to step 4
Step 3	Determine whether repairs qualify for a section 11(d) deduction	(a)	Did the repairs form part of an overall reconstruction or refurbishment	Yes	Proceed to step 3(b)
				No	Section 11(d) deduction
		(b)	Can the costs relating to repairs be identified and separated from the costs of reconstruction	Yes	Section 11(d) deduction
				No	Proceed to step 4
Step 4	Determine whether expenditure resulted in separately identifiable articles which qualify for a section 11(e) wear and tear deduction	(a)	Expenditure relates to an item or article that is separately identifiable	Yes	Proceed to step 4(b)
				No	Proceed to step 6
		(b)	The item is structurally integrated or incorporated into the building, or separating it would cause substantial damage to the item or the building	Yes	Proceed to step 6
				No	Proceed to step 4(c)
		(c)	In terms of the lease agreement ownership of the item remains with lessee for duration of the lease	Yes	Claim section 11(e) allowance for duration of the lease. Proceed to step 5
				No	Lessee not entitled to section 11(e) allowance, proceed to step 6

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Step 5	Determine quantum of section 11(e) deduction	(a)	Cost of item acquired can be identified	Yes	Use cost (excluding finance charges) to calculate allowance
				No	Base allowance on the reasonable value of the item
		(b)	Write-off period in terms of Annexure A to Interpretation Note 47 is shorter than lease term	Yes	Use write-off period as per Annexure A of Interpretation Note 47
				No	Write off item over the period of the lease, OR apply to SARS for a shorter write-off period
Step 6	Determine whether expenditure is of a capital nature or not	Expenditure relates to creating or improving the taxpayer's income-earning structure, or relates to acquisition of a revenue producing source		Yes	Proceed to step 7
				No	Section 11(a) to be further considered
Step 7	Expenditure relates to improvements to the leased premises	Include in base cost for CGT purposes		Time of disposal for CGT will be when lease expires	

The final framework should be beneficial to most lessees as it sets out the legislation that needs to be considered for leasehold improvements in a simple and easily understandable manner. A disadvantage however is that due to its simplicity, the framework may not provide sufficient guidance in complex situations, especially in instances where the questions asked in the framework cannot be simply answered “yes” or “no”. Nevertheless, the framework is designed to consider sections of the Act in such order that it will ensure that a lessee claims the most beneficial tax deduction for which it qualifies in respect of leasehold improvement expenditure incurred.

4.3 CONCLUSION

The framework to be used by lessees in determining the correct tax treatment for expenditure incurred on leased premises was finalised. The final framework differs slightly from the preliminary framework as it considers the specifics of the section 11(e) allowance in more detail. In the final framework ownership of the assets that qualify for a section 11(e) allowance is taken into consideration, as well as the cost to be used in calculating the allowance and selecting the correct write-off period.

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CHAPTER 5

CONCLUSION

5.1 INTRODUCTION

The issue that formed the topic of this study was to determine what the correct tax treatment is for expenditure that lessees incur on leased premises. Taxpayers often incur expenditure on leased premises which is generally capitalised as "leasehold improvements" for accounting purposes and written off over the lease term. In practice taxpayers do not always consider the correct tax treatment of such expenditure properly and proceed to treat leasehold expenditure for tax purposes the same as for accounting purposes, by claiming a wear--and-tear allowance over the period of the lease.

The applicable section of the Act which provides a deduction to the lessee in respect of leasehold improvement is section 11(g), which allows the lessee to claim such expenditure over the term of the lease. The problem with section 11(g) is however that it requires the lessor to be taxed on the value of the improvements effected by the lessee, *and* the lease agreement must impose an obligation on the lessee to effect specified improvements before the lessee can qualify for the section 11(g) allowance. The strict requirements of section 11(g) result in the lessee's expenditure more often than not falling outside of its scope and thus not eligible for a deduction under this section. The primary objective of this study was for that reason to analyse the alternative tax deductions available to the lessee in respect of expenditure incurred on leased premises. Furthermore the objective was to develop a framework that will be of practical assistance to lessees in determining the correct tax treatment of such expenditure.

The research objectives were formulated in chapter one and were designed to achieve the primary objective of the study. In this chapter the findings and conclusions to the research objectives are presented.

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5.2 SUMMARY OF FINDINGS AND ANSWERS TO RESEARCH OBJECTIVES

The primary objective of this study was the development of a framework which lessees can use in determining the correct tax treatment of *"leasehold improvement"* expenditure incurred.

Firstly it was necessary to identify and analyse the tax deductions, other than the section 11(g) allowance, that could apply to expenditure incurred by lessees on leased premises. The applicable sections that were identified were section 11(d) which permits a deduction for repairs incurred on premises occupied for the purposes of trade, and section 11(e) which allows for wear and tear for assets that can be separately identified and are not fixed to the leased premises. The general deduction formula in section 11(a) of the Act was also considered in the context of this study as it could apply to expenditure incurred by lessees that do not qualify for any other specific deduction and are not of a capital nature. Lastly the CGT implications were considered as it was said that the lease agreement constitutes an asset for the lessee, and costs incurred by the lessee which do not qualify for any normal income tax deduction should be included in the base cost of the lease, which will result in the lessee incurring a capital loss at the time the lease is terminated.

A further objective of the study was to identify the type of expenditure that taxpayers typically classify as *"leasehold improvements"*. This was done using a case study approach and selecting three companies from different industries that had incurred significant expenditure on leased premises in recent years. The types of expenditure identified from these three case studies included the following:

- A payment made to the lessor to cover the lessee's portion of the overall refurbishment of the building undertaken by the lessor, as agreed upfront between the parties and stipulated in the lease agreement.
- Project management and design fees, which included the drafting of plans for the internal design of the premises occupied by the lessee.
- Alterations to existing dry walls which included demolition, construction and painting of new walls, doors, ceilings, as well as replacing carpets.

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- Electrical installations which included installing new cables, plug points, light fittings and related items.
- Construction of a recording booth consisting of brick walls.
- Computer costs which included the moving and installation of data cables, network points and other related items.
- Design and installation of signage.
- Replacing existing tiles with new tiles.
- Installing new counter tops.
- Overall revamp of shop premises which included repairs and plastering of brick walls.

The final two objectives of the study were to develop a framework which will assist lessees in determining the correct tax treatment of expenditure incurred on leased premises, and to evaluate the usefulness of the framework. In developing the framework the key concepts of sections 11(g), 11(d), 11(e) and 11(a) had to be considered. These key concepts include the distinction between *"repairs"* and *"improvements"*, determining whether improvements were made *to the leased premises* or resulted in assets *separate from the premises*, and lastly whether the expenditure were of a capital nature or not. The framework was applied to each type of expense identified in the three case studies mentioned above, and was found to be of much practical use in the sense that it provides guidance through the relevant sections of the Act that should be considered by the lessee in respect of expenditure incurred on leased premises.

5.3 RECOMMENDATIONS AND FUTURE RESEARCH

This study recommends that the newly developed framework should be endorsed by SARS and distributed for it may alleviate conflict with regard to annual tax assessments.

The scope of this study was designed to exclude deductions relating to lease premiums under section 11(f) of the Act, as well as the implications of the section 11(o) allowance relating to depreciable asset disposals. Further research into these two sections may be very valuable. Future studies could expand on the framework by including these two sections.

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The framework could also be revised to cater for industries that qualify for special capital allowances, such as hotel buildings, industrial buildings, ship-building structures or farmland.

Future researchers may also want to consider the application of the framework developed in this study in the context of a subleasing agreement, or in a sale and leaseback arrangement.

5.4 CONCLUDING REMARKS

Leasehold improvements are an area that concerns most corporate taxpayers in South Africa, as many businesses operate from leased premises. Differences between the accounting and the tax treatment of leasehold improvement expenditure adds to the complexity of the matter, resulting in taxpayers often relying on accounting principles when calculating tax deductions applicable to leasehold improvements. The framework developed in this study will serve as a practical tool to taxpayers who have incurred expenditure on leased premises and assist in determining the correct tax treatment thereof.

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APPENDIX A

- Informed consent form -

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Faculty of Economic and
Management Sciences

Informed consent for participation in an academic research study

Dept. of Taxation

LEASEHOLD IMPROVEMENTS: DEVELOPING A FRAMEWORK FOR THE TAX DEDUCTIONS APPLICABLE TO LESSEES

Research conducted by:

Mrs R Theart (22054503)
Cell: 082 449 2607

Dear Respondent

You are invited to participate in an academic research study conducted by Reinette Theart, a Masters student from the Department of Taxation at the University of Pretoria.

The purpose of the study is to analyse the different tax deductions applicable to expenditure incurred by lessees in respect of leased premises, and to develop a framework which will assist lessees in determining the correct tax deductions available in respect of leasehold improvements.

Please note the following:

- This study involves an anonymous case study. Names and company information will not be disclosed and will be treated as strictly confidential.
- Your participation in this study is very important to us. You may, however, choose not to participate and you may also stop participating at any time without any negative consequences.
- The results of the study will be used for academic purposes only and may be published in an academic journal. We will provide you with a summary of our findings on request.
  - Please contact my supervisor, Mrs H du Preez, tel: +27 12 420 4638, email: Hanneke.DuPreez@up.ac.za if you have any questions or comments regarding the study.

Please sign the form to indicate that:

- You have read and understand the information provided above.
- You give your consent to participate in the study on a voluntary basis.

____________________________ ____________________

Respondent's signature **Date**

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