Dear Sir/Madam

CALL FOR COMMENTS: DRAFT INTERPRETATION NOTE – LEASEHOLD IMPROVEMENTS

We refer to the call for comments on the above mentioned Draft Interpretation Note (‘DIN’). Set out below please find the SAICA National Tax Committee’s submission comments.

General comments
This submission provides inputs on the draft VAT Interpretation Note on leasehold improvements. It should be read in conjunction with the memorandum provided on the topic by Messrs and Edward Nathan Sonnenbergs dated 11 April 2012 addressed to Mr. Rodney Govender.

We confirm that we are in agreement with the interpretation and application of the Value-Added Tax Act, No 89 of 1991 (”the VAT Act”) as set out in the DIN.

Specific comments
The same principles as described in paragraph 4 of the DIN are applicable to all types of immovable property, irrespective of the nature thereof. The difference is of course that in the case of a dwelling the lessee (if a vendor) would not be liable for output tax even if a

Ref#: 398355
Submission File

31 May 2012

Legal & Policy Division
SARS
PO Box 402
Pretoria
0001

BY E-MAIL: policycomments@sars.gov.za
consideration is paid by the lessor, and the lessee would not be entitled to claim any input tax on the improvements effected. With regard to a partially taxable immovable property, the lessee (if a vendor) should be liable for output tax to the extent that the leasehold improvements are attributable to the taxable use of the property and payment has been made for such improvements. The lessee should further only be entitled to claim input tax on the improvements to the extent that it relates to taxable supplies. We recommend that the DIN clarifies the above accordingly under a separate paragraph, as opposed to excluding these situations under paragraph 5.

A fundamental principle of the VAT system is that VAT is only payable on the consideration charged for a supply, unless the provisions of section 10(4) of the VAT Act apply. The exclusion of transactions where the rental is not market related for any reason, would be contrary to such principles. There also does not seem to be any reason as to why such principle should not apply to leasehold improvements only, whereas it applies to all other types of transactions where a supply is made for a consideration less than market value. There is also not risk of any loss to the fiscus if both the lessor and the lessee are registered vendors and entitled to a full input tax deduction. If a transaction is entered into with the intention to avoid or postpone the payment of VAT, or to obtain an undue VAT refund, the anti-avoidance provisions of the VAT Act will always apply, as in the case of all other VAT interpretation notes.

We recommend that the detail on section 10(4) of the VAT Act be included, for example: the VAT value of supply rule applicable to “connected persons” (as defined) provides that where (i) a supply is made for no consideration or for a consideration which is less than the open market value; (ii) the supplier and recipient are connected persons; and (iii) if a consideration equal to the open market value had been paid by the recipient, he would not have been entitled to a full input tax deduction, the consideration in money for the supply is deemed to be the open market value of the supply.

We recommend that the third and fourth bullets under paragraph 5 be deleted from the DIN.

We recommend that the DIN address the use of leasehold improvements by and the passing thereof to the land owner or lessor on or before the termination of the lease.
We recommend that the DIN includes more detail on issues such as the definition of “consideration” which includes payment made or to be made, in money or otherwise, or any act or forbearance, whether voluntary or not, in respect of, in response to, or for the inducement of a supply.

We recommend that the DIN address the fact that the VAT Act determines that the value of the consideration shall be the amount of money (lease premiums) to the extent that the consideration is consideration in money; and the open market value of the consideration to the extent that the consideration is not in money. As a result, where the lessor and lessee agree open market value lease premiums without any other obligations arising for the lessee, the value of the consideration would be the lease premiums. However, where the lessor and lessee agree that, in addition to the lease premiums, the lessee undertakes to effect leasehold improvements, the consideration for the use of property changes from a straightforward “consideration in money” scenario to a situation which includes part “consideration in money” (i.e. the lease premiums agreed) and part “not consideration in money” (i.e. the leasehold improvements). The lessor receives lease premiums and leasehold improvements in exchange for the supply of the use of the property (a typical barter transaction). The lessor then needs to determine (presumably by valuation) the open market value of the leasehold improvements which, together with the lease premiums, constitute the consideration for the supply of the use of the property provided by the lessor to the lessee. As the leasehold improvements will generally only pass to the land owner or lessor on termination of the lease this diminishing effect on the open market value of the leasehold improvements in the hands of the lessor would arguably need to be taken into account in determining the value of this component of the consideration. Where it can be demonstrated that the value of the leasehold improvements would, in effect, be reduced to nil or consumed in full by the lessee over the duration of the lease, it is arguable that no value should be attached to this component of the consideration. The combined consideration sum is then the value for VAT purposes.

We recommend that the DIN address in more detail the VAT time of supply rules in respect of leasehold improvements, such as the following: Generally, the VAT time of supply will not be triggered if no invoice has been issued and no payment is made for the leasehold improvements, irrespective of whether an obligation exists to effect the improvements. The lessee will then not be obliged to account for output tax and the lessor will not be entitled to an input tax deduction in respect of the improvements. However, as the term “consideration”
includes “any act or forbearance” in respect of, in response to, or for the inducement of a supply, a reduction in lease premiums agreed by the lessor in lieu of leasehold improvements to be effected could arguably constitute payment of consideration and trigger the VAT time of supply. Alternatively, the lease agreement could determine or imply that the leasehold improvements to be effected results in or effects reduced lease premiums payable and could constitute “a document notifying an obligation to make payment”, which could trigger the VAT time of supply. The actual payment of consideration by the lessor to the lessee as consideration for the improvements will also trigger the VAT time of supply.

We recommend that the interpretation note addresses in more detail the VAT value of supply rules in respect of leasehold improvements, such as the following: The VAT value of the supply of the leasehold improvements will generally be the consideration paid by the lessor where the lessor and lessee agree the open market value consideration. Where the lessor and lessee agree that the lessee undertakes to effect leasehold improvements, in exchange for actual payment and reduced lease premiums payable, the consideration for the leasehold improvements changes from a straightforward “consideration in money” scenario to a situation which includes part “consideration in money” (i.e. actual payment agreed for the improvements) and part “not consideration in money” (i.e. the reduced lease premiums agreed). The lessee receives actual payment for the leasehold improvements and pays reduced lease premiums (again a typical barter transaction). The lessee then arguably needs to determine the net present value of the reduction in lease premiums which, together with the actual payment received for effecting the leasehold improvements, constitute the consideration for the supply of the leasehold improvements by the lessee to the lessor.

Please do not hesitate to contact us, should you have any questions regarding the above.

Yours faithfully

Piet Nel CA(SA) 
PROJECT DIRECTOR: TAX

Muneer Hassan CA(SA) 
SENIOR EXECUTIVE: STANDARDS

The South African Institute of Chartered Accountants

cc: nalberts@sars.gov.za