Leases

Content of the session

- VAT consequences of leases
- Income tax for the lessor
- Income tax for the lessee
- Limitation of allowances claimable by lessors
- Sale-and-leasebacks
- Recoupments at the end of the lease term

VAT consequences of leases

Instalment credit agreements

- Definition (section 1)
- Time of supply
  - *Earlier* of:
    - when goods are delivered; ***or***
    - when *<u>any</u>* consideration is paid
  - Even for vendors applying the payments basis
- Value of supply = Cash value
  - Why is this cash value used and not the actual consideration?
  - Banker / Financier
    - Use cost of goods
  - Dealer
    - Use normal cash selling price

"Instalment credit agreement"

"instalment credit agreement" means any agreement entered into on or after the commencement date whereby any goods consisting of corporeal movable goods or of any machinery or plant, whether movable or immovable—

(*a*) are supplied under a **sale** under which—

(i) the goods are sold by the seller to the purchaser against payment by the purchaser to the seller of a stated or determinable sum of money at a stated or determinable future date or in whole or in part in instalments over a period in the future; and

(ii) such sum of money includes finance charges stipulated in the agreement of sale; and

(iii) the aggregate of the amounts payable by the purchaser to the seller under such agreement exceeds the cash value of the supply; and

(iv) (*aa*) the purchaser does not become the owner of those goods merely by virtue of the delivery to or the use, possession or enjoyment by him thereof; or

(*bb*) the seller is entitled to the return of those goods if the purchaser fails to comply with any term of that agreement; or

ICA (continued)

(*b*) are supplied under a **lease** under which—

(i) the rent consists of a stated or determinable sum of money payable at a stated or determinable future date or periodically in whole or in part in instalments over a period in the future; and

(ii) such sum of money includes finance charges stipulated in the lease; and

(iii) the aggregate of the amounts payable under such lease by the lessee to the lessor for the period of such lease (disregarding the right of any party thereto to terminate the lease before the end of such period) and any residual value of the leased goods on termination of the lease, as stipulated in the lease, exceeds the cash value of the supply; and

(iv) the lessee is entitled to the possession, use or enjoyment of those goods for a period of at least 12 months; and

(v) the lessee accepts the full risk of destruction or loss of, or other disadvantage to, those goods and assumes all obligations of whatever nature arising in connection with the insurance, maintenance and repair of those goods while the agreement remains in force;

Example

- On 31 March 2017 XYZ Ltd paid an instalment of R7 700 to ABC Bank in terms of the following agreement:
- XYZ Ltd acquired a Bantam single cab bakkie on 20 January 2016 when the all-inclusive cash cost was R500 000 and financed it through ABC Bank.
- XYZ Ltd needs to pay R7 700 per month for 72 months starting on 31 January 2016.
- XYZ Ltd is responsible for all maintenance and insurance on the vehicle and should XYZ Ltd fail to make payment when due, ABC Bank is entitled to repossess the vehicle.

Solution

- The purchase meets the requirements of an Instalment Credit Agreement as defined as the following requirements have been met:
  - the payment consists of a stated or determinable sum of money payable at a stated or determinable future date or periodically in whole or in part in instalments over a period in the future (instalments of R7 700 payable monthly over 72 months); and
  - such sum of money includes finance charges (R7 700 x 72 = R554 400 – R500 000 = R54 400 interest); and
  - the aggregate of the amounts payable under such lease by the lessee to the lessor for the period of such lease (disregarding the right of any party thereto to terminate the lease before the end of such period) and any residual value of the leased goods on termination of the lease, as stipulated in the lease, exceeds the cash value of the supply (R7 700 x 72 = R554 400 which exceeds R500 000); and
  - the lessee is entitled to the possession, use or enjoyment of those goods for a period of at least 12 months (72 months > 12 months); and`
  - the lessee accepts the full risk of destruction or loss of, or other disadvantage to, those goods and assumes all obligations of whatever nature arising in connection with the insurance, maintenance and repair of those goods while the agreement remains in force (XYZ is responsible for maintenance and insurance of the vehicle)
- Therefore, the full input VAT consequences (i.e. 100%) would have been claimed at the earlier of:
  - Date of any payment (31 January 2016)
  - Date of receipt of the item (20 January 2016)
- Therefore, 20 January 2016 and in the VAT period ending 31 January 2016.
- When the instalment of R7 700 is paid, no further VAT consequences arise as the full VAT consequences would have been accounted for in the January 2016 VAT return.
- The interest charged constitutes an exempt financial service and therefore does not have any VAT consequences

Example

On 1 January 2017 Africa Bank Ltd entered into a finance lease with Production (Pty) Ltd for the lease of a motor vehicle as defined. The vehicle was delivered and brought into use on that date. The agreement stipulates that 48 monthly instalments of R3 000 per month are payable starting on 31 January 2017.

Cost price of the vehicle	R100 000
VAT	R14 000
	R114 000
Finance charges	R30 000
	R144 000

Rental agreements

- Any lease agreement other than an instalment credit agreement
- Time of supply = Earlier of:
  - when payment is due; or
  - when payment is received
- Value of supply = Actual lease instalment

Example

KLM Ltd rents a copier from a supplier at a monthly cost of R1 000 (including VAT) per month. The supplier has to maintain and repair the copier and KLM does not carry the risk of loss or destruction of the asset. KLM has to pay the R1 000 on the last day of each month, but due to cash flow difficulties has only managed to pay the February 2017 rental on 5 March 2017.

VAT on every instalment, i.e. R1 000 x 14/114 = R123
Timing: Earlier of when the instalment is due (28 February 2017) or when it is actually paid (5 March 2017)
Therefore, 28 February 2017

Additional considerations

- Residential letting = Exempt supply
  - Therefore, no VAT on purchase of property
  - No VAT on lease instalments
  - No VAT on lease premiums
  - No VAT on leasehold improvements
- Commercial letting = Taxable supply
  - Therefore, VAT on purchase of property
  - VAT on lease instalments
  - VAT on lease premiums
  - VAT on leasehold improvements

Income tax for the lessor

Inclusions in gross income

- Lease instalments
  - Earlier of receipt / accrual
- Lease premium
  - Include 100% earlier of receipt / accrual
  - Relief in terms of section 11(h)
- Leasehold improvements
  - Include in gross income
    - Theory – When it accrues to him (contract concluded)
    - Practice – When improvements are completed
  - Excludes voluntary improvements
  - Relief in terms of section11(h)
- Claim an allowance on the leased asset

Section 11(h) relief

- Not available if:
  - The lessor / lessee = company and other has an interest of > 50% in the company; *or*
  - Lessor and lessee = company and 3rd party has an interest of > 50% in both entities
- Deduction =
  - Amount included in gross income

    LESS

    PV of that amount (6%, n = same period)

Example

- The lessor is taxed on a lease premium received of R2 670 000 (excluding VAT)
- The section 11(h) relief is calculated as follows:
- Improvement included 2 670 000
- PV of improvement (848 830)
- Amount claimed as deduction 1 821 170

Allowance claimable on commercial property rented out

Section 13*quin*

- 5% allowance per year based on the lesser of:
  - Actual cost; ***or***
  - Market value
- Only available if:
  - Building is new and unused
  - Building was contracted for on / after 1 April 2007; and
  - Construction commenced on / after 1 April 2007

Allowance claimable on manufacturing property rented out

Section 13(1)

- For buildings used wholly / mainly in a process of manufacturing
  - Building includes offices / cafeteria
    - Erected at the same time; *AND*
    - Erected on the same site; *AND*
    - >50% manufacturing
- Subsequent improvements?
- No allowance on land

Allowance claimable on movable property rented out

- Section 12C
  - If lessee uses asset in a manufacturing process as defined
  - Regardless of whether asset is new or second-hand
    - Allowance will be 20/20/20/20/20
- Section 11(e)
  - Over write-off period on a straight-line basis
  - Write-off to R1
  - If asset was donated and therefore doesn’t have cost
    - Use MV

Income tax consequences for the lessee

Lease instalments

- Deductible in terms of section 11(a) if in the production of income
- Prepayments must also be considered in terms of section 23H
  - Within 6 months
  - Aggregate < R100 000

Lease premiums
Section 11(f)

- Only if the lessor included the lease premium in gross income
- What is a lease premium?
  - Consideration with a determinable monetary value
  - From lessee to lessor
  - In cash or otherwise
  - Separate from, on top of or in stead of lease payments
- Deduction must be apportioned based on number of months in production of income
  - <u>Premium</u>

    Lease period (limited to 25 years)
- If lease period = not determined?

Leasehold improvements Section 11(g)

- Only if the lessor included the lease premium in gross income
- Deduction must be apportioned based on number of months in production of income
  - <u>Amount included in gross income of lessor</u>

  Lease period from completion of improvements
- Limited to 25 years
- What will the 11(g) allowance be based on?

Spends > Stipulated in contract	Spends = Stipulated in contract	Spends < Stipulated in contract
Actual : R1 500 000 Contract : R1 000 000	Actual : R1 000 000 Contract : R1 000 000	Actual : R800 000 Contract : R1 000 000
11(g) on R1 000 000 13 on R500 000	11(g) on R1 000 000	11(g) on R800 000

Voluntary improvements

- Amount spent > Contract amount
  - Excess not included in gross income of lessor (based on lower of contract amount or actual)
  - Excess qualifies for allowance by lessee depending on type of building
    - Manufacturing?
    - Commercial?

Example

- On 1 July 2015 Company A entered into a 10-year operating lease agreement with Company B for the lease of a property. This lease agreement stipulated that Company A would –
  - pay a premium of R100 000 on 1 July 2015; and
  - erect a factory on the site at a cost of R2 500 000;
  - Both companies have 31 December year-ends
- The erection of the factory commenced on 1 August 2015. It was completed on 31 October 2015 and was immediately brought into use. The cost of the factory was R3 000 000.

1. Calculate the deductions available to Company A
2. How would your solution change if this was a commercial building instead of a factory
3. What would happened if the building was leased from a municipality

Solution

- Deductions claimable by Company A
  - Premium: 100 000/10 x 6/12 = 5 000
  - Improvements:
    - 2 500 000/116 x 2 = 43 103
    - S13 allowance on voluntary improvements: (3 000 000 – 2 500 000) = 500 000 x 5% = 25 000
- If the building was a commercial building
  - All deductions would remain the same however the allowance of 5% of the excess will not be able to be claimable under section 13*quin*
- If the lessor was a municipality
  - A municipality is a government agency and thus are exempt from tax
  - Therefore, section 11(f) and 11(g) cannot be claimed for the premium and improvements as the amounts are not taxed in the hands of the lessor

Limitation of allowances claimable by lessors
Section 23A

Definitions

- ***Affected asset:***
  - Machinery, plant, implement, utensil, article, aircraft or ship which has been let and the lessor was entitled to an allowance in terms of s 11(*e*), 12B, 12C, 12DA or 37B(2)(*a*)
  - **Exclude**: Assets let under an operating lease OR assets used by the lessor in the course of any other trade (not letting)

- ***Operating lease:***
  Letting of movable property if –
  - hired by general public for a period less than a month;
  - repairs and maintenance cost is borne by the lessor; and
  - subject to any claim that the lessor may have against the lessee – the risk of destruction, loss or other disadvantage remains with the lessor.

- ***Rental income:***
  Income derived from letting of any 'affected asset' in respect of which an allowance has been granted to the lessor in terms of s 11(*e*), 12B, 12C, 12DA or 37B(2)(*a*)

Working

All allowances in terms of sections11(*e*), 11(*o*), 12B, 12C, 12 DA, 14*bis* and 37B(2)(*a*) in respect of affected assets must be limited to the taxable rental income that is accrued or received during the year of assessment

- Taxable rental income is net of general expenses related to rental income (apportioned based on ratio to total income)
- Portion disallowed is carried forward and deductible in following year
  - Again limited to taxable rental income in following year

Example

ABC Ltd lets a second-hand machine to DEF Ltd at R240 000 a year. The machine is used by DEF Ltd in the process of manufacturing from the inception of the lease (i.e. 1 July 2016). ABC Ltd acquired the machine at a cost of R1 000 000 on 30 June 2016.

ABC Ltd earned the following income & incurred the following expenses during 2017 financial year ending 28 February 2017:

- Rental income R240 000
- Other income R120 000
- Tax deductible expenses R 90 000

Solution

Income	R240 000
Other expenses	(R60 000)
(R90 000 x (R240 000 / R360 000))	
Rental taxable income	R180 000
Section 12C allowance	
(R1 000 000 x 20% = R200 000)	
However, limited to R180 000	(R180 000)

Excess allowance of R20 000 carried forward to following y.o.a.

Sale-and-leaseback (section 23D)

Basic working

- If asset is sold
  - VAT on selling price if taxable supply
  - Allowance up to date of sale
  - CGT
- Asset is then leased back
  - Lease instalment deductible in terms of section 11(a)
  - Allowances claimable by lessor cannot be based on a value in excess of:
    - Original CP to lessee
    - Less: Deductions claimable by lessee
    - Plus: Recoupment on the sale from the lessee's perspective
    - Plus: Taxable capital gain realised by the lessee

Example

AAA Ltd sold a machine (used in a process of manufacturing) to BBB Ltd for R1 800 000 and then hired it back on 1 May 2017. The machine qualifies for a 20% allowance in terms of section 12C. AAA Ltd originally bought the machine for R1 500 000 and claimed allowances of R900 000 up to date of sale.

Solution

Cost	1 500 000
Allowances	(900 000)
Tax base	600 000

- Recoupment (R1 800 000 ltd to R1 500 000 – R600 000) = R900 000
- Capital gain

Proceeds: 1 800 000 – 900 000	900 000
Base cost: 1 500 000 – 900 000	(600 000)
Capital gain	300 000

- Allowance claimable by BBB based on R1 800 000
- Limited to:
    - Original CP to lessee (R1 500 000)
    - Less: Deductions claimable by lessee (R900 000)
    - Plus: Recoupment on the sale from the lessee's perspective (R900 000)
    - Plus: Taxable capital gain realised by the lessee (R300 000 x 80% = R240 000)
- Therefore, allowances can only be claimed on R1 740 000

Recoupments at the end of the lease term
Section 8(5)

Acquisition of lease assets (s8(5))

Fair MV – Purchase price (if applicable)

Ltd to rentals claimed as a deduction in the past

What happens when the lessee is allowed to use the property after the termination of the lease without the payment of any rental or for a nominal rental?

Example : Acquisition

Lease-a-Lot leased a copier for a period of 3 years. In terms of the lease agreement a lease instalment of R1 000 per month is payable. The lease agreement allows Lease-a-Lot to acquire the copier at the end of the lease term at R50 000 less the rentals paid to date.

What is the recoupment? Ignore VAT.

R1 000 x 36 = R36 000

Example : Acquisition

Lease-a-Lot leased a copier for a period of 3 years. In terms of the lease agreement a lease instalment of R1 000 per month is payable. The lease agreement allows Lease-a-Lot to acquire the copier at the end of the lease term at R20 000 when the market value thereof was R25 000

What is the recoupment? Ignore VAT.

R25 000 – R20 000 = R5 000 limited to R36 000

Therefore, R5 000

Example : Acquisition

Lease-a-Lot leased a copier for a period of 3 years. In terms of the lease agreement a lease instalment of R1 000 per month is payable. The lessor originally paid R30 000 for the copier. Lease-a-Lot can continue using the copier after the end of the lease term at a nominal rental of R100 per month.

What is the recoupment? Ignore VAT.

Deemed tax MV : R30 000 x 80% x 80% x 80% = R15 360
Annual rentals = R1 200 (<10% van R15 360)
Recoupment is therefore R15 360 limited to R36 000, therefore R15 360