PIETER VAN DER ZWAN
& ASSOCIATES
TAX & IFRS ADVISORS

+27 83 417 5904
pieter@pvdz.co.za
www.pvdz.co.za

Tax complexities of lease arrangements

The tax implications of lease arrangements may be inherently complex in nature. The tax court recently considered a case dealing with lease premiums. While it is perhaps not possible to glean much from the judgment from a technical perspective, it is submitted that there are some lessons to be learnt from this case for taxpayers who enter into and have to dispute rather complex commercial arrangements.

The tax implications of lease arrangements may be inherently complex in nature. This includes the tax treatment of lease premiums and leasehold improvements. The tax court recently considered a case dealing with lease premiums in case no 14189. This article provides an overview and brief analysis of this case.

Facts of the case

The taxpayer, a state-owned company, has a mandate to develop and operate industrial land in a special economic zone (SEZ). It concluded a lease with a tenant with an international footprint ('Tenant 1'), to lease a property, including facilities on the land, for R13 million per year for at least 12 years with extensions possible. The facilities had not yet been constructed. The taxpayer contracted a constructor to do so, but ran into financial difficulty soon after.

To overcome this difficulty and retain the presence of Tenant 1 in the SEZ, the taxpayer entered into the following arrangement:

- It agreed to lease the property to another tenant (Tenant 2), subject to the tenancy of Tenant 1.
- Tenant 2 leased the property at a nominal amount for the first 12 years and thereafter on a turnover based rental.
- The taxpayer ceded and assigned the lease with Tenant 1 to Tenant 2. Tenant 2 paid the taxpayer R125 million in consideration for the cession and assignment of the lease with Tenant 1. Tenant 2 replaced the taxpayer as the landlord in terms of the lease with Tenant 1.

Tenant 2 subsequently sold the rental enterprise to another party for R135 million, described as a lease premium. The third party paid R125 million of the consideration directly to the taxpayer.

Dispute

The taxpayer amortised the R125 million in its tax return. SARS raised an assessment for the full amount, presumably on the basis that it constituted a lease premium. It is difficult to fully gather the taxpayer's arguments from the judgment. It appears to have ranged from a position that the amount constituted a deposit, a view that it was received in respect of a sale of an asset and therefore capital in nature, to an argument that the substance of the transaction had to be considered (apparent from par 41).

Judgment

Mali J considered a wide range of aspects in relation to the arrangements. These included a change in intention from being a landlord to a seller of assets, the basis for calculation of the amount of R125 million, the sale of the rental enterprise by Tenant 2 as well as the accounting treatment of the transaction in the investment property note of the financial statements. She concluded that the taxpayer intended to enter into a rental, rather than the purported cession and assignment, and crossed the line to obtain an undue tax benefit in structuring the transactions. Consequently the amount of R125 million was taxable as income.

Analysis

It is unclear from the judgment whether the conclusion was reached on the application of the definition of gross income (specific inclusion for lease premiums) or based on the application of anti-avoidance rules. To comment on the case from a technical perspective one would arguably need more information than what is provided in the judgment. It is however submitted that this case illustrates the importance for a taxpayer of clearly and consistently articulating its position throughout the dispute process. This position should be based on a cohesive commercial and legal analysis, which in turn supports the application of the relevant provisions of the tax laws. As an outsider reading the taxpayer's arguments in the judgment, the taxpayer's case appears to have fell short in this regard.