

Tax consequences on improvements on land under a sub-lease



By [Graeme Palmer](#)

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The South African Revenue Service (SARS) was recently called upon to make a ruling on the income tax consequences for the lessor, lessee and the sub-lessee of land, arising from an obligation on the sub-lessee to effect improvements on the land under a sub-lease in circumstances where no express obligation for improvements was placed on the lessee by the main lease.



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The parties to the leases were all independent persons with no common shareholders or any interest in each other. A 99 year renewable lease agreement was concluded (main lease) with the lessee in respect of land. The main lease provided that the lessee was under no obligation to effect any improvements on the land, but the lessee or sub-lessee may do so at its own cost.

The main lease did however specify the type of improvements that could be effected and, if such improvements were effected, the time periods in which they must be completed. At the time of concluding the main lease, the lessee concluded a further 99 year lease (sub-lease) on the same terms, save for the obligation to make improvements and the rental.

The sub-lease provided that the sub-lessee was obliged to effect improvements to the land. The rental for both leases were based on the developmental cost of improvements effected on the land, however, the sub-lease provided for increases after an agreed period of time.

Lessor's responsibilities

In its ruling SARS stated that the lessor would have to include in its gross income, the fair and reasonable value of all improvements effected by the sub-lessee as contemplated in paragraph (h) (ii) of the definition of 'gross income' of the Income Tax Act.

Having regard to the circumstances and the duration of the leases, the lessor would be entitled to an allowance under section 11(h) determined by using the present value of the actual development costs discounted at a rate of 6% over the 99 year lease period.

The sub-lessee on the other hand was entitled to an allowance under section 11(g) over a 25 year period for any expenditure actually incurred in effecting the improvements, provided that the improvements are occupied or used by it in the production of income.

If the sub-lease was terminated before the expiry of the 25 years, the unredeemed balance of the allowance at the termination date could be deducted by the sub-lessee from its income.

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