

# Tax Pitfalls and Opportunities: Leases

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## **Marina Pretorius**

### **Kreston South Africa**

- Marina joined the Kreston Pretoria team on 1 March 2021 after specialising in tax at KPMG for the last 13 years. She is an experienced tax advisor who holds an H. Dip(Tax) Degree. She completed her articles at Deloitte where she also passed the CA(SA) qualifying examination.
- She worked in the UK on large listed clients for 2 years and joined KPMG tax department in 2007.
- As Associate Director and head of KPMG's Global Compliance Managed Services business unit, she is very experienced in tax and accounting reporting requirements for large multi-nationals.
- This includes ITR 14 disclosures required for multi-nationals as well as submissions of CbC Reports, Master Files and Local Files.

### **Education and Qualifications**

- B. Com (Accounting)
- B. Com (Accounting) (Hons)
- Certificate in the Theory of Accounting
- Passed qualifying CA(SA) exam.
- H.Dip (Tax)
- Registered Tax Practitioner



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# ABOUT THE PRESENTER

**Johan Heydenrych**

**Kreston South Africa**

**Johan is a Chartered Accountant who specialised in taxation since 1991. He holds the following qualifications:**

- B. Com (Accounting) (Cum Laude)
- B. Com (Accounting) (Hons) (Cum Laude) (Award: “Best student in Audit 700”)
- Certificate in the Theory of Accounting
- M. Com (Taxation) (Cum Laude) (Award: “Best M. Com (Tax) student”)
- Chartered Accountant (Specialising in Taxation)
- Member of SAICA
- Registered Tax Practitioner

**Johan was a tax partner at KPMG from 1997 to 2020 and is currently a partner in the Kreston SA network specialising in taxation.**

**He provides a wide range of tax services to various clients across industries. These include but are not limited to the following:**

- Advice on Tax Risk Management and Tax Governance.
- Tax compliance services including but not limited to ITR 14 and IT 14SD
- Dealing with tax disputes including representing clients at Alternative Dispute Resolution (ADR) hearings.
- Submission of documentation and revised returns under the Voluntary Disclosure Programme.
- Issuing of tax technical opinions on Income Tax, VAT and PAYE. This include preparing briefs to Senior Counsel and submissions of requests for Binding Opinions from SARS.
- Audit support services that includes Normal Tax and Deferred Tax disclosure and disclosure of uncertain tax positions.
- Assistance with implementation of tax reporting for new accounting standards such as IFRIC 23, IFRS 9, IFRS 15 and IFRS 16.
- Facilitation of tax diagnostic sessions with existing and prospective clients.
- Advice on mergers, acquisitions and reorganizations.
- Tax due diligences
- Advice on tax implications of recapitalization transactions, debt restructures, liquidations and deregistration’s



# Content

- Term loan arrangement
  - Secured
  - Unsecured
- Operating Lease agreement
- Instalment Sale Agreement
- Finance lease agreement
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Vanilla  
secured/unsecured loan

## Secured or unsecured term loan

- Financier does not acquire and sell the underlying asset.
- Financier simply provides a vanilla loan to the customer which the customer then uses for purposes of acquiring an asset from a supplier.
- The Financier loan is either totally unsecured and Financier has no right to repossess the underlying asset financed in the case of default.
- In some cases the loan can be secured by a cession of other assets, e.g. shares, immovable property, 3<sup>rd</sup> party guarantee etc. It may not necessarily be secured by the asset being financed.

# Tax Considerations: Secured or unsecured term loan

- Tax pitfalls and opportunities for the borrower
  - Deductibility of interest is governed by Section 24J
  - If the loan is used for non-trade purposes of earning exempt income then a deduction may not be claimed
  - Section 11G to be considered once the section become effective on 1 January 2025
  - Interest incurred to purchase shares generally only deductible under Section 24O
  - Various anti-avoidance legislation e.g. S8F, 8FA, 23M, 23N
  - VAT on raising fees, guarantee fees etc is contentious (See Consol Glass case when existing loan was refinanced).
- Financier generally taxed on interest income.
- Interest income is exempt from VAT
- Raising fees, guarantee fees, facility fees generally attracts VAT

**11G. Deduction of expenses incurred in production of interest.**—(1) For purposes of this section “interest” means interest as defined in section 24J.

(2) For purposes of determining the taxable income derived by any person, there shall be allowed as a deduction from the income of that person, interest incurred by that person to the extent that the interest—

- (a) is incurred in the production of interest that is included in the income of that person; and
- (b) is not incurred in carrying on a trade.

(3) The amount allowed to be deducted under this section shall not exceed the amount of interest income referred to in subsection (2) (a), that is received by or accrued to the person, during the year of assessment.

## The Law:

- 24O - Incurral of interest in respect of certain debts deemed to be in the production of income
- 8F - Interest on hybrid debt instruments deemed to be dividends in specie
- 8FA - Hybrid interest deemed to be dividends in specie
- 23M - Limitation of interest deductions in respect of debts owed to persons not subject to tax
- 23N - Limitation of interest deductions in respect of reorganisation and acquisition transactions

# Operating lease

# Operating leases

- The asset is acquired from the supplier by the financier.
- The asset is leased to the customer at an agreed monthly rate.
- There is no residual value stipulated in the rental agreement and the rental payments are not necessarily designed to cover the full cost of the asset.

# Tax implications: Operating leases

- **Lessor:** Income Tax and VAT
  - The lessor owns the asset and may claim capital allowances thereon
    - Section 23A may however limit the capital allowances available to the lessor – See Interpretation Note 53
  - The lessor must include monthly lease income in the gross income
  - VAT is generally charged on the monthly rentals
  - The financier claims VAT on the acquisition of the asset.
- **Lessee:** Income Tax and VAT
  - The lessee may claim the VAT on monthly rental if the asset is used to make taxable supplies
  - The lessee generally claims the monthly lease payments as a tax deduction. If prepaid, then limited in terms of S23A
- If the lessee must apply **IFRS 16**, then the accounting entries must be reversed, and the actual lease payments claimed
  - Under IFRS 16 the present value of the lease is capitalised as ROU asset with a contra ROU liability
  - **ROU Liability**
    - Notional interest is credited against ROU Liability and I/S debited
    - Lease payments are debited to the ROU liability account and not against I/S
  - **ROU asset**
    - Depreciation is credited to the ROU Asset and Dr to the I/S
  - **Deferred tax** asset is created on ROU liability and deferred tax liability on ROU asset

# Tax implications: Operating leases

- IFRS 16 is a standard that specifies how to account for leases in financial statements
- IFRS 16 requires that the “right of use asset” and the lease liability should initially be measured at the present value of the minimum lease payments
- The objective of IFRS 16 is to faithfully represent lease transactions and provide a basis for users of financial statements to assess the cash flows arising from leases

## Tax implications: Operating leases

- Company A enters into a 5-year lease of a building and recognises a right-of-use asset and a lease liability of R1 500 000.

Right of use asset	1 500 000	
Lease liability		1 500 000
<i>To recognise lease liability and right-of-use asset</i>		

# Tax adjustments: IFRS 16 Operating leases

		2023	2022
<b>IFRS 16 - Income Statement Method</b>			
Depreciation on Finance leases	TB / AFS / IFRS 16 schedule	353 655	
Interest on Finance Liability	TB / AFS / IFRS 16 schedule	63 253	
Actual lease payments made during the year	TB / AFS / IFRS 16 schedule	-602 361	
		<b>-185 453</b>	
<b>IFRS 16 - Balance Statement Method</b>			
Add: Finance lease liability	TB / AFS	-862 173	-1 215 828
Deduct: Assets under finance lease	TB / AFS	577 522	1 116 630
Deduct: Finance lease liability	PY	1 215 828	6 537 888
Add: Assets under finance lease	PY	-1 116 630	-4 732 612
		<b>-185 453</b>	

# Tax implications: Decommissioning Liability

Company B recognises a provision of R1 000 000 for decommissioning its Wind Farm plant.

The provision is capitalised as part of the cost of the plant.

For tax purposes, the expenditure will be deducted only when it is incurred and when the tax deduction is allocated to the decommissioning liability

Property, Plant and Equipment	1 000 000	
Decommissioning liability		1 000 000
<i>To recognise decommissioning liability</i>		

**Deferred tax** to be recognised at 27%:

- Liability on PPE
- Asset on Liability

# Instalment Sale Agreement

# Instalment sale agreement

- Instalment Sale Agreement is an agreement between a seller and buyer of any property or good, where the buyer pays the purchase price in more than one instalment over a period of time.
- Ownership passes to the buyer upon delivery of asset.
- Even though ownership passes to the buyer, the asset serves contractually as security to the debt.

# Accounting: Instalment sale agreement

- Debt receivable.
- Recognise interest on yield to maturity basis.

# Tax: Instalment sale agreement

- The finance is linked to a specific asset.
- If the asset is used by the borrower in the course of a trade then the buyer:
  - May claim capital allowances on the asset.
  - May claim the interest as a tax deduction.
  - VAT on asset may be claimed if the asset is used to make taxable supplies.
  - VAT on raising fees etc can be claimed if the underlying asset is used to make taxable supplies.
  - Income tax on raising fees and transaction fees may be contentious.
- Buyer generally claims VAT on purchase of the asset and then pays output VAT on immediate on-supply of the asset.
  - SARS ignores this back-to-back vatable transaction for the buyer when calculating an apportionment ratio for claimable VAT on costs incurred for purposes of making mixed supplies
  - Interest is exempt for VAT
- Generally there is an alignment between accounting and tax for both the seller (lender) and the buyer (borrower).

# Finance lease agreement

# Finance lease agreement

- The asset is leased to the customer at an agreed monthly rate.
- The customer may acquire ownership at the end of the lease period upon payment of the residual value as stipulated in the lease agreement.
- There is a residual value stipulated in the rental agreement and the rental payments and the residual value are designed to cover the full cost of the asset together with interest as stipulated in the agreement.
- Risk and rewards of ownership is transferred to the lessee, but not full ownership.
- No capital allowances can be claimed since buyer is not the owner of the asset.
- Even though ownership is retained by the seller, from an accounting perspective, the transaction is treated exactly the same as an instalment credit agreement.
  - i.e. a Debtor is reflected
  - the gross rentals received are recognised as a repayment of capital and interest.
  - This is due to the fact that the accounting recognition is based on "substance over form".
- IFRS 9 is applied on loan impairments.

# Income Tax treatment

- A finance lease is treated the same as an operating lease for Income Tax purposes.
- From an Income Tax perspective, ownership of the leased asset still vests in the lessor.
- Therefore, the lessor and not the lessee will be entitled to claim the capital allowance available in terms of the Income Tax Act.
- In addition section 11(a) of the Income Tax Act will entitle the lessee to claim a deduction equal to the total amount of rent that is payable during the year of assessment.
- The deduction is available if the asset is applied in the taxpayer's trade and all requirements of section 11(a) are met.
- Therefore, the asset needs to be used in the production of income.
- In terms of section 23C taxpayers are required that the VAT portion of expenditure is excluded from the amount recognised for Income Tax purposes if the taxpayer was entitled to an input tax deduction.
- Therefore, the lessee needs to reduce the deduction claimed on the rental installments with the VAT portion that relates to it.
- Since input tax is claimable once-off at the commencement of a finance lease, it needs to be determined how much of the total VAT paid in terms of the agreement relates to the rental payments actually incurred during the assessment period.

# Income Tax treatment

- Section 11(e), 12C etc generally allows the lessee under an ICA to claim allowances on an asset acquired by the taxpayer as purchaser in terms of an agreement contemplated in **paragraph (a)** of the definition of “instalment credit agreement” in section 1 of the Value-Added Tax Act and used by the taxpayer for the purpose of his or her trade.
- The lessee may however not claim capital allowances when the asset has been acquired by the purchaser in terms of an agreement contemplated in **paragraph (b)** of the definition of “instalment credit agreement” in section 1 of the Value-Added Tax Act.
- The VAT distinction is therefore extremely important since the accounting treatment may be similar for par (a) and par (b) ICA but the income tax treatment may be vastly different for both the lender and the borrower.

## VAT treatment

- These agreements generally qualify as Instalment Credit Agreements (“ICA”) as defined in section 1 of the VAT Act
  - This definition caters for 2 situations, namely
    - An agreement where the assets are supplied under a “sale”
    - An agreement where the assets are supplied under a “lease”
- If the agreement qualifies as an ICA, then VAT is payable upfront even though ownership is retained by the financier
  - The borrower may claim this upfront VAT for VAT purposes

## VAT treatment – assets supplied under a “sale”

“**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

# VAT treatment – assets supplied under a “lease”

“**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—

(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, including any amount determined with reference to the time value of money, stipulated in the lease; and  
[[Sub-para. \(ii\)](#) substituted by [s. 145 \(1\) \(a\)](#) of [Act No. 22 of 2012](#) with effect from 1 January, 2013 and applicable in respect of goods supplied on or after that date.]

### Wording of Sections

- (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) (aa) 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; or  
(bb) (A) the lessor 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 of those goods; and  
(B) the lessee accepts the full risk of maintenance and repair of those goods and reimburses the lessor for the insurance of those goods, while the agreement remains in force;

# Difference between Finance lease and Instalment Sale

- In lease finance, the lessor retains ownership of the asset throughout the lease term, while the lessee merely has the right to use the asset. In contrast, an installment sale involves the transfer of ownership from the seller to the buyer, typically after the final payment is made.
- The purpose of an installment sale agreement is to buy the car and to own it once it is paid off, versus the lease, where you pay for the usage of the car for a specific time without the intention to own it

# Section 23A

## Section 23A

### 23A. Limitation of allowances granted to lessors of certain assets

- **“affected asset”** means any machinery, plant, implement, utensil, article, aircraft or ship which has been let and in respect of which the lessor is or was entitled to an allowance under section 11 (*e*), 12B, 12BA, 12C, 12DA or 37B (2) (*a*), whether in the current or a previous year of assessment, but excluding any such asset let by the lessor under an operating lease or any such asset which was during the year of assessment mainly used by the taxpayer in the course of any trade carried on by the taxpayer, other than the letting of any such asset;
  - **“operating lease”** means a lease of movable property concluded by a lessor in the ordinary course of a business (not being a banking, financial services or insurance business) of letting such property, if—
    - (a) such property may be hired by members of the general public directly from that lessor in terms of such a lease, for a period of less than one month;
    - (b) the cost of maintaining such property and of carrying out repairs thereto required in consequence of normal wear and tear, is borne by the lessor; and
    - (c) subject to any claim that the lessor may have against the lessee by reason of the lessee’s failure to take proper care of the property, the risk of destruction or loss of or other disadvantage to such property is not assumed by the lessee;
- (2) Notwithstanding the provisions of sections 11 (*e*) and (*o*), 12B, 12BA, 12C, 12DA, and 37B (2) (*a*) the sum of the deduction which may be allowed to any taxpayer in any year of assessment under those provisions in respect of any affected assets let by the taxpayer shall not exceed the taxable income (as determined before making the said deductions) derived by the taxpayer during such year from rental income.
- (4) Any deduction which is disallowed under the provisions of subsection (2) shall be carried forward to the succeeding year of assessment and shall, subject to the provisions of this section as applicable in relation to that year, be deemed to be a deduction to which the taxpayer is entitled in that year.

## Section 23A

- Section 23A is an **anti-avoidance provision** in the Income Tax Act
- It is intended to prevent the misuse of accelerated capital allowances available in respect of certain assets.
- Taxpayers were acquiring assets for purposes of letting them, and the accelerated capital allowances resulted in large assessed losses from the letting activities, which were then set off against the taxpayers' other taxable income.
- Exemptions applies to entities engaged in specific fields that are of public interest, such as educational institutions, hospitals and medical institutions, charitable institutions, and news agencies.
- Section 23A limits the deduction of specified capital allowances on affected assets to a lessor's taxable income derived from the letting of these assets, before taking into account the specified capital allowances.
- SARS issued Interpretation Note 53 on section 23A

## Section 23A

### **Example 1 – Operating lease**

#### *Facts:*

Company X purchased an aircraft which was brought into use in the first year of assessment. Company X entered into a lease agreement with a charterer who hired it out to the general public.

#### *Result:*

The lease is not an operating lease because the aircraft is not hired by the general public directly from the owner of the aircraft. Therefore, the overall exclusion from the definition of an affected asset of any asset let by a lessor under an operating lease is inapplicable.

## Section 23A

### Example 2 – Limitation of allowances on affected assets

*Facts:*

Company A purchased two used manufacturing machines in year 1 and let them from date of purchase. The machinery qualified for the allowance under section 12C at the rate of 20% per year of assessment. The following information relates to these machines for the first and second years of assessment:

		Machine A	Machine B
		R	R
Cost		600 000	760 000
Rent received	Year 1	200 000	150 000
	Year 2	180 000	120 000
Interest payable*	Year 1	72 000	91 200
	Year 2	75 000	86 000
Section 12C allowance (20%)		120 000	152 000

\* interest is payable on the debt used to purchase the machines

## Section 23A

	R	R
<i>Year 1</i>		
Rental income from affected assets (R200 000 + R150 000)		350 000
<i>Less: Allowable deductions – interest (R72 000 + R91 200)</i>		<u>(163 200)</u>
Net rental income		186 800
<i>Less: Allowances – section 12C (R120 000 + R152 000)</i>	(272 000)	
Limited to net rental income [section 23A(2)]	<u>(186 800)</u>	<u>(186 800)</u>
<b>Taxable income</b>		<u><b>Nil</b></u>
Amount disallowed under section 23A(2) and carried forward under section 23A(4) to the succeeding year of assessment (R272 000 – R186 800)		85 200

## Section 23A

<i>Year 2</i>		
Rental income from affected assets (R180 000 + R120 000)		300 000
<i>Less:</i> Allowable deductions – interest (R75 000 + R86 000)		<u>(161 000)</u>
Net rental income		139 000
<i>Less:</i> Allowances – section 12C (R120 000 + R152 000 + carry-forward of R85 200)	(357 200)	
Limited to net rental income [section 23A(2)]	<u>(139 000)</u>	<u>(139 000)</u>
<b>Taxable income</b>		<u><b>Nil</b></u>
Amount disallowed under section 23A(2) and carried forward under section 23A(4) to the succeeding year of assessment (R357 200 – R139 000)		218 200

Thank you