

LEASING AN ASSET

Part 2 – leasing from an income tax and VAT perspective

In Part 1 of these series, we dealt with the accounting implications of leasing specifically looking at a finance lease. We will look at the income tax and VAT implications of leases. When considering whether to purchase or lease an asset it is recommended to determine the after tax cash flows in each option. In order to determine this, it is important that both the income tax as well as the VAT implications need to be determined.

From a lessee perspective

VAT considerations

The VAT implications of the finance lease from a lessee's perspective are different to that of the income tax treatment. To fully understand the distinction it is necessary to interpret Section 9(3)(c) of the Value Added Tax Act. This section states the following when determining the time of supply:

“where goods are supplied under an instalment credit

agreement that supply . . . shall be deemed to take place at the time the goods are delivered or the time any payment of consideration is received by the supplier in respect of that supply, whichever time is earlier.”

It is vitally important to understand that the Value Added Tax Act defines an instalment credit agreement in terms of a lease in Section 1 as follows:

*“(i) the rent consists of a stated or determinable sum of money payable at a stated or determinable future date; and
(ii) such sum of money includes finance charges; and
(iii) the aggregate of amounts payable under such lease and any residual value of the leased goods on termination of the lease, as stipulated in the lease, exceeds the cash value of 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”

The criteria under the instalment credit agreement pertaining to a lease are similar but not identical to the requirements of IAS 17 determining whether a lease is a finance lease.

Therefore, if the lease that is entered into is a finance lease, it is likely that the lease will fall within the definition of instalment credit agreement from a VAT perspective which renders the time of supply on delivery of the asset that is being leased.

The benefits to the lessee is that from a VAT point of view, the VAT can be claimed up front on the condition that the lessee is a vendor and that the input VAT is not prohibited as a deduction under Section 16(2) of the Value Added Tax Act.

In simple terms, the VAT can be claimed as an input VAT deduction on signing the lease as from a VAT point of view the lessee is seen as the "owner". This treatment is the same as accounting (see below).

The lessee will then, clearly, be blocked from claiming any input tax deduction on the monthly rentals as the VAT has been claimed upfront.

Furthermore, as from a VAT perspective, we recognize a sale and a purchase and a subsequent liability payable to the lessor, the monthly payment that you will be making to the lessor will be divided between three components:

- Interest;
- Capital; and
- VAT

It is important to understand the composition of the payment to understand the income tax implications for both the lessee as well as the lessor.

Furthermore, it is important to understand that there is no VAT on finance charges/interest as this falls within the definition of financial service in Section 2 of the Value Added Tax Act.

Income tax considerations

The Income Tax Act is structured largely on a legal form basis rather than the economic substance of the transaction. Whereas from an

accounting perspective, the economic substance overrides the legal form (i.e. in a finance lease, ownership may not transfer but in substance the lessee has enjoyed the benefits of the asset for its full economic life hence we capitalize the asset as in substance, the lessee has the full benefit of the asset). The income tax will not allow a lessee of the asset an income tax deduction because the asset is not "owned" by the taxpayer. This is confirmed by both Section 11(e), Section 12C as well as Section 13 which states:

"owned by the taxpayer or acquired in terms of an instalment sale agreement"

Important to understand that the term "instalment sale agreement" is not defined in the Income Tax Act and hence the ordinary common law meaning needs to be understood. Note that this is different to the Value Added Tax Act. An instalment sale agreement is an agreement where the asset is sold on credit and includes interest. The asset remains the property of the seller until the final payment has been made. When the final payment has been made ownership automatically passes. This is distinguishable from a finance lease. Therefore, from an income tax point of view, the lessee cannot claim any capital allowances on the asset. The allowances that the lessee can

claim are the rental payments that the lessee incurs for the right of use of the asset. The deduction is allowed in terms of the normal Section 11(a) of the Income Tax Act.

However, taxpayers must be careful with claiming a deduction on the lease payments. The applicable section is Section 23C of the Income Tax Act. The logic behind this section is that the taxpayer is allowed to claim deductions or allowances on the cost of an asset or expenditure. The cost is what the taxpayer has given up. If the taxpayer acquired an asset for R114 and R14 is VAT the cost to the taxpayer is R114. If the taxpayer is a VAT vendor, then the cost to the vendor for income tax purposes must be reduced by the VAT that has been claimed for VAT purposes. This is logical as the true cost to the taxpayer is R 100.

This principle is important in that the lessee claims the VAT upfront and the obligation is paid over the period of the lease. As discussed above the lease payment essentially is made up of three components and to the extent that the payment is allocated to VAT, this amount will not be allowed as a deduction due to the provisions of Section 23C of the Income Tax Act. The VAT element of the payment is simply calculated as the total payments for the current year over total payments (including the residual

value of the lease agreement). This is what is referred to as the VAT clawback. The full lease payment is deductible and this portion is added back to gross income in essence we are claiming the net as a deduction read in conjunction with Section 11(a) and 23C of the Income Tax Act.

From a lessor perspective

VAT considerations

In terms of the Value Added Tax Act, a finance lease is treated as a pure sale. In other words from the lessor's perspective the lessor would account for output VAT on delivery of the asset to the lessee (or on payment whichever is earlier).

The rental receipts will have no VAT implications as the VAT has been accounted for upfront.

Income tax considerations

As a result of ownership of the asset, the lessor will be receiving lease rentals which will be subjected to tax as well as entitlement to an income tax capital allowance.

Lease rentals

The lease rentals that have been received by the lessor falls within the gross income definition of the Income Tax Act. The full amount is included in the lessor's taxable

income. However, if you look at the mechanics of the contract a lease receipt (as discussed above) comprises of 3 components:

- Capital payments
- Interest
- VAT

It is clear that if there is no adjustment to the lessors rental receipts, the lessor will be taxed on the recovery of the VAT element of the receipt.

The solution to the issue was sanctioned in Practice Note 15 which allowed the VAT, that has been paid over to SARS on delivery of the asset to the lessee, to be added to the cost of the asset in determining the capital allowance.

In my opinion, this was not the correct treatment. If you look at the provisions of Section 11(e) or Section 12C of the Income Tax Act, it refers to the "cost" of an asset. The only provisions (other than anti-avoidance) that adjust this cost is sanctioned by Section 23C which states that any VAT that has been paid in acquiring the asset must be reduced from the cost of the asset for the purposes of claiming any allowance for income tax purposes. It is important to note that what is stated in the practice notes and interpretations are NOT law and are not binding on SARS. It will be considered as persuasive

evidence (See ITC 1830 and assessed losses Interpretation Note 33). This Practice Note has been withdrawn and replaced by Interpretation Note 47. No provisions within this Note cater for the inflated cost to take into account the VAT element.

It is submitted that the issue is simply resolved by similar treatment as the lessee regarding the VAT payment.

Included in the lease receipt, is a portion relating to VAT (i.e. in deciding how much the lessor would set the monthly payments, he would factor into the payment the recovery of the VAT). The portion that is attributable to the VAT element is not taxable based on the gross income definition which states that the amount must have been received by or accrued to the taxpayer for his own benefit. It is submitted that the amount that has been received by the taxpayer for his own benefit is the amount excluding the VAT element which must be calculated in the same manner based on lease receipts to date over total receipts (including the residual value) multiply by the VAT that has been paid over to SARS.

Capital allowance

The lessor will be entitled to a capital allowance based on the cost to the taxpayer.