Tax ruling on refurbishment costs (3/27/18)

On 9 May 2018 the State Revenue Service (SRS) posted on their website an advance ruling on the tax treatment of a company's expenditure on refurbishing a building and redecorating premises when leasing the property from the company's shareholder. This article explores the opinion expressed in the ruling as well as some aspects of tax treatment that are not covered by the ruling but should still be taken into account.

Background

The ruling gives the following background information:

1. The company's core business activity is labour migration, arranging qualification documents and organising workforce training. To carry out this activity, the company needs a place to accommodate its employees;
2. The company is considering a lease of private property from its board member and shareholder;
3. To adapt the property to the company's needs, it is necessary to refurbish the building and redecorate the premises, and so the company is seeking a tax ruling.

Based on this background, the company asked whether the cost of refurbishing the building and redecorating the premises is considered a business expense if the building is leased from an individual. That person will notify the SRS of a trade but will not be registered as a trader, and the company should withhold a 10% PIT on the lease payments.

The SRS opinion

The SRS believes that any expenses the company incurs in refurbishing the building owned by the company shareholder (in which the company carries on business) and redecorating the premises should be recognised as the company's business expenses subject to transfer pricing methods.

Having analysed the ruling, we find that the SRS believes that transactions with related parties (entities or individuals) should be arm's length to ensure the company does not overpay for lease services. However, investment in the leasehold property does not attract corporate income tax under general procedure even though the property owner is a person related to an individual.

Additional comment

In the ruling, the SRS has not looked at how the individual might benefit if the lease is terminated before the improvements are depreciated.

Section 8(3)(14) of the PIT Act provides that the individual's income includes any increase in the property value on the expiry of a lease arising from the tenant's reconstruction, restoration, renovation, improvement or other capital investment on the leasehold property if the property owner has not reimbursed that increase to the tenant. This income will be treated as gained on the date the lease was terminated.

Accordingly, if the lease is terminated, the individual will have to assess extra tax on the benefit from

improvements to the building he has not reimbursed to the company. Under the current rules, we believe that this income should attract a 10% PIT, but the rules are not clear enough. It is possible that the SRS will treat this income as other income and charge the standard rate. This treatment might be applied on the grounds that a 10% PIT applies only on income from property, i.e. when leasing out property (or selling security of tenure), passing the asset on to a subtenant, renting out movables, receiving fees for the use of natural resources or for restrictions on such use, or gaining income from the disposal of movables. Income arising from improvements to a building is not on this list and could therefore be treated as other income.