

# The taxation of lease inducement payments

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*An officials' issues paper*

July 2012

*Prepared by the Policy Advice Division of Inland Revenue and the New Zealand Treasury*

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# CHAPTER 1

## Introduction

- 1.1 This issues paper discusses officials' concerns with the current tax treatment of lease inducement payments and the resulting revenue risk to the tax base, and suggests a possible solution by making these payments taxable.

### Current rules and risks

- 1.2 A lease inducement payment is a payment given by a landlord to a prospective tenant as an "inducement" to enter into a commercial lease. Following the recent economic downturn, arrangements involving lease inducement payments have become a popular option for landlords to attract tenants without needing to reduce the rental income payable. This trend is reflected in more of these payments being identified by Inland Revenue during its tax audits.
- 1.3 For income tax purposes, a lease inducement payment is typically tax deductible for the payer (generally the landlord) and non-taxable for the recipient (the tenant). This systematic deductible/non-taxable tax treatment in a commercial context poses a risk to the tax base.
- 1.4 A lease inducement payment confers a tax advantage when inducing a tenant to enter into a lease arrangement compared with other forms of inducement such as reduced rents and contributions for fit-out costs. As the payments are non-taxable for a recipient, they effectively increase the recipient's total after-tax income.

### Suggested solution

- 1.5 Given the arbitrage opportunity and revenue risk inherent in the current rules, officials seek feedback on making lease inducement payments taxable. A specific legislative solution would be required to allocate income and expenditure arising or incurred from these payments. Furthermore, an anti-avoidance provision would also be required to prevent arbitrage opportunities arising from the timing of income. The details of these suggested changes are discussed more fully in Chapter 3.
- 1.6 Officials invite submissions on the suggested solutions. Submissions will be taken into account when we make recommendations to the Government on any necessary legislative changes.
- 1.7 These would be included in a tax bill introduced in Parliament later this year, and would apply to commercial lease arrangements entered into on or after the day this issues paper is publicly released.

## Submissions

1.8 Submissions should include a brief summary of major points and recommendations. Submissions should also indicate whether it would be acceptable for officials to contact the submitter to discuss the points raised, if required.

1.9 Submissions should be made by 31 August 2012 and be addressed to:

Lease inducement payments  
C/- Deputy Commissioner, Policy  
Policy Advice Division  
Inland Revenue Department  
PO Box 2198  
Wellington 6140

Or emailed to [policy.webmaster@ird.govt.nz](mailto:policy.webmaster@ird.govt.nz) with “Lease inducement payments” in the subject line. Electronic submissions are encouraged.

1.10 Submissions may be the subject of a request under the Official Information Act 1982, which may result in their publication. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. Submitters who consider that their submission or any part of it should properly be withheld under the Act should indicate this clearly.

## CHAPTER 2

### Tax problem

- 2.1 This chapter explains how lease inducement payments represent a risk to the tax base.

#### Lease inducement payments

- 2.2 A lease inducement payment is typically an unconditional lump sum cash payment from a landlord to a prospective tenant as an inducement to enter into a commercial lease.
- 2.3 Lease inducement payments usually proliferate when there is an oversupply of business premises during an economic downturn. The payments are used as an effective bargaining tool for landlords to entice tenants to enter into a lease without needing to reduce the rent. In this way, landlords can maintain a consistent and unimpaired flow of rental income from their property unlike other forms of inducements, such as reduced rent or a rent-free holiday.
- 2.4 Even in economic upturns, when there may be a shortage of business premises, lease inducement payments can enable landlords to secure major tenants in large buildings or for a longer term for the reasons outlined above.

#### Tax treatment of lease inducement payments

- 2.5 There are no specific legislative provisions that deal with lease inducement cash payments. Therefore, the taxation of lease inducement payments is determined under general principles and provisions in the Income Tax Act 2007.
- 2.6 Currently, lease inducement payments can be characterised differently for a payer and a recipient for income tax purposes. This is because the quality of a payment is determined separately for the payer and the recipient.
- 2.7 For the payer (normally the landlord), the payment would typically be tax deductible if the payer incurs the expenditure in the course of carrying on a business. For the recipient (the tenant), the payment is generally a non-taxable capital receipt if the payment is received in relation to a lease that relates to the structure of the tenant's business. Also, the payment is a "negative" premium, and premium payments are usually recognised by the courts as capital rather than revenue. The capital nature of a lease inducement payment was confirmed by the Privy Council in *Wattie*.<sup>1</sup>

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<sup>1</sup> *Commissioner of Inland Revenue v Wattie* [1999] 1 NZLR 529.

## Revenue risk

- 2.8 The current asymmetric tax treatment of lease inducement payments in being generally tax deductible for the landlord and a non-taxable receipt for the tenant is systematic in a commercial context and poses a risk to the revenue base. The tax cash value of deductible but non-taxable payments can be highly sensitive to both commercial and tax implications.
- 2.9 The systematic deductible/non-taxable tax treatment of lease inducement payments creates an incentive for contracting parties to sign up to a lease agreement that results in a tax advantage. These payments are tax-effective when inducing a tenant to enter into a lease arrangement compared with other forms of inducement, such as reduced rent and contributions for fit-out costs. As the payments are treated as a non-taxable capital receipt for the tenant, they effectively increase the total after-tax income for the tenant.
- 2.10 For example, a commercial landlord with premises that are used to generate \$1,000,000 of rental income per year during an economic upturn would struggle to do so in a downturn. To induce a tenant to enter into a lease for a term of one year, the landlord could either reduce the rent from \$1,000,000 to \$600,000, or offer a lease inducement payment of \$400,000 while maintaining the rent of \$1,000,000.
- 2.11 Under the latter arrangement, it is mostly the tenant who receives the tax advantage as they do not pay income tax on the amount of lease inducement of \$400,000, and can claim a tax deduction for rental income expense of \$1,000,000 against their taxable income. As the lease inducement payment is deductible for the landlord, the landlord receives the same amount of after-tax income of \$432,000 (\$1,000,000 minus \$400,000 lease inducement resulting in taxable income of \$600,000 less income tax at 28%) while maintaining an unimpaired rental flow.
- 2.12 Although the tenant primarily receives the tax benefit in the above example, the benefit could be shared in practice between the tenant and the landlord through the level of the rent and the lease inducement payment.
- 2.13 The asymmetric tax treatment of lease inducement payments encourages taxpayers to convert revenue receipts into non-taxable capital receipts.<sup>2</sup>
- 2.14 Other forms of lease inducements, such as reduced rent or a rent-free holiday, do not pose the same risk to the revenue base because the tax treatment of these inducements is symmetrical. The reduced rent or rent-free holiday reduces the deductible expenses of the tenant as well as the taxable income of the landlord.<sup>3</sup>

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<sup>2</sup> However, a lump sum rent subsidy paid by a landlord would remain taxable under the current law.

<sup>3</sup> Also, section GC 5 of the Income Tax Act 2007 prevents avoidance opportunities from properties being rented out for inadequate rents.



## Case for specific legislative solution

- 2.15 In the past, specific legislative provisions were provided to deal with types of payments that posed similar revenue risks. The legislative provisions modified the judicially delineated capital/revenue boundary to counter arrangements based on converting revenue receipts into capital receipts.
- 2.16 For example, contributions for fit-out costs previously presented a similar revenue risk to cash lease inducement payments, as the amount was non-taxable to the tenant and tax deductible for the landlord. The problem was addressed in Budget 2010, which introduced new capital contribution rules.<sup>4</sup> The amount is either included as income of the recipient or reduces the cost basis of the depreciable property.
- 2.17 Cash lease inducement payments are the only form of lease inducement that confers a tax advantage; and as such, could distort commercial decision-making processes. It is also not sensible for cash lease inducement payments, which could be used by tenants to pay for the fit-out of their premises, to be treated differently for tax purposes from payments that are contractually required to be spent on the same fit-out.
- 2.18 The suggested solution of making lease inducement payments taxable would result in a consistent tax treatment of premiums paid in relation to leases of land. Premiums paid to landlords are already taxable under section CC 1 of the Income Tax Act 2007.
- 2.19 Other examples where Parliament has modified the capital/revenue boundary include redundancy payments,<sup>5</sup> payments received for restrictive covenants<sup>6</sup> and exit inducements.<sup>7</sup>
- 2.20 Given the revenue risks associated with lease inducement payments, other countries such as the United Kingdom, Ireland and Canada have enacted legislation to make these payments taxable. Making lease inducement payments taxable would therefore be in line with international norms.

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<sup>4</sup> See sections CG 8, DB 64, EE 48 and the definition of “capital contribution” in section YA 1 of the Income Tax Act 2007.

<sup>5</sup> Section CE 1(1)(f) of the Income Tax Act 2007.

<sup>6</sup> Section CE 9 of the Income Tax Act 2007.

<sup>7</sup> Section CE 10 of the Income Tax Act 2007.

## CHAPTER 3

### Suggested solution

- 3.1 To address the revenue risks associated with lease inducement payments, this chapter discusses how these payments might be made taxable under the Income Tax Act 2007.
- 3.2 The changes suggested in this paper are based on legislation operating in the United Kingdom and Ireland, which provides a useful model for New Zealand.<sup>8</sup>

#### Making lease inducement payments taxable

- 3.3 Under the suggested solution, an amount derived by a person or an associated person as an inducement to enter into, or in connection with, an arrangement that grants an estate or interest in, or a right in or over, land would be taxable.
- 3.4 In practice, this would mainly apply to commercial lease arrangements, including subleases, but would also cover licences and easements. The proposal would also apply to a transfer or extension of an interest or right granted in or over land, such as an assignment or renewal of a lease.
- 3.5 Arrangements involving a sale of land, including a leaseback agreement<sup>9</sup> would be specifically excluded. However, it is expected that lease arrangements with the option to purchase would be covered by the proposed changes. Also, the amounts derived by a person would not be taxable if the person is not able to deduct the amount of rent as their expenditure. This would exclude amounts relating to private residential purposes.
- 3.6 Under the suggested changes, the lease inducement amount could be paid by any person. Although the person making the lease inducement payment is likely to be a grantor of the interest or right in land (that is, a landlord), they could instead be an associated person. A broad application would preclude avoidance opportunities through lease inducement payments being made by persons other than the grantor.<sup>10</sup> The suggested solution would cover an amount paid by an assignor to induce an assignee to assign the existing lease.

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<sup>8</sup> Sections 99 to 103 of the Income Tax (Trading and Other Income) Act 2005 (UK); and section 98A of the Taxes Consolidation Act 1997 (Ireland).

<sup>9</sup> When an owner sells the property and it is leased back to them so that they can continue to use the property without owning it.

<sup>10</sup> Note that the UK and Ireland impose a condition that the payment must be made by the grantor, an associated person, a nominee or a person acting on behalf of the grantor.

- 3.7 The amount derived by a person would include not only a lump-sum cash payment but also an amount in money's worth.<sup>11</sup> Non-cash benefits received by the person as a lease inducement would be included in the person's income. Examples of non-cash benefits could include:
- A contribution to a tenant's costs such as for start-up or relocation. A contribution for depreciable property that is already included in the capital contribution rules (section CG 8) would be specifically excluded.
  - A satisfaction or forgiveness of a tenant's liabilities. Examples include meeting the tenant's obligation to pay rent or an early termination payment under the old lease, forgiving debts, or providing interest-free loans.
  - Other non-cash benefits, such as a transfer of shares.

### **Deductibility of lease inducement payments**

- 3.8 The provisions of the Income Tax Act 2007 would apply to determine the deductibility of lease inducement payments. No special legislation should be necessary. The deductibility of these payments will depend on the taxpayer meeting the general permission in section DA 1.

### **Timing of income and expenditure**

- 3.9 Under the suggested approach, income from lease inducement payments and expenditure on them would be allocated on a straight-line basis over either the period of the lease arrangement or the period when the first rent review is due, whichever is the shorter. This approach is consistent with the ordinary accounting principles and provisions of the Income Tax Act 2007.<sup>12</sup>
- 3.10 Officials would prefer a specific legislative solution to provide certainty with timing the allocation of such payments for both income and deduction purposes. Specific timing provisions are currently provided for similar types of payments, such as premiums paid for the grant of leases (that is, the right to use land). Income from lease premiums is spread over six years, subject to the Commissioner's discretion in section EI 7 of the Income Tax Act 2007. Expenditure on lease premiums is spread over the term of the lease under the depreciation rules and schedule 14. A similar approach could be taken for reverse premiums such as lease inducement payments.

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<sup>11</sup> See the definition of "amount" in section YA 1 of the Income Tax Act 2007.

<sup>12</sup> Sections BD 3 and BD 4 of the Income Tax Act 2007. Also see the New Zealand Equivalent to International Accounting Standard 17 and New Zealand SIC-15 *Operative Leases – Incentives*.

- 3.11 A specific anti-avoidance provision would be necessary to prevent arbitrage opportunities on the timing of income – for example, arrangements between associated parties with a very long duration that are designed to delay the recognition of income. Similarly, for arrangements that are entered into that require up-front payment but the commencement of the lease is delayed, the income would be recognised in the year of receipt.

### **Legislative timetable and application date**

- 3.12 The proposal to make lease inducement payments taxable could be included in a tax bill introduced in Parliament later this year, and apply to commercial lease arrangements entered into on or after the day this issues paper is publicly released. This application date would minimise risks to the revenue base and persons entering into commercial lease arrangements after this issues paper is released would be aware of the proposed changes to the rules.