The taxation of land-related lease payments

An officials' issues paper

April 2013

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CHAPTER 1

Summary

Background

1.1 This paper reviews the income tax treatment of land-related lease payments. The review follows the recent lease inducement and lease surrender payments reforms introduced in Supplementary Order Paper No. 167 to the Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Bill.[1]

1.2 The review is two-fold. First, the paper considers the current tax treatment of land-related lease transfer payments in light of the recent lease surrender payments reform, and suggests making them taxable to remove current distortions.

1.3 The paper further examines the overall tax treatment of land-related lease payments. The current rules have been implemented separately for particular payments over a long period of time, and because similar payments can be treated differently, results can be inconsistent for taxpayers.

1.4 The paper suggests generic income, deduction and timing rules for all land-related lease payments. This should provide a more consistent and coherent tax treatment of these lease payments that is in line with New Zealand's broad-base, low-rate tax framework.

Land-related lease transfer payments

1.5 A land-related lease transfer payment is generally received by an exiting tenant (transferor) from a new incoming tenant (transferee) for the transfer or assignment of a lease. For income tax purposes, the payment is generally tax deductible to the incoming tenant under the depreciation rules and non-taxable to the exiting tenant.

1.6 As part of extending the lease inducement payments reform to include lease surrender payments, a further policy problem involving the current tax treatment of lease transfer payments was identified. The current non-taxable status of lease transfer payments in tandem with the proposed lease surrender payments reform distorts the commercial decisions of the exiting tenant.

1.7 It would be more tax advantageous for the tenant to exit a lease by transferring the lease to a third party for a tax-free payment rather than surrendering it to a landlord for a taxable payment even though there is no economic difference between the two from the tenant's perspective. Treating similar payments differently for income tax purposes distorts business decisions, resulting in economic inefficiency and unfairness.

[1] The Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Bill was before Parliament at the time this officials' paper was published. If implemented, these payments would be treated as taxable to the recipient and deductible to the payer under the Income Tax Act 2007 from 1 April 2013.

1.8 To remove this distortion, we suggest that lease transfer payments be made taxable.

Land-related lease payments

1.9 Following the above suggestion to make lease transfer payments taxable, we consider the overall tax treatment of land-related lease payments should be reviewed for a more consistent and coherent tax treatment of these payments.

1.10 There are a number of provisions in the Income Tax Act 2007 that specifically provide for the tax treatment of certain land-related lease payments for income, deduction and timing purposes. However, these provisions are not comprehensive, and can result in inconsistent and incoherent outcomes for taxpayers.

1.11 These provisions in the Act may produce gaps, which mean that similar payments can be treated differently. Some taxpayers may treat certain payments as a revenue account item and others as a capital account item.

Suggested approach

1.12 To treat land-related lease payments consistently and coherently for income tax purposes, we suggest that generic income, deduction and timing rules for these payments be introduced.

1.13 Under these new rules, any land-related lease payment would be treated as deductible to a payer and taxable to a recipient under the Income Tax Act 2007. Note that payments derived by a tenant of residential premises would be excluded from the new rules.

1.14 The rules would apply only to a land right (leases or licences of land) if the land right has a term of less than 50 years. This way, payments made in relation to a land right that lasts 50 years or more, such as a permanent easement, would be treated similarly to payments made in relation to a freehold estate.

1.15 A separate timing rule would also be introduced to spread the income and deductions over the term of the relevant land right.

1.16 The new rules would change the tax treatment of some land-related lease payments from the status quo. Some payments that are currently non-taxable to the recipient would become taxable under new rules. For example, lease transfer payments (which are currently generally non-taxable to tenants) would become taxable, as suggested in this paper. Also, certain payments that are now generally non-deductible to the tenant would become tax deductible – such as lease modification payments.

1.17 Moreover, the new rules would rationalise the existing rules in light of the proposed changes to lease inducement and lease surrender payments. Under the current rules, income from lease premium payments may be spread over six years whereas income from lease inducement payments would be spread over the term of the lease. The suggested new rules would spread lease premium income over the term of the lease.

1.18 Rationalising the existing rules would result in a more consistent and coherent tax treatment of land-related lease payments in line with New Zealand's broad-base, low-rate tax framework. It would also improve fairness and business efficiency.

1.19 The technical details of the suggested reforms are discussed more fully in Chapter 4.

Submissions

1.20 You are invited to make a submission on the suggested reforms raised in this issues paper, in particular:

- Should non-taxable lease transfer payments be made taxable in light of the recent lease surrender payments reform contained in the Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Bill?
- Are there any aspects of the suggested new income, deduction and timing rules for all land-related lease payments that do not adequately meet the objective of this review – that is, providing a more consistent and coherent tax treatment of land-related lease payments?
- Are transitional issues arising from the suggested new rules adequately addressed?
- Are there any aspects of the suggested new rules that will create unwarranted compliance costs?

1.21 Submissions will be taken into account when we make recommendations to the Government on any necessary legislative changes.

How to make a submission

1.22 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.

1.23 Submissions should be made by **4 June 2013** and be addressed to:

Land-related lease payments
C/- Deputy Commissioner, Policy and Strategy
Policy and Strategy
Inland Revenue
PO Box 2198
Wellington 6140

Or email to policy.webmaster@ird.govt.nz with "Land-related lease payments" in the subject line. Electronic submissions are encouraged.

1.24 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

Background

2.1 In July 2012, an officials' issues paper, *The taxation of lease inducement payments*, was released, seeking feedback on proposals to deal with revenue risks associated with the tax treatment of lease inducement payments. The tax treatment of generally deductible but non-taxable lease inducement payments created an opportunity for taxpayers to substitute tax deductible rent payments with non-taxable cash lease inducement payments.

2.2 During public consultation on the proposals, concerns around another type of land-related lease payment – lease surrender payments – were raised. Lease surrender payments are regarded as "black hole" expenditure (non-deductible business expenditure) to a commercial tenant when they are made to a landlord.

2.3 Supplementary Order Paper No. 167 to the Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Bill released on 11 December 2012 proposed changes to both lease inducement and lease surrender payments.[2] If implemented, these payments will be treated as taxable to the recipient and deductible to the payer under the Income Tax Act 2007, effective from 1 April 2013. Generally, income and expenditure derived or incurred on these payments would be spread over the term of a lease.

2.4 When the lease inducement and lease surrender payments reforms were added to the bill, the Government stated that there would be a further review of the tax treatment of other land-related lease payments, such as lease transfer payments.

2.5 This issues paper considers the overall income tax treatment of land-related lease payments. The objective of this review is to provide a consistent and coherent tax treatment of land-related lease payments that is aligned with New Zealand's broad-base, low-rate tax framework. The paper therefore suggests further reforms to the tax treatment of land-related lease payments to deal with aspects that distort business decisions. This will improve business efficiency and bring greater fairness to the tax rules.

[2] This bill is currently before Parliament.

CHAPTER 3

Tax treatment of land-related lease payments

3.1 This chapter examines the tax treatment of land-related lease transfer payments and suggests making them taxable to remove existing distortions. It further examines the overall tax treatment of land-related lease payments more generally and suggests rationalising the rules.

Land-related lease transfer payments

Current rules

3.2 After a lease begins, a tenant may transfer or assign their lease to another person. Generally, lease transfer payments are consideration received by an exiting tenant (transferor) from a new incoming tenant (transferee) for the transfer or assignment of the lease. These payments generally relate to goodwill that is closely related to a particular site or locality (known as "site goodwill") and may occur when there is a transfer of business, such as the transfer of a hotel business, from one person to another.

3.3 Under the current tax rules, amounts derived by an owner of land[3] from a lease are taxable under section CC 1 of the Income Tax Act 2007. However, it does not apply to lease transfer payments. In the absence of a specific provision in the Act, lease transfer payments are typically recognised as a non-taxable capital receipt to the exiting tenant unless they are in the business of leasing property or acquired the lease with a view to sell it. Note that lease transfer payments received by the exiting tenant may be taken into account under the depreciation rules in certain circumstances.[4]

3.4 Lease transfer payments are generally tax deductible for the incoming tenant under the depreciation rules. A lease is included in the list of depreciable intangible property in schedule 14 of the Act, being "the right to use land". Consequently, a tenant can usually claim depreciation deductions for its cost to acquire a lease (i.e. a lease premium or transfer payment) over the remaining term of the lease.

Inconsistent tax treatment between similar payments

3.5 As part of extending the lease inducement payments reform to include lease surrender payments to achieve a balanced reform in response to concerns raised in submissions, a further policy problem involving the current tax treatment of lease transfer payments was identified.

[3] Section YA 1 of the Income Tax Act 2007 defines "own" for land as having an estate or interest in land, and therefore includes holding a leasehold estate.

[4] For example, if the lease transfer payment received by a tenant is more than the adjusted tax value of the cost of acquiring the lease (lease premium payments), the rules recognise that there has been excess depreciation deducted over the term of the lease. As result, the excess depreciation deductions are clawed back as income.

3.6 If the lease inducement and lease surrender payments reforms are implemented and the current tax treatment of generally deductible but non-taxable lease transfer payments is retained, it would be tax advantageous for a tenant to exit a lease by transferring the lease to a third party for a tax-free payment rather than surrendering it to a landlord for a taxable payment. The tax advantage of receiving a non-taxable lease transfer payment would distort a tenant's commercial decisions when exiting a lease. An example of the problem is illustrated below:

Example

On 1 April 2014, a landlord and a tenant enter into a 10-year lease. After three years, the landlord expands its business to retail, by setting up a subsidiary company. The landlord wishes the tenant to exit the lease so that the subsidiary company can use the premises to carry on its retail business.

If the landlord pays a lease surrender payment to the tenant, the payment would be taxable to the tenant and deductible to the landlord under the proposed rules in the Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Bill (proposed new sections CC 1C and DB 20C).

To induce the tenant to exit the lease, the subsidiary company and the tenant enter into an agreement to transfer the lease. The subsidiary company pays the tenant $100,000 for the transfer.

Under the current rules, the lease transfer payment of $100,000 is deductible to the subsidiary company over the remaining seven years under the depreciation rules. The lease transfer payment is non-taxable to the exiting tenant. The exiting tenant is $28,000 ($100,000 x 28%) better off than receiving a lease surrender payment from the landlord.

3.7 Although lease transfers and lease surrenders are different in form, from the exiting tenant's perspective there is no economic difference between surrendering the lease to the landlord and transferring it to a third party. The effect is the same – the tenant exits the lease and receives consideration for it. The exiting tenant is indifferent between receiving a lease surrender or a lease transfer payment. Treating similar payments differently for income tax purposes distorts business decisions and results in economic inefficiency and unfairness.

Rationale for change

3.8 The McLeod tax review in 2001 considered the income tax base in New Zealand. Instead of introducing a traditional capital gains tax, it found that the tax base should continue to be protected by dealing with specific capital gains issues as they arise. There are a number of situations when Parliament modified the judicially delineated capital/revenue boundary to address a particular risk to the tax base. Examples include redundancy payments,[5]

[5] Section CE 1(1)(f) of the Income Tax Act 2007.

payments received for restrictive covenants[6] and exit inducements,[7] capital contribution payments[8] and most recently, proposed changes to lease inducement payments included in the Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Bill.

3.9 Along with the proposed changes to lease surrender payments, the capital-revenue boundary for lease transfer payments should be modified so that similar payments are treated the same for income tax purposes – that is, treated as taxable to the recipient and deductible to the payer. As a result of this proposal, the exiting tenant would be taxed on a lease transfer payment received from the new tenant that is currently not taxed.

3.10 Retaining the current tax treatment of lease transfer payments would continue to distort commercial decisions of tenants when exiting a lease. Reforms are necessary to maintain the robustness and integrity of the tax system.

3.11 The suggested changes to the tax treatment of lease transfer payments are part of a balanced package of reforms including lease surrender payments. Making lease transfer payments taxable would result in a more consistent and coherent tax treatment of different types of payments received by a tenant when they exit the lease regardless of their legal form.

Land-related lease payments

3.12 Following the above suggestion to make lease transfer payments taxable, officials consider the tax treatment of land-related lease payments more generally should also be reviewed for a more consistent and coherent tax treatment of these payments.

Overview of current law

3.13 Land-related lease payments that are revenue in nature, such as amounts derived in the ordinary course of business (that is, the business of leasing property), are treated as income and are therefore taxable.[9] Unless specifically taxed under the Income Tax Act 2007,[10] payments that are capital in nature, such as receipts derived outside the ordinary course of business, are not treated as income and are therefore not taxed.

3.14 Under the general permission in section DA 1 of the Income Tax Act 2007, expenditure incurred in deriving income, or in the course of carrying on a business for the purpose of deriving income, is deductible. However, the general permission is subject to the capital limitation rule in section DA 2, which prohibits deductions for expenditure of a capital nature. Other specific

[6] Section CE 9 of the Income Tax Act 2007.

[7] Section CE 10 of the Income Tax Act 2007.

[8] See sections CG 8, DB 64, EE 48 and the definition of "capital contribution" in section YA 1 of the Income Tax Act 2007.

[9] See sections CA 1(2) and CB 1 of the Income Tax Act 2007. Also note that there is a land disposal rule in section CB 6 that if a person acquired land (which includes a lease) with a view to selling or disposing of it, the amount is taxable.

[10] For example, lease premium payments are traditionally regarded as capital in nature but taxable under section CC 1 of the Income Tax Act 2007.

deduction provisions are subject to the capital limitation rule unless they expressly override it.

3.15 There are also a number of provisions in the Income Tax Act 2007 that specifically provide for the tax treatment of certain land-related lease payments for income, deduction and timing purposes.

3.16 The table below summarises how the current provisions in the Act apply to certain payments for income, deduction and timing purposes. Note that this table includes changes proposed for lease inducement and lease surrender payments contained in Supplementary Order Paper No. 167 to the Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Bill. If implemented, these changes will apply from 1 April 2013.

Payment-type	Income	Deductions
Payments relating to a lease or licence to use land such as rents, fines, premiums or other revenues	Taxable to a landowner under section CC 1. Income derived in anticipation from fines, premiums, a payment of goodwill on the grant of a lease can be allocated over six years under section EI 7 if the Commissioner approves.	Generally deductible if the payment is revenue in nature (such as rent) and the general permission in section DA 1 is satisfied. Unless there is an unexpired portion of the expenditure (section EA 3), the payment is deductible in the year the person incurs the expenditure. The cost incurred for acquiring “the right to use land” is generally tax deductible over the term of the lease under the depreciation rules.[11]
Payments for non-compliance with covenant to repair	Taxable under section CC 2. Income could be spread over five years if the lessor chooses to under section EI 5. Note that section EI 6 provides a special timing rule for income when the lessor ceases to own land.	Generally deductible under section DB 21. A specific timing rule in section EJ 11 may apply, which allows the lessee to either claim the deduction in the income year in which the amount is incurred or spread it over three earlier income years provided the lessee used the land for deriving income. Note that there is a special deduction provision in section DB 22 that deals with restoration costs for a lessor who changes the use of the land.

[11] A lease is included in the list of depreciable intangible property in schedule 14 of the Income Tax Act 2007, being “the right to use land”.

Payment-type	Income	Deductions
Contributions for fit-out costs[12]	Taxable under section CG 8. Income is spread over 10 years unless the recipient chooses to reduce, for depreciation purposes, the cost of the new capital asset under section DB 64.	Generally deductible if the general permission is satisfied – i.e. a commercial landlord who is in the business of leasing property and the payment is not of a capital nature. [13]
Lease inducement payments	Taxable over the term of the lease.	Generally deductible if the general permission is satisfied. The payment is spread over the term of the lease.
Lease surrender payments	Taxable in the year of receipt.	Generally deductible in the year the expenditure is incurred.

3.17 Also, section DB 18 specifically allows deductions for costs incurred for the preparation and registration, or the renewal, of a lease.

Inconsistent tax treatment of payments

3.18 Over the years, tax rules for land-related lease payments have been implemented in an ad hoc manner, which has produced inconsistent and incoherent outcomes for taxpayers.

3.19 Current provisions in the Act may therefore produce gaps, which mean that similar payments can be treated differently. For example, payments for the grant of a lease (lease premium payments) are generally deductible to a tenant but payments to modify or waive terms of a lease (lease modification payments) are generally non-deductible to the tenant. Also, payments for the transfer of a lease (lease transfer payments) are generally non-taxable to an exiting tenant but payments to induce the transfer of a lease (lease inducement payments) would be taxable to an incoming tenant, if the lease inducement payments reform is implemented.

3.20 Moreover, the existing timing rules provided for different types of payments vary because they were developed separately over the years. For example, a landowner receiving lease premium payments may spread the income over six years under section EI 7 instead of over the term of the lease which would be a more rational basis for timing the recognition of this income. These payments are deductible to a tenant making these payments over the term of the lease under the depreciation rules.

[12] These payments are generally paid by landlords to prospective tenants to enter into a commercial lease with a specific contractual requirement to spend the amount on fit-out.
[13] Note that Supplementary Order Paper No. 167 to the Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Bill proposes to codify deductibility of these costs.

Suggested approach for all land-related lease payments

3.21 Together with the lease inducement and lease surrender payments reforms and the suggested reform to tax lease transfer payments discussed in this chapter, the existing tax treatment of land-related lease payments could be significantly improved if the rules are rationalised.

3.22 To treat land-related lease payments consistently and coherently, generic income and deduction rules for these payments could be introduced.

3.23 Under the suggested new rules, any land-related lease payments would be treated as taxable to the recipient and deductible to the payer under the Income Tax Act 2007. Note that payments derived by a tenant of residential premises would be excluded from the new rules.

3.24 Also, as part of this rationalisation, a separate timing rule would be introduced to spread income and deductions over the term of the relevant land right (leases or licences of land).

3.25 To provide certainty about when land-related lease payments are on capital or revenue account, we suggest a 50-year threshold for applying the new rules. For example, the new rules would treat all land-related lease payments, other than rent, made in relation to a "land right" (that is, leases or licences of land) with a term of less than 50 years as income to the recipient and deductible expenditure to the payer under the Income Tax Act 2007.

3.26 In effect, leases or licences that last less than 50 years would be put on revenue account. It is envisaged that the 50-year threshold would mean the new rules would apply to most commercial leases, which generally expire before 50 years. Payments, other than rent, made in relation to a land right that lasts 50 years or more would be treated similarly to payments made in relation to a sale of freehold land.

3.27 As a result of introducing the 50-year threshold, the new rules would change the tax treatment of land-related lease payments from the status quo. For example, payments received by a landowner for the grant of a permanent easement are currently taxable under section CC 1 even though the easement may last indefinitely. These payments would be treated as non-taxable receipts to the landowner under the new rules. Also, some payments that are currently non-taxable to the recipient would become taxable under the proposed new rules – for example, lease transfer payments.

3.28 Another example is the cost of "the right to use land" (that is, a lease premium). These payments, which are currently deductible under the depreciation rules would not be deductible under the new rules if the relevant land right lasts 50 years or more – for example, payments to acquire a lease that lasts 99 years would be non-deductible to a tenant under the new rules.

3.29 The 50-year threshold is consistent with the current 50-year threshold on buildings for depreciation purposes. It would align the tax treatment of the cost of a building that lasts 50 years or more with the cost of acquiring the right to use that building – that is, a lease premium. This would therefore

eliminate an existing tension between the cost of a building that is generally non-depreciable and the cost of acquiring the right to use land that is currently generally depreciable.

3.30 Conversely, some payments that are currently non-deductible to the payer would become deductible under the new rules. For example, lease modification payments or other lease-related payments that are generally non-deductible to tenants would be deductible if the lease lasts less than 50 years.

3.31 Rationalising the existing rules would result in a consistent and coherent tax treatment of land-related lease payments that is aligned with New Zealand's broad-base, low-rate tax framework. It would also improve fairness and business efficiency.

CHAPTER 4

Technical details

4.1 This chapter considers the technical details of how land-related lease payments would be treated for income tax purposes under the suggested approach.

4.2 If these changes proceed, all land-related lease payment provisions in the Income Tax Act 2007 would be replaced with new income, deduction and timing provisions.

4.3 Changes to current provisions in the Income Tax Act 2007 are summarised in the Appendix.

Income

4.4 Current section CC 1 would be replaced by a new comprehensive charging provision for land-related lease payments. New section CC 1 would broadly apply to treat all land-related lease payments derived by a person as assessable income.

4.5 The new charging provision would apply if the following conditions are met:

- a person (the payee) derives an amount in relation to a right (the land right) that is an estate in land or a licence to use land; and
- the payee is:
  - the person who owns the estate in land from which the land right is granted; or
  - a person who owns the land right; or
  - a person who is obtaining the land right; or
  - a person who used to own the land right; and
- the amount is in the nature of rent or the land right has a period of less than 50 years.

4.6 These conditions and exceptions are explained in more detail below.

Amount derived by a person in relation to a land right

4.7 Proposed new section CC 1 would apply to a land right that is an estate in land or a licence to use land. The term "estate" is widely defined for land purposes in section YA 1 and includes both an estate and interest in land.[14]

4.8 The term "amount" is defined in section YA 1 to include any amount in money's worth. Accordingly, consideration other than in cash would be included.

[14] Section YA 1 provides that "interest" has the same meaning as "estate" for land purposes.

4.9 The new rules focus on a land right that payments relate to. Hence, identifying which land right the payments relate to would be crucial in determining the tax treatment.

The payee

4.10 The payee is a person who derives an amount in relation to a land right. However, if a person receives an amount on behalf of another person, the existing nominee rules in section YB 21 would apply to treat the amount as derived by that other person.

4.11 A person may derive amounts in different capacities depending on the land right that the payments relate to. For example, a tenant could derive a lease inducement payment from a landlord as a prospective tenant. The same tenant could also derive a lease premium payment from a sub-tenant.

Payments relating to land right with period of less than 50 years and rent payments

4.12 Rent payments would be included under proposed new section CC 1 regardless of the term of a land right.

4.13 Other payments that relate to a land right with a term of less than 50 years would be included under new section CC 1. Examples of an amount derived in relation to a land right would include various types of payments including a:

- fine;
- premium or an inducement payment to enter an agreement for the land right;
- payment for the goodwill of a business;[15]
- payment of the benefit of a statutory licence or privilege;
- payment of a liability for the breach of a covenant;
- payment for the termination of the land right; and
- payment for the transfer of the land right.

4.14 As explained in chapter 3, the 50-year threshold would place a new parameter on what is taxable under new section CC 1. Therefore, determining how many years the relevant land right is for is important when applying new section CC 1.

4.15 Note that the 50-year period would not include the period of renewal or extension. The period of renewal or extension of a land right would be regarded as a period relating to a separate land right. This approach is intended to avoid complexities around the tax treatment of leases that are

[15] Note that a payment for the goodwill of a business referred to in existing section CC 1 of the Income Tax Act 2007 relates to the goodwill attached to land rather than personal goodwill. See *Romanos Motels Ltd v Commissioner of Inland Revenue* [1973] 1 NZLR 435 (CA).

perpetually renewable (that is, "Glasgow" leases) and modifying the spreading of income or deductions, which is discussed below.

"Glasgow" leases

4.16 Leases that last for a certain duration (7, 10 or 21 years) but are renewable in perpetuity by the lessees are commonly referred to as "Glasgow" leases. They are typically for a ground lease only. For example, a tenant pays rent regularly for the ground lease and they own improvements such as buildings.

4.17 The proposed new rules would generally apply to Glasgow leases because their initial fixed term typically lasts less than 50 years. Providing a different treatment for Glasgow leases from other leases is undesirable from a policy perspective because it would distort business decisions when entering into lease arrangements.

4.18 If the improvements on land are owned by a tenant, new section CC 1 would apply only to payments made in relation to the ground lease. Payments relating to the cost of acquiring improvements would be apportioned accordingly.

Exclusions

Tenant of residential premises

4.19 The income-charging provision in new section CC 1 would not apply to a person who is a natural person (an individual) and a tenant or licensee of residential premises. This is intended to provide symmetry of treatment for payments incurred or derived by a tenant of residential premises. The tenant would not be able to deduct lease payments or rent because they do not meet the general permission in section DA 1 and the private limitation in section DA 2(2) would apply.

4.20 If there is a concurrent use of the land right for residential and business purposes, the amount would be apportioned so that only the amount relating to the business use is taxable.

Other exclusions

4.21 In addition, new section CC 1 would not apply to amounts if:

- The amount is a compensation payment for loss or injury in relation to a land right.
- The amount is royalty under section CC 9.
- Provisions relating to forestry, petroleum mining and other mining licences apply, in particular, subparts CB, CT and CU.

Land provisions

4.22 New section CC 1 would override the existing land provisions in sections CB 6 to CB 23B to provide a consistent tax treatment of land-related lease

payments. In particular, this would clarify the tax treatment of lease transfer payments.

Tax treatment of contribution for fit-out costs

4.23 Under the proposed reforms in the Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Bill, the tax treatment of a contribution for fit-out costs continues to be determined under the existing capital contribution rules in sections CG 8 and DB 64.

4.24 However, excluding contributions for fit-out costs from the new rules would produce some inconsistencies between the existing timing rule for capital contributions (where the taxpayer can elect for the contribution to be income and spread over 10 years, or for the contribution to reduce the depreciable cost base of the relevant property) and the new timing rule (where income is spread over the term of the relevant land right).

4.25 A contribution for fit-out costs is a form of lease inducement provided by a landlord to an incoming tenant. It should therefore be treated as being similar to lease inducement payments that are covered in the new rules. Hence, under the new rules, the payee would be required to pay tax on contribution for fit-out costs under new section CC 1, but would not be required to reduce the depreciable cost base for fit-out under section DB 64. The tenant would be able to claim depreciation deductions over the life of the fit-out.

Deductions

4.26 Under the suggested new rules, a matching deduction provision would apply to provide symmetry in the tax treatment of land-related lease payments. To deduct these payments, the following conditions would need to be met:

- a person (the payer) incurs expenditure in relation to a right (the land right) that is an estate in land or a licence to use land; and
- the payer and the person (the payee) who derives the amount are each one of the following:
  - the person who owns the estate in land from which the land right is granted; or
  - the person who owns the land right; or
  - a person who is obtaining the land right; or
  - a person who used to own the land right; and
- the land right has a period of less than 50 years.

4.27 These conditions are similar to proposed new section CC 1, except the deduction provision specifies both the payer and the payee. This is to sufficiently protect the tax base.

4.28 Note that deductions are allowed only for the cost incurred in relation to the land right and not for the cost of acquiring improvements on land (in particular, when there is a transfer of a Glasgow lease). Similar to the

income provision, expenditure relating to the cost of acquiring improvements on land would be apportioned accordingly.

4.29 This deduction provision would not cover rent payments. These would continue to be deductible under the general permission in section DA 1. Neither is this provision intended to cover any transaction costs. Existing section DB 18 applies to any transaction cost incurred to prepare, register or renew a lease.

4.30 The new deduction provision would override the capital limitation in section DA 2(1). The general permission in section DA 1 would still need to be satisfied and the other general limitations in section DA 2 would also apply.

Timing of income and deductions

4.31 The proposed new timing rules for income and deductions would be similar to the timing rule currently proposed for lease inducement payments in clause 32B of the Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Bill. There would, however, be some modifications to the rules, as described below.

4.32 The rules would not apply to rent payments. These payments would be subject to the ordinary rules and be taxable when derived and deductible when incurred unless section EA 3 applies.

4.33 The rules would allocate income and deductions evenly over the term of the land right to which the amount of income or deductions relates (the spreading period). The spreading period for allocating income and deductions would be the period of a land right (which lasts less than 50 years). A period of renewal or extension would be treated as a separate spreading period.

4.34 To avoid complexities around allocating income and deductions to the number of days in an income year, it would be allocated proportionately to the number of months by using the following formula:

> amount of income or deductions x (number of months in an income year for which the spreading period exists / total number of months in the spreading period)

4.35 This approach is consistent with the straight-line method in the depreciation rules.

4.36 The allocation of income and deductions would depend on the time when the income or expenditure is derived or incurred in relation to the spreading period. The rules would spread the amount derived or incurred before the end of the spreading period evenly over the remaining period of the land right.

4.37 For example, lease premiums and lease inducement payments are generally made at the beginning of a lease, therefore the amount would be spread evenly over the lease. Lease surrender payments that are generally made at the end of a lease would typically be allocated to the income year in which

the amount is derived or incurred. This is because there would normally be no remaining period of the land right over which the amount can be spread at the time the lease surrender payments are derived or incurred.

4.38 If the amount is derived or incurred before the commencement of the land right, the amount would be allocated over the spreading period, not to the time when the amount is incurred or derived. If the amount is derived or incurred half-way through the spreading period (for example, as a lease modification payment), the amount would be spread evenly over the remaining period.

Example[16]

On 1 April 2014, a landlord receives a $100,000 lease premium from a tenant for a 10-year lease. The lease commences on the same day. The landlord and the tenant both have a 31 March balance date.

The landlord

The $100,000 received by the landlord would be taxable under the proposed new charging provision. The amount of income would be spread evenly over the 10-year period from the 2014–15 to the 2023–24 income years inclusive (i.e. $10,000 of income would be allocated to each income year).

The tenant

The $100,000 incurred by the tenant would be deductible under the new deduction provision. The amount of expenditure would be spread evenly over the 10-year period from the 2014–15 to the 2023–24 income years inclusive (i.e. $10,000 of expenditure would be allocated to each income year).

4.39 Note that, under the new rules, the timing of deductions and income would be different for the payer and payee of lease transfer payments, for example. Expenditure incurred by the payer (new tenant) for the transfer of a lease would be spread over the remaining term of the transferred lease. Income derived by the payee (exiting tenant) would be taxable when derived because the payee exits the lease and has no remaining period over which to spread the income.

[16] The example is based on an assumption that the new rules apply from 1 April 2014.

Example[17]

On 1 April 2014, a landlord and a tenant enter into a 10-year lease and the lease commences on the same day. On 1 April 2017, the tenant (transferor) transfers the lease to a new tenant (transferee) for $70,000. The taxpayers have a 31 March balance date.

The tenant (transferor)

The $70,000 received by the transferor would be taxable under the proposed new charging provision. The entire $70,000 would be taxable in the 2017–18 income year because there is no remaining period over which to spread the income.

The new tenant (transferee)

The $70,000 incurred by the transferee would be deductible under the new deduction provision. The amount of expenditure would be spread evenly over the remaining term of the lease – from the 2017–18 to the 2023–24 income years inclusive (i.e. $10,000 of expenditure would be allocated to each income year).

Disposal of the land right part-way through the spreading period

4.40 An exception would apply to the new timing rule if the person ceases to hold the relevant land right, or the estate in land from which the land right is granted. There would generally be a "wash-up" calculation of income and deductions for a person if the person ceases to hold the land right or the estate in land from which the land right is granted, part-way through the spreading period.

4.41 This "wash-up" solution would be almost identical to the one proposed for lease inducement payments in clause 32B of the Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Bill.

Timing of income

4.42 For income, if there is a remaining amount to be allocated under the main spreading rule, the amount of income would be allocated to an income year (the balance year) ending before the end of the spreading period, if:

- at the beginning of the balance year, the person holds the land right or the estate in land from which the land right is granted; and
- in the balance year, the person ceases to hold the land right or the estate in land from which the land right is granted.

[17] Ibid.

Timing of deductions

4.43 For deductions, if there is a remaining amount to be allocated under the main spreading rule, the amount of deductions would be allocated to an income year (the balance year) ending before the end of the spreading period if:

- at the beginning of the balance year, either or both the land right and the estate in land from which the land right is granted are held by the person or an associated person; and
- at the end of the balance year, neither the land right nor the estate in land from which the land right is granted are held by the person or an associated person.

4.44 Note that if the land right or the estate in land from which the land right is granted is transferred to an associated person, there will be no "wash-up" calculation for deductions. The remaining amount of deductions would continue to be allocated over the spreading period. This is intended as an anti-avoidance measure to prevent the timing of deductions being accelerated by transferring the land right, or the estate in land from which the land right is granted, to an associated person.

4.45 Note that the general anti-avoidance provision in section BG 1 will also apply to counter any tax-driven transactions that attempt to exploit the new timing provision contrary to the policy intent.

4.46 As proposed in the Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Bill, the definition of "associated person" applicable to land provisions would apply for the purpose of this timing rule.

Relationship with financial arrangement rules

4.47 Leases are currently excluded from the financial arrangement rules because they are excepted financial arrangements.[18] Therefore, the new timing rules suggested in this paper would apply to leases of land.

4.48 However, licences to occupy land are currently regarded as financial arrangements because they are not a lease for the purposes of financial arrangement rules in the definition of "lease" in section YA 1. The existing distinction between leases and licences to occupy (that are commonly used in the context of retirement villages) is considered undesirable from a policy perspective.

4.49 For consistency, we suggest treating licences to occupy land, which are an "occupation right agreement" as defined in section 5 of the Retirement Villages Act 2003, as excepted financial arrangements. This would align the treatment of leases and these licences to occupy land for the purpose of financial arrangement rules.

[18] See section EW 5(9) of the Income Tax Act 2007. Finance leases are excepted from this exclusion; the definition of "finance lease" in section YA 1 applies only to personal property. Hence, a lease of land is an excepted financial arrangement.

4.50 In addition to the above suggestion, we would like to receive submissions on whether a wider set of licences (for example, licences to use land) should be treated as excepted financial arrangements.

Treatment of certain transactions

Consecutive leases

4.51 Under the proposed changes, if two or more land rights are granted to the same person or an associated person and are linked to take effect immediately after one terminates, these land rights would be treated as one land right. An exception to this would be the extension or renewal of an existing land right.

4.52 This suggested treatment of consecutive leases is intended to prevent the timing of deductions being accelerated by entering into multiple leases. A similar treatment is currently applied for the purposes of personal property lease payments.[19]

[19] See paragraph (d)(v) of the definition of "lease" in section YA 1 of the Income Tax Act 2007.

CHAPTER 5

Application date and potential transitional issue

5.1 This chapter discusses the application date and a potential transitional issue arising from the implementation of the proposed new land-related lease payments rules.

Application date

5.2 These suggested changes, if they proceed, would apply to payments derived or incurred on or after the 1 April date following the enactment of the amending legislation.

Disposal of the right to use land acquired before the application date

5.3 Consequential to rationalising the existing rules, the "right to use land" category of depreciable intangible property in clause 5, schedule 14 of the Income Tax Act 2007 would be repealed.

5.4 If implemented, the new deduction provision would apply to any expenditure incurred for the right to use land (referred to as "the land right" under the proposed new deduction provision) after the application date. Any expenditure incurred for the right to use land before the application date would continue to be deductible under the depreciation rules.

5.5 To accommodate transfers of leases and licences to use land after the application date, a transitional rule would be introduced for a person who acquired the right to use land before the application date.

5.6 Under the proposed rules, if the person disposes of (transfers) their right to use land to another person after the application date and receives consideration for the disposal, the amount of consideration would be treated as income of the person (proposed new section CC 1). The entire amount of consideration would be allocated to the year of receipt because the amount is derived at the end of the spreading period (proposed new timing provision).

5.7 To prevent depreciation recovery income also arising for the person from the disposal of the right to use land, section EE 45 would be amended. The amount of consideration derived for the disposal of their right to use land would not be included for depreciation recovery income purposes under section EE 48. In the year of disposal, the person would be able to deduct a depreciation loss for the adjusted tax value of the right to use land under section EE 48(2).

Example – tax implications for disposing of the right to use land acquired before the application date[20]

On 1 April 2011, a tenant pays a landlord a $100,000 lease premium to enter into a 10-year lease. After three years, the commercial property market tightens and there is a shortage of commercial premises. On 1 April 2014, the tenant disposes of (transfers) the lease to a third party and receives $150,000 consideration for the disposal. Taxpayers have a 31 March balance date.

From 1 April 2011, the tenant is able to deduct $100,000 of lease premium on a straight-line basis over the next 10 years under the depreciation rules.

In the 2014–15 income year, the tenant would be required to make the following calculations under the depreciation rules (section EE 48):

Amount of lease premium	$100,000
Less deductions	$30,000
Adjusted tax value (ATV)	$70,000
Consideration for the lease	$0*

*Note that consideration would be treated as $0 for the calculation under section EE 48. Section EE 45 would not treat the $150,000 lease transfer payment as consideration.

In the 2014–15 income year, the tenant would have a depreciation loss of $70,000 ($70,000 ATV minus $0) for disposing of the right to use land. The tenant would be taxed on $150,000 consideration received from the new tenant for the transfer of the lease (new section CC 1 and the new timing provision). The tenant would therefore have net income from the lease for the year of $80,000.

From the 2014–15 income year, the new tenant would be able to deduct $150,000 over the remaining term of the lease under the new deduction and timing provisions.

The income tax implications for the tenant and the new tenant is illustrated in the table below:

Income year	**Tenant (transferor)**		**New tenant (transferee)**	
	Deduction	Income	Deduction	Income
2011–12	$10,000	–	–	–
2012–13	$10,000	–	–	–
2013–14	$10,000	–	–	–
2014–15	$70,000	$150,000	$21,429	–
2015–16	–	–	$21,429	–
2016–17	–	–	$21,429	–
2017–18	–	–	$21,429	–
2018–19	–	–	$21,429	–
2019–20	–	–	$21,429	–
2020–21	–	–	$21,429	–

[20] The example is based on an assumption that the proposed new rules apply from 1 April 2014.

APPENDIX

The table below summarises changes to current provisions that would occur under the proposed new provisions in the Income Tax Act 2007.

Section(s)	Comment
Section CC 1	This section would be replaced by a more comprehensive new section CC 1, as explained in chapter 4.
Sections CC 2, DB 21, EI 5, EI 6, EI 7, EJ 11 and clause 5 “the right to use land” in schedule 14	These sections would be replaced with the new income, deduction and timing provisions.
Section DB 22	This section relates to a restoration cost relief to landlords who change use of the land. This section would be retained as it is considered still relevant. Reference to sections CC 2, EI 5 and EI 6 in that section would be changed to new section CC 1.
Proposed sections CC 1B, CC 1C, DB 20B, DB 20C and EI 4B contained in Supplementary Order Paper No. 167 to the Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Bill	If implemented, these sections would be replaced with the new income, deduction and timing provisions. Proposed sections EA(2)(db) and paragraph (bb) of “land provision” in section YA 1 would also be amended accordingly.
Section EE 45	This section would be amended for transitional purposes.
“Capital contribution” in section YA 1	The existing capital contribution rules would be overridden by the new income provisions.