



WEEKLY COMMENT: FRIDAY 4 JULY 2014

1. The *Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014* (“the Employee Allowances Tax Amendment Act 2014”) received the Royal assent on 30 June 2014. The Employee Allowances Tax Amendment Act has been referred to as an “Omnibus Amending Act” due the multitude of change legislated and the size of the Act. This week I commence looking at this Act by discussing the changes affecting lease payments.
2. The lease payments amendments require careful attention, because some of the changes that were enacted in the *Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Act 2013* (“the Assets Expenditure Tax Amendment Act 2013”) have been repealed and replaced by a new set of changes. However, the changes in the Assets Expenditure Tax Amendment Act 2013 remain effective until 31 March 2015 – i.e. they apply for 2 income years from 1 April 2013 to 31 March 2015.
3. The changes to the lease payments rules in the Employee Allowances Tax Amendment Act 2014 apply as follows:
 - (a) The policy changes apply from 1 April 2015; and
 - (b) The remedial changes apply from 1 April 2013.
4. This week I look at the taxing provisions applying to lease inducements and lease surrender payments. Next week I will look at deduction provisions and the spreading rules for lease inducement payments. Week-after-next I will look at the remaining specific changes affecting lease payments and the amendments to the spreading provisions affecting lease premiums.

Lease inducement rules up to 31 March 2015

5. The lease inducement taxation rules that apply, under existing s. CC 1B, from 1 April 2013 to 31 March 2015 may be summarised as follows:
 - (a) The rules apply to an amount that is derived on or after 1 April 2013 in relation to a lease or licence entered, renewed, extended, or transferred on or after that date.
 - (b) The amount is income of the payee if it is derived as consideration for the agreement by the payee to the grant, renewal, extension, or transfer of a land right.
 - (c) A “land right” means a leasehold estate, or a licence to use land.
6. There are 2 exceptions where the amount derived is not income of the payee:
 - (a) If the payee derives the amount as the “assignor” – i.e.:
 - (i) As the holder of a land right; and

- (ii) As consideration for the transfer of the land right to the person paying the amount; or
- (b) If the payee is a natural person:
 - (i) Who derives the amount as a tenant or licensee of residential premises; and
 - (ii) Whose expenditure on the residential premises does not meet the requirements of the general permission – i.e. whose expenditure on the residential premises is not deductible for tax purposes.
- 7. These amendments relating to lease inducement payments do not apply to an amount that is derived or incurred on or after 1 April 2013 in relation to a lease or licence entered, renewed, extended or transferred, before 1 April 2013.
- 8. Some definitional aspects noted in *Tax Information Bulletin* Vol. 25 No. 9 October 2013 (“the TIB Item”) are as follows:
 - (a) A “lease” includes an agreement to lease.
 - (b) The definition of “lease” in s. YA 1 is a disposition that creates a leasehold estate. The definition of “leasehold estate” includes any estate, however created, other than a freehold estate.
 - (c) The definition of “estate” includes both a legal or equitable estate as well as a right to the possession of the land.
- 9. There are 4 important aspects to note about these “original” rules that apply until 1 April 2015:
 - (a) The “original” rules include a leasehold estate that has a perpetual right of renewal. It was originally noted on page 88 of the *Commentary* to the *Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Bill* (“the *Commentary*”) that the recipient of a payment for a perpetually renewable lease will continue to be taxed under s. CC 1. Officials were of the view that such a payment (for example, a lease premium) is easily substitutable for taxable rent payments on a perpetually renewable lease that are periodically reset to market levels.
 - (b) The “original” rules do not apply to an amount derived by the holder of the land right as consideration for the *actual transfer* of the land right to the payer of the consideration. Therefore, an amount paid by an assignor to get the assignee to *agree* to the transfer will be caught by the “original” rules, but an amount paid for the *actual* transfer will not be taxable under these “original” rules.
 - (c) A natural person who is a residential tenant or licensee, and whose expenditure is not tax-deductible, will not be taxed under the “original” rules on amounts received even if the person is associated with the landlord.
 - (d) An amount that is subject to the existing capital contribution rules in s. CG 8 is also taxable under the “original” s. CC 1B. However, it is noted in the TIB Item and pages 84-86 of the *Commentary* that the tax treatment of amounts that are already subject to sections CC 1 and CG 8, which relate to income from land or capital contributions respectively, do not change. The amount is included in income only once under s. BD 3(6).

10. Examples in the TIB Item of payments that are taxable from 1 April 2013 under existing s. CC 1B include:
- (a) A payment from a landlord (lessor) to a tenant (lessee);
 - (b) A payment from a tenant (sub-lessor) to a sub-tenant (sub-lessee); or
 - (c) A payment from a tenant (assignor) to a new tenant (assignee).
11. However, a lease transfer payment received by an assignor from an assignee for the assignment of an existing lease is not taxable under existing s. CC 1B. (Such a payment is not an “inducement”.)

Lease inducement rules from 1 April 2015

12. The amendments that apply, under replacement s. CC 1B, from 1 April 2015 are as follows:
- (a) A “land right” will not include a leasehold estate with a perpetual right of renewal (see further at paragraph 13 below).
 - (b) A lease transfer payment received by an assignor from an assignee for the assignment of an existing lease will be taxable under replacement, subject to specific exemptions, as discussed in paragraph 14 onwards below.
 - (c) An amount derived by a natural person as a tenant or licensee of residential premises will be taxable if the natural person is associated with the owner of the estate in land from which the land right is granted (see further at paragraph 17 below).
 - (d) An amount derived by a payee as a capital contribution will be specifically excluded from being taxed under replacement s. CC 1B (but will still be taxable under s. CG 8 – i.e. the “overlap” is being removed).
13. A leasehold estate with a perpetual right of renewal will be treated as if it were a freehold estate. Following submissions received that Glasgow-type leases (with the usual term of 7, 12 or 21 years), which are renewable in perpetuity, are more akin to freehold estates, officials recommended that s. CC 1B (and s. CC 1C – see further at paragraph 19 below) should exclude payments from the transfer or surrender of Glasgow leases. (Note that the amendment to s. CC 1C in relation to lease surrenders applies from 1 April 2013 – see further at paragraph 19 below).
14. A lease transfer payment received by an assignor from an assignee will be taxable under replacement s. CC 1B in specified circumstances. Such a payment will not be taxable if:
- (a) The payee is the holder of the land right; and
 - (b) The amount is consideration for the transfer of the land right to the person paying the amount; and
 - (c) The amount is not sourced from funds provided, by the owner of the estate in land from which the land right is granted, for purposes that include obtaining the surrender or termination of the land right; and
 - (d) Each of the payee and the person paying the amount is not associated with the owner of the estate in land from which the land right is granted.

15. In the *Commentary* two situations were initially identified when lease transfer payments that are substitutable for lease surrender payments will be taxable to the payee. They are:
- (a) If the amount is sourced directly or indirectly from funds provided by the owner of the estate in land from which the land right is granted – for example, where the landlord provides funds to the new tenant and the new tenant (assignee of the lease) uses the funds to pay the exiting tenant (the assignor of the lease): the exiting tenant (the assignor) will be taxed on the payment;
 - (b) If the person paying the amount is associated with the owner of the estate in land from which the land right is granted – for example, where the landlord is associated with the new tenant and the new tenant (assignee of the lease) pays the exiting tenant (the assignor of the lease): the exiting tenant (the assignor) will be taxed on the payment.
16. However, following submissions the taxing provision was qualified with the requirement that funds provided by the owner had to be provided “for purposes that include obtaining the surrender or termination of the land right”:
- (a) Officials agreed that the original scope of section that taxed payments sourced directly or indirectly from funds provided by the landlord was too wide. Officials agreed that situations involving an arm’s-length transaction between the landlord and the incoming tenant should not be caught, and the provision was amended accordingly.
 - (b) The particular submission that gave rise to the change was that lease transfer payments could be taxable to an outgoing tenant who had no knowledge or control over the arrangement. For example, if the landlord makes a loan to the incoming tenant to enable the new tenant to purchase the outgoing tenant’s business (including the lease), the lease transfer payment made by the incoming tenant as part of the business sale would be taxable.
17. The amendment to the residential tenants’ exemption will mean that an exiting residential tenant must not be associated with the landlord. Apparently this additional limitation is to counter payments that are substitutable for lease premium payments. The payment by the new tenant (the assignee of the lease) to the exiting tenant (the assignor of the lease) could be a substitute for a payment to the landlord (because the exiting tenant is associated with the landlord), which would in effect be a premium on the lease. It is stated in the *Commentary* that:
- “This would prevent a landlord setting up a lease with a low rent with their associate and, as part of this arrangement, the associated tenant transfers the lease to a non-associated tenant and receives a non-taxable lease transfer payment.
- Taxing a lease transfer payment in such situation will supplement the existing anti-avoidance provision in section GC 5, which allows the Commissioner to set an adequate level of rent for leases between associates.”

Lease surrender payments

18. Section CC 1C, as amended by the Employee Allowances Tax Act 2014, states that an amount is income of a person (the **payee**) when the payee:
- (a) Is the owner of:
 - (i) An estate in land from which is granted a right (the **land right**) that is a leasehold estate not including a perpetual right of renewal, or is a licence to use land; or

- (ii) The land right; and
 - (b) Derives the amount as consideration for the agreement by the payee to the surrender or termination of the land right.
19. As noted on paragraph 13 above, following submissions received that Glasgow-type leases (with the usual term of 7, 12 or 21 years), which are renewable in perpetuity, are more akin to freehold estates, officials recommended that s. CC 1C should exclude payments from the transfer or surrender of Glasgow leases. The amendment to s. CC 1C in relation to lease surrenders applies from 1 April 2013.
20. The taxing rule applies both ways: if a payment is made by a tenant to a landlord and also if the payment is made by the landlord to the tenant for them to surrender an existing lease. The payee can be either:
- (a) The person who owns the estate in land from which the land right is granted; or
 - (b) The person who owns the land right.
21. Examples included in the TIB Item of payments that are taxable under s. CC 1C include:
- (a) A payment from a landlord (lessor) to a tenant (lessee);
 - (b) A payment from a tenant (lessee) to a landlord (lessor);
 - (c) A payment from a tenant (sub-lessor) to a sub-tenant (sub-lessee);
 - (d) A payment from a sub-tenant (sub-lessee) to a tenant (sub-lessor).
22. An exception for a tenant or a licensee of residential premises applies. The amount is not income if the payee is a natural person (an individual) and derives the amount as a tenant or licensee of residential premises whose expenditure on the residential premises does not meet the requirements of the general permission. This provides a consistent treatment with the parallel exception for lease inducements.



Arun David, Director
DavidCo Limited