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WEEKLY COMMENT: FRIDAY 11 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. Last week I commenced looking at the changes affecting lease payments.

2. As I noted last week, 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Assets Expenditure, and Remedial Matters) Act 2013* ("the Assets Expenditure Tax Amendment Act 2013") have been repealed and replaced effective from 1 April 2015. Other remedial changes in the Employee Allowances Tax Amendment Act 2014 apply from the original application date of 1 April 2013.

3. Last week I looked at the taxing provisions applying to lease inducements and lease surrender payments. This week I look at the deduction provisions and the spreading rules for lease inducement payments and lease premiums. Next week I will look at the remaining specific changes affecting lease payments.

Expenditure on lease inducements

4. Under s. DB 20B, from 1 April 2013, a person who makes a lease inducement payment (i.e. the **payer**) is allowed a deduction for an amount of expenditure incurred by the person as consideration for the agreement by another person (i.e. the **payee**) to the grant, renewal, extension, or transfer of a **land right**.

5. A "land right" means:

   (a) A leasehold estate or a licence to use land (for amounts incurred between 1 April to 31 March 2015); and

   (b) A leasehold estate or a licence to use land but *excluding* a leasehold estate with a perpetual right of renewal (for amounts incurred on or after 1 April 2015).

6. A deduction is only available if:

   (a) The payer is the person who owns:

      (i) The land right (i.e. the lease); or

      (ii) The estate in land from which the land right is granted (i.e. the land); and

   (b) The payee is the person who is obtaining the land right (i.e. the new lessee).

7. The deduction for a lease inducement must be spread over the period of the lease. See further at paragraph 13 onwards below.

Expenditure on lease surrender payments

8. A person who makes a lease surrender payment (the **payer**) is allowed a deduction for an amount of expenditure incurred by the person as consideration for the agreement by another person (the **payee**) to the surrender or termination of a **land right**.

9. In the case of a lease surrender payment, a "land right" means a leasehold estate or a licence to use land *excluding* a leasehold estate with a perpetual right of renewal (for amounts incurred from 1 April 2013 onwards – i.e. from the original application date).

10. For the deduction to be available:

    (a) The payer must be a person who owns the land right (i.e. the lease) or the estate in land from which the land right is granted (i.e. the land); and

    (b) The payee must be a person who owns the estate in land from which the land right is granted (i.e. the land) or who owns the land right (i.e. the lease).

11. This deduction provision works both ways, in the same way as the equivalent taxing provision: the payer could be either the landlord or the lessee, and the payee could similarly be either the landlord or the lessee.

12. As noted on page 32 of *Tax Information Bulletin* Vol. 25 No. 9 October 2013 ("the TIB Item"): no specific timing provision is provided for lease surrender payments (the spreading rules discussed in paragraph 13 onwards below apply only to lease inducements). Generally, income and deductions for lease surrender payments are allocated to the income year in which the amount is derived or incurred. There would normally be no remaining period of the land right over which the amount can be spread at the time the lease surrender payment is derived or incurred.

The spreading rules for lease inducements

13. The spreading rules apply to an amount that is income derived under s. CC 1B (refer to last week's *Weekly Comment* 4 July 2014) or expenditure incurred under s. DB 20B (refer to **paragraph 4** above) on or after 1 April 2013, in relation to a **land right** (i.e. a leasehold estate or a licence to use land) entered, renewed, extended, or transferred on or after that date.

14. The spreading period:

    (a) Begins with the commencement, or the renewal or extension, of the land right; and

    (b) Ends before the earliest following date on which the land right may be terminated, or may expire, if not extended or renewed.

15. If the amount is incurred or derived before the end of the spreading period, the amount is allocated in equal portions to each remaining month in the spreading period, with:

    (a) The first month being the month that ends immediately after the amount is incurred or derived; and

    (b) The last month being the month in which the spreading period ends; but

(c) The spreading period is limited to a maximum of 50 years from the beginning of the spreading period.

16. If the amount is incurred or derived at, or after the end of, the spreading period, the amount is allocated to the income year in which it is incurred or derived.

17. There are 3 specific qualifications to the main spreading rules:

(a) When a person ceases, in an income year, to hold a land right, or the estate in land from which the land right is granted, all of the remaining income that should be spread is allocated to that year (the **balance year**).

(b) When a person (together with associated persons) ceases, in an income year, to hold both a land right and the estate in land from which the land right is granted, any remaining deduction that should be spread is allocated to that year (the **balance year**). Note that in this case the requirement is that at the end of the balance year the person and associated persons do not hold either the land right or the estate in land from which the land right is granted – i.e. they must have relinquished everything to do with the lease.

(c) When a land right is surrendered or terminated, the holder of the estate in land from which the land right was granted (i.e. the landlord) must allocate the remaining deduction to that year (the **balance year**).

18. There are some points worth noting in the TIB Item:

(a) The spreading period is an initial fixed period set either at the grant, renewal or extension of the land right, and the spreading period is not adjusted for later changes. A later renewal or extension is regarded as a separate spreading period.

(b) An amount that is derived or incurred before the commencement of a land right is, nevertheless, allocated to the spreading period, and not to the income year in which the amount is derived or incurred.

(c) An amount that is derived or incurred part-way through the spreading period is spread evenly over the remaining spreading period.

(d) An amount that is derived or incurred at or after the end of the spreading period is allocated to the income year in which it is incurred or derived.

(e) If the spreading period is more than 50 years, the amount is allocated evenly over the first 50 income years.

19. An amount of expenditure incurred by an assignor to induce an assignee to receive an assignment of a lease is allocated to the income year in which the amount is incurred. By assigning the lease, the assignor has no remaining period over which to spread the expenditure. On the other hand, the assignee spreads the amount of income evenly over the remaining period of the lease.

20. If a person ceases to hold the relevant land right or the estate in land from which the land right is granted part-way through the spreading period, a "wash-up" calculation of income and deductions is allowed. However, if the land right or the estate in land from which the land right is granted is transferred to an associated person, no "wash-up" calculation for deductions is allowed. The remaining amount of deductions continues to be allocated over the spreading period under s. EI 4B(3). This is apparently 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.

21. The timing provision does not apply to an amount that is treated as income under s. CC 1 or CG 8, which relate to income from land or capital contributions respectively. Income under s. CC 1 is taxable when derived unless the timing rule in s. EI 7 applies. Income under s. CG 8 is spread evenly over 10 years unless the payee chooses to reduce the cost base of the depreciable property under s. DB 64.

22. The TIB Item contains the following example explaining how the spreading provision would apply to a contribution towards the cost of a fit-out:

    Example

    On 1 April 2013, a tenant receives a lease inducement payment of $100,000 from its landlord to enter into a 12-year lease. The terms and conditions of the agreement require that the tenant must use the payment for a fit-out of their lease premises.

    The tenant spends a total of $300,000 on its fit-out in the 2013–14 income year. The tenant and the landlord both have a 31 March balance date.

    The tenant

    The tenant can either choose to return $100,000 as income over the next 10 years, starting from the 2013–14 income year, or reduce the cost base of the fit-out by $100,000. Under the latter option, the tenant is only able to claim depreciation on the remaining $200,000 of expenditure incurred on the fit-out.

    The landlord

    The landlord is allowed a deduction of $100,000 under section DB 20B, which is allocated under section EI 4B over the 12-year period from the 2013–14 to the 2024–25 income years inclusive (i.e. a deduction of $8,333 is allocated to the landlord in each income year).

Consequential changes relating to the spreading rules in s. EI 4B

23. The general rules in s. EA 3 for carrying forward unexpired expenditure will not apply to a leasehold estate or a licence to use land to which the spreading rules apply.

24. The definition of "land provisions" has been amended so that the spreading rules in s. EI 4B form part of the land provisions as defined in s. YA 1. This is apparently to ensure that the meaning of 'associated person' for the purposes of the spreading rules in s. EI 4B is the meaning that applies to the land provisions.

Remedial changes to the spreading rules in s EI 7 & EI 8

25. Section EI 7 applies when a person derives income in anticipation (under s. CC 1) from fines, premiums, a payment of goodwill on the grant of a lease, or in another similar way. Relief is provided to the taxpayer, who is allowed spread the income over 6 years.

26. Apparently, following enactment of the self-assessment legislation in 2000, it became arguable that the income did not have to be spread on an even basis. Therefore, from the 2015-16 income year, s. EI 7(2) is being replaced so as to allow a person to choose to:

    (a) Divide the income into 6 equal portions; and

    (b) Allocate a portion to the income year in which they derive the amount; and

    (c) Similarly allocate a portion to each of the next 5 income years.

27. Taxpayers will make the election themselves, and will no longer have to request the Commissioner to make the allocation.

28. A transitional provision has been inserted as s. EI 7(5) which will apply when a person has derived an amount of income to which this section applies before the 2015–16 income year, and all or part of that amount remains unallocated at the start of that income year. The person must:

    (a) If the period of 5 income years after the income year of derivation has expired by the start of the 2015–16 income year, allocate the remaining amount to the 2015–16 income year; or

    (b) If the period of 5 income years after the income year of derivation has not expired before the start of the 2015–16 income year, divide the remaining amount into equal portions based on the number of income years left in the period, and allocate a portion to each of those income years falling after the end of the 2014–15 income year.

29. Section EI 8 applies when a person derives income from disposing of any of their land to the Crown. The person is allowed to spread the income over 4 years. The law has been similarly amended, with effect from the 2015-16 income year, to ensure that the income is spread on an even basis over the 4 years. A transitional provision applies similar to the one described in **paragraph 28** above.

Arun David

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