



### WEEKLY COMMENT: FRIDAY 3 MAY 2013

1. *The taxation of land-related lease payments – An officials’ issues paper* (the “IP”) was released in April 2013. Submissions must be made by 4 June 2013. This week I look at the proposals in the IP and the tax laws for land-related lease payments as they currently stand. The IP was foreshadowed on page 26 of *Commentary on Supplementary Order Paper No. 167* (to the Livestock Tax Bill).
2. The review of the treatment of land-related lease payments appears to have been prompted by the inconsistency between the proposed tax treatment of lease surrender payments (discussed in an issues paper released in July 2012, and included as draft legislation in the SOP to the Livestock Tax Bill) and the tax treatment of payments for the assignment or transfer of a lease. A payment for the assignment of a lease may be non-taxable to an exiting tenant, and officials are concerned that this would create an incentive to assign leases for a non-taxable consideration, instead of surrender them for a taxable receipt (under the proposed new laws in the SOP).
3. However, officials note that the tax treatment of land-related lease payments generally has developed piecemeal over time, and there are various inconsistencies in the timing of deductions and possibly in the treatment of receipts and payments by different taxpayers. They suggest that “generic income, deduction and timing rules” be introduced. “Generic” means “non-specific; applicable to any of a large group or class” according to the Oxford English Dictionary. What is proposed, therefore, is a single set of rules to cover the tax treatment of a whole class of receipts for land use and payments for premises or land costs.

#### **Current taxation of income from land use**

4. Under section CC 1 of the *Income Tax Act 2007*, rents, fines, premiums, payments for the goodwill of a business, payments for the benefit of a statutory licence or for the benefit of a statutory privilege, or other revenues, are treated as income of an owner of land, if the amounts are derived from a lease, licence or easement affecting the land, or from the grant of a right to take the profits of the land.
5. A payment received by a lessor for non-compliance by a lessee with an obligation to maintain the land or to make repairs or improvements to the land, is income of the lessor under section CC 2.
6. Deductions for land use may be authorised under the general permission in section DA 1, or specifically provided for in sections DB 18 to DB 22: a lessee is allowed a deduction under section DB 21 for a payment for non-compliance with a covenant to repair, and a lessor is

allowed a deduction under section DB 22 if the payment is subsequently used to repair the premises.

7. In the IP, officials have included section CG 8 as a taxing provision relating to land use. Section CG 8 does not specifically relate to land-use: it relates to any payment that is a capital contribution received by a recipient from a payer. In a footnote, officials have stated that “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”. Instead of being taxed under section CG 8, a recipient could choose to reduce the depreciable cost base of the asset acquired under section DB 64.
8. There are a number of different spreading rules that apply, and this is what officials are not comfortable with:
  - (a) Income in anticipation from fines, premiums, a payment of goodwill on the grant of a lease, or in another similar way, can be spread over 6 years under section EI 7;
  - (b) Income from a lessee’s non-compliance with a covenant to repair can be spread over 5 years under section EI 5 (subject to a “wash-up” rule under section EI 6 if the lessor ceases to own the land);
  - (c) Income derived by a tenant from a capital contribution can be spread over 10 years under section CG 8;
  - (d) Rent payments are usually deductible when incurred, unless there is an unexpired portion that must be deferred under section EA 3 and no exemption from the deferral is available under Determination E12 (which provides an exemption from deferral if the unexpired portion does not exceed \$26,000 and the expiry date is no later than 6 months after balance date);
  - (e) The right to use land is depreciable intangible property under Schedule 14 and a payment for the right use land can accordingly be depreciated under the depreciation timing rules;
  - (f) A payment for a failure to comply with a covenant to repair can be spread over the 3 income years prior to the year of payment, under section EJ 11, if the land was used to derive income over that period; and
  - (g) A deduction subsequently allowed to a lessor, for using a payment from a lessee’s failure to comply with repair obligations, must correspond to any election to spread income under section EI 5.

### **Proposed taxation of lease inducement and lease surrender payments**

9. The proposed rules for taxation of lease inducement and lease surrender payments were discussed in *Weekly Comment 22 March 2013*.
10. The recipient will be taxed on a lease inducement payment, and the payer will get a tax deduction. The income and the deduction will be required to be spread over the term of the lease.
11. Similarly, the recipient will be taxed on a lease surrender payment, and the payer will get a tax deduction. In this case, there is no specific spreading rule, and the general timing provisions will apply.

### **Leases or licences that last less than 50 years to be on revenue account**

12. Officials favour making all land-related lease payments, for leases or licences that last less than 50 years, taxable to the recipient and deductible to the payer. A timing rule would be introduced to spread income and deductions over the term of the lease or licence.
13. The rules would not apply to:
- (a) Payments derived by a tenant of residential premises; or
  - (b) Payments, other than rent, made in relation to a land right that lasts 50 years or more; such payments would be treated similarly to payments made in relation to a sale of freehold land.
14. The 50-year period would not include any 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.
15. The following instances of changes to the existing tax treatment are provided in the IP:
- (a) Payments for the assignment of a lease would be taxable to the recipient.
  - (b) Some payments that are currently non-deductible to the payer, such as lease modification payments, would be deductible if the lease lasts less than 50 years.
  - (c) Payments received by a landowner for the grant of a permanent easement, that are currently taxable under section CC 1, would be treated as non-taxable (because the land right would last 50 years or more).
  - (d) Payments to acquire a land right that lasts 50 years or more, such as a payment to acquire a lease that lasts 99 years, would no longer be deductible under the tax depreciation rules; officials consider the 50 year threshold is consistent with the 50 year threshold on buildings for depreciation purposes.

### **Specific rules**

16. Officials favour replacing all existing land-related lease payment provisions with new income, deduction and timing provisions. The proposed new rules on lease inducements and lease surrender payments, if enacted, will also be replaced by the new provisions envisaged in the IP.
17. The proposed rules would not apply to:
- (a) A natural person who is a tenant or licensee of residential premises;
  - (b) Rent (which would continue to be subject to existing rules);
  - (c) Compensation payments for loss or injury in relation to a land right;
  - (d) Royalties under section CC 9;
  - (e) Forestry, petroleum mining and other mining if the specific provision in subparts CB, CT and CU apply.
18. The new rules would apply to all amounts (in cash, or consideration other than cash) derived, or paid, in relation to a "land right" that is an estate or interest in land, or a licence to use land, and lasts for less than 50 years.

19. The payee, who is taxed on a receipt, could be:
- (a) The person who owns the relevant estate in land from which the right is granted; or
  - (b) The person who owns the land right; or
  - (c) The person who is obtaining the land right; or
  - (d) The person who used to own the land right.
20. In order to get a deduction under the proposed rules, both the payer and the payee must be persons who fall within the above four categories.
21. The timing rules currently proposed for lease inducements in clause 32B of the Livestock Tax Bill would apply (see paragraphs 9 to 16 of *Weekly Comment 22 March*) subject to the following modifications:
- (a) The spreading period (the term of the land right to which a receipt or payment relates) would be measured in whole months;
  - (b) Income and deductions would be allocated based on the spreading period in the income year as a proportion of the entire spreading period;
  - (c) Amounts derived or incurred before the commencement of the land right would be allocated over the spreading period;
  - (d) Amounts derived or incurred before the end of the spreading period would be allocated to the remaining spreading period; and
  - (e) Renewals or extensions would be treated as separate spreading periods.
22. If the land right is disposed of part way through the spreading period, a “wash-up” solution is proposed that will be almost identical to the one proposed for lease inducement payments in clause 32B of the Livestock Tax Bill (see paragraphs 9 to 16 of *Weekly Comment 22 March*).
23. Other points of interest are:
- (a) The proposed new rules would override the existing land provisions in sections CB 6 to CB 23B of the Act.
  - (b) The proposed “land right” rules will not apply to improvements that are owned by a tenant, or to expenditure on acquiring improvements; if a payment includes the cost of improvements, the payment will have to be apportioned between the cost of the improvements and the relevant land right(s).
  - (c) Consecutive leases under which land rights are granted to the same person, or an associated person, and are linked to take effect one after the other, would be treated as a single land right (unless the second lease is a renewal or extension of an existing land right).
  - (d) If there is concurrent use of land for residential and business purposes, the amount will have to be apportioned, so that only the portion that corresponds to business use will be subject to these rules.

### **Cases where income arises up-front but deductions must be deferred**

24. There are two important instances identified in the IP when income must be returned in the year of receipt, but deductions must be spread.
25. The first is in the case of an assignment or transfer of a lease. The assignor/payee will have to return the amount received in the year of receipt, because there will be no remaining spreading period in relation to the land right being transferred. The assignee/payer, however, will be the new tenant, and will have to spread the deductions over the remaining spreading period.
26. The second is in the case of capital contributions. A receipt in respect of capital contributions will be taxable over the spreading period. Deductions on account of depreciation will, however, have to be spread based on the depreciation rate. The existing concession that allows the pre-tax amount of the capital contribution to be deducted from the depreciable cost of the assets acquired is to be withdrawn.

### **Relationship with the financial arrangements rules**

27. Officials note that licenses to occupy land are currently regarded as financial arrangements. However, officials consider that the existing distinction between leases and licences to occupy (that are commonly used in the context of retirement villages) is undesirable from a policy perspective.
28. Officials have suggested 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. The rules proposed in the IP would, therefore, apply to licences to occupy land.
29. Officials have also said they would like to receive submissions on whether a wider set of licenses (for example, licences to use land) should be treated as excepted financial arrangements.

### **Commencement and interaction with depreciation recovery rules**

30. The proposed commencement date for the changes suggested in the IP would be the 1st of April that follows the date of enactment of the amending legislation. The rules would apply to payments derived or incurred on or after that date.
31. That raises an issue in relation to land right payments that are being depreciated, and the depreciation that would be recovered if such rights were disposed of after the new rules come into effect. An example is provided on page 23 of the IP to explain how the proposed rules would operate in such cases.
32. A payment derived by the seller upon disposal would be taxable in full under the new rules: whereas currently only depreciation recovered would be taxed. The proposal is to treat the disposal as being for a nil consideration for depreciation purposes, and the tax the entire proceeds under the proposed new rules.
33. The effect will be a loss on disposal for tax depreciation purposes equal to the adjusted tax value at the time of disposal, combined with a taxable receipt equal to the proceeds received upon disposal.

34. The buyer would have to spread the deductions for the payments made under the proposed new rules.

A handwritten signature in black ink that reads "Arun David". The signature is written in a cursive, slightly slanted style.

Arun David, Director  
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