

Regulatory Impact Statement

The taxation of lease inducement payments

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

The problem addressed in this statement is whether the current tax treatment of lease inducement payments is appropriate and, if not, how it should be changed.

Following consultation, alternative solutions for the tax treatment of lease inducement payments were considered and are covered in this Regulatory Impact Statement. Two significant recommendations that resulted from consultation are:

1. treating lease inducement and surrender payments as taxable to the recipient and deductible to the payer; and
2. the application date has been modified to address concerns raised in submissions.

It is estimated that the preferred option would impose additional tax costs of around \$14 million per annum on businesses (both landlords and tenants) with lease inducement or surrender payments. Note that this estimate is based on the number of arrangements involving lease inducement payments and lease surrender payments that Inland Revenue has identified to date; this estimate does not include taxpayers' behavioural change if the existing tax advantage for lease inducement payment is removed.

The preferred option would reverse the case law on the tax treatment of lease inducement and surrender payments.

No significant administrative or compliance implications arise from the preferred option. Except as noted in this statement, none of the policy options impair private property rights, provide disincentives to innovate, or override common law principles.

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28 November 2012

STATUS QUO AND PROBLEM DEFINITION

1. Following the recent economic downturn, arrangements involving lease inducement payments have become a popular option for landlords to attract tenants. These payments, usually by way of an unconditional lump sum cash payment, are made by commercial landlords to induce tenants to sign up for a lease without needing to reduce the rental income payable. Even in economic upturns, when there is a shortage of business premises, lease inducement payments enable landlords to secure major tenants in large buildings or for a longer term.

2. For income tax purposes, lease inducement payments can be characterised differently for a payer (generally the landlord) and a recipient (the tenant), because the quality of a payment is determined separately for the payer and the recipient. For the payer, the payment would generally be tax deductible if the payer incurs the expenditure in the course of carrying on a business of leasing. For the recipient, 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. The capital nature of a lease inducement payment was confirmed by the Privy Council in *Wattie*.¹

3. The current deductible/non-taxable tax treatment of lease inducement payments poses a risk to the tax base. It creates an incentive for contracting parties to enter into lease arrangements that are tax advantaged: the tenant receives a non-taxable cash lease inducement payment as a substitute for above market value deductible rent payments. This arbitrage opportunity is possible because lease inducement payments and rents, while different in form, are similar in substance and have readily substitutable elements. The tax cash value of deductible but non-taxable payments can be highly sensitive to commercial and tax considerations.

Example 1 – current situation

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.

Under the latter arrangement, 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%). The tenant receives the tax advantage as they do not pay income tax on the amount of lease inducement of \$400,000, while claiming a tax deduction for rental income expense of \$1,000,000 against their taxable income. The tenant is \$112,000 (tax cash value of non-taxable lease inducement payment of \$400,000 at 28%) better off than simply paying the rent of \$600,000. The deduction of \$400,000 extra rent shelters otherwise taxable income of the same amount.

4. Cash lease inducement payments are the only type of lease inducement that confers a tax advantage compared with other types of inducement such as rent holidays and contributions for fit-out costs. This tax advantage can distort business decisions when entering into lease arrangements. For example, a cash lease inducement that is used by the tenant for building fit-out costs is tax advantaged, whereas a lease inducement payment that is contractually required to be spent on the same fit-out is not. The latter type of inducement is now taxable under the capital contribution rules introduced in Budget 2010.

¹ *Commissioner of Inland Revenue v Wattie* [1999] 1 NZLR 529.

5. The problem addressed in this statement is whether the current tax treatment of lease inducement payments is appropriate and if not, how it should be changed.

OBJECTIVES

6. The objectives are to provide fair and efficient tax treatment for lease inducement payments and to remove distortions that create a risk to the tax base.

REGULATORY IMPACT ANALYSIS

Policy options

7. Four options have been considered on the taxation of lease inducement payments:

- **Option 1 (preferred long-term approach):** treat all commercial lease-related payments as taxable income to the recipient and tax deductible expenditure to the payer under the Income Tax Act 2007.
- **Option 2 (preferred short-term approach):** treat lease inducement payments as taxable income to the recipient and tax deductible expenditure to the payer under the Income Tax Act 2007 and extend the scope of the reform to apply to lease surrender payments.
- **Option 3:** treat lease inducement payments as taxable income and tax deductible expenditure under the Income Tax Act 2007.
- **Option 4:** treat lease inducement payments as taxable income under the Income Tax Act 2007.
- **Option 5:** retain the status quo.

8. Option four was the option originally suggested by officials in the July 2012 issues paper. Options one to three arose from consultation.

9. Officials' analysis of the options is summarised in the following table:

Options	Costs	Benefits	Net Impact
<p>One: treat all commercial lease-related payments as taxable income and tax deductible expenditure</p>	<ul style="list-style-type: none"> Estimated tax costs to commercial landlords and tenants of \$14 million per annum 	<ul style="list-style-type: none"> Consistent tax treatment of all lease-related payments Removes tax arbitrage opportunities – removes distortions Equitable outcome for taxpayers Provides certainty of tax treatment for commercial lease-related payments, increasing efficiency Ensures substitutable payments are treated the same Removes “black hole” expenditure – non-deductible lease surrender payments – from the tax system Estimated revenue gain of \$14 million per annum 	<p>Not preferred at this stage</p> <p>Further review to be undertaken on extending scope of the reform to other land lease-related payments</p>
<p>Two:</p> <ul style="list-style-type: none"> treat lease inducement payments as taxable income and tax deductible expenditure extend the scope of the reform to apply to lease surrender payments 	<ul style="list-style-type: none"> May discourage using lease inducement payments when compared to the status quo, but not when compared to other lease inducements such as reduced rent or contributions for fit-outs Inconsistent tax treatment of other lease-related payments such as lease transfer payments Estimated tax costs to commercial landlords and tenants of \$14 million per annum 	<ul style="list-style-type: none"> Limits tax arbitrage opportunities – removes distortion when inducing or surrendering commercial leases Equitable outcome for taxpayers with lease inducement or surrender payments (both landlords and tenants) Provides certainty of tax treatment for commercial lease inducement and surrender payments, increasing efficiency Ensures substitutable payments are treated the same Removes “black hole” expenditure – non-deductible lease surrender payments – from the tax system Estimated revenue gain of \$14 million per annum 	<p>Preferred option</p> <p>Improvement on the status quo (see benefits)</p> <p>Sufficient consultation undertaken on this option</p> <p>Estimated revenue gain of \$14 million per annum</p>

Options	Costs	Benefits	Net Impact
<p>Three: treat lease inducement payments as taxable income and tax deductible expenditure</p>	<ul style="list-style-type: none"> • May discourage using lease inducement payments when compared to the status quo, but not when compared to other lease inducements such as reduced rent or contributions for fit-outs • Inconsistent tax treatment of lease-related payments • Estimated tax costs to commercial landlords and tenants of \$18.5 million per annum 	<ul style="list-style-type: none"> • Limits tax arbitrage opportunities – removes distortion • Equitable outcome for taxpayers (both landlords and tenants) • Provides certainty of tax treatment for commercial lease inducement payments, increasing efficiency • Ensures substitutable payments are treated the same • Estimated revenue gain of \$18.5 million per annum 	<p>Not preferred</p> <p>Improvement on the status quo as in option one but does not remove “black hole” expenditure – non-deductible lease surrender payments – and is inconsistent with the tax treatment of other lease-related payments such as lease surrender or transfer payments</p> <p>Estimated revenue gain of \$18.5 million per annum</p>
<p>Four: treat lease inducement payments as taxable income</p>	<ul style="list-style-type: none"> • May discourage using lease inducement payments when compared to the status quo, but not when compared to other lease inducements such as reduced rent or contributions for fit-outs • Lack of equity for landlords • Inconsistent tax treatment of other lease-related payment • Estimated tax costs to commercial landlords and tenants of \$20 million per annum 	<ul style="list-style-type: none"> • Limits tax arbitrage opportunities – removes distortion • Ensures substitutable payments are treated the same • Estimated revenue gain of \$20 million per annum 	<p>Not preferred</p> <p>Improvement on the status quo but inequitable outcome, does not remove “black hole” expenditure – non-deductible lease surrender payments – and is inconsistent with the tax treatment of other lease-related payments such as lease surrender or transfer payments</p> <p>Estimated revenue gain of \$20 million per annum</p>

Options	Costs	Benefits	Net Impact
Five: retain status quo	<ul style="list-style-type: none"> • There are tax arbitrage opportunities – revenue risk • Existing tax advantage distorts business decisions on lease inducements when entering into leases • Lack of consistent tax treatment with substitutable payments • Lack of equity for taxpayers • Less certainty on tax treatment of lease inducement payments and other lease-related payments • Litigation cost if disputed • Estimated revenue loss of \$20 million per annum 	<ul style="list-style-type: none"> • May encourage using lease inducement payments when compared to other lease inducements such as reduced rent or contributions for fit-outs • Estimated tax benefits to commercial landlords and tenants of \$20 million per annum 	<p>Not preferred</p> <p>Maintains the status quo (tax arbitrage opportunities, inequitable, inconsistent and uncertain outcome)</p> <p>Estimated revenue loss of \$20 million per annum</p>

10. Note that the above revenue estimates are based on the number of arrangements involving lease inducement payments and lease surrender payments that Inland Revenue has identified to date. Revenue estimates for other commercial lease-related payments, such as lease transfer or modification payments, under option one has not been specifically quantified for the purpose of this Regulatory Impact Analysis.

11. Our preferred short-term approach is option two. By making commercial lease inducement and surrender payments taxable, this option ensures a fair and efficient tax treatment these payments by removing the existing tax advantage as described in paragraphs 3 and 4 and addresses the revenue risk. Also, under this option the normal commercial bargaining process would no longer be distorted by the tax benefits of non-taxable lease inducement payments when entering into leases. This option may discourage commercial landlords from using lease inducement payments when compared to the status quo and encourage the use of other lease inducements such as reduced rent. Overall, this option would eliminate an existing tax advantage that distorts business decisions when entering into leases and treat all forms of lease inducements similarly for tax purposes.

12. Option two ensures a consistent treatment of lease inducement payments for income and expenditure purposes and it accords with the substance over form approach taken in this reform – that is, it recognises that while different in form, lease inducement payments and rents are all part of the price paid for the lease. Furthermore, this short-term approach ensures consistency with the tax treatment of lease premiums, such as “key money”, paid by tenants to landlords.² Note that for consistency, deductions would also be allowed for expenditure incurred for contributions to fit-outs, because they are a form of lease inducement.

² Lease premiums are currently taxable under section CC 1 and tax deductible under the depreciation rules and schedule 14 of the Income Tax Act 2007 for all landlords and tenants.

13. This option would also eliminate another existing asymmetry in the tax system for lease surrender payments, thereby removing “black hole” expenditure and distortion in the tax system.

14. Accordingly, option two would result in a fair and equitable outcome for taxpayers with lease inducement or surrender payments – there would be horizontal equity among taxpayers entering into lease arrangements with or without lease inducements or surrendering an existing lease with or without consideration, and among landlords or tenants whether they are in the business of leasing property or not. This option would also provide certainty for businesses on the tax treatment of these payments, thereby increasing efficiency.

15. Note that option two would reverse the case law on lease inducement and surrender payments, particularly *Wattie* and *McKenzies*³ respectively.

16. Our preferred long-term approach, option one, would result in a consistent and coherent tax treatment of all commercial lease-related payments that is consistent with the broad-base, low-rate tax framework. There are other asymmetries in the tax system for lease-related payments such as lease transfer or modification payments. However, it is proposed that this broader reform scope of lease-related payments would be further consulted on, consistent with the Generic Tax Policy Process. Officials will prepare and release an issues paper early next year seeking feedback on making all commercial lease-related payments, such as lease transfer payments, taxable to the recipient and deductible to the payer.

17. Although options three and four prevent tax arbitrage opportunities, they do not result in an equitable outcome for taxpayers or a consistent and coherent tax treatment for lease inducement and surrender payments. For example, lease surrender payments would continue to be “black hole” expenditure – that is, generally non-deductible business expenditure to the tenant yet taxable to the landlord. Therefore, these options are not preferred.

18. Option five is not preferred because it does not meet any of the objectives – the current tax treatment of lease inducement payments poses a risk to the tax base, which is a result of an existing tax advantage distorting business decisions on leases. The objectives cannot be resolved without legislatively modifying the boundary between non-taxable capital and taxable revenue receipts which currently results in lease inducement payments having a non-taxable capital character.

19. The economic, fiscal and social implications of the options are outlined in the table above. There are no significant compliance and administrative implications arising from the options. No environmental or cultural costs are expected to arise under the options.

³ *Commissioner of Inland Revenue v McKenzies New Zealand Limited* [1988] 2 NZLR 736.

Application date

20. The preferred short-term approach, option two, would apply to commercial lease arrangements entered into on or after 1 April 2013. We consider this application date would provide businesses certainty when entering into lease arrangements, while addressing the revenue risk associated with lease inducement payments. In particular, businesses would have knowledge of the detail of the reform via the bill itself.

21. Option two modifies the suggested application date from the day the issues paper was publicly released as suggested in the issues paper (that is, 26 July 2012) to 1 April 2013 in order to address concerns raised in submissions about business certainty. Although some taxpayers may have changed their behaviour for the period between the date the issues paper was released and the Government announcement of this decision, on balance, an application date of 1 April 2013 is a better date for this reform as stated above.

CONSULTATION

22. Inland Revenue has consulted on the reform in an officials' issues paper, *The taxation of lease inducement payments*, released in July 2012 and 19 submissions were received. The submitters had the following key concerns with the suggested reform:

- *Policy rationale for the reform:* while submitters generally recognised the revenue risks associated with the current tax treatment of lease inducement payments, some submitters raised questions over the policy justifications for the reform.
- *Application date:* most submitters raised strong objections to the application date of 26 July 2012 which was initially suggested in the issues paper. This suggested date is retrospective, creates business uncertainty and poses practical problems such as provisional tax and distributions for listed portfolio investment entities.
- *Symmetrical tax treatment of payments made in relation to commercial lease arrangements:* most submitters suggested that other existing asymmetrical tax treatment of payments made in relation to commercial lease arrangements should be addressed – examples of possible changes could include ensuring a deduction for lease inducement payments, and a symmetrical tax treatment for lease surrender and modification payments.
- *Timing of expenditure:* most submitters considered that lease inducement payments should be deductible immediately because the full cost is incurred by a landlord upfront and there is generally no right of recourse if the lease is terminated early.
- *Scope of the reform:* some submitters were concerned about the potential overreach of the reform, particularly the coverage of non-cash benefits.
- *Impact on the Canterbury region:* some submitters were concerned about the potential impact of the reform on the Canterbury region as the reform may act as a barrier to economic growth and re-investment into the region.

23. Officials considered the submissions and modified the proposals as below:
- *Application date:* The reform should apply to commercial lease arrangements entered on or after 1 April 2013, which would be announced by Ministers before the introduction of the tax bill containing the reform.
 - *Deductibility of lease inducement payments:* The reform should treat lease inducement payments as deductible expenditure under the Income Tax Act 2007 by overriding the capital limitation in section DA 2.
 - *Timing of income and expenditure:* The reform should spread the income and expenditure over the term of the lease, accompanied by an anti-avoidance provision designed to prevent timing arbitrage opportunities.
 - *Symmetrical tax treatment of payments made in relation to commercial lease arrangements:* The reform should be extended to lease surrender payments by making them taxable to the recipient and deductible to the payer. Other existing asymmetries in relation to commercial lease payments will be reviewed further under the Generic Tax Policy Process.
24. We considered concerns about potential overreach from including non-cash benefits in the reform. However, non-cash benefits are directly substitutable for cash payments posing similar revenue risks and therefore should be covered by the reform.
25. The reform should not provide a temporary exemption for the Canterbury region as to do so would be to provide a poorly targeted tax concession to only one type of lease arrangement. The approach to date with the Canterbury earthquakes has been to remove tax impediments that have inadvertently arisen rather than provide explicit tax concessions.
26. Inland Revenue has also consulted with the Treasury, which agrees with the analysis and recommended option.

CONCLUSIONS AND RECOMMENDATIONS

27. The recommended option is to enact specific legislative provisions in the Income Tax Act 2007 to treat lease inducement and surrender payments as taxable income and tax deductible expenditure.

Example 2 – situation under the preferred option

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.

Under the latter arrangement, 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%). The tenant is not better off than simply paying the rent of \$600,000 because the lease inducement payment of \$400,000 would be taxable income to the tenant. The tenant is able to claim a net tax deduction of \$600,000 only against their taxable income (\$1,000,000 rent expense minus \$400,000 taxable lease inducement payment).

IMPLEMENTATION

28. The necessary legislative change would apply to commercial lease arrangements entered into on or after 1 April 2013.

29. The recipients of lease inducement payments would be required to pay tax on the payments at their correct marginal tax rate over the term of the lease. The payers would be allowed to deduct these payments as their expenditure over the term of the lease.

30. Similarly, the recipients of lease surrender payments would be required to pay tax on the payments at their correct marginal tax rate. The payers would be allowed to deduct these payments as their expenditure.

31. There are no significant administrative issues arising from the amendment.

MONITORING, EVALUATION AND REVIEW

32. Following this reform of lease inducement and surrender payments, it is proposed that there will be a further review of the taxation of other commercial lease-related payments. As the current reform is limited in scope, the purpose of the review would be to provide a consistent and coherent tax treatment for all commercial lease-related payments that is consistent with the broad-base, low-rate tax framework. It is expected that an officials' issues paper will be released for public consultation early next year seeking feedback on making all commercial lease-related payments, such as lease transfer payments, taxable to the recipient and deductible to the payer.

33. In general, Inland Revenue monitors, evaluates and reviews new legislation under the Generic Tax Policy Process (GTPP). The GTPP is a multi-stage tax policy process that has been used to design tax policy in New Zealand since 1995. The final stage in the GTPP is the implementation and review stage, which involves post-implementation review of the legislation, and the identification of any remedial issues. Opportunities for external consultation are also built into this stage. In practice, changes identified as necessary for the new legislation to have its intended effect would generally be added to the tax policy work programme, and proposals would go through the GTPP.