# Regulatory Impact Statement

## The taxation of land-related lease payments

### Agency Disclosure Statement

This Regulatory Impact Statement (RIS) has been prepared by Inland Revenue.

The problem addressed in this statement is whether the different tax treatment of similar land-related lease payments is appropriate and, if not, how it should be changed.

The current tax treatment of land-related lease payments can produce inconsistent and incoherent outcomes for taxpayers. One of the main problems identified in this RIS is the inconsistent treatment of lease surrender payments and lease transfer payments. The current non-taxable status of lease transfer payments, in tandem with taxable lease surrender payments, can distort business decisions when leases are sold.

This RIS provides an analysis of options that provide a fair and efficient tax treatment of land-related lease payments by:

(i) removing a tax advantage associated with lease transfer payments that has an effect of distorting business decisions on leases and licences of land.

(ii) aligning the tax treatment of similar leases and licences of land for consistency and certainty.

The preferred approach would have additional costs for certain businesses, in particular, certain circumstances in which commercial tenants sell their lease to a third party. Residential tenants would not be affected by the reform targeting lease transfer payments made in substitution for lease surrender payments. The reform would address a risk to the tax base by preventing non-taxable lease transfer payments being substituted for taxable lease payments, such as lease surrender payments and lease premiums. The reform would also affect taxpayers (landlords and tenants) with certain rights to use land, in particular, Glasgow leases (perpetually renewable leases), permanent easements (perpetual rights of way), consecutive leases (multiple leases granted to a person or their associates), and licences to occupy land.

Revenue estimates for the targeted reform have not been quantified because the identified revenue risk arises from lease surrender payments only becoming taxable from 1 April 2013. Previously, lease surrender payments were non-taxable to the exiting tenant. However, we expect that the identified revenue risk would increase over time if the status quo is retained.

No significant administrative or compliance implications arise from the targeted reform. 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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24 July 2013

## STATUS QUO AND PROBLEM DEFINITION

### *Status quo*

1. Generally, payments that are revenue in nature, such as receipts or expenditure derived or incurred in the ordinary course of business, are treated as taxable income and tax deductible expenditure. Generally, payments that are capital in nature are treated as non-taxable income and non-deductible expenditure.

2. Notwithstanding this general principle, the Income Tax Act 2007 (the Act) specifically provides for the tax treatment of certain land-related lease payments. The table below summarises the tax treatment of certain commercial land-related lease payments that are covered in the Act.[1]

| Payment type | Income | Deductions |
|---|---|---|
| Payments relating to a lease or licence to use land, such as rents, fines, premiums or other revenues | Taxable | Generally deductible |
| Payments for non-compliance with covenant to repair | Taxable | Generally deductible |
| Contributions for fit-out costs[2] | Taxable | Generally deductible |
| Lease inducement payments | Taxable | Generally deductible |
| Lease surrender payments | Taxable | Generally deductible |

3. The Act does not provide comprehensive coverage of all land-related lease payments. The tax treatment of other land-related lease payments, which are not specifically covered under the Act, is determined under general principles as described in paragraph 1.

### *Problem definition*

4. The Act's treatment of land-related lease payments can produce inconsistent and incoherent outcomes for taxpayers. The Act treats similar lease payments differently for income tax purposes, which can result in a tax advantage that has the effect of distorting business decisions on leases and licences of land.

*Inconsistent tax treatment between lease surrender payments and lease transfer payments*

5. One of the main problems identified in this RIS is the tax treatment of lease transfer payments. Lease transfer payments are generally received by an exiting tenant (assignor) from a new incoming tenant (assignee), for the transfer or assignment of a lease. For income tax purposes, the payment is generally non-taxable to the exiting tenant.

6. The current non-taxable status of lease transfer payments, in tandem with taxable lease surrender payments, can distort the commercial decisions of the exiting tenant. As lease transfer payments are generally not taxable, it would be tax advantageous for a tenant to exit a

[1] The recently enacted Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Act 2013 includes land-related lease inducement payments and lease surrender payments amendments.

[2] 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.

lease by transferring the lease to a third party for a tax-free lease transfer payment, rather than surrendering it to a landlord for a taxable lease surrender payment.

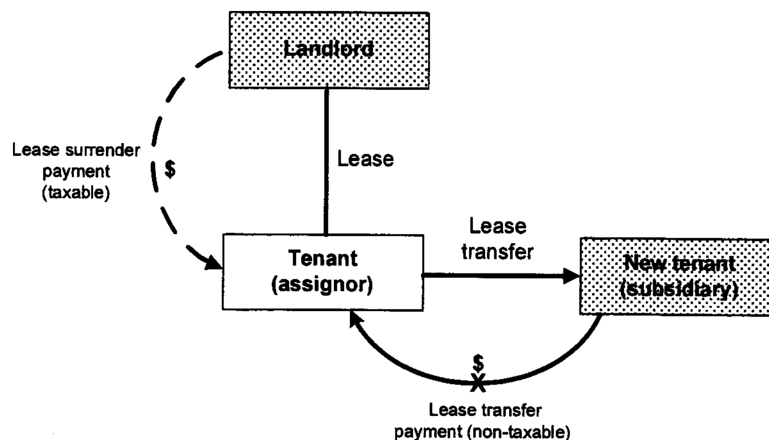
7. From the outgoing tenant's perspective, there is no economic difference (putting tax aside) between surrendering the lease to the landlord and transferring it to a third party. The effect is the same – the tenant exits the lease and receives consideration for it. Treating similar payments differently for income tax purposes distorts business decisions and results in economic inefficiency and unfairness.

**Example**

On 1 April 2014, a landlord and a tenant enter into a 10-year lease. After three years, the landlord expands their 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 is taxable to the tenant and deductible to the landlord.

A subsidiary company of the landlord 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.

8. The revenue risk increases when the commercial property market tightens – that is, when there is a shortage of business premises in economic upturns. This is because lease transfer payments from new tenants or lease surrender payments from landlords tend to occur more often when leases become valuable in a tight commercial property market. For example, prospective tenants or landlords would be more prepared to pay existing tenants for the transfer or surrender of a lease.

9. The size of the risk is not quantifiable because the problem arises from lease surrender payments only becoming taxable to the exiting tenant from 1 April 2013. Previously, lease surrender payments were non-taxable to the exiting tenant. We expect that the identified risk would increase over time if the status quo is retained.

*Problems with other land-related lease payments*

10. Other problems include the following:

*A.* *Treatment of similar leases and licences of land:* Similar leases and licences of land can be treated differently for income tax purposes. For example, Glasgow leases (perpetually renewable leases) and permanent easements (perpetual rights of way) are similar to freehold land, but they are treated as leases. Also, consecutive leases (multiple leases granted to a person or their associates) are, in substance, similar to holding a single lease, but they are treated as separate leases under the depreciation rules. Lastly, certain licences to occupy land are subject to the financial arrangement rules, whereas leases of land are excluded from such rules.

*B.* *Treatment of overall land-related lease payments:*

a. *Income and deductions:* The rules can 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) are taxable to an incoming tenant.

b. *Timing rules:* 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 but a tenant receiving lease inducement payments spreads the income over the term of the lease.

11. The problem addressed in this statement is whether the different tax treatment for similar land-related lease payments is appropriate and, if not, how it should be changed.

## OBJECTIVES

12. The objective is to provide a fair and efficient tax treatment of land-related lease payments by:

(i) removing a tax advantage associated with lease transfer payments that has an effect of distorting business decisions on leases and licences of land.

(ii) aligning the tax treatment of similar leases and licences of land for consistency and certainty.

## REGULATORY IMPACT ANALYSIS

### Policy options

13. Three options have been considered on the tax treatment of land-related lease payments, particularly lease transfer payments:

- **Option 1 (preferred approach)**: introduce a targeted reform that would address revenue risk by making lease transfer payments taxable, and provide consistency and certainty for certain leases and licences of land. In particular, the reform would:

  (i) amend the tax treatment of certain lease transfer payments to prevent them being substitutable for taxable lease surrender payments or lease premiums.

  (ii) amend the tax treatment of certain leases and licences of land so that:

    - "Glasgow" leases (perpetually renewable leases) are treated similarly to freehold land for depreciation deduction purposes

    - permanent easements (perpetual rights of way) are treated similarly to freehold land for income tax purposes

    - consecutive leases (multiple leases granted to a person or their associates) are treated as a single lease for depreciation deduction purposes

    - certain licences to occupy land are excluded from the financial arrangement rules.

- **Option 2**: introduce a broad reform that would provide a consistent treatment for all leases and licences of land. In particular, the reform would treat all commercial land-related lease payments as taxable and deductible by introducing a bright-line rule of 50 years for leases and licences of land. As result, leases or licences of land lasting less than 50 years would be put on revenue account, which would cover most commercial leases and licences of land. Leases or licences of land lasting 50 years or more would be put on capital account, which would provide a similar tax treatment to most freehold land.

- **Option 3:** retain the status quo.

14. Option two (broad reform) was suggested by officials in the issues paper, *The taxation of land-related lease payments*, released for consultation in April 2013. Option one (targeted reform) arose from consultation on that issues paper.

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

| Options | Disadvantages | Advantages | Net impact |
|---|---|---|---|
| **One:** introduce a targeted reform that would:<br>• address revenue risk with lease transfer payments by making them taxable; and<br>• provide consistency and certainty for certain leases and licences of land<br><br>*(targeted reform)* | • Retains various tax rules relating to leases and licences of land<br>• Increased tax costs to certain businesses over time, mainly from making certain lease transfer payments taxable | • Targeted base maintenance measure with minimal disruptions to the tax landscape<br>• Limits tax arbitrage opportunities when commercial leases are sold, preventing future revenue loss<br>• Ensures substitutable payments are treated the same<br>• Provides consistency and certainty for certain leases and licences of land<br>• Revenue gain over time, mainly from making certain lease transfer payments taxable | Preferred option<br><br>Improvement on the status quo and addresses disadvantages under option two – this option prevents future revenue risk, provides consistency and certainty for certain leases and licences of land, and minimises disruptions to the tax landscape |
| **Two:** introduce a broad reform by introducing a bright-line test of 50 years for all leases and licences of land.<br><br>*(broad reform)* | • May increase compliance costs from uncertainties and boundary issues<br>• Creates new distortions (e.g., with the 50-year threshold)<br>• Inconsistent tax treatment between land rules and lease rules<br>• Increased tax costs to businesses over time, mainly from making lease transfer payments taxable | • Consistent tax treatment of leases and licences of land<br>• Removes tax arbitrage opportunities – e.g., removes distortions between taxable and non-taxable lease payments – preventing future revenue loss<br>• Provides certainty of tax treatment for commercial lease payments, increasing efficiency<br>• Removes non-deductible business expenditure ("black hole expenditure")<br>• Revenue gain over time, mainly from making lease transfer payments taxable | Not preferred<br><br>Improvement on the status quo, but may disrupt the existing tax landscape by introducing new distortions |
| **Three:** retain status quo | • Potential future revenue loss – does not address tax arbitrage opportunities<br>• Existing tax advantage distorts business decisions when leases are sold<br>• Less consistency on tax treatment of similar rights to use land<br>• Less consistency on tax treatment of land-related lease payments | • Tax benefits to commercial tenants who are exiting leases – may encourage using non-taxable lease transfer payments in substitution for taxable lease payments, such as lease surrender payments | Not preferred<br><br>Maintains the status quo (tax arbitrage opportunities, inconsistent outcome) |

*Impacts of all options*

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

## CONCLUSION AND RECOMMENDATIONS

17. Our preferred approach is the targeted reform in option one. By introducing a targeted reform, this option would sufficiently address the specific revenue risk with lease transfer payments. This option would also provide consistency and certainty for certain land rights such as Glasgow leases and permanent easements.

18. We do not prefer the broad reform in option two, which was suggested in the April 2013 issues paper. By putting leases and licences of land lasting less than 50 years on revenue account, new distortions and uncertainties may arise, disrupting the existing tax landscape. It would also increase compliance costs. Therefore, our preferred option is the targeted reform in option one because it minimises disruptions to the tax landscape (as highlighted in submissions), while addressing revenue risk concerns.

19. Option three is not preferred because it does not meet any of the objectives – the current tax treatment of lease transfer payments poses a risk to the tax base, which is a result of an existing tax advantage distorting business decisions on leases. Although the size of the risk is not quantified because it has only recently arisen, the risk is expected to be realised when the leasing market tightens. The objectives cannot be resolved without legislatively modifying the capital-revenue boundary for certain lease transfer payments.

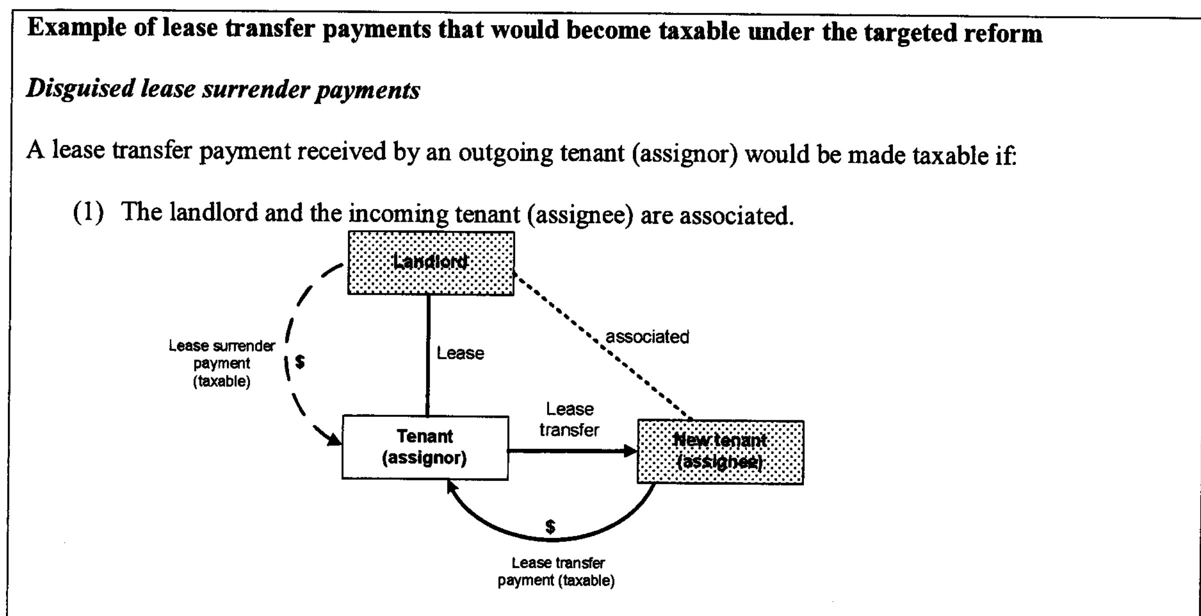
20. The recommended option would involve enacting specific legislative provisions in the Income Tax Act 2007 to treat certain lease transfer payments as taxable to prevent them being substitutable for taxable lease premiums ("key money") or lease surrender payments. This would remove the risk of existing business decisions being distorted by the tax benefits of non-taxable lease transfer payments.

**Example of lease transfer payments that would become taxable under the targeted reform**

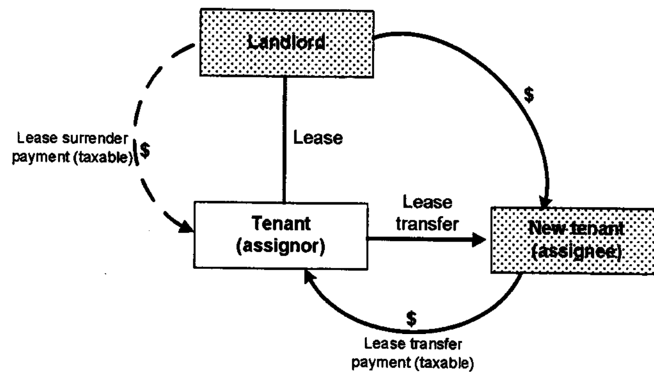
***Disguised lease surrender payments***

A lease transfer payment received by an outgoing tenant (assignor) would be made taxable if:

(1) The landlord and the incoming tenant (assignee) are associated.

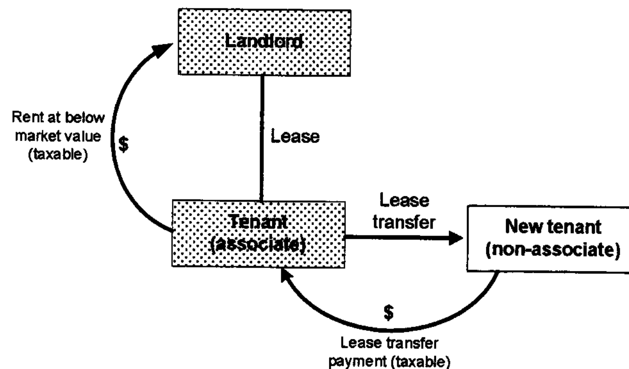


(2) The landlord and the incoming tenant (assignee) are not associated, but the lease transfer payment to the outgoing tenant is fully or partially funded by the landlord.[3]




***Disguised lease premiums***

A lease transfer payment received by an outgoing tenant (assignor) would be taxable if a landlord and the outgoing tenant are associated. This would supplement an existing anti-avoidance provision in section GC 5 of the Income Tax Act 2007, which allows the Commissioner to set an adequate level of rent for leases between associates.




21. Also, the recommended option would involve making the following amendments to the Income Tax Act 2007. These amendments would provide consistency and certainty of the tax treatment of certain leases and licences of land.

- Permanent easements would be treated akin to freehold land for income tax purposes because of their permanent nature. Accordingly, a payment for a permanent easement would not be treated as taxable income to the grantor under the existing lease rules (section CC 1)[4] and a payment for a permanent easement would not be deductible to the grantee under the depreciation rules.

- Glasgow leases would be treated akin to freehold land for depreciation deduction purposes because they are perpetually renewable. A payment for a Glasgow lease would be non-deductible because these leases would be treated as non-depreciable property. This would prevent tenants of Glasgow leases claiming depreciation loss when these leases are sold.[5] Note that lease premiums for Glasgow leases will

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[3] Note that the payment from the landlord to the new tenant is taxable to the new tenant and deductible to the landlord under sections CC 1B, DB 20B and EI 4B of the Income Tax Act 2007.

[4] Note that permanent easements continue to be subject to the existing land sale rules and may be taxable in certain circumstances.

[5] Under the current tax rules, "the right to use land", which includes Glasgow leases, is contained in the list of depreciable intangible property in schedule 14 of the Income Tax Act 2007. Usually, a commercial tenant of a lease can claim depreciation deductions for their cost to acquire the lease (i.e. a lease premium or lease transfer payment) over the term of the lease. However, a tenant under a Glasgow lease cannot claim depreciation deductions during the term of the lease because these leases have a perpetually renewable lease period, and

continue to be taxable income to the landlord under the existing lease rules (section CC 1), because they are easily substitutable for periodically reviewed taxable rent payments on the ground lease.

- Consecutive leases, which are multiple leases that are granted to the same person or an associated person, would be treated as one lease for depreciation deduction purposes. This is a base maintenance measure that would prevent taxpayers entering into consecutive leases to accelerate depreciation deductions for a lease.

- Certain licences to occupy land, which are an "occupation right agreement" as defined in the Retirement Villages Act 2003, would be excluded from the financial arrangement rules. This would ensure that licences to occupy land are treated similarly to leases of land under the financial arrangement rules and provide certainty that retirement village residents are not subject to these rules.

22. Inland Revenue has consulted with the Treasury, which agrees with the analysis and recommended option.

## CONSULTATION

23. The reform to leases and licences of land was consulted on in an officials' issues paper, *The taxation of land-related lease payments*, released in April 2013. A broad reform to leases and licences of land was suggested by putting all leases and licences of land lasting 50 years on revenue account. Nine submissions were received from taxpayers, tax advisors, New Zealand Law Society and New Zealand Institute of Chartered Accountants.

24. On the policy rationale for the broad reform, the majority of the submissions opposed the broad scope of the land-related lease payments reform as suggested in the paper. One of the main criticisms was that shifting the capital-revenue boundary to make lease transfer payments taxable amounted to a type of capital gains tax. Some submissions suggested that the identified revenue risk could be addressed by introducing a more targeted rule.

25. Also, concerns were raised about introducing a bright-line test for putting leases or licences of land lasting less than 50 years on revenue account. Some suggested that the reform in this area would not provide a more consistent and coherent income tax treatment because it would remove one distortion (lease transfer payments and lease surrender payments), but introduce another (the 50-year threshold).

26. Some believed that the broad reform would introduce new anomalies and distortions into the tax system, which would not achieve the objective of the reform and would increase compliance costs. A number of examples were given where boundary issues and uncertainties would arise, particularly regarding the scope of the reform and the bright-line test. Also, there were questions as to how the new rules would interact with other parts of the Income Tax Act 2007.

27. Officials considered the submissions in light of the main base-maintenance policy rationale of the reform, and modified the proposals. The proposals target specific revenue concerns and provide consistency and certainty of the tax treatment for certain land rights.

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therefore there is no finite period that the lease can depreciate over as required in the tax depreciation rules. However, the tenant may be able to claim a depreciation loss when the Glasgow lease is sold, if they are expected to decline in value.

The targeted approach is preferable to a broad reform approach, as suggested in the issues paper, because it minimises disruptions to the tax landscape.

28. Specific submissions were received on the technical details of the proposals in the issues paper, if the broad reform went ahead. The table below outlines key concerns and suggestions raised in submissions and officials' response.

| Key concerns raised | Officials' response |
|---|---|
| The cost of finite leases should continue to be depreciable. If the lease that lasts 50 years or more is sold with less than 50 years remaining, the lease should not be on capital account. | The concerns raised in submissions with the broad reform are addressed by recommending the targeted reform. The issues raised do not arise under the targeted reform. |
| No imputed or deemed income should apply to lease transfers between associates. | Same as above. |
| Not clear why the fit-out contribution change was not contemplated as part of the lease inducement changes. | The fit-out contribution change did not form part of the lease inducement reform because that reform covered inducement payments that are not already covered in the Income Tax Act 2007. The existing capital contribution rule provides a specific treatment for fit-out contribution income. |
| All land rights relating to residential premises could be excluded instead of the proposed residential tenant exclusion. | The existing residential tenant exclusion in the lease surrender payments rules would be introduced for lease transfer payments that are in substitution for taxable lease surrender payments. |
| The deductibility of lease payments should be determined solely by reference to the payer of a payment to provide symmetry with the income provision. Also, the deductibility of all expenses related to land rights should be made explicit as a consequence of categorising certain land rights as revenue account property. | The concerns raised in submissions with the broad reform are addressed by recommending the targeted reform. The issues raised do not arise under the targeted reform. |
| Glasgow leases should not be treated as leases because they are akin to holding freehold land. | We agree. Given the unique feature of Glasgow leases, they should be treated similarly to freehold land. Accordingly, Glasgow leases should be excluded from being depreciable property under the tax depreciation rules. |
| A permanent easement should form part of the cost base of a depreciable asset because they are inextricably linked to the asset. | We disagree. Given the permanent nature of these easements, they are akin to freehold land and should be treated similarly for tax purposes. |
| The proposed definition of consecutive leases would result in uncertainties. | Treating consecutive leases as one lease is necessary to prevent acceleration of deductions on leases or licences of land. Uncertainty concerns raised in this submission will be considered further when developing draft legislation. |
| Not clear whether it is necessary to deem licence to occupy as an excepted financial arrangement given the Commissioner's Determination S16. | It is necessary to exclude certain licences to occupy land from the financial arrangement rules. To ensure that licences to occupy land are treated similarly to leases of land under the financial arrangement rules, and provide certainty that retirement village residents are not subject to these rules. |
| Under the proposed transitional rule, there is a possibility of unintended consequences if "the right to use land" is removed from the depreciation rules. Also, the "right to use land" acquired before the application date should continue to be treated as depreciable property. | The concerns raised in submissions with the broad reform are addressed by recommending the targeted reform. The issues raised do not arise under the targeted reform. |
| Compliance costs would increase for taxpayers because there will be valuation and apportionment issues when leases are transferred as part of business sales. Also, various uncertainties and boundary issues would add to compliance costs. | Concerns regarding compliance costs are largely addressed by introducing a targeted reform. |

## IMPLEMENTATION

29. The necessary legislative change would apply from 1 April following the enactment of the amending legislation.

30. There are no significant compliance issues arising from the amendment. The following taxpayers would be affected as follows:

- The recipients of certain lease transfer payments would be required to pay tax on the payments.
- The grantors of permanent easements would not be required to pay tax on the payments for these easements.
- Tenants with Glasgow leases would not be able to claim a depreciation loss when these leases are sold.
- The tenants of consecutive leases would be required to treat these leases as one lease for depreciation deduction purposes.

Individual residents with certain licences to occupy retirement villages would not be affected by the financial arrangement rules.

31. The changes will be communicated to taxpayers and tax advisors when the Minister of Revenue makes an announcement on the contents of the relevant tax bill when it is introduced into the House. Inland Revenue will also publish details of the changes in a *Tax Information Bulletin* once the tax bill containing the amendments is enacted.

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

## MONITORING, EVALUATION AND REVIEW

33. There are no specific plans to monitor, evaluate and review the changes under the Income Tax Act 2007. If any specific concerns are raised, officials will determine whether there are substantive grounds for review under the Generic Tax Policy Process (GTPP).

34. In general, Inland Revenue monitors, evaluates and reviews new legislation under the 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 identifies 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 specific proposals would go through the GTPP.