



WEEKLY COMMENT: FRIDAY 7 MARCH 2014

1. The *Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Bill* (“the November Bill”), which was introduced on 22 November 2013 contains a number of proposed amendments relating to the taxation of land-related lease payments. The Finance and Expenditure Committee is due to report back on the Bill by 10 June 2014.
2. This week and next week, I am going to look at the lease amendments. This week I look at the amendments relating to lease transfer payments. First, I briefly review the amendments in the *Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Act 2013* (“the Assets Expenditure Tax Act”). These are covered in detail in *Weekly Comment 22 March 2013*. I then look at the extensions to the rules proposed in the November Bill.
3. The topics covered this week are:
 - (a) Lease inducements;
 - (b) Lease surrender payments;
 - (c) Extension of the rules for lease transfers;
 - (d) Taxing substitutes for lease premiums;
 - (e) Exclusion of capital contributions.

Lease inducements

4. The new rules for taxing income and allowing deductions for lease inducements apply, under s. 7(3) and 27(3) of the Assets Expenditure Tax Act, 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. They 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.
5. Included as income, under new s. CC 1B of the *Income Tax Act 2007*, is an amount derived as consideration for “the agreement by the payee to the grant, renewal, or transfer of a land right”. The “land right” must be a leasehold estate or a licence to use land. Freehold estates are not covered by these rules.
6. A “lease”, for these purposes, includes an agreement to lease. 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. The definition of “estate” includes both a legal or equitable estate as well as a right to the possession of the land.

7. These rules do not apply to:
 - (a) An amount paid to the holder of the land right as consideration for the transfer of the land right to the payer: therefore, a payment by a lessee to secure a lease is not covered; and
 - (b) A lease inducement to a natural person to take up a residential lease unless the expenditure on the residential lease is deductible for tax purposes.
8. The payer is allowed a corresponding deduction under s. DB 20B, providing that:
 - (a) The payer is the owner of the land right or the estate in land from which the land right is granted; and
 - (b) The payee is the person who is obtaining the land right.
9. There are spreading rules in new s. EI 4B, which require the amount derived and incurred to be spread over the duration of the land right. The maximum spreading period is 50 years. If a person ceases to hold a land right in an income year, the person's remaining income or expenditure is allocated to that year. Also, amounts derived or incurred after the end of the spreading period are allocated to the income year in which they are derived or incurred.

Lease surrender payments

10. The new rules for taxing income and allowing deductions for lease surrender payments apply, under s. 7(4) and 27(4) of the Assets Expenditure Tax Act, to amounts derived or incurred on or after 1 April 2013. Apparently, there is no saving provision for lease surrenders agreed to before 1 April 2013, but paid after 1 April 2013.
11. Under new s. CC 1C, consideration derived by a payee for the agreement by the payee to the surrender of a leasehold estate or the termination of a licence to use land, is income of the payee if the payee is the person who owns the leasehold estate or licence, or who owns the estate in land from which the leasehold estate or licence is granted.
12. The rules apply both ways: to a surrender payment from a tenant to a landlord, and also to a surrender payment from a landlord to a tenant. In addition, the rules include consideration that is other than cash.
13. However, these rules do not apply if the payee is a natural person who derives the amount as a tenant of residential premises, unless the expenditure on the residential lease is deductible for tax purposes.
14. The payer is allowed a corresponding deduction, under s. DB 20C, if:
 - (a) The payer is a person who owns the leasehold estate or licence or the estate in land from which the leasehold estate or licence is granted; and
 - (b) The payee is a person who owns the leasehold estate or licence or the estate in land from which the leasehold estate or licence is granted.

Extension of the rules for lease transfers

15. Clause 9 of the November Bill contains a replacement s. CC 1B. The changes are:
 - (a) An amount is income of a payee if it is consideration for the transfer of a land right from the holder of the land right to another person;

- (b) An amount derived as a natural person tenant of residential premises is income if the natural person tenant is associated with the owner of the estate in land from which the land right is granted;
 - (c) However, an amount will not be income of a payee if:
 - (i) The payee is the holder of the land right; and
 - (ii) The land right is being transferred to the payer; and
 - (iii) The payment is not sourced, directly or indirectly, from funds provided by the owner of the estate in land from which the land right is granted; and
 - (iv) Neither the payee nor the payer is associated with the owner of the estate in land from which the land right is granted.
 - (d) An amount will also not be income of the payee if it is derived as a capital contribution.
16. These proposed new rules are to apply from 1 April 2015, and they will make amounts derived for lease transfers taxable. There are no changes to the deduction rules in s. DB 20B or DB 20C.
17. It is noted in the *Commentary* to the November Bill that the situations involving lease transfer payments that are covered by the proposed new rules are payments that are substitutable for taxable lease surrender payments in section CC 1C and taxable lease premiums in s. CC 1.
18. Other types of lease payments that satisfy the conditions noted in paragraph 15(c) above will not be taxable – i.e. where:
- (a) The payee is the holder of the land right (for example, the exiting tenant);
 - (b) The payment is for transferring the land right to the person paying the amount (for example, the new tenant);
 - (c) The payment is not sourced directly or indirectly from funds provided by the owner of the estate in land from which the land right is granted; and
 - (d) Neither the payee nor the payer is not associated with the owner of the estate in land from which the land right is granted.
19. If a lease is transferred as part of a business transfer, consideration for goodwill attaching to the land will be taxable to the payee. However, consideration for business or personal goodwill will not be subject to the charging provision. These rules have always applied, and there is no change proposed.
20. The *Commentary* identifies two situations 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.

Taxing substitutes for lease premiums

21. In the two situations described in paragraph 20 above, the amount is not income if the payee is a natural person (individual) and derives the amount as a tenant or licensee of residential premises unless:
- (a) The expenditure on the residential lease is deductible for tax purposes; or
 - (b) The natural person tenant is associated with the landlord.
22. The latter rule in paragraph 21 above is to counter payments that are substitutable for lease premium payments. If the payee is associated with the owner of the estate in land from which the land right is granted, lease transfer payments will be taxable. 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, which would in effect be a premium on the lease.
23. 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.”

Exclusion of capital contributions

24. An amount that is subject to the existing capital contribution rules will not be taxable under the proposed new rules (proposed section CC 1B(5)). A capital contribution will continue to be income under section CG 8 and spread evenly over 10 years unless the payee chooses to reduce the cost base of the depreciable property under section DB 64.



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