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Landlord incentives

The tax rules changed in 2015 for lease payments of commercial property. We look at various lease incentive options and the tax implications for landlords and tenants.

CLIENTS in the commercial property market often ask us about the tax implications of various incentive arrangements in leasing situations, such as when entering a new lease or surrendering or assigning a lease.

Incentives vary with supply and demand

Where supply is short, desperate tenants will pay a lease premium or key money.

Where the market is oversupplied, landlords will offer incentives to enter new leases or renew existing leases. The usual options are a cash lump sum, free fit-outs or rent holidays. Table 1 summarises the more commonly used incentives.

Tax rules tightened

There was a time when it was possible to structure some types of payments to prospective tenants so that they were tax deductible to the landlord and non-taxable in the hands of the tenant.

Those days are gone following changes to the tax legislation in 2013. As part of the changes, Inland Revenue introduced generic income, deduction and timing rules for all land-related lease payments which have applied since 1 April 2015.

Surrendering a lease

There has never been any doubt that the landlord is taxable on the receipt of payments by tenants to surrender a lease.

However, more importantly, the rule changes have confirmed the deduction of surrender payments for the tenant, as the tenant was previously unable to deduct the payment.

Some options more attractive

The key change to the former rules around incentives provided to tenants has been to explicitly tax recipients of lump sum cash incentives. However, there are still differences in the tax treatment of various options that may make one more attractive than another, depending on the circumstances of both landlords and their prospective tenants.

Rent-free period

The rent-free option is attractive to tenants for obvious reasons. While landlords may not like the short-term lack of rent, most play a long game where they want quality tenants on a long lease paying decent rental. For the landlord, the short-term pain of the rent holiday is offset by the retention of higher rental at the end of the holiday, and the rental underpins the building's value.

Some clients ask whether they can average out their rental cost, taking the rent holiday into account, as they usually will in their financial statements. However, the tax treatment is straightforward - no income for the landlord and no deduction for the tenant until they start paying rent.

Lease inducement payments

Lease inducement payments were previously favoured because the landlord would deduct the cost and the prospective tenant could treat the receipt as non-taxable. Under the new rules, we have symmetrical tax treatment, with no tax advantage for either party. Cash inducements can still encourage tenants to enter a longer-term lease while not discounting the headline annual rental underpinning the building's value.

The tax rules spread the recognition of the payment/receipt for the landlord/tenant over the term of the lease. The spreading period

Table 1

More commonly used incentives

INCENTIVE TYPE	PAYER
Lease surrender	Tenant
Key money/lease premium payments	Tenant
Rent-free period (rent holiday)	N/A
Cash incentive to enter lease	Landlord
Free fit-out	Landlord
Fit-out contribution	Landlord

is an initial fixed period that ends at the renewal or extension of the land right. The rationale for this approach is to avoid complexities around adjusting the spreading period when the initial fixed period is later modified, renewed or extended. If there is a payment for a renewal or extension of the land right, that subsequent payment is spread over the fixed renewal or extension period, regarded as a separate spreading period.

Free fit-out

A fit-out financed by the landlord retains some tax advantages. The landlord can depreciate the cost, while the tenant has no tax to pay on the benefit of the fit-out.

These arrangements are most advantageous when the cost to the landlord is significantly less than the value of the benefit to the tenant. Tenants are often inexperienced in fit-outs and are sometimes vulnerable to being upsold on fixtures and fittings by their architects. The experienced landlord will be awake to that risk and will demand sharper costing and better value in every aspect of the fit-out.

There is the risk of the landlord being too cheap with the choice of materials and specifications, but smart landlords generally have pride in their premises and look for durability where it matters.

There is also the risk for the tenant that the fit-out is generic. Most arrangements we see, however, allow for some bespoke features to add the tenant's personality, although this may also be at the tenant's cost.

Still differences to weigh up

So, while Inland Revenue has dealt with some of the asymmetrical tax treatment around lease incentives, there are still commercial, legal and tax differences that may make one incentive option more appealing than another.