Property Council New Zealand

SUBMISSION ON THE TAXATION OF LEASE INDUCEMENT PAYMENTS ISSUES PAPER

To : Inland Revenue Department

From : Property Council of New Zealand

Property Council New Zealand is pleased to make a submission on the taxation of lease inducement payments officials' issues paper (Issues Paper).

1 About Property Council New Zealand and summary of our concerns

The Property Council New Zealand is a professional association that represents members who have a vested interest in commercial property. Its membership includes: building owners, developers, agents, construction companies, retail/shopping centre owners, investment companies, asset managers and service suppliers. Its members collectively own and manage a $14 billion commercial, retail and industrial property investment in New Zealand on behalf of over 200,000 investors.

Property Council recognises officials' concerns that the current tax treatment of lease inducements carries a revenue risk for Government. However, we are not convinced that the proposed approach is correct. Our key concerns include:

- The current application date, which means taxpayers are having to take tax positions without knowledge of the full detail (and importantly without any legislative authority). We strongly recommend a prospective date for the changes, if they proceed.

- The lack of a guaranteed deduction for the landlord. If the receipt will be taxable in all instances, a deduction should also be confirmed, as a matter of fairness.

- The proposal to spread any deduction based on accounting principles. The economic cost/enforceability of a lease incentive is incurred/expended immediately by a lessor and the tax rules should reflect this. Furthermore, if following the accounting treatment is the right outcome for the timing of the lease incentive deduction to a landlord, then a similar approach should be adopted to allow spreading of lease termination/surrender payments (which are currently fully taxable on receipt to the recipient).

- The broader problem of asymmetry in the tax treatment of payments between landlords and tenants should be addressed holistically (e.g. by considering incentives and lease surrender payments together), to reduce general inconsistency in this area.

We discuss the above concerns in more detail below:

2 Application date

Property Council considers the proposed application date of 26 July 2012, for lease incentives payable in relation to leases entered into on or after that date, is inappropriate. This is effectively law making with retrospective effect (or legislation by announcement).

Retrospective legislation in this area carries with it a number of practical issues for members of Property Council, namely:

- It will require members to take tax positions immediately, when the detail of the proposals is unknown and in the absence of any draft legislation. Absent sufficient detail on the proposed changes, members are unable to plan accordingly. Property Council understands a number of current leasing deals will be impacted by this uncertainty.
- The lack of detail also poses a further challenge in that members are unable to make the kind of detailed submissions which would be possible, were draft legislation to have accompanied the issues paper.
- A number of Property Council members are listed portfolio investment entities (PIE) and are therefore required to fully impute distributions it makes to the extent permitted by the imputation credits that the directors of the PIEs determine are available. The proposal in the Issues Paper regarding the timing of deductions for lease incentive payments poses a challenge and risks in calculating the quantum of imputation credits that will need to be attached to distributions in order for members to comply with the PIE rules, when there is no legislative authority for the lease incentive proposals.

As a matter of principle, legislative change should be prospective, to provide certainty for all concerned. We therefore, strongly recommend that the application date, if the proposals proceed, be the date the relevant Tax Bill receives Assent. Alternatively, this could be the first day of the income year beginning on or after the date legislation is passed.

3 Confirmation of a deduction for lease incentives paid by members

We are concerned that the Issues Paper notes that the deductibility of lease incentives will continue to be determined by the existing provisions of the Income Tax Act 2007. That is, the general deductibility rules would need to be met.

This is not a fair outcome, particularly if symmetry in treatment is one of the objectives. If the payment is to be taxable to a prospective tenant, the deductibility of the expenditure in the hands of the payer should also be confirmed (i.e. without the need to meet the general permission / not subject to the capital limitation) to provide certainty to landlords who provide lease incentives.

4 Spreading deduction for expenditure on lease inducement payments

The Issues Paper proposes that the landlord’s deduction would be required to be spread over the shorter of the period of the lease arrangement or the period to the first rent review effectively requiring matching of the deduction with the income.

4.1 Economic costs of expenditure incurred

It is not clear to us why matching of the deduction is required as members incur the full economic cost upfront and there is generally no right of recourse for cash incentives paid.

The current timing of a tax deduction for lease inducements is not prescribed in the Tax Act. However, in most cases we note an immediate deduction will be justified based on the expenditure being committed (i.e. when the incentive is paid) and if there is no obligation for the tenant to repay the lease incentive (e.g. on early termination).

Property Council submits that an immediate deduction should continue to be available to the payer of a lease inducement payment where the expenditure is committed and not recoverable. We see no risk to the revenue in not allowing the deduction to be recognised immediately.

In addition, Property Council would appreciate clarity around the treatment of the deduction in situations where a lease ends before the original term, if the payment is required to be spread – i.e. will the tenant/landlord be required to continue spreading the income/expense or will the residual be taxable/deductible immediately?

It is also worth noting that the current tax treatment of lease surrender receipts is that they will generally be taxable in full when derived by the landlord and there is no ability to spread the receipt over what would have been the remaining period of the lease. We discuss the need for symmetry in the treatment of lease surrender/termination payments in section 6, however, we note that timing of this income to landlords is also an issue. Therefore, if Officials are serious about changing the timing of the deduction for lease inducements, a consistent and coherent approach should be adopted in relation to other similar payments and receipts (i.e. lease surrender or termination payments).

4.2 Tax does not generally follow accounting

The Issues Paper notes that the suggested approach of spreading lease incentive expenditure is consistent with ordinary accounting principles. However, the New Zealand tax system, as a general rule, does not follow accounting principles and it is unclear why lease incentives should be any different.

Property Council is of the view that it is not appropriate for the accounting treatment of lease inducement expenditure to drive the tax treatment, particularly as the economic cost/enforceability of a lease incentive is incurred/expended immediately. Furthermore, if following the accounting treatment is the right outcome for lease incentive deductions, then a similar approach should be adopted in respect of lease termination/surrender payments received, which are currently fully taxable upfront.

5 Lease incentives that will be covered

The incentives proposed to be covered will include both cash amounts and money's worth. Property Council is concerned that this broad scope could have the effect of creating asymmetry in the tax treatment of certain payments where none has previously existed.

Take for example the case of a landlord who provides a lease inducement by way of granting an interest-free loan to their tenant. It is unclear to us what tax asymmetry arises in the case of interest-free loans, as there is no interest deduction to the landlord. Secondly, under these proposals, the tenant would presumably be deemed to derive a taxable receipt; however it is not clear that a deemed interest deduction would arise to the landlord.

Property Council considers that the above result is manifestly unfair if one of the objectives is removing asymmetry. The proposals will have the opposite effect, of creating new tax inconsistencies. Property Council would also welcome further detail to clarify, for example, what particular arrangements involving transfers of shares Officials are concerned about.

We believe that the application to non-cash transactions needs to be reconsidered. Property Council submits that only payments with an explicit cash cost should be included within the scope of these proposals.

6 Consistency in the tax treatment of other payments between landlords and tenants

Under current case law, a payment from a tenant to a landlord to surrender or terminate a lease, prior to the full lease term is non-deductible to the payer and generally taxable to the recipient. This is an example where asymmetry is clearly in favour of the Government. We are surprised that the proposals do not attempt to correct this inconsistency, by confirming that tenants are eligible for a deduction. Attempts at correcting asymmetry in the tax rules should not be one-sided, limited to removing revenue risk for Government.

In the absence of such a change, we see a scenario in which a taxpayer terminates a lease early, and is required to make a termination payment, and receives a cash incentive equivalent to their lease surrender cost being worse off after-tax due to the incentive becoming taxable but the lease surrender remaining non-deductible.

7 Further information

Please do not hesitate to contact us if you would like to discuss our submission in greater detail.

Yours sincerely

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Chief Executive