

FINDING THE RIGHT LEASE INCENTIVE





There are three basic types of financial incentive most frequently offered as an inducement to tenants to sign up for a new lease term.

Each has different tax and accounting implications for the landlord and tenant, so it is wise to explore all the options before making a final decision.

This briefing outlines the three most popular forms of incentive and considers their comparative advantages or disadvantages to both parties.

Whether you are a building owner, tenant or professional advisor, the following information should help to clarify the financial issues surrounding lease incentives.

Three types of financial inducement

Ideally, the landlord and tenant will want to find an arrangement that gives both parties an increased tax or accounting advantage over the alternative options.

It is, however, extremely difficult to evaluate the different options as there are many variables that come into play, each having different and quite complex consequences.

The three most common types of lease incentive are:

- Reverse premium payment to tenant - not linked to any specified (fit out) expenditure.
- A landlords capital contribution towards a tenants fitting out work.
- A rent-free period.

Reverse premiums

A reverse premium involves a non specific payment by the landlord to the tenant.

The landlord is required to treat the premium as a fixed capital asset, on the basis that the purpose of the payment is to enhance the value of that asset by securing an income stream. Under this scenario, the landlord will not receive tax relief on its expenditure until the property is sold.

The tenant on the other hand will have to treat their premium as taxable income, but is allowed to spread the payment over a number of years, depending on their accounting basis. If preparing accounts under UK GAAP, the income would be spread evenly over the period to first review, or the length of the lease, if there is no review. Under International Accounting Standards (IAS), the income would be spread over the whole term of the lease.

HM Revenue & Customs has confirmed that reverse premiums are outside the scope of VAT, unless there is specific evidence of the provision of a supply or service in return for the payment; this may be when the tenant is the first anchor tenant in a new development and it is considered their presence will attract other occupiers. Consequently the premium is not generally subject to VAT, meaning a significant potential saving to the landlord.

Rent-free periods

The accounting and tax treatment of rent-free periods is dealt with by UITF 28, based on the principle that an 'up-front' incentive means the rent payable would be lower than if no rent-free period had been provided. In accordance with the accruals concept, under UITF 28, the tenants 'cash saving' should be spread over the period to first rent review (or

length of lease, if no review), when market rates would then prevail. For companies preparing accounts under the IAS, the incentive (or rental saving) is spread over the term of the lease.

For a tenant with a new fifteen year lease, subject to five yearly reviews, receiving a one year (£20,000) rent free period and accounting under UK GAAP, the position would be as the table below:

Year	Actual rent paid by tenant over first five years £	Notional rent for accounting and tax purposes £
1	0	16,000
2	20,000	16,000
3	20,000	16,000
4	20,000	16,000
5	20,000	16,000
Total	£80,000	£80,000

A tenant is, therefore, able to make a rental deduction for tax purposes, in the first year on the notional rent, even though no rent has actually been paid. This results in an early cash flow 'tax' advantage.

The landlord must account for the rent-free first year in the same way, i.e. the aggregate income is allocated on a straight line basis. Consequently the landlord will be taxed on income before it has actually been received, resulting in a cash flow deficit.

This option is, nevertheless, still attractive for some landlords because it involves no up-front cash payment or 'capital' contribution, only a delay in receiving income.

Possible additional advantages to the tenant of this option include a reduced VAT liability and a reduction in the Stamp Duty Land Tax otherwise due.

Contribution to fitting-out works

The last form of inducement under consideration is a capital contribution by a landlord towards a tenant's fitting-out works. Subject to professional advice being received by each party, a landlord would normally try and seek some tax advantage from this payment, by insisting that as much of the contribution as possible was towards expenditure qualifying for some form of Capital Allowance. Typically, this is for plant and machinery allowances, but is also applicable to other forms of allowance. Often the entire contribution can be



towards 'qualifying' expenditure reducing the landlord's tax liability and as such is one reason why it is favoured by landlords.

This would obviously reduce the tax relief available to the tenant and the usual reaction being to regard this as a conflict with their own tax and accounting position.

This conflict is now, often unfounded.

As with reverse premiums, any inducement (payment) received by the tenant must be treated as a taxable revenue receipt except, crucially, for any works that permanently enhance the value of the property, or any amounts on which the tenant would have been entitled to claim Capital Allowances (had they not received the contribution). Under both circumstances the tenant is able to treat the receipt as a tax free 'capital' receipt.

The later point, in particular, is very significant because in cash flow terms, following changes to the rates of allowances given, it can often be more

favourable for the tenant to have his entitlement to any allowances reduced than it would be to receive a sum of money that would then be taxed.

Indeed, it can often be in both parties interest to structure the contribution so that the landlord first pays for the capital allowable elements of the tenants fitting out contract, with the tenant paying for the balance.

Landlords and tenants will also have to consider each of the following variables before determining the optimum solution:

Tax rate

The higher the tax rate of either the landlord or tenant, the more emphasis there will be on the tax treatment of the incentive. The lower the rate, the greater the emphasis on cash flow. Where there is a differential in tax rates, it is even more important to consider the options carefully.



Discount rate

The current economic climate of low interest rates and inflation, means that the real value of money is less affected by the passage of time. This means there is less emphasis on cash flow and a greater emphasis on tax treatment.

Holding period

The holding period is only significant insofar as it impacts on the net present value of the capital gains tax (CGT) saving on disposal. The longer the holding period, the less significant the CGT saving becomes. Its actual significance is also heavily interlinked with both the landlord's tax rate and the discount rate applied to the cash flows.

VAT status

If either the landlord or tenant has a low VAT recovery rate, they are likely to seek any option which minimises their VAT input tax.

Commercial considerations

The nature of the contribution also has to take into account the commercial considerations of each option, namely:

1. A rent-free period will compromise the rental stream of the investment.
2. In some cases the quality of the tenants covenant may make the option of a rent-free inducement more attractive than a lump sum payment or contribution. A landlord may be reluctant to provide up front cash for a tenant who may not survive to the first review.
3. Sometimes there may be insufficient profits to fully utilise the benefit of any Capital Allowances or other tax reliefs available. Similarly tax treatment may not be relevant to certain parties such as gross pension funds.

Finding the optimum solution

Davis Langdon's Banking Tax & Finance Team has developed a model which takes into account both parties' position and all the different variables and specifics of a proposed letting. Based on known information, we can quickly evaluate a specific, or indeed a combination of lease incentive options, to provide a comparison of their relative financial benefits. The service is available to professional advisors, landlords and tenants.

Helpline number:
0800 52 62 62

Whilst every effort has been made to ensure accuracy, information contained in this briefing may not be comprehensive and recipients should not act upon it without seeking professional advice.

For more information please visit
<http://bankingtaxfinance.davislangdon.com>