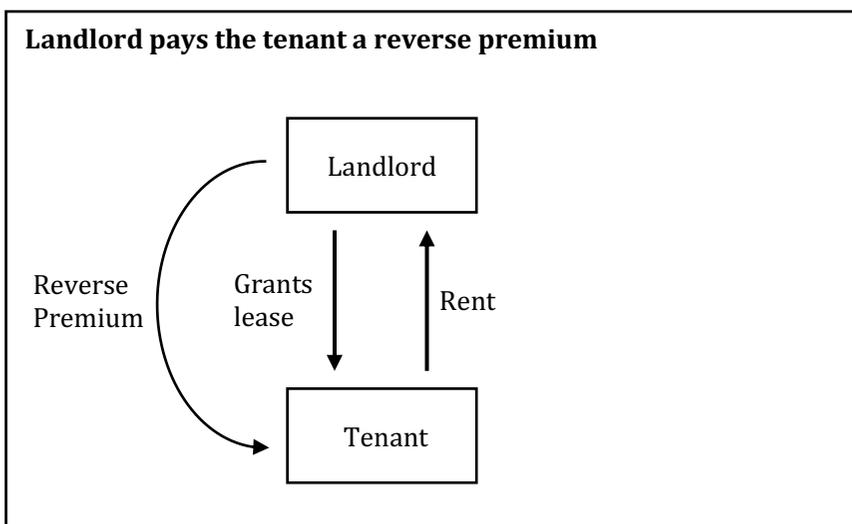


11. The taxation of reverse premiums

11.1 Introduction and overview

11.1.1 Why reverse premiums?

When a landlord grants a lease, he is permitting the tenant to have the use of his property. It is therefore natural to expect the tenant to pay for the privilege, either in the form of rent or a premium or both. Why then, in certain circumstances, is the position reversed? Why would a landlord pay the tenant a sum of money in order to enter into the lease?



There are various reasons as to why a landlord should make an inducement payment to a prospective tenant. Whereas a standard premium involves the landlord receiving a payment to grant the lease on favourable terms to the tenant, the landlord will pay a reverse premium in order to persuade the tenant to enter a lease upon terms which he might otherwise not have agreed to.

In most cases, it all boils down to a question of supply and demand. For example:

- There may be an oversupply of rental properties as a result of a market downturn. In this environment, property investors compete with each other to attract business tenants, who are in a strong position to bargain for lower rents. But lowering

the rent can impact the value of the property – what price will a prospective tenant be prepared to accept in order to enter a lease at a higher rent?

- Alternatively, consider the case where a landlord wishes to attract a better quality tenant – which, in turn, may increase the value of his other rental assets. What price will the landlord offer to attract such a tenant to rent his property, and possibly move away from his existing business premises?

Example 1 – Carraway Towers

Dagenham Investments Ltd (“Dagenham Investments”) is a property investor that has recently acquired Carraway Towers, an office block situated in the City of London. The building was constructed in the 1960s, and was originally let to quality tenants, but has since become run down.

At the date that Dagenham Investments acquires the property, there are only a handful of tenants, whose leases are set to expire within the year. The company does not intend to renew these leases. Instead, it plans to modernise the property and let it out again to a better quality tenant. Dagenham Investments enters into negotiations with leading law firm Camberwick Green LLP (“Camberwick Green”) to take on the top five floors, and is prepared to pay a sum of £10 million as an inducement to enter into the lease.

Camberwick Green is an anchor tenant – by making it known that it has secured such a tenant, Dagenham Investments hopes to attract other professional service firms and financial institutions to take up the rest of the floor space available.

Example 2 – Trumpton Park shopping mall

Belborough Properties Ltd (“Belborough Properties”) has acquired Trumpton Park, a greenfield site, and has successfully obtained planning permission to convert the property into a shopping mall.

The company is to let one of the larger units to Chigleys, a leading department store. The latter will be paid a sum of £10 million and will also be granted a rent holiday for its first year should it take up the lease.

Chigleys is an anchor tenant. Belborough Properties is prepared to grant preferential terms to Chigleys because the presence of such a tenant may attract other businesses to take up space at the mall.

11.1.2 Background to the reverse premium rules

Before 1999, the receipt of a payment as a condition for entering into a lease was not considered to be taxable in the hands of the tenant. The income tax provisions did not apply because the payment was regarded as a capital sum. Neither was the payment subject to CGT:

- There is no disposal of an asset by the tenant on receiving the payment.
- Furthermore, the payment cannot be said to have been derived from an asset owned by the tenant at the time it was made (TCGA 1992, s. 22). In fact, it is the other way round – the asset is derived from the payment as the tenant would not have entered into the lease if he had not received an inducement in the first place.

This view was confirmed in *IRC v Wattie*, a decision of the Privy Council (see however, *Commissioner of Taxation v Montgomery*, a decision of the Australian High Court, where the majority held that an inducement payment was taxable as an income receipt).

The Inland Revenue (as it then was), accepted the *Wattie* decision for leases entered into prior to 9 March 1999. However, legislation was subsequently enacted to govern the position for leases entered into on or after that date. Under the reverse premium rules, an inducement payment is treated as an income receipt and is taxable in the hands of the tenant, irrespective of whether the payment is income or capital. These rules are not limited to monetary payments but also catch certain non-cash benefits.

We now examine the reverse premium provisions in greater detail, dealing with the tenant's position first.

Law: TCGA 1992, s. 22

Cases: *IRC v Wattie* [1998] STC 1160; *Commissioner of Taxation v Montgomery* [1999] HCA 34

11.2 Direct tax treatment – tenant's position

When a landlord pays a reverse premium to induce a tenant to enter into a lease, the latter is treated as having received an income receipt. The payment is taxed in the following way:

- If the tenant has entered into the lease for the purpose of a trade, the payment is treated as a receipt to be taken into account in calculating the profits of that trade.

- In any other case, the payment is treated as a receipt of a property business, irrespective of the nature of the tenant's actual business. For example, the tenant may be an individual looking to reside in the property, or perhaps an investment company that invests in stocks and shares. If the tenant is already a property investor, the receipt is simply added as a receipt of the existing rental business.

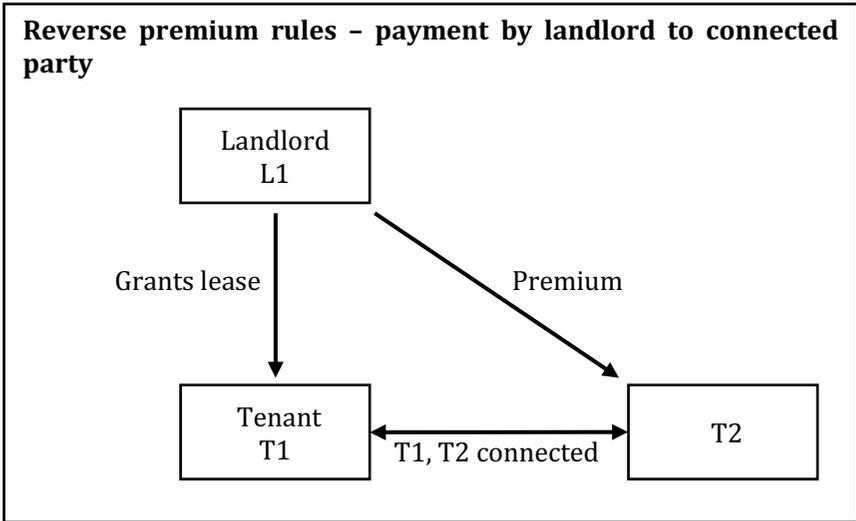
The tax charge is normally spread over a period of time, in line with the accounting treatment. This will depend on the particular accounting standard adopted by the tenant or other person receiving the payment or benefit:

- Both current international and UK accounting standards ("new UK GAAP") require the receipt to be spread on a straight line basis over the whole term of the lease.
- If accounts are being prepared under old "UK GAAP", the receipt must be spread on a straight line basis over either the term of the lease, or (if shorter) the period over which the tenant has the benefit of the lower rental payments. This is usually the period till the date of the first rent review when the rent is expected to be adjusted to market rates.

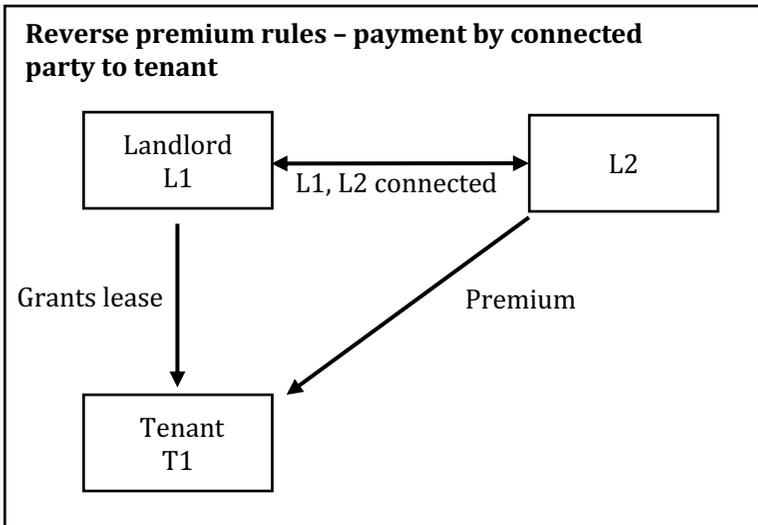
At the time of writing, old UK GAAP has been largely superseded as businesses are being required to report under the new accounting standards, either new UK GAAP or international accounting standards. The transition from one accounting period to another may require adjustments to the timing of the receipt of the reverse premium. For example, a tenant recognising an income receipt over a five-year period under old UK GAAP may be required to re-state the position by spreading the amount over a ten-year period instead. This will, in turn, affect the tax position as the tenant's liability will need to be re-calculated in accordance with the re-stated accounts.

There is a specific exception to the rule that the tax position follows the accounts, namely when payer and payee are connected parties. In this situation the whole of the premium is taxed in the accounting period in which it is received.

The reverse premium rules are not restricted to the case where the landlord pays the premium direct to the tenant. It is also possible that the landlord pays the premium to a party connected with the tenant:



Alternatively, the payment need not come from the landlord, but from a person connected to him.



Furthermore, the connected payer need not pay the tenant but may pay a person connected to the tenant instead.