



LEASE INCENTIVES – DON'T LOSE THE (TAX) BENEFIT

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It is a healthy reminder for both landlords and tenants to carefully review the structure of their next lease incentive arrangement to ensure the full tax benefit is gained by the tenant.

Inducements offered by landlords to potential tenants (or their nominees) to enter into leases are commonly referred to as lease incentives.

Typically incentives are offered to attract prestigious tenants or large space requirement tenants because of their value to the landlord. However, in economic climates where commercial precincts suffer high vacancy rates commercial landlords are willing to open their cheque books and negotiate lease incentives with a broader class of occupant.

Leasing incentives exist due to the leasing practice of landlords. The practice was described in a High Court of Australia decision (*Commissioner of Taxation v Montgomery*) as:

“Substantial capital investment was required to build major office developments. In order to maintain a competitive return, developers and owners frequently sought to protect the capital value of their buildings by fixing high levels of face rental to maintain levels of rental commensurate with the long term growth (CPI) rate or better. The method chosen by some or most of them to induce prospective tenants to commit to pay rentals of that order was to offer a range of leasing incentives. These leasing incentives were, so far as the landlords were concerned, the means of obtaining the agreement of the lessee to a benchmark level of rent fixed by them and were frequently the subject of collateral agreements. What we have so far summarised is the nature or course of the business of developers of office buildings at the time.”

In negotiating commercial lease incentives there are typically two significant differences in the positions of the landlord and the tenant, namely:

1. Market awareness

Landlords typically negotiate incentives from a position of sophisticated financial analysis expected of someone well versed in the drivers of the commercial property market. The size and form of the incentive offered would typically be analysed against the terms of the lease (such as rent review provisions, make good provisions, duration of the lease and the like) to determine the net effect of the incentive.

Tenants on the other hand are typically less sophisticated in their understanding of the commercial leasing market and are less familiar with the market and its trends as infrequent negotiators. Even where a lease negotiator is used, a tenant is usually less informed than the landlord at the negotiating table.

2. Taxation effect

It is also important for both parties to be aware that the various forms of incentives and methods of taking incentives can have different tax consequences for the tenant.

For the landlord a lease incentive is typically on revenue account and therefore considered an expense incurred in earning assessable income. For the tenant, however, the same simple tax analysis does not necessarily follow. The particular circumstances of a tenant and the method and form of the incentive taken have led to a number of well publicised cases concerning the tax effect of a particular incentive. Further, the Taxation Office has issued various rulings on both the income tax and CGT as well as GST effect of lease incentives in cases where it benefits the tenant or related parties. The cases and the rulings collectively warrant careful consideration.

Case study

A tenant client negotiated a term sheet to take commercial office space from a property trust landlord in the Sydney CBD. One of the terms was for the landlord to divide the floor plate by erecting an inter-tenancy wall and provide separate metering of the nominated premises. A further term was for the landlord to fitout the premises, in accord with the plans approved by the tenant, up to a pre-agreed sum. In the event that the fitout cost more than the pre-agreed sum, the tenant would fund the excess. In the event the fitout cost less than the pre-agreed sum, the shortfall would be taken by the tenant as rent free.

The documents were submitted by the landlord's advisers which were not in accord with various matters dealt with in the term sheet, including the arrangement regarding the fitout. The documents submitted required the tenant to fitout the premises, pay for the fitout and thereafter seek reimbursement from the landlord on a submission of paid invoices basis.

Various meetings were held between the tenant and the landlord and various discussions were had between the advisers. It was brought to the attention of the landlord that the structure of the lease incentive could disadvantage the tenant as, amongst other things, the cost of fitout could be seen to be a capital payment and the reimbursement by the landlord could be seen to be a revenue payment. The landlord's response was that it was only willing to provide the incentive in this way as it did not want to have the obligations or financial exposure in respect of the fitout. The tenant observed to the landlord that this was contrary to the term sheet and it would force the tenant to take on a tax risk which was unnecessary.

The matter reached an impasse which resulted in negotiations ending and the tenant informing the landlord it intended to seek alternate premises.

About seven weeks later the landlord agreed to vary its approach to the fitout and an agreement to lease was entered on terms acceptable to the tenant.

In excess of six months after the term sheet was agreed, the agreement to lease was finally executed and the landlord was able to start fitting out the premises.

The lessons from the case are for:

- Landlords - The landlord ran the risk of losing a willing tenant due to its lack of flexibility. Further, the delay in the negotiations meant that the landlord postponed its enjoyment of rent from its investment in the premises for a further six months longer than necessary. The premises had been vacant for some two years prior to the term sheet having been negotiated.
- Tenants – Although a landlord is typically keen to lease premises, tenants should always remember that landlords are usually only concerned for their own position. Tenants should not presume an incentive offered by a landlord is necessarily tax effective to the tenant as

landlords are generally driven by commercial issues separate from the tax effect of the form of the incentive on the tenant.

An understanding of the taxation impact of lease incentives by both parties would have resulted in the transaction being finalised and agreed much faster and would have avoided undue pressure on the landlord and tenant relationship before the tenancy commenced.

This information has been provided by way of service to you to assist you in understanding our work relationship. Clearly there are other issues which might be relevant to your individual circumstances. Should you require any further information, please do not hesitate to contact any member of the Property Team or the Taxation and Superannuation Team at The Argyle Partnership on (02) 8263 6600.