Landlord contributions – avoiding the bear traps

Personal tax | Tax voice



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David Westgate leads us through some difficulties when landlords make contributions

What's the issue?

Landlord contributions to tenants for landlord works (Cat A) and for tenant works (Cat B) are very common. Identifying the different types of contributions at the outset is critical in determining their correct treatment for contractual and tax

purposes. Incorrect treatment of contributions can result in disputes with tenants, significant tax liabilities and penalties.

Tenant incentives

So why do landlords give incentives and what form do these incentives take? In order to answer these questions we need to understand the commercial aspects of a typical lease deal.

A landlord will typically provide a building to a tenant “fit for occupation” and we refer to this as being to a “Cat A” specification. The tenant will of course wish to fit out the space to their own specification and we refer to this as tenant’s “Cat B” works.

In order to incentivise tenants to take space, landlords will typically offer inducements and these tend to take the following forms:

- Rent free period
- Cash
- Contributions towards tenants’ fit-out costs – “Cat B”

In property jargon, monetary inducements are called reverse premiums. Cash and Cat B contributions fall within this category but, a rent free period is not a reverse premium as no money changes hands.

An inducement must be freely given and there must be no expectation or obligation on the tenant to do something, other than enter into the lease. If a payment is made for works that increase the value of the Landlord’s reversion (such as works required to make building ready to let or on fitting out costs which will be taken into account in fixing market rent on a rent review), then this is not a true inducement because a service is being provided.

Practicalities

The issue of incentivising tenants will regularly arise when granting a new lease or as a result of a lease re-gear. A tenant may wish to take space in a building which has yet to be completed by the landlord. In this situation, both Parties will enter into an Agreement for Lease whereby the tenancy is conditional upon the building works

being completed by the Landlord.

As a practical matter, there may be an overlapping period when the tenant may wish to start its Cat B works whilst the landlord is finishing off its own Cat A works. This is particularly the case where the tenant's works are of a nature that impact the landlord's works. In this case, for efficiency and speed, the landlord may employ the tenant as the landlord's sub-contractor to finish works in conjunction with tenant's works. The tenant will then execute the works as a single contract, but obviously, the landlord will have to pay the tenant in respect of its own works.

Tax implications

We can see from above that the landlord makes two types of payment; an inducement to the tenant to enter into a lease and a payment for landlord's works. The tax consequences are different for each and it's therefore critical to identify what type of payment is being made.

Cat A and Cat B expenditure

There is no statutory definition of what constitutes Cat A and Cat B works and although most works should be clearly identified as being within either category, it is not always that clear.

The landlord's and tenant's proposals for allocating costs between Cat A and Cat B will also be influenced by their own tax and accounting treatment so their initial analysis may reflect these influences. One needs to bear this in mind when negotiating.

Cat A expenditure includes raised floors, suspended ceilings, M&E (mechanical and electrical) services and internal wall finishes etc. whereas Cat B expenditure includes such things as final finishes & branding, installation of offices, specialist facilities and reception fit out etc.

Difficulties arise when tenants require enhancements that could fall within either of the above categories. These may range from backup generators, roof terrace enhancements or a higher specification Cat A fit-out. Although these are tenant's requirements they could easily be seen as benefiting the landlord's reversion.

The critical issue is that the Parties agree how the expenditure will be categorised and budgeted at the outset.

VAT – The option to tax (OTT)

The default statutory position under UK VAT law is that supplies of most commercial property are exempt from VAT (Sch. 9 Gp.1 VATA 1994). The impact is that no VAT is charged on rents and the landlord is unable to recover VAT on refurbishment and construction costs.

A commercial property owner can OTT their land and this converts an exempt supply to a taxable supply (Sch. 10 VATA 1994). The impact of this is that the landlord can charge VAT on rents and recover VAT on refurbishment and construction costs.

It should be noted that the OTT is personal to the taxpayer and does not bind the tenant. If the tenant wishes to sub-let part or all of its premises it should seriously consider whether to excise the OTT.

VAT – Contributions and disapplication of the option to tax

There are anti-avoidance rules and where they apply their effect is to disapply the OTT. The rules are complex and they can be triggered on entirely innocent commercial transactions.

Under these rules, disapplication can occur if:

1. a lease is granted to a person who will occupy the premises other than for substantially wholly eligible purposes i.e. for 80% or more vatable activities (e.g. financial services tenant or a charity using the building for exempt fundraising purposes) and,
2. that person has provided financing or entered into an arrangement to provide finance for the grantor’s (landlord’s) development of the land.

The implication for contribution payments is that an option could be disapplied if a tenant pays, wholly or in part, for works which form part of an owner’s capital item e.g.:

- Where a tenant requires higher Cat A specification works and the landlord does not meet the cost or
- Landlord contribution towards Cat A works does not cover the whole of the Cat A works being undertaken by the tenant.

There is no de minimis so even if a tenant financed £1 of owner's capital item, this could in theory invoke disapplication.

Disapplication of the OTT can result in a clawback of VAT and this could obviously be significant if the landlord has just completed a major redevelopment.

An OTT will **not** be disapplied if a tenant pays for works that form part of its own capital item (Cat B works).

VAT – Contributions and invoicing

Taking a lease does not in itself constitute a supply therefore a standard inducement does not trigger VAT. (*ECJ Mirror Group* (Case C-409/98)). Also see VATSC46400.

However, the tenant will have to account for VAT on the inducement if it does something in return such as carrying out works that would otherwise be the landlord's responsibility or where the tenant acts as an "anchor tenant" i.e. with agreement to use the tenant's name to market the site. In either of these situations, there will be a vatable supply by tenant to landlord.

When a non-monetary inducement is provided by way of a rent-free period and the tenant does something in return for taking the lease, this is a vatable barter transaction and the undiscounted value of the rent-free period that relates to the supply will constitute the value of the consideration for the supply.

SDLT and inducements

Monetary inducements that are reverse premiums are not subject to SDLT.

SDLT and early access by tenants under an agreement for lease (AFL)

Entering into an AFL does not constitute a ‘chargeable event’ on the tenant for SDLT purposes unless the AFL is substantially performed (Sch. 17A para 12A (2) FA2003).

Sometimes tenants require early access to the building to commence their works in conjunction with the landlord’s works. Early access given to the tenant (usually under a licence to occupy) will constitute substantial performance as the tenant has taken possession (s44 (5) (a) FA2003) and this will trigger a principal liability to SDLT. In this event, the tenant will have to pay any SDLT due and submit a land transaction return to HMRC.

Construction Industry scheme – (CIS)

Where a landlord makes contributions to a tenant relating to construction operations the landlord may be a deemed (or main) contractor (s59 FA 2004) and the tenant a sub-contractor (s58 FA 2004) under these rules.

Payments fall within the scheme if they are made under a contract relating to construction operations (s74 FA2004). Construction operations are widely defined and include construction, building alterations, repairs, demolition, site preparation etc. Construction operations do not include professional fees e.g. architects and surveyors (unless they are involved in the management of the project), carpet fitting and making and delivery of materials used in construction etc. See guidance manual CIS340.

If the landlord is a deemed or main contractor it has responsibility under UK tax law to withhold tax on certain payments to the tenant (under s61 FA 2004) and account to HMRC for amounts withheld unless the tenant has registered gross (under s63 (2) FA2004) under the scheme. The Landlord will verify the tenant’s CIS registration status with HMRC in accordance with s69 FA2004.

If a contract includes a mixture of construction and non-construction operations, all payments under the contract by the contractor to the sub-contractor will be treated as falling within the CIS.

CIS and contributions

Contributions to tenant’s works which are inducements are excluded from CIS as reverse premiums under Reg. 20 (2) SI 2005/2045. Inducements given as rent free

are outside the CIS as there's no cash payment.

Contributions made in respect of landlord's works are consideration for construction services and CIS is applicable. In this respect the Landlord is obliged to deduct up to 30% from the payments unless the tenant is registered for gross payment.

Where Cat A and Cat B contributions are given under one contract which is often the case, all the contributions will fall within CIS. This point is often overlooked but is easily triggered by, say, giving a carpet and floor box contribution (normally Cat A) combined with a Cat B contribution under the same contract. The CIOT submission on the CIS: Landlord contributions to tenant works can be viewed on the CIOT website.

Corporate tax treatment – Capital allowances (CAs)

In most cases the recipient (tenant) cannot claim CAs where the expenditure has been met by the landlord (s532 CAA 2001). The Landlord's capital contribution is treated as capital expenditure on the provision of P&M for use in the Landlord's business and it is the Landlord that can claim the CAs. S538 CAA 2001 gives the Landlord 'deemed' ownership of the P&M for the purpose of claiming the allowances.

Contributions allowances are pooled separately by the Landlord and they are not impacted by the new mandatory pooling rules under s187A (1) (c) CAA 2001.

Corporate tax treatment – Tenant

Contributions made by a Landlord are, in principal, reverse premiums under s96 CTA 2009 and treated as a receipt of a revenue nature. The tenant is subject to tax on the reverse premium as an income receipt under s98 CTA 2009, spread over the term of the lease.

A payment is not a reverse premium if it is brought into account under s532 CAA 2001 to reduce the recipient's expenditure qualifying for CAs (s97 CTA 2009). Therefore, to the extent that the tenant is unable to claim CAs on the contribution because the expenditure is met by the Landlord, it will be treated as a 'tax free'

capital receipt, (albeit that the tenant’s claim for capital allowances is clearly reduced).

Corporate tax treatment – Landlord

In the landlord’s hands, contributions will represent capital expenditure. If the expenditure is reflected in the state or nature of the landlord’s interest at the time it is sold (s38 (1) (b) TCGA 1992), it will be included in the base cost of the building when calculating the capital gain.