IT 2631 - Income tax: lease incentives

TAXATION RULING NO. IT 2631

INCOME TAX: LEASE INCENTIVES

FOI Embargo: May be released

REF
NO Ref.: 91/247-6 Date of effect: Immediate

BO Ref.: Date original memo issued:

EDR Ref.: 11

FOI INDEX DETAIL

Reference no.:	Subject refs:	Legislative refs:
I 1012601	LEASE INCENTIVES NON CASH BUSINESS BENEFITS	21, 21A, 25(1)

OTHER RULINGS ON THIS TOPIC:

PREAMBLE
Owners of rental premises, particularly in the central business districts of the major capital cities of Australia, often provide incentives to induce businesses to enter into leases of the premises. This Ruling considers the taxation of cash and non-cash lease incentives.

2. The incentives take many forms, including large upfront cash payments, non-cash items such as top of the line motor vehicles or boats, expensive paintings, holiday packages, rent-free or rent-discounted periods for the leased premises or for premises in other cities, free fit-outs of the premises, payment of removal costs or for the surrender of the existing lease, interest-free loans, or a combination of these incentives.

3. In some cases, the incentive is given, not to the lessee, but to a person associated with the lessee.

RULING
IS A LEASE INCENTIVE INCOME?

4. In relation to both cash and non-cash incentives, the question must be asked, does the benefit have an income character?

5. This question was considered by the Full Federal Court in the case of FCT v. Cooling 90 ATC 4472. On 16 November 1990 the High Court refused special leave to appeal against this decision.

6. In the leading judgment in that case, Hill J. quoted from F.C. of T. v. Myer Emporium Ltd 87 ATC 4363 where the Full Court of the High Court said at p. 4367:

> "A receipt may constitute income, if it arises from an isolated business operation or commercial transaction entered into otherwise than in the ordinary course of the carrying on of the taxpayer's business, so long as the taxpayer entered into the transaction with the intention or purpose of making a relevant profit or gain from the transaction."

In Cooling's case, Hill J. went on to say, at p. 4484:

> "Where a taxpayer operates from leased premises, the move from one premises to another and the leasing of the premises occupied are acts of the taxpayer in the course of its business activity just as much as the trading activities that give rise more directly to the taxpayer's assessable income. Once this is accepted, the evidence established that in Queensland in 1985 it was an ordinary incident of leasing premises in a new city building, at least where the premises occupied were of substantial size, to receive incentive payments of the kind in question. Why then should a profit received during the course of business where the making of such a profit was an ordinary incident or part of the business activity of the firm not be seen to be income in ordinary concepts?"

In looking at whether the transaction giving rise to the incentive payment could be characterised as a profit-making scheme, he stated that (at p. 4484):

> "A scheme may be a profit-making scheme notwithstanding that neither the sole nor the dominant purpose of entering into it was the making of the profit."

7. He summarised his position on the same page as follows:

> "In my view the transaction entered into by the firm was a commercial transaction; it formed part of the business activity of the firm and a not insignificant purpose of it was the obtaining of a commercial profit by way of the incentive payment."

Accordingly, he decided that the payment was income according to ordinary concepts.

CASH PAYMENTS

8. In view of the decisions in Myer and Cooling, where a business taxpayer is given a cash incentive to enter into a lease of business premises, the incentive is income of the taxpayer. This position will also apply to amounts paid in consideration of the variation of a lease to take up extra space or to relocate within the same building. An incentive paid to encourage a tenant to remain in the same leased premises would also be income.

NON-CASH PAYMENTS

9. If a non-cash incentive is received in similar circumstances, that is, a business taxpayer receives a non-cash incentive to enter into or vary a lease of business premises, it will have an income character provided that it is convertible to cash, either as a matter of fact or through the operation of section 21A.

10. The question arises as to whether an incentive paid to a taxpayer entering into a lease to commence an entirely new business is income. On balance, it is considered that the decisions in Myer and Cooling could not be interpreted to treat a one-off payment of this kind to a new business taxpayer as income. Such a payment, however, would constitute an assessable capital gain by the operation of subsection 160M(7).

Can a benefit be converted to cash?

As a matter of fact

11. The question of cash convertibility was considered in the case of FCT v. Cooke and Sherden 80 ATC 4140. In that case, as the free holiday provided to the taxpayers could not be cashed in or transferred to anyone else, the Full Federal Court decided that the benefit was not income.

12. Similarly in Tennant v. Smith (1892) AC 150, where a bank employee was bound as part of his duty to occupy the bank house, but was not entitled to sublet the bank house or use it for other than bank business, it was decided that the bank employee could not be assessed on the yearly value of the rent free residence. To quote the extracts from that case used by the Full Federal Court in Cooke and Sherden, Lord Halsbury L.C. said:

> "I come to the conclusion that the Act refers to money payments made to the person who receives them, though, of course, I do not deny that if substantial things of money value were capable of being turned into money they might for that purpose represent money's worth and be therefore taxable."

And Lord Watson held that:

> "profits ... in its ordinary acceptation, appears to me to denote something acquired which the acquirer becomes possessed of and can dispose of to his advantage - in other words, money - or that which can be turned to pecuniary account."

Lord Hannen said:

> "That which could be converted into money might reasonably be regarded as money - but that is not the case before us."

13. The Full Federal Court in Cooke and Sherden went on to conclude:

> "If a taxpayer receives a benefit which cannot be turned to

> pecuniary account, he has not received income as that term is understood according to ordinary concepts and usages."

14. Some non-cash benefits can be converted into cash. An incentive in the form of a car or boat would be readily convertible into cash. In Cooke and Sherden, the Court referred to two cases which had assessed non-cash benefits. In Heaton v. Bell (1970) A.C. 728 an employee was given the free hire of a car. If the employee surrendered the free hire of the car, he would have become entitled to a higher monetary wage. In Abbott v. Philbin (1961) A.C. 352 a secretary of a company was granted an option to purchase shares in the company at a certain price. Lord Radcliffe explained why the monetary value of the option was considered to be taxable:

> "It was not incapable of being turned into money or of being turned to pecuniary account within the meaning of these phrases in Tennant v. Smith ... merely because the option itself was not assignable. What the option did was to enable the holder at any time, at his choice, to obtain shares from the company which would themselves be pieces of property or property rights of value, freely convertible into money."

15. Accordingly, where a non-cash lease incentive can be converted to cash and has been received by a business taxpayer in relation to business premises, as a general rule the benefit will be income.

After 31 August 1988 - section 21A

16. In relation to a non-cash business benefit provided after 31 August 1988, section 21A was enacted to overcome problems associated with cash convertibility. The two principle operative provisions are subsections 21A(1) and (2). Subsection 21A(1) treats a non-cash business benefit which is not convertible to cash as if it were convertible to cash. The subsection counteracts the effects of judicial authority (as, for example, in Cooke and Sherden), that a benefit that cannot be turned to pecuniary account is not income according to ordinary concepts. That is, in determining whether or not non-cash business benefits provided after 31 August 1988 are assessable income, it is not relevant to argue that the benefit cannot be converted to cash. Subsection 21A(2) requires that both "convertible" and "non-convertible" non-cash business benefits provided after 31 August 1988 that are income of a business taxpayer be included in assessable income at arm's length value, less any amount paid as consideration for the benefit.

Otherwise deductible rule

17. Some non-cash lease incentives are revenue neutral, that is, they have no adverse tax consequences. This will be the case if the taxpayer would have been able to deduct the cost of the benefit if he or she had incurred an expense in relation to the benefit.

18. This position is consistent with the Treasurer's Press Release of 4 February 1985 on non-cash benefits which stated that:

> "In those situations where a benefit is used in a way such that its cost would have been fully tax deductible, the benefit will not be subject to tax. Where that cost would have been partly tax deductible, only the non-deductible part of its assessable value will be taxed. Where the benefit consists of an item of depreciable plant, depreciation will be allowed on the basis of its taxable value, but investment allowance will not be available if the plant would otherwise qualify."

19. This policy is put into effect by subsection 21A(3), which stipulates that where a non-cash business benefit is income of a taxpayer in a year of income, and, if the taxpayer had, at the time the benefit was provided, incurred and paid unreimbursed expenditure in respect of the benefit equal to the amount of the arm's length value of the benefit, a once-only deduction would have been allowable to the taxpayer in respect of a percentage of the expenditure, the assessable amount will be reduced by the deductible percentage. This is known as the "otherwise deductible" rule.

20. A once-only deduction for this purpose is defined in subsection 21A(5) as a deduction in a year of income in respect of a percentage of expenditure where no deduction is allowable in respect of a percentage of the expenditure in any other year of income.

21. In accordance with this otherwise deductible rule, revenue expenses such as rent which would have been deductible in that year, if they had been incurred, would be able to be taken into account to reduce the assessable income.

22. Depreciation allowances are not once-only deductions, as defined. Subsection 21A(3) will not apply therefore to reduce the taxable amount of a business benefit in the form of depreciable plant or articles. Nevertheless, consistent with Taxation Ruling No. IT 2308, where a non-cash lease incentive is a new unit of property within the meaning of subsection 54(2), the cost for depreciation purposes will be deemed to be the cost to the landlord.

Rent-free periods and rent discounts

23. In relation to rent-free periods, if the lessee had paid rent or a higher level of rent for the premises, he or she would have been able to claim a deduction for the rent. Accordingly, the effect of the otherwise deductible rule in subsection 21A(3) will be to reduce the taxable amount of the benefit to nil. Section 82KZM would not alter that conclusion in a case where the period of the lease is more than 13 months.

Interest-free loans

24. In relation to interest-free loans, if the lessee had paid interest on the loan, he or she would have been able to claim a deduction for the interest, on an assumption that the loan funds were applied to an income producing purpose. Accordingly, the effect of the otherwise deductible rule in subsection 21A(3) will be to reduce the taxable amount of the benefit to nil. However, available information suggests that consideration is being given to providing long-term interest free loans in lieu of cash incentives. In the circumstances, it would be necessary to establish that the true nature of the transaction was a loan rather than an arrangement for the avoidance of the tax to which Part IVA might apply.

Free fit-outs

25. In relation to a free-fit out, the position will depend upon whether the ownership of the fit-out has passed to the tenant or remains with the landlord.

26. If the landlord has ownership of the fit-out, the only benefit to the tenant is the use of the fit-out during the term of the lease. This benefit will have some value to the tenant, presumably equivalent to a reduction in rent. Payments for the use of a fit-out, as with rental payments, would generally have a revenue character and be fully deductible. Accordingly, such a benefit will be effectively tax-free by the operation of subsection 21A(3).

27. The situation will be different if ownership of the fit-out has been given to the tenant. In those circumstances, if the tenant had incurred expenditure in relation to the acquisition of the fit-out, that expenditure would have been capital in nature so that the "otherwise deductible" rule would not apply to reduce the value of the benefit included in assessable income. However, to the extent that the fit-out represents plant or articles within the meaning of section 54, the lessee would be entitled to claim deductions for depreciation. If the tenant subsequently disposes of the asset, for capital gains tax purposes it will be accepted that the cost base of the asset is its market value in accordance with subsection 160ZH(9).

28. The landlord will be considered to have retained ownership of fixtures which were affixed by the landlord. If the lessee has a contractual right to remove the fixtures, he or she would have a valuable interest in the fixtures akin to ownership. For the purposes of section 21A, the value of that interest is considered to be the cost of the fit-out. The lessee would be entitled to claim a deduction for depreciation to the extent that the fit-out qualifies as depreciable plant or articles. In a case where the lessee has a contractual obligation to remove the fixtures but the landlord may direct that the items remain on the premises, the landlord will be considered to have retained ownership of the fixtures.

29. If in the process of negotiating a lease incentive, it was agreed that a certain percentage of a cash lease incentive would

be expended on a fit-out which becomes the property of the lessor, so that the lessee received from the lessor an amount net of the agreed fit-out costs, only that net amount would be treated as assessable income. However, if the lessee paid for the fit-out after receiving a cash incentive from the lessor, the lessee will be considered to have derived an assessable amount equal to the full cash incentive. In a case where the lessee has responsibility for the fit-out and the lessor pays part or all of the fit-out costs to the contractor, the constructive receipt provisions of section 19 would apply and the lessee will be taken to have derived an assessable amount equal to those payments and any cash incentive.

Free plant

30. If the lessee is given plant or articles such as a computer, the arm's length value of those items will be assessable to the lessee by virtue of subsection 21A(2), but he or she will be entitled to deductions for depreciation.

Holiday packages

31. Subsection 21A(4) has a somewhat similar effect to subsection 21A(3). It reduces the taxable value of a non-cash business benefit to the extent to which any expenditure incurred in providing the benefit is disallowed by the operation of section 51AE, that is, as entertainment expenses. The cost of complete holiday packages comprising travel, accommodation, meals and recreation provided as lease incentives would be treated as non-deductible entertainment expenses for the purpose of subsection 21A(4). The question whether incentives in the form of travel or travel and accommodation are non-deductible entertainment expenses could only be determined in the light of the facts of each case.

Removal expenses

32. Removal expenses other than those relating to the transport of trading stock are not deductible as they have a capital nature - Granite Supply Association Ltd v. Kitton (1905) 5 T.C. 168, Lister Blackstone Pty Ltd v. FCT 76 ATC 4285 and 18 C.T.B.R. (N.S.) Case 47. Hence there will generally be no reduction under subsection 21A(3) in relation to lease incentives in the form of removal expenses paid for by the lessor.

Surrender payments

33. If the lessee had made a payment to a former lessor as consideration for the surrender of a lease, that amount would not have been deductible to the lessee - Cowcher v. Mills & Co. (1927) 13 T.C. 216, West African Drug Co. v. Lilley (1947) 28 T.C. 140. Accordingly, the full amount of a lease incentive provided by a new lessor in the form of a payment to a former lessor for the surrender of an existing lease, would be included in assessable income of the lessee without reduction by subsection 21A(3).

Amounts less than $300

34. If the net income which would be assessed to the tenant by virtue of section 21A does not exceed $300, that amount is exempt income (subsection 23L(2)).

Summary

35. Subject to the more detailed discussion above, the treatment of a non-cash benefit can generally be summarised as follows:

- Cars, boats, paintings and other benefits which can be converted to cash will be taxable at their full money value. A deduction for depreciation will be available if the item is used for the purpose of producing assessable income.

Benefits provided after 31 August 1988 :

- Rent-free periods - effectively tax-free.
- Interest-free loans - effectively tax-free, provided they are genuine business loans and not disguised cash payments.
- Free fit-outs -
  - If owned by landlord - effectively tax-free.
  - If owned by tenant - assessable but a deduction will be allowed for depreciation to the extent that the fit-out qualifies as depreciable plant or articles.
- Free holidays - complete holiday packages comprising travel, accommodation, meals and recreation will be effectively tax-free to the tenant, as the cost will not be deductible to the lessor.
- Free equipment such as computers - assessable but a deduction will be allowed for depreciation.
- Payment of removal costs - fully taxable except to the extent that the costs relate to revenue items such as trading stock.
- Payment of surrender value of existing lease - fully taxable.

Value of the benefit

36. It will necessary in some circumstances to value the benefit. Where section 21A applies, the "arm's length value" of the incentive will be assessable. If section 21A does not apply, the "money value" of the benefit will be deemed to have

been paid to the lessee in accordance with section 21.

37. The arm's length value is defined in subsection 21A(5) to mean, in this context, the amount that the recipient could reasonably be expected to have been required to pay to obtain the benefit from the provider under a transaction where the parties to the transaction are dealing with each other at arm's length in relation to the transaction; or if such an amount cannot be practically determined, such amount as the Commissioner considers reasonable. In determining the arm's length value of the benefit, any conditions that would prevent or restrict the conversion of the benefit to cash should be disregarded (paragraph 21A(2)(b)). In practice the "arm's length value" would normally be the amount which would be paid on the open market from a normal supplier of the particular goods or services.

LESSOR'S DEDUCTIONS

38. The provision of lease incentives will usually give rise to an allowable deduction to the lessor under section 51(1). This would follow from the characterisation of the outgoing as having been incurred for the purpose of gaining or producing assessable income. However, that conclusion may not be appropriate where the true purpose of providing the incentive was not to induce the entering into of the lease, and it might therefore be appropriate to apply Part IVA. Examples might include the purposes of benefiting an associate or shifting income to an associate with carry forward losses. Such cases will depend on their facts including the degree of association between the parties, their relative financial positions and whether the incentive can be characterised as being at arm's length. The general conclusion expressed above would not be appropriate if the landlord retained ownership of the fit-out (refer to paragraph 26). In that case the expenditure is capital in nature and therefore not an allowable deduction under subsection 51(1). Depreciation would be allowable in respect of plant or articles.

39. Where the incentive provided is a rent free or a reduced rent period, the lessor will not be allowed a deduction for the rent forgone because it is not posssible to characterise that forgoing as a loss or outgoing incurred (Commissioners of Taxation v. Antill [1902] AC 422). In addition, in some cases, as explained above, section 51AE might apply to prevent a deduction being allowable where the benefit is in the form of a complete holiday package or other entertainment.

PENALTIES AND INTEREST

40. Section 223 imposes, by way of penalty, additional tax where a person makes a statement in connection with the operation of the taxation law that is false or misleading in a material particular. In the application of section 223, the omission of assessable income derived by a person from a tax return is to be taken as a statement to the effect that the income was not derived (subsection 223(7)). The additional tax

imposed by section 223 is equal to double the amount by which the tax properly payable by the taxpayer exceeds the tax that would have been payable if it had been assessed on the basis that the statement was not false or misleading.

41. If a taxpayer has disclosed the receipt of a lease incentive in his or her return in sufficient detail to have enabled the Commissioner to determine whether or not the incentive should be included in assessable income, but treated it as a non-assessable receipt, section 223 is not considered to apply. However, if on the basis of this Ruling the incentive is a taxable benefit and an amendment of the taxpayer's assessment is made to increase taxable income by the amount of the benefit, interest in accordance with section 170AA is payable on the difference between the tax payable on the amended assessment and the tax previously assessed. Section 170AA applies to assessments made on or after 1 July 1986 in respect of 1985/86 and subsequent income years.

42. Where there has not been a sufficient disclosure, penalty tax would be imposed under section 223.

43. Questions relating to disclosure by companies under the self assessment system are discussed in paragraphs 12-18 of Taxation Ruling No. IT 2624, especially paragraph 15.

44. Broadly, the interest imposed by section 170AA on underpayments of tax is designed to compensate the revenue for the full amount of tax not having been paid by the due date. The interest rate is currently 14.026% per annum.

45. Subsections 227(3) and 170AA(11) give the Commissioner a discretion to remit the whole or any part of section 223 additional tax or section 170AA interest. Any decision to remit needs to take account of the facts of each particular case, as explained in paragraph 8 of Taxation Ruling No. IT 2517. The following guidelines are provided to assist officers in the exercise of the discretion and to help ensure that taxpayers do not receive inconsistent treatment.

46. In accordance with the general policies outlined in Taxation Rulings Nos. IT 2444 and IT 2517 in relation to the remission of additional tax and interest, but subject to the more specific guidelines in those Rulings, the following approach is considered appropriate in relation to lease incentives.

47. If a taxpayer voluntarily discloses the omission of a taxable lease incentive from assessable income, the additional tax imposed by subsection 223(1) may be remitted on the basis specified in paragraph 21 of IT 2517, that is, to an extent necessary to reduce the additional tax to an amount equal to 10% per annum of the tax avoided, subject to a maximum of 50% of the tax avoided in any one year.

48. Where there had been a disclosure of the lease incentive as explained in paragraph 41 above, and the taxpayer voluntarily

advises that an underpayment of tax has resulted from treating the incentive as a non-assessable receipt, interest payable under section 170AA on the underpayment may be remitted on the basis specified in paragraph 16 of IT 2444, that is, to an amount equal to the lesser of interest calculated at the rate of 10% per annum or 75% of interest otherwise payable.

49. It is important for taxpayers to understand that, even though the receipt of a lease incentive may have been disclosed in a tax return, but treated as a non-taxable amount, they will still need to come forward and request amendment of their assessments to take advantage of the remission of interest outlined in paragraph 48. If they do not do so, interest will be imposed at 14.026% per annum under section 170AA instead of the reduced rate explained in paragraph 48 that will apply in voluntary disclosure cases.

50. Consistent with the policy expressed in paragraph 28 of IT 2517, a taxpayer will be considered to have voluntarily disclosed the omission or understatement even though the Taxation Office may have commenced a project to detect undisclosed lease incentives, as long as no ATO action concerning the taxpayer personally or an associated partnership, trust or private company has been initiated. In the case of a partnership, a disclosure made by a partner after the ATO has first made contact with the representatives of the partnership, of which he or she is a member, is not regarded as voluntary in the sense of warranting concessional treatment. Similarly, a disclosure made by a taxpayer after first contact with a trust or private company in which the taxpayer is a principal beneficiary or shareholder (or director) should not be treated as voluntary if the disclosure relates to the taxpayer's interest in the trust or private company.

51. A national audit strategy using both internal and external information on databases is in place. This strategy co-ordinated by the Brisbane Tax Office will enable auditors to identify all recipients of lease incentives. Audit action to give effect to this Ruling will be deferred until 30 April to allow time for recipients to make voluntary disclosures.

52. In cases where an underpayment of tax has occurred and the taxpayer has made a subsection 169A(2) request in relation to the treatment of the lease incentive, and sufficient details were provided to enable the determination of the question at the time the assessment was made, interest may be remitted in full provided that the question had not been ruled on previously by the Commissioner in response to a prior subsection 169A(2) request or Advance Opinion request in a way that differs from the position adopted subsequently by the taxpayer. This is consistent with the policy expressed in paragraph 30 of Taxation Ruling No. IT 2616.

53. In a case where the taxpayer has not voluntarily disclosed the omission of a taxable lease incentive, the discretion under subsection 227(3) may be exercised in conformity with the policy expressed in paragraphs 32-41 of IT 2517 in relation to

"contentious items" for the period to the date of this Ruling and in relation to "non-contentious items" after the relevant date. That is, penalty may be reduced to an amount equal to a per annum rate equivalent to that prevailing under section 170AA, plus (as a culpability component) a flat percentage (5% plus a pro rata percentage adjustment for the non-contentious period) of the tax avoided. The pro rata adjustment may be calculated by multiplying the non-contentious rate, as determined under Taxation Ruling No. 2517, minus 5% by the fraction obtained by dividing the non-contentious period by the total period.

54. As mentioned in paragraph 19 of IT 2517, something may be regarded as contentious where the relevant law is unsettled or where, although the principles of law are settled, there is a serious question about the application of those principles to the circumstances of the particular case. The matter could not be treated as contentious from now on. Where a taxpayer fails to disclose a taxable lease incentive in a return of income lodged after the date of this Ruling, the policy set out in paragraphs 31-41 of IT 2517 relating to the non-voluntary detection of non-contentious items should be observed.

55. If the taxpayer made a sufficient disclosure of the receipt of the lease incentive in his or her return, but claimed that it was not assessable, and has not voluntarily disclosed an underpayment, interest will be payable in accordance with section 170AA at the rate of 14.026% per annum provided that penalty tax has not been imposed under Part VII.

DATE OF EFFECT

56. This Ruling will apply to all cash lease incentives, and to all non-cash lease incentives that are readily convertible to cash, such as cars, boats and paintings. In relation to "non-convertible" non-cash lease incentives, the Ruling will apply to incentives provided after 31 August 1988 to which section 21A applies.

COMMISSIONER OF TAXATION
5 April 1991

ADDENDUM

Since Taxation Ruling IT 2631 issued on 5 April, 1991, questions have been raised about the application of the last sentence of paragraph 29.

2. That sentence is considered to apply only where the lessee is to have ownership of the fit out or a right to remove the fit-out as discussed earlier in the Ruling. In the context of paragraph 29, a lessee will be considered to have responsibility for a fit out if he or she enteres into contracts relating to the fit out as principal or as agent of an undisclosed principal.

3. Paragraph 23 of the ruling should be altered so that the

last sentence reads:

> 'Section 82KZM would not alter that conclusion in a case where the rent free or rent discounted period is more than 13 months.'

COMMISSIONER OF TAXATION
8 August 1991