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briefcounsel

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IRD channels Muldoon on lease inducement payments

The IRD yesterday issued a statement summarily reversing a 14 year old Privy Council decision relating to lease inducement payments.

Worse, it suggested that it would apply the change immediately – before the new policy has even been introduced into Parliament, let alone enacted.

In our view, this is entirely inappropriate and reminiscent of then Prime Minister Rob Muldoon's 1975 announcement that workers could stop paying superannuation contributions before the law permitting this was passed.

The IRD's statement

Taxpayers should be on their toes after yesterday's announcement by the IRD that they plan to make lease inducement payments taxable even before legislation effecting the law change has been written or submitted on.

The statement suggests a change to the tax legislation to make previously untaxed "inducement payments" taxable. This includes any payment by a landlord to a lessee to induce the lessee to enter into the lease.

The proposed changes include not just leases, but inducement payments and other payment "in connection with" a contract that grants an interest in land. Tax on the payment would not have to be paid up front, but would in most cases be spread over a number of tax years.

IRD has raised a number of options for the period over which lease inducement income could be spread (a) the life of the lease or interest in land; (b) the period from entering into the lease until the first rent review; or (c) potentially a set period of time e.g. six years as is the case for spreading of lease premium income.

Retrospectivity

The IRD proposes that the changes, when enacted, would take effect from yesterday, the date the officials' issues paper was released. The IRD justifies the retrospective legislation by saying that taxpayers who make lease inducement payments after yesterday "would be aware of the proposed changes".

We object very strongly to a purported change of law by the IRD, a member of the Executive branch of government. Changes to legislation only have effect when Parliament passes an amendment. Until that time, taxpayers are entitled to rely on the law as it is written on the books, not as proposed by the tax department.

Muldoon was held to have been in breach of the Bill of Rights 1688 when he attempted a similar action back in 1975.[1] Muldoon said that workers could stop paying superannuation contributions as he would introduce and pass legislation in Parliament in the 1976 Parliamentary session which would retroactively abolish the superannuation scheme. The court held that "the pretended power of suspending" laws by the Executive was illegal.

In our view, IRD's announcement yesterday is attempting the same thing. The "pretended power" of imposing tax on lease inducement payments, prior to consideration and ratification by Parliament, is unconstitutional. It is also not in keeping with the IRD's Generic Tax Policy Process *(GTPP)*, which requires consultation on most matters before changes are proposed or enacted. Though the IRD argues it does not have to follow the GTPP where "immediate action" is needed to protect the revenue base, this cannot be justified in the present case as this risk has been present in New Zealand tax law at least since 1997.

The change is significant, and the detail of it has yet to be worked through. Taxpayers are entitled to know what the tax law is before they enter into transactions on which tax is assessed. To suggest taxpayers are, as a result of the issues paper, in a position to understand their tax risks in this case is simplistic and naive.

Substance of the paper

We do not have a problem with the substance of the IRD's suggestion. However, the timing of the paper means that it is difficult to work through the detail of the proposals and their ramifications. Consultation with tax professionals and taxpayers is necessary to ensure that there is no unintended fallout from these changes and that the changes are part of coherent scheme of reform.

It was settled in New Zealand in 1997 in *Wattie*[2] that lease inducement payments were receipts of a "capital" nature, and therefore were not taxable. In that case, the accounting firm Coopers and Lybrand accepted an inducement from the owners of what is now the ANZ Tower. The Privy Council held that the payment was not taxable as it related to a fixed capital asset of the business, the lease. The IRD's statement proposes to reverse this decision.

The IRD argues there is some risk to the revenue base as the payments are generally deductible to the landlord. This is because, from the landlord's point of view, the leases are not long-term capital assets but are more like trading stock. The fact that two businesses can treat the same asset (and the same payment) as capital for one and revenue for the other has been an accepted part of income tax law since its inception. The nature of payment in the hands of the recipient has no bearing on the characterisation of that payment as capital or revenue for the payer. In some cases a payment can be both assessable and non-deductible.

The IRD benefits from this asymmetry in the reverse direction. When a lessee has to pay a "break fee" to exit early from a lease that has become onerous, this will usually be non-deductible to the tenant as the lease is a capital asset (see for example *McKenzies*[3]). However, the receipt of the break fee by the landlord will be taxable. The IRD is not currently proposing to reverse this particular asymmetry.

We advise taxpayers who may make or receive lease inducements or similar payments to contact us to discuss how this proposed change may affect them.

Footnotes

1. See *Fitzgerald v Muldoon* [1976] 2 NZLR 615

2. *Wattie v Commissioner of Inland Revenue* (1997) 18 NZTC 13,297

3. *Commissioner of Inland Revenue v McKenzies New Zealand Ltd* (1988) 10 NZTC 5,233

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