Property tax issues for partnerships

Given the significance of the property requirements of firms, and the potential for property costs to be a very significant part of the profit and loss account, we are often called upon to advise on property related matters. We set out below some of the areas that you may need to be aware of.

Subletting surplus space

For those with surplus property space, subletting this to a third party can be a valuable way of mitigating the excess costs that arise. The tax rules in relation to this are far from straightforward so we highlight some points for consideration. The accounting treatment is that the income received is shown in the profit and loss account as other income and the net effect is that the total rental expense of the firm is reduced by the sublet income received. Most firms assume that the tax treatment in relation to the letting of surplus space will simply follow the accounting treatment; however, there are strict conditions that need to be met in order for this to be the case.

The conditions are that:

- The space being sublet must only be temporarily surplus to trade requirements. Specifically, the accommodation must have been used within the last three years for the trade or it must have been acquired in the last three years.
- The premises concerned must be used partly for the firm’s trade and partially let.
- The sublet income receipts are ‘relatively small’ (which is undefined).
- The rent relates to surplus accommodation only and not land.

If any of the above conditions are not met, the surplus space is required to be treated as a separate rental trade and the corresponding costs will have to be stripped out of the firm’s deductible expenses.

The condition most often not met is the three year limit on the sublet period. Many firms we speak to are unaware that going beyond a three year sublet triggers the need for the rental income received and associated expenses to be shown as a separate rental business.

Quite often in this scenario, firms are simply seeking to achieve a contribution towards fixed rental costs and in the current market, many of these subleases are generating income that is less than the head lease rental cost. Unfortunately, rental losses can only be set against rental profits and cannot be used against trading profits. As most firms don’t have any rental profits to relieve these losses they become trapped.

The need to strip out rental costs from the trading profit tax computation also has the effect of increasing taxable profits. Therefore, in order to assess the overall commercial benefit to the firm of any sub-let intentions, the increase in tax payable has to be weighed up against the value of the income received from sublease.

Put simply, where profits are taxed at the highest rate of 47%, if space is left as excess to requirements it’s ‘net cost’ is effectively 53% of the rent cost (ie after tax relief at 47%). Therefore, the income received from the sublease will need to be at least 47% of the cost of the unused premises in order for the sublease to start to be beneficial. In reality, because of the additional administrative burden associated with having to treat the sublease as a separate rental business, firms may want this percentage to be higher before they see it as a worthwhile option.
Lease premiums
It has become more common in recent years for landlords to offer a variety of different types of inducement to firms as they enter into new leases. Typically these will be cash payments, rent-free periods or contributions towards fit-out costs.

The income tax treatment of these different incentives varies and therefore we set out a summary as follows:

- A cash payment received by a firm from a landlord is normally treated as a reverse premium and therefore taxed as a business receipt. The timing of the tax is determined by the accounting treatment, which will require this benefit to be spread over the period to the first rent review (UK GAAP) or the full lease term (IFRS and FRS102). Therefore, tax arises in line with the credit to the firm’s profit and loss account.

- A rent-free period is not taxable as a business receipt. Tax again follows the accounting treatment, namely that the benefit of the rent free period is spread over the period to the first rent review (UK GAAP) or the full lease term (IFRS and FRS102), meaning that the actual rent payable over the period of the lease is spread evenly over that period. Therefore, during the rent free period, you are entitled to tax relief for the rent charge included in the profit and loss account even if no payment is made to the landlord. In later years, once the rent free period has expired, you will be likely to be paying the landlord a greater amount than the rental charge in the profit and loss account and the tax relief is therefore lower than the payments. Overall, the tax relief is accelerated by following the accounting treatment.

- A contribution by a landlord towards a firm’s fit out costs is taxable as a business receipt, other than to the extent that the firm uses the contribution to purchase items that qualify for capital allowances. This exemption from tax where qualifying assets are purchased does though mean that the firm is not then entitled to claim capital allowances on these assets (ie – there cannot be a duplication of the tax benefit).

Surrender of a lease
If a tenant wishes to exit their current premises or finds a lease onerous, they may be prepared to pay a sum to the landlord to achieve a surrender of the lease. Often the outgoing tenant may obtain no tax deduction for the payment, but the landlord remains taxable on the receipt. There may be other factors involved in the termination of the lease (for example where the tenant is liable for dilapidations) so careful upfront consideration should be given to such situations so as to avoid unintentionally triggering additional tax.

It is also not uncommon for a tenant to receive a payment from the landlord in return for the surrender of a lease. This can trigger a capital gain for the tenant, the calculation of which can become quite complicated and the potential liability should not be overlooked when considering a property move.

These payments can be structured in a manner to maximise any available tax relief and may provide the landlord/tenant with the opportunity to negotiate a better settlement.

Other issues
It is also important for tenants to consider the VAT and Stamp Duty Land Tax (SDLT) implications of any lease transaction.

For example, on the grant of a new lease, SDLT will be chargeable on a premium payable by the tenant as well as on the rents payable.

With regard to VAT, if an Option to Tax has been made by the landlord on the premises in question VAT will be payable on both the premium paid for the lease as well as on the rents. This should not be a major issue as most firms should be able to reclaim this input VAT.

Next steps
The above headline issues give an indication of the many areas where early consideration of issues surrounding property decisions could prove beneficial. In some cases, a full awareness of the tax implications of seemingly similar commercial decisions could help you to avoid triggering additional tax. In other cases, the tax due is the tax due and whilst it may not be able to be mitigated, early consideration of the issue will ensure you are aware of the impact and can incorporate this into the cost / benefit assessment and the associated cash forecasting. Therefore, if you are considering transactions where any of the above items are present, do contact your local Grant Thornton contact so that we can help you identify and address the issues that could arise.
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