

Lease Taxation

What are the key tax considerations for tenants re-negotiating with landlords?

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Introduction



The COVID-19 pandemic has accelerated the structural changes which were seen in the retail and hospitality markets pre-pandemic, such as a shift to online and delivery models. This lower footfall and decreased demand materially impacted site revenue, profitability, and a tenant's ability to pay rent.

We will discuss the key tax considerations for those tenants entering discussions with landlords hoping to improve financial performance, explaining the differences between negotiating lease terms within or outside of an insolvency procedure.

Lease surrenders and variations

Given the wider market conditions and shifts in behaviours, tenants may approach their landlords to amend the existing terms of their lease or exit the lease altogether.

Amending the lease: Where the lease is not simply exited, the terms of leases may be varied; such amendments may include (but are not limited to):

- extension / reduction of the length of the lease;
- increase / decrease of the quantum of rent; and
- including an option to terminate the lease.

Common features of both amending/exiting the lease: Regardless of the way the terms of lease are amended or exited, there are often some common features, for instance:

- the lease is an onerous lease (with corresponding onerous lease provisions having been recognised in the financial statements);
- the lease has dilapidation provisions recognised;
- a payment may be made by the tenant to the landlord for the surrender or variation; and
- as part of the surrender or variation, some or all of the existing rent arrears will be waived.



Tax considerations

UK Corporation Tax

From a UK corporation tax perspective, there are two material consequences from the surrender or variation of a lease.

1. Onerous lease provisions and dilapidation provisions

On the surrender of a lease, any associated onerous lease provision and dilapidation provision (if any) will be reversed giving rise to a taxable credit in the period in which they are released. For companies that have adopted International Financial Reporting Standards, rather than the reversal of an onerous lease provision, there may be an analogous reversal of an impairment of a “right of use” asset in respect of the lease.

Where there are significant brought forward tax losses, normally only 50% of the current year profits in excess of £5m can be sheltered using brought forward losses (in addition to any current year losses). Hence, companies which are undertaking a group wide lease renegotiation strategy may be unable to shelter all the taxable credits that arise.

Distressed scenarios

In specific circumstances, there is a tax exemption which may allow tenants to access their remaining brought forward losses to shelter tax credits arising on the reversal of onerous lease provision. In order to utilise this exemption, the business must:

1. be within an insolvency procedure; or
2. demonstrate that there is a material risk that at some time within the next 12 months the business would be unable to pay its debts as they fall due.

Where a company is within an insolvency procedure, the test to meet the exemption should be clear. However, where negotiations with landlords are undertaken outside of an insolvency procedure, the second limb of the test is clearly more subjective and the company will need to be comfortable that it meets the test given there is no statutory definition of “unable to pay its debts”.

We note that this exemption only applies to onerous lease provisions. Neither the reversal of a dilapidation provision nor (unfortunately due to the very specific scope of the exemption) of a right of use asset impairment (under IFRS) qualify. Hence, any taxable credit arising on the reversal of dilapidation provisions or right of use asset impairments will need to be sheltered using available current year tax losses (or restricted brought forward losses) making a cash tax charge much more likely.



2. Rent waivers

The waiver of rent arrears will be taxable in the hands of the tenant.

To the extent that unpaid rent accrues in the same accounting period as the waiver, there should be no corporation tax impact as the deduction and income arise in the same period.

It should be noted that if the accrued rent has arisen in a previous financial period to the waiver, the release will prima facie be taxable and, similar to onerous leases, may only be sheltered using current year losses and brought forward losses.

Nonetheless, to the extent that the rent arrears have accrued in the accounts as a trade creditor, the arrears may be considered as ‘relevant non lending relationships’ (“RNLRs”). The advantage of this is that the rent arrears may then fall within the loan relationship provisions where there are many tax exemptions in respect of releases.

Distressed scenarios

In a distressed scenario, it may be possible to exempt a potential taxable credit if the company is either:

1. in a statutory insolvency arrangement; or
2. if immediately before release it is reasonable to assume that, without the arrangements of which the release forms part, there would be a material risk that at some time within the next twelve months the company would be unable to pay its debts.

Again, there is far greater clarity in waiving the debts as part of an insolvency arrangement. If not, for these purposes, a company is “unable to pay its debts” if:

- it is unable to pay its debts as they fall due; or
- the value of the company’s assets is less than its liabilities, taking into account its contingent and prospective liabilities (the so-called “insolvent balance sheet test”).

In our experience, HMRC tends to adopt a stricter approach when determining “unable to pay its debts” and expect most commonly that a company would be able to demonstrate that it satisfies both limbs of the test (i.e., is balance sheet insolvent and unable to pay its debts as they fall due).

If a company is relying on the corporate rescue exemption, we would strongly recommend that a defence file is created to demonstrate its application. This is particularly important when any HMRC challenge in future years would inevitably arise after any turnaround in fortune and therefore offers the opportunity to question if the company’s affairs were genuinely in that perilous a position. Having worked closely with HMRC around the introduction of the exemption, we are in a particularly strong position to advise clients in this area.

Stamp Duty

Where a lease is surrendered, a payment from the tenant to the landlord does not attract stamp duty land tax (“SDLT”) since such reverse premium payments do not count as chargeable consideration.

Where the rent arrears are waived and the quantum is less than the market value of the lease, stamp duty may arise. However, it is unlikely to be an issue where it is an onerous lease where the rent waived is the element exceeding normal market terms.

The SDLT position is considerably more complicated in respect of lease variations and should be considered on a case-by-case basis.

Where a tenant makes a payment to a landlord in return for the landlord surrendering the lease, this will broadly be a supply by the landlord to the tenant, which should be subject to VAT both where the landlord has and has not opted to tax the property.



VAT

Where VAT is charged on the surrender payment, then the tenant should be able to recover this VAT on the basis that it relates to its taxable business activities. Therefore, this should not be a cost to the company.

In respect of historical rent arrears, if these remain unpaid, a tenant will need to repay to HMRC any input tax it has recovered previously on those rents. This will either be due to the bad debt relief rules, (which require a company to repay input tax if a debt remains unpaid more than six months from the date of the invoice) or if the landlord issues a credit note for the rent previously invoiced. Either way, any VAT recovered will need to be repaid and this will create a cash flow cost for the company.



How Teneo can help

We have a market leading team of experienced and commercial tax professionals who specialise in the restructuring market.

Our strong project implementation skills ensure our advice results in appropriate steps and actions to produce a realistic, practical, and user-friendly deliverable.

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