Landlord contributions to tenants: the commercial aspects of a lease deal

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In order to incentivise tenants to take space, landlords will typically offer inducements to tenants. The commercial aspects of a typical lease deal can have a significant impact on how landlord contributions to tenants are taxed.

Key Points

What is the issue?

Landlord contributions to tenants for landlord works (Category A and Category A+) and for tenant works (Category 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.

What does it mean for me?

The landlord may make 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 is therefore critical to identify what type of payment is being made.

What can I take away?

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

This article supersedes a previous article published in July 2017 'Landlord contributions – avoiding the bear traps'. Due to the changes in working practices, new legislation and a number of amendments to existing legislation, I feel it is appropriate to provide a comprehensive update.

Landlord contributions to tenants for landlord works (Category A and Category A+) and for tenant works (Category 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. There are four classifications of fit out used by the property industry (see ***Four categories of fit out used by the property industry*** for further information).

Difficulties arise when tenants require enhancements that could fall within more than one of these categories. These may range from backup generators, roof terrace enhancements or a higher specification Category 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, which may be driven by their own tax and accounting treatment. In order to incentivise tenants to take space, landlords will typically offer inducements, which tend to take the following forms:

- a rent-free period;
- cash; and
- contributions towards tenants' fit-out costs (Category B).

In property jargon, monetary inducements are called reverse premiums. Cash and Category B contributions fall within this category buta 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 a 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.

Four classifications of fit out used by the property industry

Shell and Core: The first category is Shell and Core, which includes only the most basic elements of the building. It generally refers to the structural framework and exterior envelope of the building.

Category A: A landlord will typically provide a building to a tenant 'ready for fit out'. It includes the essential infrastructure and finishes necessary for occupancy, such as raised floors, suspended ceilings, M&E (mechanical and electrical) services and internal wall finishes.

Category A+: This is an enhanced level of Category A. To reflect the changing nature of the workplace dynamic, landlords are also providing fully furnished space, including enhanced features such as meeting rooms, break out spaces, kitchenettes, desking and advanced IT infrastructure, allowing tenants to move into a ready to use space.

Category B: The tenant can, of course, fit out the space to their own specification and customisation. Category B expenditure includes such things as final finishes and branding, installation of offices, specialist facilities and reception fit out, etc.

Practicalities

The issue of incentivising tenants will regularly arise when granting a new lease or as a result of a lease re-gear (the renegotiation of a lease during its term). A tenant may wish to take space in a building which has yet to be completed. 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 bean overlapping period when the tenant may wish to start its Category B works whilst the landlord is finishing off its own Category 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 the 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 may make 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 is therefore critical to identify what type of payment is being made.

Note that reference to Category A includes reference to Category A+ unless specifically stated.

VAT

The option to tax

The default statutory position under UKVAT law is that supplies of most commercial property are exempt from VAT (Value Added Tax Act (VATA) 1994 Group 1 Sch 9). 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 opt to tax their land and this generally converts an exempt supply to a taxable supply (VATA 1994 Sch 10), subject to any disapplication (see below). The impact of this is that the landlord will charge VAT on rents and recover VAT on refurbishment and construction costs.

The option to tax 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 opt to tax its own title. By contrast, supplies of construction services (e.g. the tenant carrying out Category A works for the landlord) will generally be standard-rated regardless of any option to tax, unless they qualify for one of the specified categories of zero-rating.

Contributions and disapplication of the option to tax

There are anti-avoidance rules and where they apply their effect is to disapply the option to tax. The rules are complex, and whilst they are intended to catch schemes by VAT exempt businesses to recover VAT on construction costs, they can be triggered on entirely innocent commercial transactions.

Under these rules, disapplication can occur if:

- 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. a financial services tenant or a charity using the building for exempt fundraising purposes); and
- 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 to tax could be disapplied if a tenant pays, wholly or in part, for works which form part of the landlord’s capital item; for example, where:

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

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

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

An option to tax will **not** be disapplied merely because a tenant pays for works that form part of its own capital item (Category B works).

Contributions and invoicing

Taking a lease does not in itself constitute a supply; therefore, a standard inducement does not trigger VAT. (See the European Court of Justice judgment in *Mirror Group* (Case C-409/98) and also the VAT Supply and Consideration Manual 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 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, subject to the comment below, a VATable barter transaction. The undiscounted value of the rent free that relates to the supply will constitute the value of the consideration for the supply.

When a non-monetary inducement is provided by way of a rent free in return for extending the lease, the removal of a break clause or granting a reversionary lease, this does not constitute a supply for VAT purposes and is not therefore a barter transaction (Revenue and Customs Brief 11 (2020).

The Construction Industry Scheme

Where a landlord makes contributions to a tenant relating to construction operations, the landlord may be a deemed (or mainstream) contractor (Finance Act 2004 s 59) and the tenant a sub-contractor (Finance Act 2004 s 58) under these rules.

Payments fall within the Construction Industry Scheme if they are made under a contract relating to construction operations (Finance Act 2004 s 74). 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 the making and delivery of materials used in construction (see Construction Industry Scheme Guide CIS340).

If the landlord is a deemed or mainstream contractor, it has responsibility under UK tax law to withhold tax on certain payments to the tenant (Finance Act 2004 s 61) and account to HMRC for amounts withheld unless the tenant has registered gross under the scheme (Finance Act 2004 s63(2)). The landlord will verify the tenant's Construction Industry Scheme registration status with HMRC in accordance with Finance Act 2004 s 69.

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

Construction Industry Scheme and contributions

Contributions to tenant's works which are inducements are excluded from the Construction Industry Scheme as reverse premiums under SI 2005/2045 Reg 20(2). Inducements given as rent free are outside the scope of the Construction Industry Scheme as there is no cash payment.

Contributions made to tenants in respect of landlord's works meeting the conditions set out in SI 2024/308 Reg 20A are outside the scope of the Construction Industry Scheme (see below).

Contributions made to tenants in respect of landlord's works excluded from the provisions of Regs 20 and 20A are consideration for construction services and the Construction Industry Scheme 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.

Contributions falling under Reg20A

SI 2024/308 Reg 20A exempts Category A payments made by or on behalf of a landlord to a tenant under a construction contract from the definition of ‘contract payment’ in Finance Act 2004 s 60. If all five conditions of the SI are met the payments will be out of scope for the Construction Industry Scheme.

One of the conditions of Reg 20A states that the landlord’s payment to a tenant has to be for works that are intended primarily for the benefit and use of the tenant that occupies or will occupy the property under the lease. This extends to works that provide incidental benefits to the landlord and tenants and/or minor structural works specific to the tenants’ needs. The guidance at Construction Industry Scheme Reform Manual CISR14048 provides further clarification and some examples of how to apply this in practice.

If the landlord’s payment (or any part of the payment) is not for works intended primarily for the benefit and use of the tenant, Reg 20A will not apply and the whole payment will be within scope of the Construction Industry Scheme.

The condition that the payments have to be primarily for the benefit and use of the tenant that occupies or will occupy the property under the lease is to ensure that the Construction Industry Scheme provisions cannot be circumvented by routing works that are unrelated to the tenant’s demise via the tenant or, in extreme cases, grant a lease so as to make a sub-contractor a tenant for the purposes of the regulation.

Interaction with the domestic reverse charge

If the Construction Industry Scheme is applicable to Cat A payments made by a landlord to a tenant (i.e. Reg 20A does not apply), such payments are excluded from domestic reverse charge under Article 8(1)(b)(ii)(bb) on the basis that the landlord and tenant have a relevant interest in the same land. The landlord will need to issue a *written notification of its end user status* to the tenant for VAT to apply in the normal way – otherwise the domestic reverse charge will apply.

If the Construction Industry Scheme is not applicable to payments made by a landlord to a tenant due to the payments meeting the conditions in Reg 20A, such payments are outside the scope of the domestic reverse charge. For VAT purposes, the payment is to be accounted for as normal by default and there is no need for a written notification of end user status.

Stamp duty land tax and inducements

Monetary inducements that are reverse premiums are not subject to stamp duty land tax.

Stamp duty land tax and early access by tenants under an agreement for lease

Entering into an agreement for lease does not constitute a ‘chargeable event’ on the tenant for stamp duty land tax purposes unless the agreement for lease is substantially performed (Finance Act2003 Sch 17A para 12A(2)).

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 (Finance Act 2003 s 44(5)(a)) and this may trigger a principal liability to stamp duty land tax. In this event, the tenant may have to pay any stamp duty land tax due and submit a land transaction return to HMRC before the lease has actually been granted.

Capital allowances

In most cases, the recipient (tenant) cannot claim capital allowances where the expenditure has been met by the landlord (Capital Allowances Act 2001 s532). The landlord’s capital contribution towards a tenant’s fit-out costs is treated as capital expenditure on the provision of plant and machinery for use in the landlord’s business and it is the landlord that can claim the capital allowances. Capital Allowances Act 2001 s 538 gives the landlord ‘deemed’ ownership of the plant and machinery for the purpose of claiming the allowances.

Contributions allowances are pooled separately by the landlord, and they are not impacted by the mandatory pooling rules under Capital Allowances Act 2001 s 187A(1)(c).

Capital allowances and corporate tax treatment: tenant

Contributions made by a landlord towards the tenant’s fit-out costs are, in principal, reverse premiums under Corporation Tax Act 2009 s 96 and treated as a receipt of a

revenue nature. The tenant is subject to tax on the reverse premium as an income receipt under Corporation Tax Act 2009 s 98, spread over the term of the lease.

A payment is not a reverse premium if it is brought into account under Capital Allowances Act 2001 s 532 to reduce the recipient's expenditure qualifying for capital allowances (Corporation Tax Act 2009 s 97). Therefore, to the extent that the tenant is unable to claim capital allowances 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).

Capital allowances and 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 (Taxation of Chargeable Gains Act 1992 s 38(1)(b)), it will be included in the base cost of the building when calculating the capital gain.

Capital allowances and Category A+ considerations: landlord

When the government introduces new enhanced allowances provisions such as the super deduction and more recently, full expensing, these allowances do not generally extend to plant and machinery lessors, except in regard to 'background plant' in leased buildings (although this restriction is currently under review for full expensing). Background plant refers to the type of installations generally installed in most buildings. SI 2007/303 tells us what is included and excluded from the definition of background plant and machinery.

If a landlord contributes towards a Category A+ fit out, the works may include the provision of fixed and loose 'furniture fittings and equipment' (equipment). Loose equipment qualifies as plant and machinery but does not qualify as background plant and machinery (unlike fixed equipment) and will not therefore be eligible for enhanced allowances unless the government extends new enhanced allowance provisions to plant and machinery lessors.

If loose equipment is included in a capital allowance claim for a Category A+ fit-out, it should be separately identified to ensure it is excluded in the event of bringing in a disposal value for a s198 election. This is because it is not a fixture for capital allowance purposes under Capital Allowances Act 2001 s 173.

If a property includes loose equipment, these are normally identified as chattels. These items should be separately documented in the sales pack with a separate value. This value can then be taken out of the capital allowance pool on disposal.

Finally, consideration should be given to the long funding lease rules which may be relevant depending upon the amount of loose equipment included in a Category A+ fit-out. A discussion on the long funding lease rules is outside the scope of this article.

Tenant requested modifications

The scope of this article is limited to the tax implications of payments made by landlords to tenants. The tax issues pertaining to payments that tenants make to landlords in respect of tenant requested modifications are outside the scope of this article (save as regards the comments made in relation to the possible disapplication of the option to tax above).