



PREMIUMS FOR THE GRANT OF A LEASE

- THE TAX TREATMENT

When the owner of the freehold of a property grants a lease to a new tenant, it is not unusual for the tenant to pay a lump sum up front, as well as agreeing to pay an amount of rent monthly or quarterly during the term of the lease. Such an upfront payment is usually known as a “premium”. Note that here we are talking about the grant of a new lease from the landlord to the tenant, not the “assignment” of an existing lease from one tenant to another, for which the rules are different.

The tax treatment of a premium depends on the length of the lease concerned. For leases of less than two years, the premium is simply treated as additional rent. For leases of more than 50 years, the premium is treated as a payment for a disposal of part of the property,

giving rise to a capital gain in the hands of the landlord.

For leases of between two and 50 years, the treatment is more complicated, and works by splitting the premium into two payments – one of rent, and the other of a capital sum. The calculation is quite simple. Take the number of complete years in the term of the lease, deduct one year, and multiply the result by 2%. This gives you the capital gains element of the premium, and the balance of the payment is rent.

For example, if Mr Jones pays a premium of £10,000 for a twenty-one year lease of a shop, the capital element is £4,000. Twenty times 2% is 40%, and 40% of £10,000 is £4,000. The other £6,000 is treated as rent.

If the tenant is able to deduct the rent he pays from the income of a business, as can Mr Jones the shopkeeper, he can also deduct the “rent” element of the premium he has paid.

Because the lease is for twenty-one years, Mr Jones can deduct £286 (£6,000 divided by 21) each year from his income from trading in the shop, as if it were rent, in addition to the actual rent he pays. The landlord who granted the lease, however, is treated as receiving £6,000 rent in the first year, again in addition to the actual rent he receives.

This treatment does not only apply to cash premiums paid for leases. It is quite common for a lease to be granted on the basis that the tenant agrees to do work on the property instead of paying a cash sum. In such a case, the landlord is treated as if he had received a premium equivalent to the benefit of the work done by the tenant under the terms of the lease.

The legislation says that the “premium” here is the increase in value of his interest in the property immediately after granting the lease, as compared with what the value would have been if the tenant had not been required to do any work.

Calculating this is not as simple as it sounds. The first point is that the increase in value, not the cost of the work, is the relevant figure. It is also necessary to consider the length of the lease, because the landlord will only get the benefit of the improvements when the lease ends and he can take possession of the property again. Finally, these rules only apply if the landlord could not have claimed a deduction from his rental income for the work done, if he had done it himself, so for example, routine repairs will not give rise to a charge.

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