

## QUESTIONS WE'VE BEEN ASKED

# **GST – How do the compulsory zero-rating of land rules apply to transactions involving commercial leases?**

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**QB 21/08**

The compulsory zero-rating of land rules (CZR rules) were enacted with effect from 1 April 2011. This item looks at how the CZR rules apply to:

- a supply by a lessor to a lessee under a lease
- the assignment, surrender or procurement of a lease
- the sale of a business that includes a lease.

### **Key provisions**

Goods and Services Tax Act 1985, s 11(1)(mb) and (8D)

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## Question

How do the CZR rules apply to transactions involving commercial leases?

## Answer

Generally, the CZR rules will not apply to supplies made under commercial leases. However, some supplies made under or in relation to commercial leases are subject to the CZR rules. These supplies are:

- (a) a supply made under a commercial lease where the consideration includes a non-regular payment (lump-sum payment) of more than 25% of the term consideration, and certain other supplies made under the same lease;
- (b) the assignment or surrender of a commercial lease;
- (c) the reverse surrender of a commercial lease (where a lessee pays a lessor to take back a lease); and
- (d) a supply of lease procurement services; that is, a supply made under an arrangement that involves the lessee's surrender of a commercial lease and the grant of a new commercial lease by the lessor to another person.

## Explanation

1. All legislative references are to the Goods and Services Tax Act 1985 unless otherwise stated.
2. This Question We've Been Asked (QWBA) deals with the application of the CZR rules to commercial lease transactions between GST-registered persons where the leased premises are used in a taxable activity.
3. A commercial lease is a lease that is not a lease of a dwelling (s 2(1), definition of "land", para (b)(ii)).

## Overview of the CZR rules

4. Usually, a registered person making a supply in the course or furtherance of their taxable activity charges GST at the prevailing standard rate on the supply (s 8(1)). In some situations, zero-rating rules apply. These rules require the supplier to charge GST at the rate of 0% on the supply (s 11). Consequently, the recipient cannot claim an input tax deduction for that supply.
5. The core provision of the CZR rules is s 11(1)(mb). Under ss 8 and 11(1)(mb), a vendor must zero-rate a supply if:

- the supply is a supply of goods that wholly or partly consists of land;
  - the vendor is GST registered (or will be GST registered or will be treated as GST registered) at the time of settlement;
  - the supply is being made by the vendor in the course or furtherance of their taxable activity;
  - the purchaser is a GST-registered purchaser (or will be GST registered or treated as GST registered) at the time of settlement;
  - the purchaser acquires the goods (including the land) with the intention of using them (in whole or part) for making taxable supplies; and
  - none of the land included in the supply is intended to be used as the purchaser's principal place of residence or the principal place of residence of a relative of the purchaser.
6. If a supply is not made in the course or furtherance of a GST-registered vendor's taxable activity (for example, when a GST-registered vendor sells their private home), the supply is generally outside the GST rules.
7. If a leasehold interest in land is supplied as part of a larger supply (and the requirements of s 11(1)(mb) are met) the whole supply is zero-rated. The supply may also be zero-rated under s 11(1)(m) (transfer of a going concern), if the requirements of that section are met.
8. For a more detailed overview of the CZR rules, see ["IS 17/08: Goods and Services Tax – compulsory zero-rating of land rules \(general application\)", Tax Information Bulletin Vol 29, No 10 \(November 2017\): 17.](#)

## Section 11(8D)

9. Most supplies made under commercial leases are excluded from the CZR rules by s 11(8D)(b). However, commercial leases with characteristics making them substitutable for land sales and transactions involving the assignment, surrender or procurement of commercial leases may be subject to the CZR rules if certain conditions, including the conditions in s 11(1)(mb), are met (s 11(8D)(a), (ab) and (c)).
10. Section 11(8D) applies to "interests in land" and agreements for the supply of "interests in land". A lease is an interest in land.
11. The following elements of s 11(8D) are considered in more detail below:
- regular lease payments and non-regular lease payments that are 25% or less of the term consideration are generally excluded from the CZR rules under s 11(8D)(b) (see [12]);

- assignments and surrenders of leases are subject to the CZR rules under s 11(8D)(a) (see [24]);
- reverse surrenders (where a landlord receives a payment for the surrender of a right to receive lease payments) are subject to the CZR rules under s 11(8D)(ab) (see [27]); and
- lease procurement services are subject to the CZR rules under s 11(8D)(c) (see [29]).

## Non-regular payments of more than 25% of the term consideration

12. The CZR rules treat certain supplies of land as zero-rated rather than taxable. The rules were introduced to help combat phoenix fraud where a supplier of land absconds or is wound up without returning GST, but the purchaser (generally a related party) is still entitled to an input tax deduction. Most transactions that are, economically, a supply of commercial land are captured by the rules. An exception is a commercial lease, which, to reduce compliance costs, is excluded unless it possesses the less usual feature of irregular large lump-sum payments, which could suggest it could be substitutable for a transfer of land. See *"Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Bill (Commentary on the Bill, May 2016)"*: 75.
13. The effect of s 11(8D)(b) is that the CZR rules generally will **not** apply to:
  - regular payments made under a lease; and
  - lump-sum payments that are 25% or less of the term consideration (see [17] for the meaning of "term consideration").
14. Specifically, a supply made under a lease agreement that meets the requirements of s 11(1)(mb) is not subject to the CZR rules, if all of the following three elements are met (see Example 1):
  - When the lease agreement is entered into, each lump-sum payment is expected to be 25% or less of the term consideration.
  - The payment to which the supply relates, if it is a lump-sum payment, is in fact 25% or less of the term consideration.
  - Each lump-sum payment that is paid or payable before the payment to which the supply relates is 25% or less of the term consideration.
15. In the nine examples below, it is assumed that the lessee or purchaser (as the case may be) meets the requirements of s 11(1)(mb)(i) (ie, they are a registered person who acquires the goods with the intention of using them for making taxable supplies) and that the supply meets the requirements of s 11(1)(mb)(ii) (ie, it is not a supply of land intended to be used as a principal place of residence of the recipient of the supply or a person associated with them under s 2A(1)(c)).

**Example 1: Lease payments excluded from the CZR rules**

Alex owns a property on a busy street in a large city. She is registered for GST. On 1 September 2019, she enters into an agreement to lease the property to a retail company for a period of five years, with a right of renewal for a further five years.

Under the terms of the lease, the company is required to pay monthly rent of \$6,250 (\$75,000 per year), plus additional non-regular payments on 30 April 2020 and 30 April 2021 of \$50,000 each.

The term consideration under the agreement is \$475,000 (regular lease payments of \$75,000 × 5 years, plus the non-regular payments of \$100,000). The payment of \$50,000 on 30 April 2020 is less than 25% of the term consideration, so s 11(8D)(b) excludes the 30 April 2020 supply under the lease agreement from zero-rating under s 11(1)(mb).

The further payment of \$50,000 on 30 April 2021 is less than 25% of the term consideration, and the previous \$50,000 payment was also less than 25% of the term consideration. Therefore, s 11(8D)(b) excludes the 30 April 2021 supply under the lease agreement from zero-rating under s 11(1)(mb).

16. The following elements of s 11(8D)(b) are considered in more detail below:
- term consideration (see [17]);
  - regular, periodic lease payments not subject to the CZR rules (from [18]); and
  - lump-sum payments subject to the CZR rules (from [21]).

**Term consideration**

17. For commercial leases, the term consideration is the total amount of consideration calculated under the lease agreement during a period that is the longer of one year and the shortest possible fixed term under the lease agreement; that is not including any renewal period (s 11(8D)(b)(iv)). See Example 2.

**Example 2: Term consideration**

As Alex (from Example 1) entered into a five-year lease, with an option to extend for a further five years, the term consideration is the sum of the monthly rental payments received during the first five-year period plus any lump-sum payments Alex received during that time.

If the parties had entered into a monthly lease with no fixed term, then the term consideration would be the total payments Alex received in the first year.

### **Regular, periodic lease payments not generally subject to the CZR rules**

18. Section 11(8D)(b) applies where payments that are not “regular payments” are made under a lease.
19. The term regular payment is not defined in the Act. The *Concise Oxford English Dictionary* (12th ed, Oxford University Press, New York, 2011) contains the following definition:

Regular *adj* ... 2. Recurring at short uniform intervals... done or happening frequently.

20. In the context of leases, a regular payment is generally a payment of rent. Therefore, where an ordinary payment of rent that is more than 25% of the term consideration is made, the CZR rules will not apply, provided that no lump-sum payments are anticipated, when the lease is entered into, to be more than 25% of the term consideration, and provided each lump-sum payment paid or payable before the regular payment has actually been 25% or less of the term consideration. See Example 3.

#### **Example 3: Regular, periodic lease payments**

Instead of a five-year lease, Alex (from Example 1) enters into a one-year lease with quarterly payments but without any lump-sum payments. The quarterly payments vary slightly as they are based on the annual rent of \$75,000 pro-rated for the number of days in the quarter.

The payments are not zero-rated, even though some represent more than 25% of the term consideration.

### **Lump-sum payments (and certain regular payments) subject to the CZR rules**

21. If a lump-sum payment is payable under a lease agreement and is anticipated, when the lease agreement is entered into, to be more than 25% of the term consideration, the CZR rules apply to all payments made under the lease including regular payments. Section 11(8D)(b) prevents taxpayers circumventing the CZR rules by making large lump-sum payments under lease agreements.
22. Further, if a lump-sum payment of more than 25% of the term consideration is in fact made but was not anticipated when the lease agreement was entered into, all lease payments including regular payments will be subject to the CZR rules from that

payment onwards. There is no requirement to retrospectively zero-rate payments made earlier. See Example 4.

#### **Example 4: Lump-sum payments**

Following from Example 1, Alex's property is on the main street of a smaller city. The terms of the lease remain the same as Example 1 except the monthly rent is \$2,250 and only one lump-sum payment, anticipated, when the agreement is entered into, to be \$30,000, but in fact, \$50,000, is made on 30 April 2020.

The term consideration as anticipated when the agreement is entered into would be \$165,000 (regular lease payments of \$27,000 × 5 years, plus the non-regular payment of \$30,000). The anticipated payment of \$30,000 would be less than 25% of the anticipated term consideration.

The actual term consideration under the agreement would be \$185,000 (regular lease payments of \$27,000 × 5 years, plus the non-regular payment of \$50,000).

The non-regular payment of \$50,000 is more than 25% of the term consideration, so s 11(8D)(b) does not exclude the supply under the lease agreement from zero-rating under s 11(1)(mb).

If the requirements of s 11(1)(mb) are met, the lump-sum payment of \$50,000 and all subsequent payments must be zero-rated.

#### **Lease granted on business asset sale**

23. A vendor may choose to grant a lease or sub-lease of the business premises to a purchaser of the business instead of selling the business premises or assigning their lease. This type of transaction is not zero-rated under s 11(8D)(b), even if the lease payments are zero-rated under s 11(8D)(b). This is because the business assets are not transferred "under an agreement providing for periodic payments for supplies of the interest in land" as required by s 11(8D)(b). The transaction may be zero-rated as a transfer of a going concern under s 11(1)(m) if the requirements of that section are met on the facts.

#### **Assignments and surrenders**

24. An assignment or surrender of a lease is subject to the CZR rules if it meets the requirements of s 11(1)(mb) (s 11(8D)(a)). See Example 5.

**Example 5: Lease assignment**

JM Ltd is carrying on a taxable activity and is registered for GST. JM Ltd's business premises are leased. JM Ltd is moving to larger business premises and enters into an agreement to assign its interest as lessee under the existing lease to a third party.

The lease assignment is zero-rated in accordance with s 11(1)(mb) and (8D)(a). JM Ltd has an interest in land, and it is assigning that interest in land to the third party.

25. Where a lease is assigned together with other business assets both the lease assignment and other business assets will be zero-rated, assuming the assignment of the lease and the sale of the other business assets are part of a single composite supply. This will be the case even if no consideration is allocated to the lease assignment. See Example 6.
26. For a detailed discussion of whether goods and services are supplied as elements of a single composite supply or as multiple supplies, see ["IS 18/04: Goods and services tax – single supply or multiple supplies", Tax Information Bulletin Vol 30, No 10 \(November 2018\): 5.](#)

**Example 6: Lease assignment on business asset sale**

JM Ltd (from Example 5) enters into an agreement to sell its business (including the lease of the new business premises) to a third party. The agreement for sale and purchase of the business provides that the lease will be assigned but no consideration is allocated to the lease assignment in the agreement.

The sale of business assets (including the lease assignment) is zero-rated in accordance with s 11(1)(mb) and (8D)(a) (assuming the lease and other business assets are supplied as a single composite supply). JM Ltd has an interest in land, and it is assigning that interest in land to the third party.

**Reverse surrenders**

27. A supply that is a surrender of a right to a payment under an agreement for the supply of an interest in land is subject to the CZR rules if it meets the requirements of s 11(1)(mb) (s 11(8D)(ab)).
28. Section 11(8D)(ab) is intended to catch "reverse surrender" payments a tenant makes to a landlord (where the landlord surrenders their contractual right to receive payment under the lease).



## Arrangements for the surrender of a lease and grant of a new lease to another person

29. Section 11(8D)(c) deals with situations that arise when a supply is made by a person who is a lessee under a lease agreement. If all the following three elements are satisfied then, despite s 11(8D)(b), s 11(1)(mb) will apply to zero-rate the supply:
- The supply is made to a person who is not the lessor. The lessor in this context is the person who is supplying an interest in land under the lease agreement to the lessee.
  - The supply is made under an arrangement that involves the:
    - lessee's surrender of the interest in land to the lessor; and
    - supply by the lessor of the interest in land under another lease agreement to a person other than the lessee.
  - The supplies of the interests in land under the lease agreements meet the requirements set out in s 11(1)(mb).
30. Section 11(8D)(c) is likely to be relevant in the context of a business sale, where a lease is novated or a new lease is otherwise procured for the purchaser. See Example 7.

### Example 7: Lease procurement

Following from Example 6, JM Ltd is carrying on a new taxable activity and is registered for GST. JM's business premises are leased but JM's lease cannot be assigned.

JM Ltd enters into an agreement to sell its business assets to a purchaser. During negotiation of the sale agreement for the business, it is agreed that JM Ltd will use all reasonable endeavours to procure that the landlord will enter into a new lease agreement over the premises with the purchaser. The surrender of the existing lease and the grant of the new lease are closing actions in the agreement for sale and purchase.

It is considered that the business asset sale agreement, the surrender, and the grant of the new lease will together constitute an arrangement for these purposes (*CIR v Europa Oil (NZ) Ltd* [1971] NZLR 641 (PC)).

The sale of the business is zero-rated in accordance with s 11(1)(mb) and (8D)(c) (assuming the lease procurement services and business assets are supplied as a single composite supply). JM Ltd has an interest in land, and it is surrendering that interest in land so the landlord can enter into a new lease with the purchaser.

31. Section 11(8D)(c) may also apply to lease procurement services in the context of a business asset sale where a lease that has expired continues on an implied term under s 210 of the Property Law Act 2007 (PLA) and is surrendered (with a new lease being granted by the vendor's lessor to the purchaser) on a business sale. See Example 8.
32. Note s 11(8D)(c) applies if the supplies under the lease agreements are supplies of "interests in land" (s 11(8D)(c)(i)-(iii)).
33. A lease continuing on an implied term under s 210(1)(b) of the PLA is a "statutory tenancy" and a "short-term lease" (s 207 PLA). A lessee who occupies land under a "short-term lease" has a legal interest in the land (s 209(1) PLA). However this is subject to the Land Transfer Act 2017 (s 209(2) PLA). The lessee's legal interest in the short-term lease can be defeated in the same way as an equitable interest by the registration without fraud of an adverse interest (see Hinde, McMorland & Sim, *Land Law in New Zealand* (LexisNexis NZ Limited, online version, accessed 14 June 2021) at [11.021]).

#### **Example 8: Lease continuing on implied term**

Following from Example 7, JM Ltd is carrying on the new taxable activity but instead of its lease being unable to be assigned, the term of its lease of the premises has expired. The lease continues on an implied term under s 210 of the Property Law Act 2007.

JM Ltd enters into an agreement to sell its business assets to a purchaser. During negotiation of the sale agreement for the business, it is agreed that JM Ltd will surrender its lease and the landlord will enter into a new lease agreement over the premises with the purchaser. The surrender of the existing lease and the grant of the new lease are closing actions in the agreement for sale and purchase. The lessee's legal interest in land has not been defeated by the registration without fraud of an adverse interest.

The sale of the business is zero-rated in accordance with s 11(1)(mb) and (8D)(c) (assuming the lease procurement services and business assets are supplied as a single composite supply). JM Ltd has an interest in land, and it is surrendering that interest in land so the landlord can enter into a new lease with the purchaser.

34. Section 11(8D)(c) may also apply to lease procurement services and business assets a vendor supplies as a single composite supply on the sale of a business where a lease is cancelled under s 245 of the Property Law Act 2007 because the tenant has fallen into arrears and the vendor's landlord grants a new lease to the purchaser of the business assets. See Example 9.

**Example 9: Lease cancellation**

Following from Examples 7 and 8, JM Ltd is carrying on the new taxable activity but has instead been experiencing financial difficulties. It enters into an agreement to sell its business assets to MC Ltd.

The premises are an important element of the business. However, due to JM Ltd's financial difficulties, it has fallen into arrears in payment of rent to its landlord. The landlord has served a notice to cancel the lease of the premises in accordance with s 245 of the Property Law Act 2007.

As the lease is being cancelled in accordance with s 245 of the Property Law Act 2007, it cannot be assigned to MC Ltd. During negotiations of the sale agreement for the business, it is agreed that MC Ltd will pay an amount to the landlord and the landlord will enter into a new lease agreement with MC Ltd. The grant of the new lease is a closing action in the sale agreement.

The supply will be zero-rated in accordance with s 11(1)(mb) and (8D)(c) (assuming the lease procurement services and business assets are supplied as a single composite supply).

35. This clarification in respect of lease cancellations was made by s 184 of the Taxation (Annual Rates for 2020-21, Feasibility Expenditure, and Remedial Matters) Act 2021, and applies to supplies made by a person on or after 30 June 2014. Savings provisions apply to supplies for which a contrary tax position was taken before 30 March 2021 (the date of Royal Assent of the above act).

## References

### Legislative references

Goods and Services Tax Act 1985, ss 2(1) ("land"), 8(1), 11

Property Law Act 2007, ss 207, 209, 210, 245

Taxation (Annual Rates for 2020-21, Feasibility Expenditure, and Remedial Matters) Act 2021, s 184.

### Other references

*Concise Oxford English Dictionary* (12th ed, Oxford University Press, New York, 2011).

"IS 17/08: Goods and services tax – compulsory zero-rating of land rules (general application)", *Tax Information Bulletin* Vol 29, No 10 (November 2017): 17.

<https://www.taxtechnical.ird.govt.nz/tib/volume-29---2017/tib-vol29-no10>

"IS 18/04: Goods and services tax – single supply or multiple supplies", *Tax Information Bulletin* Vol 30, No 10 (November 2018): 5. <https://www.taxtechnical.ird.govt.nz/tib/volume-30---2018/tib-vol30-no10>

"*Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Bill* (Commentary on the Bill, May 2016)": 75.

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