

Preserving rental income streams in the current economic climate: the impact of GST

In the current economic climate the capital value of a commercial investment property cannot necessarily be relied upon to produce a return for property investors. It is, therefore, all the more crucial to ensure that an investment property's rental income stream is preserved and maximised.

Reduction in the rental income stream caused by Goods and Services Tax

Under the Goods and Services Tax (Jersey) Law 2007 ("GST Law") a landlord of commercial property is liable to account to the States of Jersey for 3% of its rental income if its total annual income (i.e. not just its rental income) is in excess of £300,000 per annum.

In other words, if the landlord of commercial property has income in excess of £300,000 per annum then it will be liable to pay GST at 3% to the States of Jersey on all of its commercial property rental income.†

It is important to note that under the GST Law it is the landlord and not the tenant who is liable to pay GST on its rental income. However, a landlord can recover that additional 3% GST liability from its tenant provided the lease in question contains GST recovery provisions enabling the landlord to charge the tenant rent plus GST.

Notably, this means that if a particular lease does not oblige the tenant to pay the landlord rent plus GST the landlord will lose 3% of its rental income stream because it will have to pay the States of Jersey its 3% GST liability out of its rental income without the ability to recover that additional amount from its tenant. The same principles also apply to GST on service charge payments received by a commercial landlord.

Leases entered into prior to the introduction of the GST Law and 'grandfathering' provisions

Commercial leases that were entered into prior to the introduction of the GST Law may well have been drafted without the inclusion of adequate GST recovery provisions obliging the tenant to pay the landlord rent plus GST because at that time such provisions would not have been considered necessary.

† NB: Rental income derived from a lease to an 'International Services Entity' ("ISE") tenant falls outside of the scope of the GST Law. Therefore, a landlord is not liable to pay 3% GST on rent that it receives from an ISE tenant. However, in many cases an ISE may in fact take a lease via a group related company which itself is not an ISE and so careful consideration is required in this regard. An ISE tenant may also, at some point in the future, assign its lease to a third party non-ISE entity and so its lease should be structured for GST purposes irrespective of the tenant's ISE status.

Consequently, under the GST Law commercial leases entered into before the GST Law was published have been 'grandfathered'.

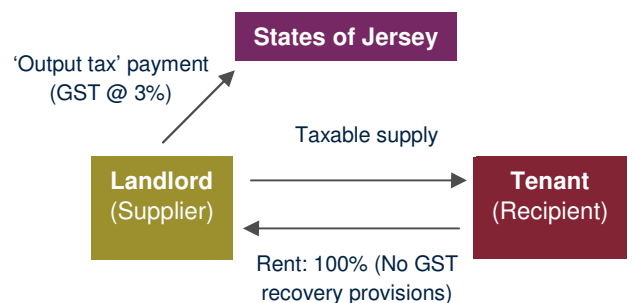
This means that where a commercial lease was entered into before 17 August 2007, supplies under the lease will be counted as zero rated supplies for a period of 5 years from that date (that is, to 16 August 2012) or until the lease is varied, whichever is the earlier.

So, where a commercial lease was entered into before 17 August 2007 and the landlord's income is in excess of £300,000 per annum the landlord will be deemed to be making a zero rated supply to its tenant and will not have to account to the States of Jersey for 3% GST on its rental income under that lease until 16 August 2012 (unless the lease in question is varied before that date).

A variation will not be held to have occurred if there is a rise in the rental due to existing contractual JRPI or market review of rents or if there is an assignment of the lease in its existing format.

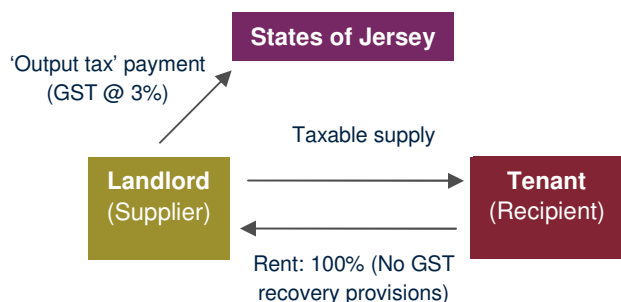
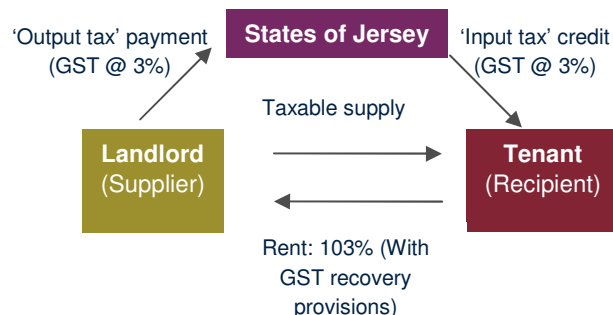
In practice, the effect of the GST Law on rental income streams is as follows:

- Where: (i) a commercial lease was entered into before 17 August 2007; (ii) the lease provisions do not provide for the landlord to recover GST in addition to the rent; and (iii) there is **no variation** of the lease before 16 August 2012, the landlord will lose 3% of its rental income from 16 August 2012 until expiry of the lease.



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2. Where: (i) a commercial lease was entered into before 17 August 2007; (ii) the lease provisions do not provide for the landlord to recover GST in addition to the rent; and (iii) there **is a variation** of the lease before 16 August 2012, the landlord will lose 3% of its rental income from the date of the variation until expiry of the lease (unless the variation of lease includes GST recovery provisions).



NB: A summary of the effect of the GST Law on rental income streams is set out in the table attached at schedule 1

How can a landlord preserve its rental income stream?

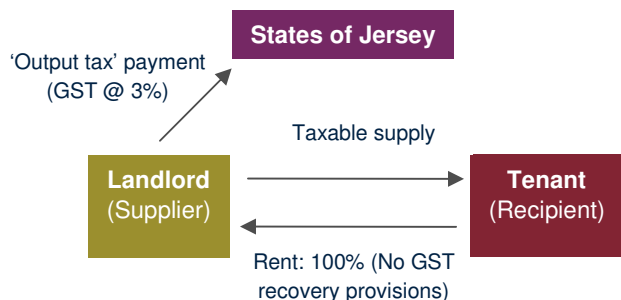
To preserve rental income streams in light of the GST Law commercial property investors and stakeholders must ensure that leases are structured correctly in terms of GST recovery provisions.

In other words, landlords need to ensure that commercial leases enable them to recover rent plus GST from their tenants.

Whilst at first glance this suggests that the tenant will be worse off as it will be paying rent at 103% it should be noted that provided a tenant is itself registered for GST it will be able to recover 100% of the GST that it pays to its landlord by way of an input tax credit from the States of Jersey. Provided this position is made clear to tenants and their advisors landlords who seek to structure new leases (or re-structure existing leases) correctly for GST purposes should face limited opposition during related negotiations.

If, however, commercial leases are not structured correctly then investors and stakeholders face the reality of losing 3% from their rental income stream resulting not only in loss of rent but also in a detrimental effect on the net asset value of the investment property going forward.

3. Where: (i) a commercial lease is entered into after 17 August 2007 and (ii) the lease provisions **do not** provide for the landlord to recover GST in addition to the rent, the landlord will lose 3% of its rental income from the date of lease commencement until expiry of the lease (unless the lease is varied to incorporate GST recovery provisions).



4. Where: (i) a commercial lease is entered into after 17 August 2007 and (ii) the lease provisions do provide for the landlord to recover GST in addition to the rent, the landlord will be able to recover rent plus GST from the date of lease commencement. Provided the tenant is registered for GST it will then be able to claim an input tax credit from the States of Jersey for the GST paid to its landlord.

For further advice concerning the effect of GST on all commercial property transactions including sales, acquisitions, sales and leasebacks and commercial leases please contact jonathan.hughes@ogier.com

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Schedule 1: Table of impact of GST on rental income streams under commercial leases in Jersey

Commencement date of lease	GST recovery provisions in lease	Variation of lease before 16 August 2012	GST liability (Landlord to pay States GST on rent received) †	Landlord's contractual ability to recover GST from Tenant
Before 17 August 2007	No	No	Yes, from 16 August 2012	None (unless lease varied to include GST recovery clause)
Before 17 August 2007	No	Yes	Yes, from date of variation	None (unless variation includes GST recovery clause)
After 17 August 2007	No	n/a (as no 'grandfathering provisions')	Yes, from date of lease commencement	None (unless lease varied to include GST recovery clause)
After 17 August 2007	Yes	n/a (as no 'grandfathering provisions')	Yes, from date of lease commencement	Yes, from date of lease commencement

† NB: Rent received from ISE registered tenant excepted.

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