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TAX TREATMENT OF PAYMENTS RECEIVED BY PETROL RETAILERS IN RETURN FOR TRADE TIES

In Public Information Bulletin 178 (February 1989), in an item entitled "*Petrol Retailers—Inducement Payments Paid by Oil Companies*" the Commissioner outlined his views regarding the general position on the income tax treatment of payments received by petrol retailers in return for trade ties. In particular, the item stated that lump sum payments made in return for trade ties would not be assessable.

The Court of Appeal in *Birkdale Service Station v CIR* (2000) 19 NZTC 15,981 has reiterated that for income tax purposes the method of payment does not determine whether an amount received by a petrol retailer is capital or revenue. Accordingly, the Commissioner advises that the item in PIB 178 (referred to above) is withdrawn, as it is not consistent with the approach the Court of Appeal has set out for determining whether a lump sum amount is capital or income.

Taxpayers and agents should refer to the commentary below for general assistance concerning the proper character of trade tie payments received by petrol retailers.

Birkdale Service Station v CIR (2000) 19 NZTC 15,981

The relevant taxpayers in the *Birkdale* case were five retail service station proprietors and one used vehicle dealer and the case considered whether lump sum trade tie inducement (or compensation) payments made to the taxpayers by an oil company were capital or income. While the precise nature of the commitments differed, each case involved a written contract stipulating that certain payments, called inducement or compensation payments, would be made by the oil company in consideration for the retailers entering into an exclusive supply (trade tie) agreement. The Commissioner assessed the payments as income under section 65(2)(a), section 65(2)(e) and section 65(2)(l) of the Income Tax Act 1976 (the present equivalent sections are CD 3, CD 4 and CD5 of the Income Tax Act 1994).

The taxpayers indicated that while there were differences in the specific provisions contained in the different contracts between the oil company and each of them, those factual differences did not produce a requirement to distinguish between them. The broad facts of each case were that the retailers entered into a series of interrelated agreements; including a standard inducement agreement, a retail supply agreement and an equipment loan contract, in return for inducement payments. In each case there were two separate inducement payments, the first being for an initial agreement, and then a second payment for an agreement negotiated following the expiry of the first. However, in one case the trade tie was secured by a 15 year lease of the premises and land to the oil company, and a sub-lease back to the retailer.

In that case, at any time during the 15 year term the oil company had the right to call upon the retailer to enter into a redevelopment of the site, and if the retailer did not within a short time negotiate satisfactory terms with the oil company, the oil company could pay the retailer the value of the site improvements and take a 20 year lease at ground rent, again with a corresponding sublease back to the retailer. There was also a restrictive covenant preventing the retailer and its shareholders from trading in competition with the outlet from other premises within a 10 kilometre radius of the premises during the lease term.

The correct approach

The judgment of the Court of Appeal was delivered by Blanchard J, and began by stating that the High Court (*Birkdale Service Station v CIR* (1999) 19 NZTC 15,493) followed the correct approach (at p. 15,987):

> Laurenson J in the High Court adopted the correct approach in order to determine whether the lump sum payments were capital or income. It was that followed by the Privy Council in *Wattie* and to be found in the following passage from the advice of the Privy Council delivered by Lord *Pearce* in *BP Australia v Commissioner of Taxation of the Commonwealth of Australia* [1966] AC 224 at p 264:
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>> The solution to the problem is not to be found by any rigid test or description. It has to be derived from many aspects of the whole set of circumstances some of which may point in one direction, some in the other. One consideration may point so clearly that it dominates other and vaguer indications in the contrary direction. It is a commonsense appreciation of all the guiding features which must provide the ultimate answer. Although the categories of capital and income expenditure are distinct and easily ascertainable in obvious cases that lie far from the boundary, the line of distinction is often hard to draw in border line cases; and conflicting considerations may produce a situation where the answer turns on questions of emphasis and degree. That answer:
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>>> "depends on what the expenditure is calculated to effect from a practical and business point of view rather than on the juristic classification of the legal rights, if any, secured employed or exhausted in the process": per Dixon J in Hallstroms Pty Ltd v Federal Commissioner of Taxation (1946) 72 CLR 634, 648.

The Court of Appeal then noted that in applying the above approach, the background to the transaction was of "considerable importance". In the context of the actual case, the Court recognised that there were no multi-brand retailers in New Zealand at the time of the relevant agreements, and that the contractual freedom of the retailers was thus in practical terms limited to their ability to make a choice between four wholesalers and to negotiate the term and amount. Further, the Court noted that the businesses of the retailers were described by one witness as "marginal" and that if they were minded to continue to operate their business in the deregulated environment they had in reality no choice but to tie themselves to one of the four major wholesalers (at p. 15,988).

Other trade tie cases discussed in Birkdale

The appellants referred the Court to three cases in particular where lump sum payments made in return for trade ties had been characterised as capital. The cases were: *Commrs of IR v Coia* 1959 SC 89, *Dickenson v FCT* (1958) 98 CLR 460 and *C of IR v Dunlops (Wanganui) Ltd* [1970] NZLR 1125. These cases were briefly discussed in the judgment of Blanchard J.

In *Coia* the retailer gave up being a multi-brand outlet, and accepted a payment in return for a 10 year tie with an oil company. In the leading judgment Lord Clyde observed that the retailer had expended the monies on capital outlays. However, he also stated that the payment was made in return for a trade tie, the acceptance of which required the retailer to give up his unrestricted freedom to trade as he wished and required him to accept petrol at the oil company's posted prices. Lord Patrick concurred, stating that the retailer had given up a valuable asset of a capital nature in ceasing to be a multi-brand retailer and accepting the payment in return for a trade tie of 10 years.

In *Dickenson* the taxpayer accepted payment in return for a 10 year trade tie with an oil company, having been a multi-brand retailer prior to entering into the tie. The oil company's rights were also secured by a 10 year lease and sub-lease (similar to the arrangement in the case of one of the retailers in *Birkdale*). The majority of the High Court of Australia found that the payments were of a capital nature. *Dixon* CJ said that:

> The appellant's business constituted a profit-yielding organisation of a definite structure under his control and he received the money as part of an inducement to change a feature in it. The feature to be changed was the use of a plurality of petrols and oils, and this was replaced by a restriction to the purchase and sale of the products of one company. (p. 474)

The Chief Justice added that there was nothing recurrent in the nature of the payment. It was not a normal or natural incident of carrying on such a business and it did not represent a purpose for which such a business was carried on. In addition, Kitto J stated that the payment seemed to be made in return for a substantial and enduring detraction from pre-existing rights, and the restriction took a substantial piece out of the ordinary scope of business activities in which the taxpayer would otherwise have been engaged:

> But a lump sum payment for a restriction of a garage and its proprietor to one brand of petroleum products for a period of ten years, effectuated by means of a lease and sub-lease of the premises as well as by personal covenants, seems in the nature of a sale price for a substantial and enduring detraction from pre-existing rights. The restriction does not strike my mind as an obligation undertaken incidentally to the carrying on of the business. Rather it does take a substantial piece out of the ordinary scope of business activities to which otherwise the appellant might apply himself and for which he might use his premises….(p. 492)

The *Dunlops* case was a decision of the New Zealand Court of Appeal. In this case the taxpayer had, until 1961, sold all available brands of petrol. In that year an oil company offered a lump sum payment if the company would sell that company's petrol only. North P concluded that the payment had been made in consideration of the retailer giving up a part of its business and confining itself to a more limited field. The other members of the Court agreed.

Following the discussion of these cases in *Birkdale*, Blanchard J stated that:

> The question of whether the payment for an asset is received as capital or income turns in our view upon the nature of the asset in the hands of the seller. Is it sold as a capital asset or is the seller disposing of it in the carrying on of the operations of a business or in pursuance of a particular venture? Are the retailers in their particular circumstances to be seen as having disposed of a part of their businesses, as the retailers did in *Coia, Dickenson* and *Dunlops*, or did they accept the sums of compensation as an incident of the carrying on of their businesses without any change of a structural nature having occurred? In other words, the question is what the retailers' acceptance of Mobil's payments effected from a practical and business point of view, to adapt *Dixon* J's words in *Hallstroms*.

(p. 15,991)

Relevant factors to consider

In the *Birkdale* case the Court of Appeal considered the following factors to be relevant in determining what the trade tie payments effected from a practical and business point of view:

1. the fact that little was surrendered by the retailers,
2. the length of the trade ties, and
3. the proper accounting treatment.

1. Little was surrendered by the retailers

In this regard the Court stated:

> …the appellant's apparent freedom to contract as they wished for purchases of motor spirits was illusory. In reality, each had no choice, if it wished to remain in business, other than to accept a tie to one of the four oil companies. It was merely a matter of choosing for which one of them the retailer would become an "agent" and negotiating the period of the tie, the amount of the payment to be received upfront and the applicable conditions. The details of the arrangements were not likely to vary much at all as between the oil companies, for the reasons already stated. There is no doubt that Mobil imposed quite severe restrictions and controls, including the right of first refusal. But the effect of these on the pre-existing business structure had to be measured against the situation in which the retailers found themselves upon deregulation of the industry.

Importantly in this case therefore, the retailers in reality had no choice but to tie themselves to one of four oil companies. This point "readily distinguished the present case from the three cited to us by the appellant, [being] *Coia, Dickenson* and *Dunlops*" (at p. 15,992) all of which involved the retailers giving up the ability to continue as a multi-brand retailer.

The Court found that in addition to not giving up any significant freedom, the structure of the business of the appellants had hardly changed, stating:

> Therefore, in accepting the trade tie payments, the appellants were not giving up a significant freedom. In addition, the other features of the structure of the business had hardly changed. There was no alteration in the ownership of the land or the chattels employed in the conduct of the business, nor in their nature.
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> The manner of conducting the business of the retailer may have changed because of the contractual requirements imposed by Mobil on service station operations. But that involved the way in which the revenues were to be derived rather than an alteration in the structure from which they were derived.
> (at p. 15,992)

The degree of structural alteration the Court considered significant enough to render the transaction an affair of capital can be seen in the judgment relating to the Kenlock 2 arrangement. In this regard, the Court stated:

… Two factors, both singly and even more powerfully in combination, convince us that Kenlock 2 is different from the other arrangements. They are, first, that Mobil obtained security for its tie by means of a 15 year lease with a sublease to Kenlock on a back-to-back basis and, secondly, that the term for which Kenlock became committed to Mobil was potentially very substantially longer than 15 years…. There was also a restrictive covenant preventing Kenlock and its shareholders from trading in competition with the outlet from other premises within a 10 kilometre radius of the premises during the lease term.

Even though the choices realistically open to Kenlock Motors were no greater than for the other retailers, or for itself when it entered into Kenlock 1, on accepting such terms of Kenlock 2, particularly by the granting of a long term interest in its land and buildings, we consider that Kenlock Motors was altering its business structure in such a material way that the payment it received in exchange has to be regarded as of a capital nature. (at p. 15,995)

2. The length of the trade ties

None of the initial ties in the *Birkdale* case were longer than five years. The Court noted the weight given to the length of the ties in the judgments in *Regent Oil v Strick (Inspector of Taxes)* [1966] AC 295, and cited a passage from *BP Australia v C of T* [1966] AC 224 (adapting the words to the position of a recipient rather than a payer):

Length of time, though theoretically not a deciding factor, does in practice shed a light on the nature of the advantage [granted]. The longer the duration of the agreements, the greater the indication that a structural solution was being sought.

Blanchard J additionally said:

The length of the trade ties also distinguishes the present case from the three cited to us by counsel for the appellants. In the present case, in no instance was the initial tie for a period of more than five years and in two cases it was as short as three years. Although, in theory, at the end of that period the retailer could switch to another wholesaler, the best that could actually be hoped for was the renegotiation of a further package either with Mobil or possibly with one of the other oil companies. (p. 15,993)

3. The proper accounting treatment

The Court noted that the evidence showed that proper accounting treatment showed the payments should be taken into the revenue account of the retailer. Although it was stated that such a requirement was not determinative, the Court stated it did provide a minor degree of support for the view that the payments were revenue in nature.

Conclusion

In the *Birkdale* case, the background and commercial context of the transactions pointed towards a conclusion that the payments were received in the ordinary course of business. The lack of structural alterations to the business structure of the retailers (in all but the case where the tie was secured by a long term interest in the land and buildings of a retailer and accompanied by restrictive trading covenants) additionally supported the conclusion that the payments were revenue, and the length of the ties was insufficient to change this result.

In finding the payments to be of a revenue nature, the Court stated:

> In the end, the decision in this case comes down to the impression created by the combination of circumstances, including the length, and thus potential for recurrence in the short and medium term, of each tie, and the insignificant nature of the supposed freedom given up by the appellants.(p. 15,994)

Tax treatment of payments made to petrol retailers in return for trade ties

The decision in *Birkdale* reinforces the point that, in considering the character of a payment or receipt a conventional capital/revenue analysis should be undertaken. As was stated by the Privy Council in *Wattie* (1998) 18 NZTC 13,991 (and reiterated in *Birkdale*), the correct characterisation of a particular transaction depends upon what the transaction was calculated to effect, from a practical and business point of view. The nature of the asset in the hands of the seller is the primary consideration. Is the asset sold as a capital asset or is it sold in the carrying on of the operations of a business or in pursuance of a particular venture?

The relevant consideration is therefore the nature of the payment and what is provided in return. In considering the background to the transaction in *Birkdale* and the recurrent nature of the agreements, the Court of Appeal discussed the argument that the receipt of a trade tie was an ordinary incident of business:

> The recurrent nature of each transaction is obvious and there is much force in the Commissioner's argument that the receipt of payments in return for a trade tie ought therefore to be seen as an incident of the motor spirits retailing business… It may not be going too far, on the evidence, to say that by the time the second ties were entered into by the retailers in this case ties to wholesalers were a universal experience in New Zealand. Certainly they were common. And it is worth noting that repetition of a tie involved no change at all to the business structure, other than in relation to length of term in instances where that was different from the retailer's first tie with Mobil. In short, the further tie and any longer period have to be considered in that context. (p. 15,993)

A combination of circumstances, including the length of each tie and the insignificant nature of the supposed freedom given up by the appellants, led to the payments in *Birkdale* (in all cases except where the tie was secured by the long term interest in land and buildings) being revenue in nature as they were ordinary incidents of business in the commercial environment of one brand motor spirits retailing.

In its focus upon the background of each transaction the Court of Appeal in *Birkdale* distinguished the *Coia, Dickenson* and *Dunlops* cases, making some general observations regarding the treatment of trade ties in the current commercial environment as it applies to petrol retailers. Of particular note in this emphasis upon the commercial reality of petrol retailing is the recognition that there is no multi-brand trading. In addition, the relative lack of competition between the four main oil companies also appears to have contributed to the Court's view that the retailers were not giving up any significant freedoms in return for accepting a trade tie.

The outcome in the *Birkdale* case suggests that the ability to enter into an exclusive supply contract is in fact a revenue "asset" in the hands of the retailer. Of note in particular is that the Court of Appeal did not consider the significant restrictions placed upon the retailers to effect any "structural" alterations to the retailers' businesses. Unless other factors are strongly indicative of a capital character, in particular significant structural alterations effected to the business (rather than its trading operations), the case suggests the Court will find such payments to be received in the ordinary course of business.

Factors to consider in analysing whether a payment received by a petrol retailer in return for a trade tie is capital or revenue in nature

In determining the tax treatment of payments received by petrol retailers in return for trade ties, each case will necessarily depend on its facts (rather than merely the nature of the payment).

The relevant question in any case is what is the payment for, i.e. what is provided in return for the payment? Primarily, the context of commercial operations in the petrol industry means payments received in return for entering into a trade tie will be received in the ordinary course of business (and therefore will be revenue in nature), unless other factors are strongly indicative of a capital character. These factors include:

- Whether the retailers have given up anything significant in return for the tie, and in particular, whether they have made structural alterations to their overall business operations. [Note that in *Birkdale* the Court considered the retailers in question had no choice but to accept a trade tie with one of the four oil companies, and this was noted by the Court in the course of its finding that the retailers (except for Kenlock 2 who entered into the lease/sub-lease agreement) had not given up anything significant in return for the tie, nor had they made any significant structural alterations to their businesses.]

- The length of the trade ties, which will be relevant in considering the significance of any structural alterations (as the length of the trade tie can indicate the nature of the advantage gained).

- The correct accounting treatment, while not decisive in itself, can provide support for a particular characterisation of a receipt where this is indicated by the other factors above.

In the context of an agreement in the nature of a trade tie, it is the Commissioner's view that the presence or absence of a dedicated use to which a receipt must be put is not necessarily determinative of the character of the receipt, because it is the totality of the circumstances in which the payment is received which need to be taken into account in determining the nature of that receipt in the hands of a petrol retailer.

The *Birkdale* case makes it clear that it is not the "lump sum" nature of the payment that determines its tax consequences, as is stated in PIB 178. The nature of the payment in the hands of the recipient will be determined by what is provided in return, rather than the form of payment. In the current context of commercial operations, some retailers have little choice but to accept a tie to one of four oil companies. This appears to be an important point of difference between the cases heard prior to the issue of PIB 178 and the *Birkdale* case, as the earlier cases concerned trade ties where the industry context was such that these arrangements were not the norm.