Inland Revenue
Te Tari Taake

LEASE SURRENDER PAYMENTS RECEIVED BY A LANDLORD – INCOME TAX TREATMENT

Note (not part of ruling): The issue dealt with in this Ruling was covered by Public Rulings BR Pub 97/1 and 97/1A, published in *Tax Information Bulletin* Vol 9, No 1 (January 1997). The Ruling has been amended to allow for an exception where the surrender of the lease constitutes the surrender of a significant structural asset of the landlord's business and thus the surrender payment received is a capital amount. In addition, the Ruling clarifies that it only applies to landlords in the business of leasing. The period of application of the Ruling is from 1 April 2000 to 31 March 2005. BR Pub 97/1 applied from 1 March 1997 to 30 September 1997 and BR Pub 97/1A from 1 March 1997 to 31 March 2000.

PUBLIC RULING - BR Pub 00/12

This is a public ruling made under section 91D of the Tax Administration Act 1994.

Taxation Law

All legislative references are to the Income Tax Act 1994 unless otherwise stated.

This Ruling applies in respect of sections CD 3 and CE 1(1)(e).

The Arrangement to which this Ruling applies

The Arrangement is the receipt of a lease surrender payment by a landlord from a tenant when the landlord, who is in the business of leasing property, agrees to accept the early termination of the lease. For the purposes of this Ruling, and for the avoidance of doubt, the term "business of leasing" has the same meaning as the term "business of renting", and means the business of letting property for a rent. The business of leasing property need not be the sole activity or the principal activity of the person. However, the activity must be sufficient, of itself, to amount to a business.

This Ruling applies only in respect of landlords in the business of leasing.

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

- A lease surrender payment received by a landlord in the business of leasing property is gross income as an amount derived from any business.
- A lease surrender payment received by a landlord in the business of leasing property may not be gross income as an amount derived from any business if the surrender of the lease is of such significance to the business that it constitutes the loss of a structural asset and the payment is thereby a capital amount. This will be a question of fact and degree to be determined in the particular circumstances of each case.

- A lease surrender payment is not gross income under section CE 1(1)(e).

The period for which this Ruling applies

This Ruling will apply to payments received by such a landlord between 1 April 2000 and 31 March 2005.

This Ruling is signed by me on the 18th day of December 2000.

Martin Smith
General Manager (Adjudication & Rulings)

Inland Revenue
Te Tari Taake

COMMENTARY ON PUBLIC RULING BR Pub 00/12

This commentary is not a legally binding statement, but is intended to provide assistance in understanding and applying the conclusions reached in Public Ruling BR Pub 00/12 ("the Ruling").

Background

The subject matter covered in the Ruling was previously dealt with in Public Rulings BR Pub 97/1 and 97/1A (*Tax Information Bulletin* Vol 9, No 1 (January 1997). The Ruling has been amended to allow for an exception where the surrender of the lease constitutes the surrender of a significant structural asset of the landlord's business and thus the surrender payment received is a capital amount.

The Ruling sets out the tax treatment of lease surrender payments received by a landlord who is in the business of leasing. The Ruling does not apply if the landlord is not in the business of leasing. However, it is to be noted that the fact that a landlord is not in the business of leasing, and is therefore not covered by the Ruling, does not automatically mean that any lease surrender payment received will not be gross income of that landlord.

Legislation

Under section CD 3, the gross income of any person includes any amount derived from any business.

Section CE 1(1)(e) includes within a person's gross income:

All rents, fines, premiums, or other revenues (including payment for or in respect of the goodwill of any business, or the benefit of any statutory licence or privilege) derived by the owner of land from any lease, licence, or easement affecting the land, or from the grant of any right of taking the profits of the land.

Application of the Legislation

From any business

Under section CD 3, the gross income of any person includes any amount derived from any business. In the Court of Appeal decision in *CIR v City Motor Service Limited; CIR v Napier Motors Limited* [1969] NZLR 1,010, Turner J considered what was meant by the words "from any business" in a predecessor provision. His Honour stated (at pages 1,017-1,018):

I think perhaps I do no more than reach his conclusion using other words when I say that in my opinion in the words "from the business" of the company something more is meant than merely "as a result of the fact that the company was carrying on this business". I think that *from the business* must mean *from the current operations of the business*. The distinction between capital accretions and revenue operations runs all through the law of income tax.

… and remembering that "Income Tax is always a tax on Income" I conclude without difficulty that the words "from any business" in an Income Tax Act must mean "from the current operations of any

business" and no more. They are not, in my opinion, apt to include accretions to the capital assets of the taxpayer which, although they may result from the fact of this carrying on business, yet do not arise from the actual current operations of that business."

His Honour went on to consider the decision of the majority of the High Court of Australia in *Dickenson v FCT* (1958) 98 CLR 460, and then concluded (at page 1,019):

But income tax being "always a tax on income", the crucial question in New Zealand must therefore in result be the same as that in Australia. Is the receipt income or capital? If it is gains or profits from a business, then the question reduces itself to whether these were derived from the *current* operations of the business, and therefore income, or whether no more can be contended, as regards their connection with the business, than that without the existence of the business they would not have accrued. If no more than this last can be proved, the gains cannot be assessable income, and simply because they are not derived from the current operations of the business.

Thus, if a receipt is an amount from a business, it is necessary only to consider whether or not that amount was derived from the current operations of the business in order to determine whether it is within the words "from any business" in section CD 3, i.e. a revenue amount rather than a capital amount. Richardson J summarised it succinctly when delivering the Court of Appeal judgment in *AA Finance Ltd v CIR* (1994) 16 NZTC 11,383 at 11,391 as follows:

Whether gains produced in a business are revenue or capital depends on the nature of the business and the relationship of the transactions producing the gain to the conduct of the business. … A transaction may be part of the ordinary business of the taxpayer or, short of that, an ordinary incident of the business activity of the taxpayer although not its main activity. A gain made in the ordinary course of carrying on the business is thus stamped with an income character.

Sometimes the amount will not arise from the ordinary course of carrying on a business. The classic statement covering such situations is that of the Lord Justice Clerk in *Californian Copper Syndicate Ltd (Limited and Reduced) v Harris (Surveyor of Taxes)* (1904) 5 TC 159 at 165-166:

It is quite a well settled principle in dealing with questions of assessment of Income Tax, that where the owner of an ordinary investment chooses to realise it, and obtains a greater price for it than he originally acquired it at, the enhanced price is not profit in the sense of Schedule D of the Income Tax Act of 1842 assessable to Income Tax. But it is equally well established that enhanced values obtained from realisation or conversion of securities may be so assessable, where what is done is not merely a realisation or change of investment, but an act done in what is truly the carrying on, or carrying out, of a business. …

…

What is the line which separates the two classes of cases may be difficult to define, and each case must be considered according to its facts; the question to be determined being – Is the sum of gain that has been made a mere enhancement of value by realising a security, or is it a gain made in an operation of business carrying out a scheme for profit-making?

The *Californian Copper* decision related to profits or gains made outside the ordinary course of a taxpayer's business. The New Zealand Court of Appeal confirmed this in its decision in *Wattie & Anor v CIR* (1997) 18 NZTC 13,297, when rejecting the argument that the High Court of Australia decision in *FCT v The Myer Emporium Ltd* (1987) 87 ATC 4,363 had extended the categories of profit or gain that are treated as revenue amounts.

The Court of Appeal considered the following oft-quoted extract from *Myer*:

Although it is well settled that a profit or gain made in the ordinary course of carrying on a business constitutes income, it does not follow that a profit or gain made in a transaction entered into otherwise than in the ordinary course of carrying on the taxpayer's business is not income. Because a business is carried on with a view to a profit, a gain made in the ordinary course of carrying on the business is invested with the profit-making purpose, thereby stamping the profit with the character of income. But a gain made otherwise than in the ordinary course of carrying on the business which nevertheless arises from a transaction entered into by the taxpayer with the intention or purpose of making a profit or gain may well constitute income. Whether it does depends very much on the circumstances of the case. Generally speaking, however, it may be said that if the circumstances are such as to give rise to the inference that the taxpayer's intention or purpose in entering into the transaction was to make a profit or gain, the profit or gain will be income, notwithstanding that the transaction was extraordinary judged by reference to the ordinary course of the taxpayer's business. Nor does the fact that a profit or gain is made as the result of an isolated venture or a "one-off" transaction preclude it from being properly characterized as income … . The authorities establish that a profit or gain so made will constitute income if the property generating the profit or gain was acquired in a business operation or commercial transaction for the purpose of profit-making by the means giving rise to the profit.

The Court of Appeal in *Wattie* then continued:

Immediately afterwards the Court referred to the decision in *Californian Copper Syndicate Ltd v Harris (Surveyor of Taxes)*, (1904) 5 TC 159 as making the point. But that is simply the classic example of the well recognised assessability of a profit derived from an adventure in the nature of trade or, as it is put in a passage then quoted from *Californian Copper*, "a gain made in an operation of business in carrying out a scheme for profit making". At p211 the High Court observed that the important proposition to be derived from *Californian Copper Syndicate*:

> "… is that a receipt may constitute income, if it arises from an isolated business operation or commercial transaction entered into otherwise than in the ordinary course of the carrying on of the taxpayer's business, so long as the taxpayer entered into the transaction with the intention or purpose of making a relevant profit or gain from the transaction."

That seems to be a description of an adventure in the nature of trade, a description well able to be applied to what occurred in *Myer* itself. A gain from an adventure deliberately entered into with a view to the profit, though perhaps unprecedented for the taxpayer, will constitute income. It is a profit-making scheme. The profit is income in accordance with ordinary concepts.

Although the decision in *Wattie* was appealed to the Privy Council ((1998) 18 NZTC 1,991), counsel accepted the Court of Appeal's interpretation of *Myer* as contemplating a profit arising from what is commonly referred to as an adventure in the nature of trade, of the kind illustrated by the decision in *Californian Copper*.

In circumstances where profits or gains are made outside the ordinary course of a taxpayer's business, it is necessary to consider whether such a profit or gain is of a revenue or capital nature. If the gain is made by way of the mere realisation of a capital asset, it will be a capital amount. However, if the gain is made by way of what has become known as "an adventure in the nature of trade", the gain will be a revenue amount.

In summary, therefore, the following statements can be made:

- An amount arising in the ordinary course of a taxpayer's business will automatically be treated as having a profit-making purpose and will thus be a revenue amount.
- Similarly, an amount arising as an ordinary incident of a taxpayer's business activity will be a revenue amount.
- An amount arising outside the ordinary course of a taxpayer's business will be a revenue amount if it arises from a business operation or commercial transaction with a profit-making purpose, e.g. an adventure in the nature of trade.
- An amount arising outside the ordinary course of a taxpayer's business will be a capital amount if it arises from the mere realisation of a capital asset, or if the amount is received in circumstances in which it is not possible to find a measurable profit or gain.

The critical question in the present case, therefore, is whether the receipt of a lease surrender payment by a landlord in the business of leasing is a receipt arising in the ordinary course of the landlord's business or as an ordinary incident of that business activity.

Ordinary incident of the business activity of leasing?

In the Commissioner's opinion, the receipt of a lease surrender payment by a landlord is an ordinary incident of the business activity of leasing. The only exception to this is if the surrender payment is received in respect of a lease which is of such significance to the business that it constitutes a structural asset. This will be a question of fact in the particular circumstances of each case.

No New Zealand authorities on the taxability of a lease surrender payment received by a landlord exist, and there are very few overseas authorities on this issue. The New Zealand Court of Appeal did consider a lease surrender payment in *CIR v McKenzies New Zealand Limited* (1988) 10 NZTC 5,233. However, this decision concerned the deductibility for a lessee of a lease surrender payment paid to a lessor. While the decision is considered to be good authority in relation to the deductibility of a lease surrender payment for a lessee, the comments made by the Court in that context cannot automatically be applied to the question of the assessability of such a payment to a lessor. The character of a payment for assessability and deductibility purposes has to be tested in the hands of the particular taxpayer.

In the United Kingdom case of *Greyhound Racing Association (Liverpool) Ltd v Cooper* (1936) 20 TC 373, a lease surrender payment received by a lessor from a lessee was held to be assessable. However, the lessor in that case was not in the business of leasing and the decision was therefore based on different grounds to those discussed in this Ruling. On the facts of that case the Court concluded that the payment was a revenue payment, because it was nothing more than a lump sum payment in place of future rents.

In the Australian Administrative Appeals Tribunal decision in *Case U99* (1987) 87 ATC 602, the Tribunal concluded that a lease surrender payment received by a lessor was a capital amount and not assessable to the lessor. In view of the other authorities discussed in this Ruling, this case is not considered good authority in New Zealand.

However, the significant point in relation to the Ruling is that once again the lessor was not in the business of leasing, and the case is therefore of little relevance in the present situation.

A Canadian decision that does have greater relevance is the decision in *Monart Corporation v Minister of National Revenue* [1967] CTC 263. The taxpayer in that case owned a large office building. One of its tenants, occupying one-tenth of the leased floor area of the building, gave notice that it was going to vacate and the taxpayer accepted $75,000 to cancel the lease for the remaining six years of its term. The Court concluded that the sum of $75,000 paid to the taxpayer was in lieu of future rent and was also in the nature of profit derived from a property or business of the taxpayer. It was therefore assessable to the taxpayer.

Although Canadian and New Zealand law differs on the characterisation of a lease asset, for present purposes it is relevant to note that Dumoulin J in *Monart Corporation* stated that the taxpayer corporation's, "raison d'être, and sole pursuit, consist in *the business* of renting office accommodation". His Honour then went on to expressly accept the submission of counsel for the respondent that (at page 271):

> … the amount received by the Appellant was paid to it for damages suffered or to be suffered as the result of the premature termination of the lease, and that the termination can be considered as a normal incident in the activities of a landlord renting properties.

Some guidance on the question of whether a lease surrender payment is a capital or revenue receipt may also be gained from considering cases concerning compensation for termination of agency contracts. An analogy can be drawn between receiving a lease surrender payment (compensation for terminating a lease) and receiving compensation for termination of an agency contract.

In *Kelsall Parsons & Co. v Commissioners of Inland Revenue* (1938) 21 TC 608, the taxpayers carried on business as commission agents for the sale in Scotland of the products of various manufacturers, and entered agency agreements for that purpose. One particular agency was cancelled and the taxpayers were paid £1,500 in compensation. The taxpayers claimed it was a capital amount, whereas the Commissioners claimed it was a revenue amount. The Court upheld the Commissioners' view.

The Lord President, Lord Normand, stated (at pages 619-620):

> The sum which the Appellants received was, as the Commissioners have found, paid as compensation for the cancellation of the agency contract. That was a contract incidental to the normal course of the Appellants' business. Their business, indeed, was to obtain as many contracts of this kind as they could, and their profits were gained by rendering services in fulfilment of such contracts.
> …
> It was a normal incident of a business such as that of the Appellants that the contracts might be modified, altered or discharged from time to time, and it was quite normal that the business carried on by the Appellants should be adjustable to variations in the number and importance of the agencies held by them, and to modifications of the agency agreements, including modifications of their duration, which might be made from time to time. … In parting with the benefit of the contract, moreover, the Appellants were not parting with something which could be described as an enduring asset of the business. The contract would have been terminated in any event as at the 30th September, 1935.

In *Commissioners of Inland Revenue v Fleming & Co (Machinery) Ltd* (1951) 33 TC 57, the taxpayer company carried on the business of agents and merchants for the sale of machinery and explosives; the agency work greatly predominating. In 1948 one of its agencies was cancelled and the company received a sum in compensation. The Court of Session (First Division) held that the sum was a revenue receipt.

The Lord President, Lord Cooper, noted (at page 61) that the issue belonged to a type exemplified by a number of earlier cases in which, broadly speaking, the line had been drawn between:

… (a) the cancellation of a contract which affects the profit-making structure of the recipient of compensation and involves the loss by him of an enduring trading asset; and (b) the cancellation of a contract which does not affect the recipient's trading structure nor deprive him of any enduring trading asset, but leaves him free to devote his energies and organisation released by the cancellation of the contract to replacing the contract which has been lost by other like contracts.

Lord Russell explained this distinction further (at page 63):

When the rights and advantages surrendered on cancellation are such as to destroy or materially to cripple the whole structure of the recipient's profit-making apparatus, involving the serious dislocation of the normal commercial organisation, and resulting perhaps in the cutting down of the staff previously required, the recipient of the compensation may properly affirm that the compensation represents the price paid for the loss or sterilisation of a capital asset and is therefore a capital and not a revenue receipt. … On the other hand when the benefit surrendered on cancellation does not represent the loss of an enduring asset in circumstances such as those above mentioned – where for example the structure of the recipient's business is so fashioned as to absorb the shock as one of the normal incidents to be looked for and where it appears that the compensation received is no more than a surrogatum for the future profits surrendered – the compensation received is in use to be treated as a revenue receipt and not a capital receipt.

It was held that the company's main business consisted of acquiring agencies, and the diminution or increase in the number of agencies (whether prior to the due date of expiration or not) could be regarded as a normal incident of its business. The structure of the company's business was not affected. The sum received had to be regarded as compensation for loss of profits and not for loss of a profit earning asset.

In *Wiseburgh v Domville (Inspector of Taxes)* [1956] 1 All ER 754 (CA), the taxpayer was a manufacturers' agent. One agency was determined by the principals without the required notice, and the taxpayer suffered a serious reduction in his earnings. The taxpayer brought an action for damages for breach of the contract and for commission due up to the breach. The action was settled and the taxpayer received £4,000, expressed to be damages for the breach of agreement and costs; the claim for commission having been abandoned.

Lord Evershed MR noted that at the time the agency was terminated the taxpayer held only two agencies, although he had held a varying number of agencies during his time as an agent. It was also noted that, "the effect of the loss of this contract, quoad the taxpayer's agency business, was very substantially to depreciate his earnings". Nevertheless, his Lordship stated (at pages 758-759):

Here, the taxpayer has been carrying on a business which for thirteen years has shown variations in the actual agreements which it has comprehended. The business has suffered something perhaps of a

disaster by reason of this quarrel with a valuable customer. But, beyond that, it seems to me it is not right to say that the taxpayer had his undertaking as a sales agent partially destroyed or taken away.
…
Harman J., said ([1955] 3 All ER at p.551):

> "The taxpayer was a manufacturers' agent. He had other agencies from time to time and carried on business as an agent, and one of the incidents of such businesses is that one agency may be stopped and another begun. The fact that an agency was a key agency, and was therefore important to him and represented half of his income, seems to me to be irrelevant."

With the possible exception of substituting "inconclusive" for "irrelevant", I agree entirely with that statement; and I agree with what the judge said later (ibid.):

> "… it was a normal incident in this kind of business that an agency should come to an end, and it seems to me that the compensation paid is quite clearly income."

The case of *Van den Berghs Ltd v Clark (Inspector of Taxes)* [1935] All ER 874 concerned payments made under agreements entered between competitor companies (both margarine manufacturers) for the sharing of profits and losses and the regulation of their activities. Following a dispute under the agreements, the taxpayer received a payment of £450,000 as "damages" and in consideration of the termination of the agreements. The House of Lords held that the payment was a capital receipt. Lord MacMillan discussed the case of *Atherton v The British Insulated & Helsby Cables Ltd* [1926] AC 213 and then proceeded to consider the facts before him. He considered that it was important to bear in mind that the taxpayer's trade was to manufacture and deal in margarine. The payment received was in consideration for the taxpayer giving up its rights under the agreements for the following 13 years. Lord MacMillan said (at page 888) that these agreements:

> … were not ordinary commercial contracts made in the course of carrying on their trade; they were not contracts for the disposal of their products or for the engagement of agents or other employees necessary for the conduct of their business; nor were they merely agreements as to how their trading profits, when earned, should be distributed as between the contracting parties. On the contrary, the cancelled agreements related to the whole structure of the appellants' profit-making apparatus. They regulated the appellants' activities, defined what they might and what they might not do, and affected the whole conduct of their business. I have difficulty in seeing how money laid out to secure, or money received for the cancellation of, so fundamental an organisation of a trader's activities can be regarded as an income disbursement or an income receipt. … In the present case, however, it is not the largeness of the sum that is important but the nature of the asset that was surrendered. In my opinion that asset, the congeries of rights which the appellants enjoyed under the agreements and which, for a price they surrendered, was a capital asset.

In *Barr, Crombie & Co Ltd v CIR* (1945) 26 TC 406, from the formation of a shipping company in 1924, the appellant company managed its ships under certain agreements, the latest of which provided that the appellant company should continue to act as managers for the shipping company for 15 years from 1 January 1936. A clause in the contract provided that if the second company went into liquidation or ceased to trade, then the remuneration owing to the appellant from that day until the date on which it was due to expire would become immediately payable to the appellant. In 1942 this occurred and the appellant received the amount due.

The Lord President (Normand) found that the appellant's business had consisted almost entirely of the agency. For the previous 16 years it had contributed about 84%

of the appellant's income. Upon liquidation of the other company, it lost almost its entire business. Despite the fact that the sum payable was calculated by reference to what the appellant would have received had the company not gone into liquidation, the Lord President found that the sum received was a capital amount. He quoted Lord Buckmaster in the case of *Glenboig Union Fireclay Co Ltd v CIR* (1922) 12 TC 427 at page 464 where he said:

> … although annual payments in the nature of profits may be used as the measure by which to calculate the sum which is to be paid, the resultant sum is not thereby made itself an annual payment or a profit.

His Lordship distinguished the case of *Kelsall Parsons & Co* (above). He regarded the payment before him as being "once and for all", i.e. the price of the surrender of its only important capital asset. In contrast, in *Kelsall*, the payment was in return for the loss of a single agency contract out of about a dozen, and the fact that the payment in that case did not represent the whole capital asset of the company was shown by the fact that the next year its profits were no less than they had been before. Another contrasting feature was that in that case there was a single payment for the surrender of profits over one year, as opposed to a payment for the surrender of an agreement while there was still a substantial period to run. Lord President Normand considered the case analogous to *Van den Berghs* in that the structure of the company was radically affected and its whole character as a business decisively altered. He said:

> … where you have a payment for the loss of the contract upon which the whole trade of the Company has been built, where the expected profits of the contract are used to measure the loss of them for a period of future years, and where in consequence of the loss the Company's structure and character are greatly affected, the payment seems to me to be beyond doubt a capital payment.

The leading case in New Zealand, regarding the characterisation of a payment received for cancellation of a contract, is the Court of Appeal judgment of *CIR v Thomas Borthwick & Sons (Australasia) Ltd* (1992) 14 NZTC 9,101. That case involved the receipt by the taxpayer of $2.25m as consideration for the variation and partial surrender of its rights under a long-term supply contract. The issue was how to characterise the receipt in the hands of the recipient.

The Court of Appeal stated that the crucial consideration in the case was whether, on the facts, the 1972 supply and marketing contract was to be characterised as providing an advantage for the enduring benefit of Borthwick's trade and as forming part of the structure of Borthwick's marketing operations.

The Court of Appeal rejected the Commissioner's argument that in deciding this issue Justice Gallen had placed too much emphasis on the duration of the marketing rights and too little on its limited impact on the taxpayer's business as a whole. In applying what it described as being the leading case in which a contract was held to be a structural asset, *Van den Berghs Ltd v Clark* [1935] AC 431, the Court of Appeal stated that "whether a supply and agency contract is structural or revenue turns on the nature and significance of the contract in the operations of the business" (at page 9,105). The Court confirmed that duration, arguably over business share, is significant. Applying the observations of Lord Pearce in *BP Australia Ltd v C of T* [1966] AC 224, the longer the duration, the greater the indication that a structural

solution is being sought. The Court, deciding the sum was capital, found on the facts that:

- The marketing agreement assured the taxpayer of a long-term source of supply of produce for its marketing business.

- The supply of produce replaced the previously held capital asset, i.e. the freezing works, and in that way the agreement was then the framework for making profits from the South Island.

- Globally the agreement was of major significance to the taxpayer's business, i.e. 40% increase in share of NZ lamb kill.

- The size of the payment indicated the value and importance of the agreement to the business.

An analogy can be drawn between the receipt of compensation for the termination of a contract, and the receipt of a lease surrender payment on the termination of a lease.

In general, it is a normal incident of the business of leasing that leases might be modified, altered, or surrendered from time to time and it is quite normal that such a business should be able to take into account such modifications, alterations, or surrenders. In addition, in most cases, in accepting the surrender of a lease, a landlord is not parting with an enduring asset of the business because, as in the case of an agency contract, the lease would have been terminated at some point in the future in any event.

The termination of a lease will not generally affect the profit-making structure of a landlord's business, neither will it involve the loss of an enduring trading asset. In most cases the structure of a landlord's business is such that it is fashioned to absorb the shock of the termination of a lease as one of the normal incidents of the business. The landlord is left free to devote energy and organisation to replacing the lost lease with a new lease.

However, in certain circumstances the surrender of a lease may constitute the loss of an enduring asset of the business and the receipt of a lease surrender payment by the landlord may be a capital amount. This will be a question of fact in any particular case. The cases discussed above indicate that the following principles will apply:

- The nature and significance of the lease to the landlord's business will be crucial.

- In determining the significance of a lease, the length of the lease and the size of the payment will be relevant.

- If the lease constitutes the whole structure of the profit-making apparatus, the receipt may be on capital account.

- If the landlord has several leases as part of its business structure and the receipt relates to only one of them, the general rule is that the receipt will not relate to the

capital structure. However, this general rule may not apply if the one lease out of several constitutes a significant part of the business.

- The method of calculation of the sum payable is not determinative.

It is to be noted, in this regard, that if the facts of a situation suggest that a taxpayer has structured its, or its group's, affairs in a particular way for the purpose or effect of converting a revenue receipt into a capital receipt, the Commissioner may consider the application of the anti-avoidance provisions of the Income Tax Act 1994.

Conclusion

The receipt of a lease surrender payment by a landlord in the business of leasing is a normal incident of that business. Such a receipt will therefore constitute gross income within section CD 3 as an amount derived from any business. The only exception to this is where the surrender payment is received in respect of a lease that is of such significance to the landlord's business that it constitutes a structural asset. This will be a question of fact in the particular circumstances of each case.

Although the Ruling deals only with the receipt of a lease surrender payment by a landlord in the business of leasing, it should be noted that the fact that a lease surrender payment is received by a landlord who is not in the business of leasing will not automatically exclude that payment from the landlord's gross income. It will still be necessary to consider whether the payment is to be included as a revenue amount on some other basis, such as on the basis that the amount arose from an adventure in the nature of trade. Equally, the receipt could be a normal incident of some other business activity of the recipient and thus a revenue receipt.

Example 1

Landlord A owns a number of commercial properties, and is in the business of leasing them. She leases one building to Tenant. Landlord A and Tenant execute a lease for 15 years at a rental of $50,000 per annum: the rental being reviewable every five years. The lease provides for one right of renewal for a further 15-year period.

Five years into the lease Tenant's business outgrows Landlord A's building. Tenant moves the business to another property. Tenant offers to pay Landlord A $200,000 if she will accept a surrender of the lease by Tenant and the cancellation of all Tenant's obligations under the lease. Landlord A agrees, the lease is cancelled, and Tenant pays Landlord A the $200,000.

Under section CD 3, the amount is gross income of Landlord A.

Example 2

Landlord Z is a company and is the landlord of a commercial property that was purpose built for a particular tenant. The management of the leasing arrangements takes considerable time and effort and is carried out solely by Landlord Z, which has no other business activities. The lease was for 50 years and has 30 years still to run.

The building is now in an unfashionable area and the tenant has to move to survive. There is no possibility of securing a further tenant. The tenant negotiates a lease surrender payment with Landlord Z.

Landlord Z is in the business of leasing and is therefore subject to the Ruling. However, the surrender payment is in respect of a significant asset of the Landlord's business and affects the profit-making structure of the business. The business is not fashioned to absorb the shock of the termination of the lease as a normal incident and neither can a new lease be found. The surrender payment received by Landlord Z will be a capital amount.

Section CE 1(1)(e)

Section CE 1(1)(e) potentially applies to a lease surrender payment. That section includes within the landowner's gross income, "premiums or other revenues" derived by a land owner "from any lease". The words "premiums or other revenues" are potentially wide enough to include a lease surrender payment. However, in the Commissioner's view, the words "from any lease" imply that the premiums or other revenues arise from a lease that will continue in existence after the payment is made. The words do not cover a situation where the lease is terminated on payment of the surrender payment. Accordingly, section CE 1(1)(e) does not apply. Support for this view is contained in obiter dicta of Richardson J in *CIR v McKenzies NZ Ltd* (1988) 10 NZTC 5,233 at 5,235, where His Honour said that premiums paid or received on the surrender of a lease were not dealt with in a predecessor section to section CE 1(1)(e).

When a landlord's activity amounts to a business

The leading case on the test and criteria for whether a business exists is *Grieve v CIR* (1984) 6 NZTC 61,682. In *Grieve*, Richardson J noted there were two factors in deciding if there was a business: first, whether the taxpayer had an intention to make a profit; second, the nature of the activities carried on. He went on to set out the following factors relevant to the inquiry as to whether a taxpayer is in business:

- The nature of the taxpayer's activities.
- The period over which the taxpayer engages in the activity.
- The scope of the taxpayer's operations.
- The volume of transactions undertaken.
- The commitment of time, money, and effort by the taxpayer.
- The pattern of activity.
- The financial results achieved by the activity.

Ultimately, whether a landlord is in business is a question of fact. In seeking to determine whether a landlord is in business, the Commissioner uses the criteria identified above from the *Grieve* decision. More recently the question of whether a business existed or not arose in *Slater v CIR* (1996) 17 NZTC 12,453. The High Court examined, discussed, and approved *Grieve* and the tests proposed in that case.

A taxpayer who is in doubt as to whether or not a leasing activity amounts to a business should contact a tax adviser or Inland Revenue.

Case law on whether a landlord's leasing activity amounts to a business

A number of cases consider whether the leasing of property for rents amounts to a business.

In *L D Nathan Group Properties Ltd v CIR* (1980) 4 NZTC 61,602, the taxpayer was the property owning subsidiary of the group. Davison CJ said that the deriving of rents by a company such as the taxpayer was income from a business. This confirms the approach in *Smith v Anderson* (1880) 15 Ch D 258, *CIT v Hanover Agencies Limited* [1967] 1 All ER 954 (PC), and *American Leaf Blending Co Sdn Bhd v Director-General of Inland Revenue* [1978] 3 All ER 1185 (PC) that companies involved in leasing will readily be held to be in the business of property leasing. However, this classification is not limited to company taxpayers. For example, in *Case F111* (1984) 6 NZTC 60,094 the taxpayer owned two houses and a block of five flats. She collected the rents, interviewed tenants and did some of the maintenance and repair work. The TRA was of the view that the taxpayer was in business as a landlord.

From these cases, it would appear that leasing a number of buildings is likely to mean the taxpayer is in the business of property leasing. Leasing only one building can also mean the taxpayer is in the business of property leasing, if the requirements of the building mean the landlord is actively and regularly involved with the property (e.g. negotiating new leases, maintenance, renovations, etc.). It is also possible that leasing a single building will not mean the landlord is in the business of property leasing (e.g. when the landlord does not need to have much involvement with the day to day running of the property, or when new lessees, maintenance, or renovation work are rare). It is interesting to note that the cases suggest that the business threshold is lower when the landlord is a company than when the landlord is an individual or individuals.

Two Australian cases discussed below found the renting of property did not amount to a business. To the extent that these cases are inconsistent with the cases discussed above they should be ignored, as the above authorities, being Privy Council and New Zealand High Court and TRA cases, are more persuasive authorities in a New Zealand court.

In *Case 24* (1944) 11 TBRD 85, the taxpayer owned three properties returning rental income of over £10,000. The taxpayer employed a manager who collected and banked rents, attended to repairs and supervised them, and controlled the caretaker and cleaners. However, the taxpayer personally carried out the management of his rent-producing properties and directed policy; attending to the financial arrangements and making decisions regarding repairs. He employed an accountant to prepare accounts. The Board of Review (in a 2-1 decision) found that the taxpayer did not have a business of renting property. In light of subsequent case law, particularly *Case F111*, this decision is unlikely to be persuasive authority in New Zealand.

In *Kennedy Holdings & Property Management Pty Ltd v FCT* 92 ATC 4,918, the taxpayer co-owned a building that it rented out. It paid its lessee a sum of money to surrender the lease and sought to deduct the sum. The deduction was denied by the Commissioner, and the Federal Court (NSW) upheld the Commissioner's assessment. The Court found the taxpayer was not carrying on a business. At page 4,921 Hill J said:

> It cannot be said on the evidence of the present case that the applicant is, for purposes relevant to s.51(1), carrying on a business. The applicant and its co-owner own one property which they lease out and from which they derive rental income. The freehold held in co-ownership is, in such circumstances, the income producing entity, structure or organisation for the earning of the rental income of the co-owners. The freehold is the profit-making structure.

Again, there must be some doubt as to the persuasiveness of this case in New Zealand. However, it may be seen as an example of a company owning one building and not needing to undertake much effort in its management, and therefore not being in the business of renting property.

Example 3

Landlord B is retired and owns two properties: a family home, and another house rented to an architect for use as an office. The rent is direct credited to Landlord B's bank account. Landlord B has no day to day involvement with the tenant or the building, and only very rarely needs to arrange for repairs and maintenance to be carried out. The tenant has tenanted the building for five years, and has a further five-year lease over the building. In terms of the *Grieve* tests, the scope of Landlord B's operations, the volume of transactions undertaken, the commitment of time, money, and effort by the taxpayer, the pattern of the activity, and so on, all suggest that her renting does not amount to a business.

Example 4

Landlord C is in full-time employment, but also owns six houses that he rents out to tenants. Prior to renting out a house, Landlord C totally renovates it. Thereafter, Landlord C carries out any repairs that may be required. He undertakes advertising for new tenants, collection of rents, and associated duties. Landlord C is in the business of renting on the strength of both *Case F111* and the *Grieve* test. Unlike Landlord B above, the nature of Landlord C's activities, the scope of the operations, the volume of transactions undertaken, and the commitment of time, money, and effort all suggest a business exists.