LEASE SURRENDER PAYMENTS RECEIVED BY A LANDLORD—INCOME TAX TREATMENT

Note (not part of ruling): This ruling is essentially the same as Public Ruling BR Pub 00/12 which was published in Tax Information Bulletin Vol 13, No 1 (January 2001). BR Pub 00/12 was a reissue of BR Pub 97/1 and BR Pub 97/1A which were published in Tax Information Bulletin Vol 9, No 1 (January 1997). The Ruling has been amended to take into account the Income Tax Act 2007 and to clarify the Commissioner's position as taken in BR Pub 00/12. BR Pub 00/12 expired on 31 March 2005. BR Pub 09/06 will apply for an indefinite period beginning on the first day of the 2008/09 income year.

PUBLIC RULING - BR Pub 09/06

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 2007 unless otherwise stated.

This Ruling applies in respect of sections CB 1, CC 1(1) and CC 1(2).

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 income under section CB 1(1) as an amount derived from a business, unless 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 income under sections CC 1(1) and CC 1(2) where the payment is not provided for in the terms of the lease.

The period for which this Ruling applies

This Ruling will apply to payments received by a landlord in the business of leasing for an indefinite period beginning on the first day of the 2008/09 income year.

This Ruling is signed by me on 30 June 2009.

Susan Price
Director, Public Rulings

COMMENTARY ON PUBLIC RULING BR Pub 09/06

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 09/06 ("the Ruling").

Background

The subject matter covered in the Ruling was previously dealt with in Public Rulings BR Pub 97/1, BR Pub 97/1A (*Tax Information Bulletin* Vol 9, No 1 (January 1997)) and BR Pub 00/12 (*Tax Information Bulletin* Vol 13, No 1 (January 2001)). The Ruling has been amended to take into account the Income Tax Act 2007 and to clarify the Commissioner's position as taken in BR Pub 00/12.

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 a lease surrender payment received by a landlord who is not in the business of leasing could still be considered to be income of that landlord.

Legislation

Section CB 1 provides:

> (1) An amount that a person derives from a business is income of the person.
>
> (2) Subsection (1) does not apply to an amount that is of a capital nature.

Subsections (1) and (2) of section CC 1 include within a person's income:

> (1) An amount described in subsection (2) is income of the owner of land if they derive the amount from—
> (a) a lease, licence, or easement affecting the land; or
> (b) the grant of a right to take the profits of the land.
>
> (2) The amounts are—
> (a) rent:
> (b) a fine:
> (c) a premium:
> (d) a payment for the goodwill of a business:
> (e) a payment for the benefit of a statutory licence:
> (f) a payment for the benefit of a statutory privilege; or
> (g) other revenues.

Application of the Legislation

1. Section CB 1(1)

From a business

Under section CB 1(1), the income of a person includes an amount derived from a business. In the Court of Appeal decision in *CIR v City Motor Service Ltd; CIR v Napier Motors Ltd* [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 a business" in section CB 1(1) ie, 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 as follows (at page 11,391):

> 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 pages 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?

This point was further considered by the New Zealand Court of Appeal 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 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 taxation 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 Ltd* (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 (ie, symmetrical tax treatment is not required in terms of different parties to the same transaction). The character of a payment for assessability and deductibility purposes has to be tested in the hands of the particular taxpayer. Similarly, the Privy Council decision in *Wattie* considered the character of leases from the point of view of the lessee. It is considered that the nature of a lease in a lessor's business is different to that of a lessee.

In most cases, a lessee will use the property as accommodation for carrying out its income earning process. The lease will not directly form part of the taxpayer's profit making activities. The lease will also provide the lessee with an interest in the land which could be considered to be an enduring benefit. However, as far as a taxpayer in the business of leasing is concerned, the lease or leases will generally be part of the income earning process rather than the capital structure. On the surrender of the lease, the lessee no longer has an interest in the land or

premises and no longer has a capital asset. The lessor, in contrast, retains possession of the underlying land or premises.

A Canadian decision that is potentially relevant 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 (and the Privy Council in *Wattie* expressed some doubt as to whether Canadian law in this area could be applied in New Zealand), 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 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."

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 *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 shipping 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, Lord Normand, found that the appellant's business had consisted almost entirely of the agency. For the previous 16 years it had contributed about 84 percent 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 *Glenboig Union Fireclay Co Ltd v CIR* (1922) 12 TC 427 where he said (at page 464):

> … 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 *Kelsall Parsons & Co*. He regarded the payment before him as being "once and for all" ie, 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 Gallen J 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 ie, 40 percent increase in share of New Zealand lamb kill;

- the size of the payment indicated the agreement's value and importance 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.

Whether a lease is always a capital asset

Some commentators have suggested that *McKenzies* is authority for the proposition that a lease will always be a capital asset to both a lessor and a lessee (unless the taxpayer is in the business of buying and selling leases). Certain quotes in the judgment could be seen to support this view – most notably Richardson J's comment that "[h]ere, as in the case of most taxpayers, the lease was part of the profit making structure of the business". However, it is not clear from the judgment whether Richardson J was intending to include lessors within this, or whether he was referring to lessees whose leases would (unless the lessee was in the business of acquiring leases to sell) generally be capital assets.

To the extent that Richardson J was suggesting that the quote applied more widely to lessors as well, such comments are obiter dicta, not being relevant to deciding the issue in dispute (which involved McKenzies as a lessee making a lease surrender payment). Further, if the case is suggesting that a lease will always be some kind of capital "asset" for a lessor, in whatever circumstances, it is the Commissioner's view that this interpretation of the judgment overstates the situation for the reasons set out above.

Summary

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.

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. The more fundamental to the landlord's business a particular lease is, the more likely the payment will relate to the giving up of an enduring asset in the form of part of the business structure and will be considered capital in nature. This will be a question of fact in any particular case. The cases discussed above indicate that the following principles will apply:

- It is necessary to ascertain whether the cancelled lease is of such a nature and significance to the landlord's business so as to form part of the profit-making structure. If this is the case, then the related payment will be capital. However, where the cancelled lease does not form part of the profit-making structure or deprive the landlord of an enduring asset, then the cancellation of such a lease returns the underlying capital asset to the taxpayer to use to earn income. In such

- In determining the nature and significance of the lease in relation to the landlord's activity, regard may be had to the duration of the agreement and also to whether the landlord ordinarily enters into such agreements. In this respect, the more fundamental the agreement is to the landlord's business (ie, the more "crippled" the business is subsequent to the agreement's cancellation) the more likely it is to be capital.

- Where a lease is surrendered and the property concerned cannot readily be leased again (for example where the property has been set up for a particular purpose which is specific to the lessee), the lease surrender payment may be considered to be a capital amount.

- The method of calculation of the sum payable is not determinative (however, where a lease surrender payment is merely commutation of rent that would otherwise have been payable under the lease, this may point towards the payment being revenue in nature).

- 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, then generally the receipt will not relate to the capital structure. However, this may not be the position if the one lease out of several constitutes a significant part of the business.

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 2007.

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 income within section CB 1(1) as an amount derived from a 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 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. If the lease surrender payment is simply a lump sum payment to reflect lost rent, it is likely that it would be 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 CB 1(1), the amount is 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 surrender payment received by Landlord Z will be a capital amount.

2. Subsections (1) and (2) of section CC 1

Section CC 1 potentially applies to a lease surrender payment. That section includes within the landowner's income, "other revenues" derived by a land owner "from a lease". The words "other revenues" are potentially wide enough to include a lease surrender payment. In the Commissioner's view, the words "from a lease" require that there is a nexus between the payment and the lease ie, that the payment can be said to arise or emanate from the lease or have the lease as its source.

The Commissioner considers that the amounts listed in section CC 1(2) are amounts paid for the use of land. A lease surrender payment is paid to terminate a person's use of land. It therefore does not come within any of the types of payment listed. As a lease surrender payment is paid to prematurely end the relationship between lessee and lessor, does not enhance or further that relationship, and cannot be said to flow from the lease, there is not a sufficient nexus between the payment and the lease. Therefore, a lease surrender payment is not an amount to which section CC 1 applies.

The conclusion that the section does not apply is also supported by *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 CC 1.

This Ruling only applies in the more common situation where the terms of the lease do not provide for a lease surrender payment. In the event that a lease

provided for what is to occur upon the surrender of a lease, the specific terms would have to be considered to determine whether section CC 1 applies.

3. When a landlord's activity amounts to a business

The term "business" is defined in section YA 1 as including any profession, trade, or undertaking carried on for profit.

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. The question of whether a business existed or not also 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

Several 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 Ltd* [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 more 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 Taxation Review Authority was of the view that the taxpayer was in business as a landlord.

From these cases, it would appear that leasing several buildings is likely to mean a taxpayer is in the business of property leasing. Leasing only one building can also mean a 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 (eg, negotiating new leases, maintenance, and renovations). It is also possible that leasing a single building will not mean the landlord is in the business of

property leasing (eg, 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 are not considered to be precedential, and the above authorities, being Privy Council and New Zealand High Court and Taxation Review Authority 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. Hill J said (at page 4,921):

> 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.

Another example of a company renting out property without carrying on a business is *R & C Commissioners v Salaried Persons Postal Loans Ltd v R & C Commissioners* [2006] BTR 423. In this case a company had carried on a trade from one set of premises which it owned. In 1966 the company moved its trade to other premises and let its own premises out. In 1995 the company stopped its trade. Since then the rent received for its original premises had been the sole source of income. The company had had no employees or a bank account and had not paid any money to directors or made any distributions. The tenant of the original premises had remained the same throughout the years.

The Court found that a company whose sole activity is the collection of a modest amount of rent under a longstanding lease is not carrying on a business.

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 part-time employment, but also owns six houses that he rents out to tenants. Before 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 in example 3, 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.

Period of the Ruling

The Ruling commences on the first day of the 2008/09 income year. The previous ruling expired on 31 March 2005. Given the terms of section 91C of the Tax Administration Act 1994, it is not possible to issue a ruling in respect of the Income Tax Act 2004 for the period beginning 1 April 2005 to the end of the 2007/08 income year. However, the Commissioner is of the view that the same principles and conclusions as set out in this ruling apply to any lease surrender payments received by a landlord in the business of leasing during this period.