Inland Revenue
Te Tari Taake

EASEMENTS - DEDUCTIBILITY OF THE COSTS OF PREPARATION, STAMPING, AND REGISTRATION

PUBLIC RULING - BR Pub 98/7

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

Taxation Laws

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

This Ruling applies in respect of sections DJ 11, BD 2(2)(e), EF 1(5), and the section OB 1 definitions of: “estate” or “interest”, “lease”, and “leasehold estate”.

The Arrangement to which this Ruling applies

The Arrangement is the tax deductibility of expenditure incurred in the preparation, stamping, and registration of easements used in the derivation of the taxpayer’s gross income.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- Easements will be treated as leases for the purposes of section DJ 11.

- The Commissioner will allow a deduction for costs incurred by a taxpayer in the preparation, stamping, and registration of easements where they are used in the derivation of the taxpayer’s gross income, in the income year in which the expenditure is incurred.

The period for which this Ruling applies

This Ruling will apply for the period 1 January 1999 to 31 March 2002.

This Ruling is signed by me on the 30th day of November 1998.

Martin Smith
General Manager (Adjudication & Rulings)

Inland Revenue
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COMMENTARY ON PUBLIC RULING BR Pub 98/7

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 98/7 ("the Ruling").

Background

Land may have its utility enhanced by the right to the use of an easement. Once registered an easement gives an interest in the land that is of enduring benefit.

Subject to the exercise of the Commissioner's discretion, section DJ 11 permits a deduction for the costs of the preparation, stamping, and registration of "any lease of property used in the derivation of the taxpayer's gross income". The issue is whether an easement is a "lease of property" as defined in the Act.

Legislation

Section DJ 11 states:

The Commissioner may allow such deduction as the Commissioner thinks fit in respect of expenditure incurred by a taxpayer during an income year for the preparation, stamping, and registration of any lease of property used in the derivation of the taxpayer's gross income, of any renewal of any such lease, or in the borrowing of money employed by the taxpayer as capital in the derivation of gross income.

Section BD 2(2) specifically excludes certain expenditure or losses as allowable deductions from gross income derived by a taxpayer. Relevant for the purposes of this Ruling is the section BD 2(2)(e) exclusion for expenditure or loss of a capital nature which states:

An amount of expenditure or loss is not an allowable deduction of a taxpayer to the extent that it is

…

(e) of a capital nature, unless allowed as a deduction under Part D (Deductions Further Defined) or E (Timing of Income and Deductions), or

Section EF 1(5)(d) states:

The amount of the unexpired portion (if any) of any amount of accrual expenditure of any person to be taken into account in any income year shall be -

…

(d) Where the expenditure relates to a payment for, or in relation to, a chose in action, the amount that relates to the unexpired part of the period in relation to which the chose is enforceable.

The following are defined terms in section OB 1:

"Estate" or **"interest",** in relation to land, means any estate or interest in land, whether legal or equitable, and whether vested or contingent, in possession, reversion or remainder; and includes any right to the possession of land or to receipt of the rents or profits from the land, or to the proceeds of the sale or other disposition of the land, whether immediate or through a trustee, or otherwise; but does not include a mortgage:

"Interest" –
…
(b) In relation to land, has the same meaning as **"estate"**

"Lease" –
(a) Except as provided in paragraphs (b), (d), (e), and (f) means any disposition whatever by which a leasehold estate is created:

"Leasehold estate" includes any estate however created, other than a freehold estate:

Application of the Legislation

The nature of an easement

The essential elements of an easement, as developed by common law, are that:

- there must be a dominant tenement and a servient tenement (*Hawkins v Rutter* [1892] 1 QB 668); and
- the easement must accommodate the dominant tenement such that it is related to the utility of the land and must do more than confer a personal benefit on the owner of the land (*Re Ellenborough Park* [1955] 3 All ER 667); and
- the dominant owner and servient owner must be different persons (*Metropolitan Rly Co v Fowler* [1892] 1 QB 165); and
- the easement must be capable of forming the subject matter of the grant (*Re Ellenborough Park*).

In New Zealand the common law elements of an easement have been modified by statute. The statutory modification has created "easements in gross". Section 122 of the Property Law Act 1952 allows the creation of easements in gross. An easement in gross is one where there is no requirement for a dominant tenement. The right created by the easement is not appurtenant to another parcel of land. This modifies the first element of a common law easement, that there be a dominant and servient tenement.

While statute permits an easement where there is no dominant tenement, there must be a servient tenement. This is necessary, for if the right granted by the easement arises from ownership of the land, there is no requirement to claim that right as an easement as it already exists.

Two other features of an easement, while not defining characteristics, further describe the rights and limitations of an easement:

- An easement permanently binds the land over which the right is exercised, and similarly subsists permanently for the benefit of the dominant tenement. One issue that arises is whether the rule against perpetuities applies to an easement. If the right created by the easement vests immediately with the grantee, authority indicates that the rule against perpetuities does not apply (*Ellison v Vukicevic* (1986) 7 NSWLR 104).

- The notion that an easement cannot and does not confer a right to possession in the land over which the right is granted (*Copeland v Greenhalf* [1952] 1 All ER 809).

An easement is a lease for the purposes of the Act

Although an easement is not an estate in land, it is an interest in land as contemplated by the law of real property. In *Auckland City Council v Man O'War Station Limited* [1996] 3 NZLR 460, Anderson J observed:

> An easement… is an incorporeal hereditament, which is a right in respect of land, and therefore an **interest** in land, but it is not land in the tangible sense nor an **estate** in land in the common law sense. [page 465] [emphasis added]

An easement may be distinguished from other lesser rights such as a licence. A licence is a personal right and so does not pass an interest in the land in the way that an easement does (*Errington v Errington* [1952] 1 All ER 149 and *Thomas v Sorrell* (1673) 124 E.R. 1098).

A lease, as contemplated in the law of real property, is an estate of less than freehold. Estates of less than freehold exist where the duration of the estate is certain or capable of being made certain (*Charles Clay & Sons Ltd v British Railways Board* [1971] 1 All ER 1007). Adams EC (Ed) in *Garrow's Law of Real Property* (Butterworths, Wellington 1961) categorises leases whether for a fixed term, at will, or at sufferance as the estates of less than freehold.

For the purposes of the Act, a "lease" is defined in section OB 1 as any disposition by which a "leasehold estate" is created. An easement is created by a disposition of property. The owner of the fee simple which will become the servient tenement surrenders, or disposes of, part of his or her right in the land to another person. Also implicit in the definition is that the disposition must **create** a leasehold estate. That is, the disposition must not be one that, for example, **transfers** the leasehold estate in the land. An easement qualifies, as it is not a transfer of any interest in the land but the creation of an interest in the land, a right that attaches to land so that it may improve its use and benefit.

"Leasehold estate" is also defined, as any estate however created, other than a freehold estate. The concept of a "freehold estate" was developed by common law. A freehold estate is one of uncertain duration: the feature that distinguishes it from an estate of less than freehold, i.e. a lease. In the case of individuals it is uncertain as it is measured by reference to their lives. For corporations, it is uncertain, as they may continue on indefinitely. There are three types of freehold estates in New Zealand: the fee simple which will enure until the holder of the estate dies intestate without heirs, the life estate which will continue only for the life of the holder and is extinguished on that person's death, and the stratum estate created by section 4(2) of the Unit Titles Act 1972.

The term "estate", also defined in the Act, is coupled with the word "interest". "Interest" is defined as having in relation to land the same meaning as "estate". For

the purposes of the Act, therefore, the terms "estate" or "interest" are merged and treated synonymously.

An easement is an interest in land. A lease is an estate in land. The term "lease" is the nomenclature used in the Act for estates or interest in land unless specifically excluded, such as estates of freehold and mortgages. An easement as an interest in land is therefore a "lease" as defined in the Act, and section DJ 11 applies to the costs of preparation, stamping, and registration of easements.

Exercise of the Commissioner's discretion

A deduction for the costs of preparation, stamping, and registration of an easement under section DJ 11 is subject to the exercise of the Commissioner's discretion. There exists no direct case authority on how the Commissioner should exercise the discretion conferred upon him in section DJ 11. The words granting the discretion do not fetter the exercise of the Commissioner's discretion. In this respect the Commissioner is bound only to act fairly and according to the law (*Gisborne Mills Ltd & Ors v C of IR* (1989) 11 NZTC 6194, *Reckitt & Coleman (NZ) Limited v Taxation Board of Review* [1966] NZLR 1032 and *Lowe v C of IR* (1981) 5 NZTC 61,006).

Discussed below are two legislative provisions considered by the Commissioner as relevant in exercising the discretion conferred in section DJ 11.

The first is the capital/revenue distinction. The costs of preparation, stamping, and registration of an easement are typically for most taxpayers, capital expenditure. This view is based on the one-off nature of the expenditure, the enduring nature of the benefit, and that land generally is part of the taxpayer's business structure. Capital expenditure as such is non-deductible under section BD 2(2)(e), unless the Act expressly permits otherwise. Deductions allowed in part D of the Act, which includes section DJ 11, are an expressly permitted exception to the non-deductibility of capital expenditure contained in section BD 2(2)(e). To give effect to section DJ 11, it is necessary that a deduction for such expenditure is not disallowed on the basis that the expenditure is capital in nature.

The second provision considered is spreading deductibility, for the costs of preparation, stamping, and registration of an easement, under section EF 1. Essentially, section EF 1 adds back as income the unexpired portion of any expenditure incurred. As such it is a qualification to the general rule that a deduction for expenditure is available when it is incurred. Section EF 1 does not operate to deny a deduction, but is a provision directed to the timing of the deduction.

If an allowable deduction is subject to a timing regime, the Commissioner must, under section BD 4(2), allocate the deduction to an income year in accordance with that regime. If the lease is a conventional lease which is for a term certain, the provisions of section EF 1 may be readily applied . Where the lease is one, such as an easement, which runs with the land, it may be considerably more uncertain as to the application of section EF 1. Relevant for this discussion is section EF 1(5)(d) which deals with the spreading of deductions for choses in action.

The uncertainty arises as an easement is an incorporeal hereditament, enforced by action, and therefore a chose in action. A chose in action is a term used "to describe all personal rights of property which can only be claimed or enforced by action, and not by physical possession" (*Torkington v Magee* [1902] 2 KB 427, 430).

One of the elements of section EF 1(5)(d) is the requirement to add back the amount of expenditure "that relates to the unexpired part of the period in relation to which the chose is enforceable". Important in this respect is the concept of "period".

The notion of a period has two elements:

- it is a continuous and unbroken duration of time; and
- it is an interval with a commencement point in time and a point of determination.

Therefore, a period has the connotation of a continuous interval of time for which there is a commencement point and a point of cessation (*London & India Docks* 9 T.L.R. 11, and *JLG Investments v Sandwell District Council* [1978] E.G. 845).

In applying the notion of a period to an easement, it is arguable that all expenditure incurred would be added back. As an easement runs with the land, subsisting permanently for the benefit of the dominant tenement, the total expenditure will be added back as the unexpired portion. Applying this reasoning, section EF 1 would operate to disallow a deduction, notwithstanding that the easement had been used, as part of an interest in the land, to derive gross income. As was emphasised by the Court of Appeal in *Thornton Estates Ltd v C of IR* (1998) 18 NZTC 13,577, section EF 1 spreads the timing of the deduction; it does not prohibit a deduction.

An alternative approach to section EF 1 would be to add back the costs of preparation, stamping, and registration of an easement in each period until the easement is no longer enforceable by the taxpayer, (i.e. no part of the effect of the expenditure is treated as spent in relation to the taxpayer until that taxpayer disposes of his or her interest in the land benefiting from the easement.) This interpretation assumes that the end point of a "period" need not be certain while the time is running.

The difficulty with this interpretation is that it does not distinguish between an uncertain period and no period. An easement has no period as it runs with the land indefinitely – it does not have a point of determination. A further potential issue with adopting the alternative view, is that if a taxpayer such as a corporation never disposes of the land benefiting from the easement, then the taxpayer may never receive a deduction.

It is considered that the better view of the law is that expenditure incurred in the preparation, stamping, and registration of easements is deductible when it is incurred. This approach is consistent with the view that expenditure for the preparation, stamping, and registration of easements may be allowed when incurred, under section DJ 11. It is also consistent with the view that an easement has no period over which the expenditure may be spread, and so the provisions of section EF 1 do not apply, and

that any method otherwise used by the Commissioner to spread the deduction would inevitably be arbitrary and subjective.

Incurred expenditure allowable by the Commissioner

In considering the deductibility of expenditure incurred in the preparation, stamping and registration of easements it is difficult, if not impossible, to identify the types of expenditure that may or may not meet the statutory character specified. For this reason the Ruling does not specify what expenditure comes within, and what is outside, that criteria. Rather, the character will be established by showing that the expenditure is for the preparation, stamping, and registration of the easement, such easement being used in the derivation of the taxpayer's gross income. There is, however, one exception and it is of particular relevance to the element of "preparation".

It is not uncommon for the owner of what will become the servient tenement to receive a sum of money for granting the easement. Is such a payment part of the easement's "preparation"?

The word "preparation" has not being judicially considered in terms of section DJ 11. However, the word "preparation" or "prepare" has been considered judicially (*Horsley v Collier and Cartly Ltd* [1965] 2 All ER 423 and *Calabria v R* [1982] 151 CLR 671). Those cases point to the word "preparation" indicating something that is done prior to it being ready for its use. In the case of an easement, until the right to create is granted there is nothing to prepare. A payment for the right to create an easement is the consideration that allows its "preparation" to be commenced. While it is a question of degree whether the expenditure incurred has the required nexus with the preparation of the easement to be deductible, a payment made for the grant of an easement lacks sufficient nexus to be within section DJ 11. Such payments to the owner of the servient land for the **right** to create an easement, which are not deductible, are distinguishable from payments made for the preparation, stamping, and registration of an easement, which, in some instances may also be made to the owner of the servient land, and are deductible, e.g. a payment made to the owner of the servient tenement equal to the owner's costs incurred on legal and survey fees.

Comments on technical submissions received

One submission received suggested that section EF 1 may not apply because there may be no unexpired portion in respect of expenditure made. This could occur, for example, where the solicitor preparing, stamping, and registering the easement had fully performed his or her contractual obligation in consideration for the payment received.

However section EF 1 requires that expenditure which "relates to a payment for, or in relation to…" a chose in action is spread with reference to the unexpired portion of the period that the chose is enforceable. In interpreting the phrase "relates to a payment for, or in relation to…" case authority indicates that it should be given a wide rather than a narrow interpretation (*Shell New Zealand Ltd v C of IR* (1994) 16 NZTC 11,303, *Picture Perfect Ltd v Camera House Ltd* [1996] 1 NZLR 310 and

Slattery (Trustee of) v Slattery [1993] 2 CTC 243). The phrase also imports a concept of connection or nexus between the expenditure incurred and "something". The expenditure on the legal fees must relate to, or be in relation to "something". Where that expenditure "relates to a payment for, or in relation to" a chose, section EF 1(5)(d) requires that the amount relating to the unexpired portion of the chose is added back.

The better view of the law is that the cost incurred in the preparation, stamping, and registration of an easement is expenditure that "relates to a payment for, or is in relation to," a chose. As noted above an easement is a chose that has no period over which the unexpired portion may be spread, and it is for this reason that section EF 1 does not apply.

Example

Farmer Ltd is a company conducting its agricultural and horticultural activities in an area where rainfall is limited and there is no natural irrigation. Farmer Ltd arranges for irrigation to be provided to the property. This requires reticulation across a neighbouring property. Farmer Ltd incurs survey costs and legal fees in the preparation, stamping, and registration of the easement allowing the diverted water to be transported to Farmer Ltd's property. Farmer Ltd agrees to pay the owner of the neighbouring property a one-off lump sum payment for the **right** to create the easement. In addition, the owner of the dominant tenement, Farmer Ltd, agrees to pay the legal costs for reviewing and approving the drafted easement's documentation incurred by the owner of the neighbouring property, i.e. the owner of the servient tenement.

The survey costs and legal fees, including those paid for the owner of the neighbouring property, are costs for the preparation, stamping, and registration of the easement and so are deductible in the income year in which they are incurred. The cost of the irrigation scheme itself is not part of the costs of preparation, stamping, and registration of the easement. The one-off payment to the owner of the neighbouring property for the **right** to create the easement is not for the preparation, stamping, and registration of the easement and therefore is not deductible.