



TR 1999/18 - Income tax: lease surrender receipts and payments

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Taxation Ruling

Income tax: lease surrender receipts and payments

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Preamble

The number, subject heading, Class of person/arrangement, Date of effect and Ruling parts of this document are a 'public ruling' for the purposes of Part IVAAA of the Taxation Administration Act 1953 and are legally binding on the Commissioner. Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.

What this Ruling is about

Class of person/arrangement

1. This Ruling considers whether:
 - (a) a lease surrender receipt is assessable income under section 6-5 of the *Income Tax Assessment Act 1997* (the 1997 Act); and
 - (b) a lease surrender payment is deductible under section 8-1 of the 1997 Act.
2. This Ruling also considers the application of the capital gains tax (CGT) provisions of the 1997 Act covering capital gains and capital losses. The Ruling extends to the assessability of lease surrender receipts and to the deductibility of lease surrender payments under the *Income Tax Assessment Act 1936* (the 1936 Act) to the extent to which that Act still operates.
3. The table at paragraph 74 of this Ruling cross references the provisions of the 1997 Act referred to in this Ruling to the corresponding provisions of the 1936 Act. References to provisions of the 1997 Act should be read as also including, unless a contrary intention appears, references to corresponding provisions of the 1936 Act. Cases relied upon in this Ruling that deal with issues in terms of provisions of the 1936 Act are considered to have equal application to the corresponding provisions of the 1997 Act.
4. A lease surrender amount refers to the consideration given or received for surrendering a lease. A lease surrender constitutes a disposal of a CGT asset (i.e., the lease), which can be contrasted to a mere variation or waiver of a term of a continuing lease. Expenditure incurred in obtaining a variation or waiver of a term of a lease falls for consideration under Subdivision 104-F (about leases) of the 1997 Act.

5. This Ruling only applies to the surrender of leases of land and buildings and does not apply to the surrender of leases that still come within the operation of Division 4 of Part III of the 1936 Act.

Ruling

Tax consequences for a lessee who derives a lease surrender receipt

Section 6-5

6. A lease surrender receipt of a lessee would be of a capital nature when received for the surrender of a lease that formed part of the profit-yielding structure of the business of the lessee. However, a lease surrender receipt of a lessee would constitute assessable income under section 6-5 if received:

- (a) in the ordinary course of carrying on a business of trading in leases;
- (b) as an ordinary incident of business activity (even though it was unusual or extraordinary compared to the usual transactions of the business); or
- (c) from an isolated business operation or commercial transaction entered into by the lessee (otherwise than in the ordinary course of carrying on a business), with the intention or purpose of making the relevant profit or gain.

CGT

7. A lessee makes a capital gain from surrendering a lease acquired after 19 September 1985, to the extent that the surrender receipt exceeds the cost base of the lease (including any premium paid by the lessee on the grant of the lease) (CGT event A1 about disposal of a CGT asset under section 104-10).

8. A lessee makes a capital loss upon surrendering a lease acquired after 19 September 1985, to the extent that the reduced cost base of the lease exceeds the surrender receipt, provided the lease was used solely or mainly for the purpose of producing assessable income (section 118-40).

Tax consequences for a lessee who makes a lease surrender payment***Section 8-1***

9. Where a lessee makes a lease surrender payment to dispose of an onerous lease that is part of the profit-making structure of the lessee's business or income producing activity, the payment is of a capital nature and not deductible under section 8-1.

10. In these circumstances, the lessee disposes of the whole of the lease including the right to possession of the leased premises. While the lessee also obtains a release from the obligation to pay rentals that would have been deductible under section 8-1, the lease surrender payment is still of a capital nature because there is a surrender of the whole of the lessee's interest under the lease.

11. However, where a lessee carries on a business of entering into and surrendering leases, lease surrender payments would be of a revenue rather than a capital nature.

CGT

12. A lease surrender payment made by a lessee cannot be included in the cost base of the lease disposed of as an incidental cost that relates to a CGT event (section 110-35).

Tax consequences for a lessor who derives a lease surrender receipt***Section 6-5***

13. A lease surrender receipt of a lessor would constitute assessable income under section 6-5 if received:

- (a) in the ordinary course of carrying on a business of granting and surrendering leases;
- (b) as an ordinary incident of business activity (even though it was unusual or extraordinary compared to the usual transactions of the business); or
- (c) from an isolated business operation or commercial transaction entered into by the lessor (otherwise than in the ordinary course of carrying on a business), with the intention or purpose of making the relevant profit or gain.

Otherwise the lease surrender receipt is of a capital nature.

CGT

14. A lease surrender receipt of a lessor is assessable under CGT event H2 (about receipts for events relating to CGT assets) in section 104-155 of the 1997 Act. This is because the surrender of a lease is an act, transaction, or event that occurs in relation to a CGT asset that the lessor owns. The relevant CGT asset is the land of the lessor. The lessor's reversionary interest in the land changes to an unencumbered freehold.

Tax consequences for a lessor who makes a lease surrender payment***Section 8-1***

15. Where a lessor who does not carry on a business of granting and surrendering leases makes a once and for all payment to obtain a permanent advantage, namely the surrender of the lease, the payment is of a capital nature and not deductible under section 8-1.

16. Although a lessor may make a lease surrender payment in order to re-let the property at a higher rental and so derive more assessable income, the payment is still of a capital nature because of this permanent advantage.

17. However, where a lessor carries on a business that involves granting and surrendering leases as a normal incident of its business, or that involves incurring recurrent outlays obtaining lease surrenders as part of the constant demand of its business which have to be met out of circulating capital, then the lease surrender payments would be a revenue rather than a capital outgoing.

CGT

18. A lessor who makes a lease surrender payment to obtain a conveyance or transfer of a lease or a lease surrender by operation of law, can include the payment in the cost base of that CGT asset under paragraph 110-25(2)(a). The lease is the relevant CGT asset and the lease surrender payment is the money paid in respect of acquiring that asset from the lessee. Generally, when a lease is transferred to a lessor who owns the reversionary interest in the land, the term of the lease merges into the land. The cost base of the merged asset is calculated in accordance with section 112-25 and includes the cost bases of the land and the lease acquired from the lessee.

Avoidance of double tax

19. The amount of any capital gain accruing to a lessee or lessor that arises from the surrender of a lease is reduced in accordance with

section 118-20, to the extent that the lease surrender receipt is assessable under section 6-5.

Date of effect

20. This Ruling applies to years commencing both before and after its date of issue. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Explanations

Tax consequences for a lessee who derives a lease surrender receipt

Surrender of lease as a disposal of a capital asset

21. A lease surrender receipt of a lessee would be of a capital nature when the lease formed part of the profit-yielding-structure of the lessee's business. In *Westfair Foods Limited v. The Queen*¹ the Federal Court of Canada held that two lease termination amounts received by a large food retailer with numerous distribution outlets were of a capital nature as the amounts were received for the realisation of capital assets. The leases had originally been for terms of 25 years with rights to renew for further 10-year periods and the taxpayer as lessee had used the premises as food stores for many years before surrendering the leases at the initiative of separate lessors.

22. In the following circumstances, a lease surrender receipt of a lessee would constitute assessable income under section 6-5 of the 1997 Act.

Lease surrender receipts as ordinary income

23. A lease surrender receipt of a lessee may be income according to ordinary concepts, such as when the taxpayer carries on a business of trading in leases **or the receipt occurs as an ordinary incident of business activity**. The fact that a taxpayer's business encompasses leasing premises from which to operate a business is not enough to make a lease surrender receipt income under ordinary concepts. Whether a lease surrender receipt is received in the ordinary course of business is a question of fact and degree to be determined in the circumstances of each case.

¹ 91 DTC 5073.

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24. In *FC of T v. Montgomery*² (*Montgomery's case*) the High Court of Australia held that a lease incentive receipt was assessable income. The receipt was a profit or gain severed from the capital invested in the business of the firm that had come in to the recipient for his separate use, benefit and disposal. Also, the firm had used or exploited its capital in the course of carrying on its business to obtain the incentive receipt (albeit in a transaction properly regarded as singular or extraordinary).

25. In *FC of T v. Myer Emporium Ltd*³ the High Court confirmed that a receipt may constitute income where it arises from an isolated business operation or commercial transaction entered into otherwise than in the ordinary course of business provided that the taxpayer entered into the transaction with the intention or purpose of making the relevant profit or gain.

26. The receipt of a lease surrender amount by a taxpayer who operates a business from leased premises would also constitute assessable income where:

- (a) the receipt arises **in the course of business activity** (albeit from a relatively unusual or extraordinary transaction); and/or
- (b) the lessee enters into an isolated business operation or commercial transaction (other than in the ordinary course of business) with a significant purpose of making a profit or gain from the surrender of the lease.

27. A lease surrender receipt of a lessee for the surrender of a lease which occurs as a singular transaction (other than one that occurs as an ordinary incident of business activity) would not constitute assessable income unless the transaction involved a business operation, commercial operation or adventure in the nature of trade (*Montgomery's case* at paragraph 106).

28. For the lease surrender receipt to constitute assessable income as a gain from a profit-making undertaking or scheme, the lessee must also have entered into the transaction with the intention or purpose of making the relevant profit or gain. In *Case 57/94*; *AAT Case 9787*⁴ a taxpayer exercised an option to renew a lease of premises from which he carried on his business with the intention of making a profit from vacating the premises before the expiry of the lease term. The Administrative Appeals Tribunal held that the taxpayer derived income according to ordinary concepts from a profit-making venture

² [1999] HCA 34.

³ (1987) 163 CLR 199; 87 ATC 4363; (1987) 18 ATR 693.

⁴ 94 ATC 491; (1994) 29 ATR 1191.

when he received an amount for varying the duration of the lease term.

29. In *Rotherwood Pty Ltd v. FC of T*⁵ the Full Federal Court held that a lease surrender amount of \$6 million received by a lessee who carried on a business that included subleasing premises to a firm of solicitors constituted income according to ordinary concepts. The amount was received as part of a profit-making transaction under which the lessee surrendered the lease so that the premises could be let to an associate at an increased rental for a ten-year period. The lease surrender receipt was not received as a consequence of an independent transaction to dispose of a capital asset. The surrender was one step in a business operation to carry out a profit-making scheme. In these circumstances, the fact that the lease was a capital asset not acquired for a profit-making purpose did not prevent the receipt being characterised as of a revenue nature.

Is a lease surrender receipt of a lessee assessable under the CGT provisions?

30. A CGT event happens when a lessee surrenders a lease (CGT event A1 about disposal of a CGT asset under section 104-10). A lease can be surrendered by a reconveyance of the leasehold estate to the holder of the reversion or by operation of law.

31. The lessee makes a capital gain if the surrender receipt exceeds the cost base of the lease. The lessee makes a capital loss if the reduced cost base of the lease exceeds the surrender receipt, provided that the lease was used solely or mainly for the purpose of producing assessable income (section 118-40).

Tax consequences for a lessee who makes a lease surrender payment

Is a payment by a lessee to obtain the consent of a lessor to the surrender of a lease deductible under section 8-1?

32. A lease surrender payment made by a lessee only qualifies as a deduction under section 8-1 if it is incurred in gaining or producing the lessee's assessable income or it is necessarily incurred in carrying on a business for that purpose and it is not an outgoing of capital, or of a capital nature.

⁵ 96 ATC 4203; (1996) 32 ATR 276.

33. Dixon J, in *Sun Newspapers Limited and Associated Newspapers Limited v. FC of T*⁶ (*Sun Newspapers case*) stated that in determining whether a payment was on capital or revenue account:

‘There are, I think, three matters to be considered, (a) the character of the advantage sought, and in this its lasting qualities may play a part, (b) the manner in which it is to be used, relied upon or enjoyed, and in this and under the former head recurrence may play its part, and (c) the means adopted to obtain it; that is, by providing a periodical reward or outlay to cover its use or enjoyment for periods commensurate with the payment or by making a final provision or payment so as to secure future use or enjoyment.’

34. In *GP International Pipecoaters Pty Ltd v. FC of T*⁷ the Full High Court stated that:

‘The character of expenditure is ordinarily determined by reference to the nature of the asset acquired or the liability discharged by the making of the expenditure, for the character of the advantage sought by the making of the expenditure is the chief, if not the critical, factor in determining the character of what is paid ...’

35. If the advantage sought by the lessee is to dispose of a burdensome or onerous lease the payment is of a capital nature. The expenditure relates to the profit-making structure itself. Thus, if the payment is made in connection with putting an end to a business or closing down business premises that have traded unprofitably, it is of a capital nature (see *Cowcher (HM Inspector of Taxes) v. Richard Mills and Company Ltd*⁸). This is also so if the lease constitutes a fixed capital asset and is part of the framework or structure of the business.⁹

36. In *Commissioner of Inland Revenue v. McKenzies New Zealand Limited*¹⁰ the New Zealand Court of Appeal denied a deduction to a lessee for a lease surrender payment made in respect of a long term lease. The payment was of a capital nature. The lease was a capital asset, being part of the profit-making structure of the lessee’s business. Judgment of the Court was delivered by Richardson J who stated in response to a submission that the payment

⁶ (1938) 61 CLR 337 at 363; (1938) 5 ATD 87 at 96; (1938) 1 AITR 403 at 413.

⁷ (1990) 170 CLR 124 at 137; 90 ATC 4413 at 4419; (1990) 21 ATR 1 at 7.

⁸ (1927) 13 TC 216.

⁹ Refer *Mallett (HM Inspector of Taxes) v. The Staveley Coal and Iron Company Ltd* (1928) 13 TC 772; [1928] 2 KB 405; *Foley Brothers Pty Ltd v. FC of T* (1965) 13 ATD 562.

¹⁰ (1988) 10 NZTC 5233.

was on revenue account, being for the commutation of future lease payments:

‘The surrender of a lease is a surrender of the whole interest of the lessee under the lease and it is fallacious to focus narrowly on the extinguishment of the rental obligation without recognising that at the same time the right of possession has been relinquished.’¹¹

37. Whether a lessee carries on a business of acquiring and surrendering leases is a question of fact. Most lessees use leased premises as offices, warehouses, factories or shops as part of the profit-making structure of their businesses and do not carry on a business of dealing in leases. The surrender of a lease that has been used as part of the profit-making structure of a business is not characterised as a revenue transaction, merely because the lessee carries on business from many leased premises and, therefore, surrenders leases fairly frequently.¹² It is only where the lessee carries on a business of dealing in leases that lease surrender payments are revenue outgoings. As Richardson J stated in *McKenzies case*:¹³

‘A lease will be held on revenue account if the taxpayer trades in leases so that the leases form part of its trading stock or are otherwise regarded as circulating capital. Here [a lease surrender payment by a retail company] as in the case of most taxpayers, the lease was part of the profit making structure of the business.’

Alternative view

38. We acknowledged in Taxation Ruling TR 93/7 that a borrower who pays penalty interest under a loan agreement in consideration for a lender agreeing to accept an early repayment of a loan may be allowed a deduction under subsection 51(1) of the 1936 Act. The payment is of a revenue nature if the advantage sought is release from the contractual obligation to incur a recurrent liability to pay interest on the loan and such interest would itself be deductible.¹⁴

39. It has been suggested by analogy that, to the extent that the payment by a lessee is for a release from an onerous rental obligation, the payment is not of a capital nature if the rental payments would have been deductible. Support for this proposition may also be

¹¹ (1988) 10 NZTC 5233 at 5237.

¹² Lord Morris in *Regent Oil Co Ltd v. Strick (Inspector of Taxes)* [1966] AC 295 at 333; [1965] 3 All ER 174 at 192.

¹³ (1988) 10 NZTC 5233 at 5237.

¹⁴ *FC of T v. Marbray Nominees Pty Ltd* 85 ATC 4750; (1986) 17 ATR 93; *Metals Exploration Ltd v. FC of T* 86 ATC 4505; (1986) 17 ATR 786.

provided by *Case U47*¹⁵ where P M Roach (Senior Member) held that, to the extent that a medical practitioner paid an amount to a finance company to be rid of an onerous rental obligation, the amount was deductible under subsection 51(1) of the 1936 Act.

40. In *FC of T v. Marbray Nominees Pty Ltd*¹⁶ Tadgell J stated that:

‘A price to be paid for the surrender of a capital asset will ordinarily be regarded as attributable to capital account because, in the general course of commerce, the benefit to be derived from the surrender is appropriately to be treated as a charge on capital. If, however, an outgoing is fairly to be seen as a loss or an expense necessarily incidental to the continuing conduct of the business, and not as providing an accretion to fixed capital, it will ordinarily be inappropriate to charge it to capital account.

If in this case the sum of \$5,862 had been paid as a price, in effect, to rid the respondent of a burdensome capital asset, then I should agree that the outgoing should be a charge on capital and non-deductible: *Mallett v. Staveley Coal & Iron Co. Ltd.* (1928) 2 K.B. 405 at p.422. As it is, I consider that the evidence reveals the payment of \$5,832 to have been incurred in order to rid the respondent of a recurring obligation to pay interest upon a debt that was part of the expenses of conducting the business as a whole, rather than to rid it of a proportion of the farm property - a capital asset.’

41. We take the view that Tadgell J’s remarks are limited to where there was a repayment of a debt from the general funds or assets of a business in order to obtain a release from a recurrent liability to pay interest and that they do not apply if a taxpayer disposes of a specific capital asset such as a lease. Similarly, in *Case U47* the payment by the medical practitioner was to both acquire the leased property and extinguish the obligations under the lease rather than to surrender the lease and thereby dispose of a capital asset.

Example

42. A manufacturer carries on business in Australia at several locations which it leases from a number of lessors for periods of 3 to 10 years. The locations of the premises change over time depending on various factors including demand for its product in various locations and transport availability and costs. In the past 10 years the manufacturer has surrendered 3 leases so that more favourably located premises could be leased. The business carried on cannot be said to

¹⁵ 87 ATC 326.

¹⁶ at ATC 4756-7; ATR 100-101.

be a business of deriving income from the acquiring and surrendering of leases but is a business of manufacturing. The lease surrender payments are not incurred in the course of gaining or producing the manufacturer's income or in carrying on the manufacturing business. The premises on which the business is carried on, whether owned or leased, form part of the profit making structure of the business. This does not change if from time to time and for various reasons, the business moves to different premises.

What are the CGT consequences for a lessee who makes a lease surrender payment?

43. A CGT event happens when a lessee surrenders a lease because there is a change in the ownership of the lease. The lessee disposes of the lease to the lessor (CGT event A1 about disposal of a CGT asset under section 104-10).

44. However, the lessee receives no capital proceeds from this CGT event. The lessee makes the lease surrender payment to obtain the lessor's acceptance of the surrender of the leasehold estate and to obtain an extinguishment of the covenants of the lease, such as the obligation to pay rent and to repair and maintain the leased property. While the lessee receives contractual consideration in the form of the consent of the lessor to the surrender, the lessee does not receive money or property for the purposes of the general rules about capital proceeds in section 116-20.

45. As the lessee receives no capital proceeds from a CGT event, section 116-30 would apply. Under this section the lessee is deemed to have received the market value of the lease that is the subject of the event. The market value is worked out at the time of the event.

46. However, where the market conditions governing rental properties are such that a lessee who is dealing at arm's length with a lessor has to make a lease surrender payment in order to obtain the consent of the lessor to the disposal of the lease, we would accept that the lease has a market value of nil.

47. The cost base of the lease is determined in accordance with Subdivision 110-A and includes the cost of acquiring the lease (e.g., a premium paid for the grant of the lease), certain incidental costs of acquiring the lease, and incidental costs that relate to a CGT event that happens to the lease. However, a lessee who makes a lease surrender payment cannot include the amount of the payment in the cost base of the lease. The payment is not a cost of acquiring the asset for the purposes of section 110-25. Nor can the payment be properly characterised as an incidental cost under section 110-35 which limits incidental costs to, among other things, costs of transfer, stamp duty or other similar duty.

Tax consequences for a lessor who derives a lease surrender receipt

Is a lease surrender receipt of a lessor assessable income under section 6-5?

Receipt in the ordinary course of business

48. A lease surrender receipt of the lessor received for consenting to the surrender of the lease would be assessable income under section 6-5 if received in the ordinary course of carrying on a business of granting and surrendering leases. This is a question of fact and degree to be determined in the particular circumstances of each case.

Gain from profit-making undertaking or scheme

49. A lease surrender receipt of a lessor for consenting to the surrender of a lease would constitute assessable income under section 6-5 where:

- (a) the lease surrender is an ordinary incident of business activity (even though it is unusual or extraordinary compared to the usual transactions of the business); or
- (b) the lessor entered into the lease surrender as an isolated business operation or commercial transaction (otherwise than in the ordinary course of carrying on its business) with the intention or purpose of making the relevant profit or gain from the transaction.

50. If the receipt for consenting to the surrender of a lease does not constitute assessable income within the above concepts it would be a capital receipt.

Is a lease surrender receipt of a lessor assessable under the CGT provisions?

51. A lessor who receives an amount for accepting a surrender of a lease does not dispose of a CGT asset for the purpose of CGT event A1 in section 104-10. The lessor's right to consent to the surrender of the lease is an incident of the reversion and not a separate asset.

52. However, we consider that CGT event H2 (about a receipt for an event relating to a CGT asset) in section 104-155 does occur. This section requires that an act, transaction or event occurs in relation to a CGT asset owned by the person who receives the payment. Subsection 160M(7) of the 1936 Act as enacted before 25 June 1992 would also apply in respect of such a receipt.

53. The lessor's agreement to the surrender of the lease is an act, transaction or event which occurs in relation to the lessor's reversionary interest in the property. The lease surrender receipt is received by the lessor for consenting to the lease surrender. As stated by Hill J in *Kennedy's* case,¹⁷ 'the substance of the transaction would be the freeing, by way of merger or otherwise, of the freehold from the leasehold estate, thereby leaving the freehold unencumbered'.

54. Where subsection 160M(7) applies the lessor is deemed to have disposed of 'an asset created by the disposal'. As this notional asset has a nil cost base (other than incidental costs) the lessor would derive a capital gain equal to the amount of the lease surrender receipt less indexed incidental costs.

Tax consequences for a lessor who makes a lease surrender payment

Is a payment by a lessor to obtain a lease surrender deductible under section 8-1?

55. If a lessor makes a lease surrender payment and accepts the surrender of the lease in the course of gaining or producing assessable income, or in carrying on a business for the purpose of gaining or producing such income, the payment would be an allowable deduction under section 8-1 providing it is not of a capital nature.

56. In paragraph 34 we quote Dixon J, in the *Sun Newspapers* case, on the three matters to be considered in determining whether a payment is on capital or revenue account.

57. Hill J considered the application of these matters in the context of a lease surrender payment made by a lessor in *Kennedy's* case.¹⁸ His Honour stated that:

'By the payment, the applicant secured a permanent advantage, namely the surrender of the lease with its attendant option. It could not be said that that advantage was ephemeral merely because immediately thereafter the applicant and its co-owner were able to enter into a new lease, albeit for a more advantageous rent ...'

The second and third of the matters referred to by Dixon J in *Sun Newspapers* similarly support the view that the expenditure was of a capital nature. The payment was a once and for all payment, it was not paid by way of a periodical reward or outlay to cover use and occupation for some period commensurate with

¹⁷ *Kennedy Holdings and Property Management Pty Ltd v. FC of T* 92 ATC 4918 at 4923; (1992) 24 ATR 321 at 326.

¹⁸ at ATC 4921; ATR 324-325.

the payment, nor could it appropriately be said to have been recurrent in the sense in which that expression is used in the cases. The present is not a case of a company whose business consisted of granting leases and obtaining surrenders of them as part of the normal ebb and flow of the business, in which event a different view of the matter might be taken.’

58. Accordingly, we take the view that when a lessor who does not carry on a business of granting and surrendering leases makes a once and for all payment to obtain a permanent advantage, being the surrender of the lease, the payment is of a capital nature and not deductible under section 8-1.

59. If a lessor carries on a business that involves entering into and surrendering leases as a normal incident of its business, so that lease surrender payments are a part of the normal ebb and flow of the business, the payment would be on revenue rather than capital account (see *Kennedy's* case). When a lessor carries on a business that involves incurring recurrent outlays obtaining lease surrenders, those lease surrender payments would be revenue outgoings. Recurrent expenditure in this context refers to expenditure that is part of the constant demand of the business which has to be met out of the returns of trade or circulating capital. In *FC of T v. Email Ltd* [1999] FCA 1177 at paragraph 39, Hill, Drummond and Sackville JJ stated that:

‘By recurrent expenditure it is not meant expenditure which may be incurred more than once, even if incurred on a number of occasions. Expenditure as we have already stated may still be capital, albeit that it is repeated. Recurrent expenditure is rather expenditure which is part of “the constant demand which must be answered out of the returns of a trade or its circulating capital”: *Sun Newspapers* at 362. Rates, rent, interest, even premiums of insurance of capital assets (*Australian National Hotels Ltd v. FC of T* (1988) 88 ATC 4627), notwithstanding that the proceeds of the insurance would themselves be capital, are examples of recurrent expenditure ordinarily on revenue account if incurred in the course of a taxpayer’s business. Whether the expenditure is, in the sense used, recurrent, will depend more upon the nature of the expenditure than the number of times it is repeated.’

Example

60. A shopping centre proprietor owns a large shopping centre complex in which there are 150 shops. The negotiation of leases is part of the normal ebb and flow of such a business. In the ordinary course of business affairs leases will expire and come up for renewal, tenants will want to sell their businesses and request permission to assign leases and other tenants may fail to make a satisfactory profit

and want to break their lease. On other occasions it may be the proprietor who wants to terminate particular leases in order to attract high profile tenants or to get rid of poorly performing businesses. In these circumstances the principal asset of the proprietor from a practical and commercial point of view is the shopping centre. The building forms part of the business structure whereas the leases are part of the process by which the proprietor operates to obtain regular rental income (*Sun Newspapers* at 359). In this case recurring outgoings on lease surrender payments incurred by the proprietor could form part of the normal ebb and flow of the business so that the outgoings would be on revenue rather than capital account.

What are the CGT consequences for a lessor who makes a lease surrender payment?

61. A lessor who obtains the surrender of a lease, acquires a CGT asset for the purposes of the CGT provisions.

62. A surrender of a lease may be either express or by operation of law. An express surrender must be by deed or in writing. A surrender by operation of law can be effected where a lessee delivers possession of the leased land that is accepted by the lessor. In both cases, the surrender consists of the yielding up of the term to the person who has the immediate estate in reversion. The lease term will then, by mutual agreement, merge in the reversion (see *Halsbury's Laws of England*).¹⁹

63. In *Kennedy's* case Hill J questioned whether a surrender by operation of law amounted to a conveyance of an interest in land. His Honour made no finding on the issue but made an assumption favourable to the lessor (i.e., that no capital asset was acquired) and found that, even on this basis, the lease surrender payment was not an allowable deduction under section 51 of the 1936 Act because it was of a capital nature.

64. Whether a lease surrender by operation of law constitutes a conveyance of the lease term at common law was briefly considered by the High Court of Australia in *Bagnall v. White*.²⁰ Griffiths CJ acknowledged that the exception in the *Statute of Frauds* for lease surrenders that can take effect without writing (such as surrenders by operation of law) may operate to make the surrender good as a matter of conveyancing, but then went on to find against the appellant on other grounds (see also *Phene v. Popplewell*²¹).

¹⁹ (3rd ed) Volume 23 at paragraphs 1412 to 1414; (4th ed) Volume 27 at paragraph 444.

²⁰ (1906) 4 CLR 89; 13 ALR 58; 7 SR (NSW) 184.

²¹ (1862) 12 CB (NS) 334; 31 LJ (CP) 235; 142 ER 1171.

65. The form and effect of both express lease surrenders and surrenders by operation of law are described in Volume 23 of *Halsbury*, 3rd ed, at paragraph [1413] in the following terms:

‘The surrender consists of the yielding up of the term to him who has the immediate estate in reversion in order that the term may, by mutual agreement, merge in the reversion ... The surrender vests the estate immediately in the surrenderee without express acceptance, but is made void by his dissent.’

66. On the basis of these authorities, we accept that a lease surrender operates to convey or transfer the lease from the lessee to the lessor irrespective of whether there is an express surrender or surrender by operation of law. Consequently, for CGT purposes, the lessor acquires a CGT asset being the lease and is able to include the lease surrender payment in the cost base of that asset.

67. When a lease is surrendered to a lessor who owns the land, the lease merges into the land.²² The law of merger of a lease term at law and in equity is described in Volume 27 of *Halsbury*, 4th ed, at paragraph [453] in the following terms:

‘... where a term of years becomes vested in the owner for the time being of the reversion immediately expectant on the term, the term is merged in the reversion ... Where the term merges the covenants attached to it are extinguished.’

68. The law on merger was summarised by Cozens-Hardy LJ in *Capital and Counties Bank Ltd v. Rhodes*²³:

‘The rule of the former [Courts of Law] was rigid, that whenever a term of years and a freehold estate, whether for life or in fee, immediately expectant upon the term, vested in the same person in his own right, the term was merged in the freehold, whatever may have been the intention of the parties to the transaction which resulted in the union. The Courts of Equity, on the other hand, in many cases treated the interest which merged at law as being still subsisting in equity. They had regard to the intention of the parties, and, in the absence of any direct evidence of intention, they presumed that merger was not intended, if it was to the interest of the party, or only consistent with the duty of the party, that merger should not take place.’

69. Thus, after the lease vests in the lessor, the leasehold estate merges into the reversion unless this would be contrary to the intention of the parties.

²² *Burton v. Barclay* (1831) 7 Bing 745 at 746.

²³ [1903] 1 Ch 631 at 652.

70. The statutes establishing the Torrens system are primarily concerned with the registration of titles to land and with the evidence by which titles are established, and do not change property law concepts such as the law of mergers.²⁴ For example, subsection 69(2) of the *Transfer of Land Act 1958* (Vic) confirms that when the Registrar of Titles records the surrender of a lease on a title ‘... the estate and interest of the lessee shall vest in the lessor or other proprietor of the reversion immediately expectant on the term’. In *Shell Co of Australia Ltd v. Zanelli & Ors*,²⁵ the NSW Court of Appeal held that a lease did not merge into the fee simple of Torrens title land until the Registrar-General noted the merger on the title.

71. The cost base of the merged asset is calculated in accordance with section 112-25 and would include the original cost bases of the lessor in the reversion and leasehold.

72. If the land was acquired before 20 September 1985 the merger of a lease into the freehold or the extinguishment of a lease created after 19 September 1985, does not affect the pre-CGT status of the land.

Table

73. The following table summarises the income and capital gains tax consequences of lease surrender receipts and payments for both lessees and lessors.

Lessee derives lease surrender receipt	
Assessable section 6-5?	CGT
<p>No, unless:</p> <p>(a) received in ordinary course of business of trading in leases</p> <p>(b) received as an ordinary incident of business activity</p> <p>(c) received from a profit-making business operation of commercial transaction.</p> <p>Otherwise a capital receipt. (Paragraphs 6, 21 - 29)</p>	<p>Capital gain (if receipt exceeds cost base); or</p> <p>Capital loss (if reduced cost base exceeds receipt) provided lease was used in producing assessable income. (Paragraphs 7 - 8, 30 - 31)</p>

²⁴ Maugham AJ in *Lewis v. Keene* [1936] 36 NSWLR 493 at 500.

²⁵ [1973] 1 NSWLR 216.

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Lessee makes lease surrender payment	
Deductible section 8-1?	CGT
Generally not, as a capital outgoing (cf. on revenue account if taxpayer in business of entering into and surrendering leases). (Paragraphs 9 - 11, 32 - 42)	Not included in cost base of lease (no capital loss). (Paragraphs 12, 43 - 47)
Lessor derives lease surrender receipt	
Assessable section 6-5?	CGT
Yes, if: (a) received in ordinary course of carrying on a business of granting and surrendering leases (b) as an ordinary incident of business activity (c) received from a profit-making business operation or commercial transaction. Otherwise a capital receipt. (Paragraphs 13, 48 - 50)	Capital gain. (Paragraphs 14, 51 - 54)
Lessor makes lease surrender payment	
Deductible section 8-1?	CGT
Generally not, as a capital outgoing (cf. On revenue account if taxpayer in business of entering into and surrendering leases). (Paragraphs 15 - 17, 55 - 60)	Forms part of cost base of land. (Paragraphs 18, 61 - 72)

74. The following table cross references the provisions of the 1997 Act referred to in this Ruling to the corresponding provisions of the 1936 Act.

1997 Act provision referred to	Corresponding 1936 Act provision
Section 6-5	Subsection 25(1)
Section 8-1	Subsection 51(1)
Subdivision 104-F	Section 160ZT
Section 104-10, CGT event A1	
Section 104-155, CGT event H2	Subsection 160M(7)
Subdivision 110-A	Section 160ZH
Section 110-25	Subsections 160ZH(1) to (3)
Section 110-35	Subsection 160ZH(7)
Section 112-25	Subsections 160ZH(12) and (13)
Subsection 116-10(2)	
Section 116-20	Subsection 160ZD(1)
Section 116-30	Paragraph 160ZD(2)(a)
Section 118-20	Subsection 160ZA(4)
Section 118-40	Paragraph 160Z(9)(d)

Detailed contents list

75. Below is a detailed contents list for this Ruling:

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Previous draft:

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Subject references:

- assessable income
- capital gains
- capital payments
- lease surrender payments
- lease surrender receipts
- leases
- surrender payments
- surrender receipts
- allowable deductions

Legislative references:

- TLA(Vic) 69(2)
- ITAA36 25(1)
- ITAA36 51
- ITAA36 51(1)
- ITAA36 160M(7)
- ITAA36 160Z(9)(d)
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- ITAA97 6-5
- ITAA97 8-1
- ITAA97 104-5
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- ITAA97 104-155
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- Australian National Hotels Ltd v. FC of T (1988) 19 ATR 417; 88 ATC 4627
- Bagnall v. White (1906) 4 CLR 89; 13 ALR 58; 7 SR (NSW) 184
- BP Australia Ltd v. FC of T (1965) 112 CLR 386; 14 ATD 1
- Burton v. Barclay (1831) 7 Bing 745
- Capital and Counties Bank Ltd v. Rhodes [1903] 1 Ch 631
- Commissioner of Inland Revenue v. McKenzies New Zealand Ltd (1988) 10 NZTC 5233
- Cowcher (HM Inspector of Taxes) v. Richard Mills and Company Ltd (1927) 13 TC 216
- FC of T v. Cooling (1990) 22 FCR 42; 90 ATC 4472; (1990) 21 ATR 13
- FC of T v. Email Ltd [1999] FCA 1177
- FC of T v. Marbray Nominees Pty Ltd 85 ATC 4750; (1986) 17 ATR 93
- FC of T v. Montgomery [1999] HCA 34
- FC of T v. Myer Emporium Ltd (1987) 163 CLR 199; 87 ATC 4363; (1987) 18 ATR 693
- Foley Brothers Pty Ltd v. FC of T (1965) 13 ATD 562
- GP International Pipecoaters Pty Ltd v. FC of T (1990) 170 CLR 124; 90 ATC 4413; (1990) 21 ATR 1
- Lewis v. Keene [1936] 36 NSWLR 493
- Kennedy Holdings and Property Management Pty Ltd v. FC of T 92 ATC 4918; (1992) 24 ATR 321
- Mallett v. Staveley Coal & Iron Co Ltd (1928) 13 TC 772; [1928] 2 KB 405
- Metals Exploration Ltd v. FC of T 86 ATC 4505; (1986) 17 ATR 786
- Phene v. Popplewell (1862) 12 CB (NS) 334; 31 LJ (CP) 235; 142 ER 1171

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- Regent Oil Co Ltd v. Strick (Inspector of Taxes) [1966] AC 995; [1965] 3 All ER 174
 - Rotherwood Pty Ltd v. FC of T 94 ATC 4514; (1994) 29 ATR 120
 - Rotherwood Pty Ltd v. FC of T 96 ATC 4203; (1996) 32 ATR 276
 - Shell Co of Australia Ltd v. Zanelli & Ors [1973] 1 NSWLR 216
 - Sun Newspapers Ltd and Associated Newspapers Ltd v. FC of T (1938) 61 CLR 337; (1938) 5 ATD 87; (1938) 1 AITR 403
 - Westfair Foods Ltd v. The Queen 91 DTC 5073
 - Case U47 87 ATC 326
 - Case 57/94 94 ATC 491; AAT Case 9787 (1994) 29 ATR 1191
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