


# ***TR 97/D19 - Income tax: lease surrender receipts and payments***

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This document has been finalised by TR 1999/18.



## Draft Taxation Ruling

### Income tax: lease surrender receipts and payments

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#### other Rulings on this topic

IT 2363; IT 2631; TR 93/7

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## What this Ruling is about

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### 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 Act'); and
  - (b) a lease surrender payment is deductible under section 8-1 of the Act.
2. This Ruling also considers the application of the capital gains and capital loss provisions of Part IIIA of the *Income Tax Assessment Act 1936* ('the 1936 Act').
3. Sections 6-5 and 8-1 of the Act, to which this Ruling refers, express the same ideas as subsections 25(1) and 51(1) respectively of the 1936 Act. Cases referred to in the Ruling that deal with the issues in terms of subsections 25(1) and 51(1) of the 1936 Act therefore have equal application to sections 6-5 and 8-1 of the Act.
4. A lease surrender amount refers to the consideration given or received for surrendering a lease. A lease surrender constitutes a disposal of an asset (i.e., the lease), which can be contrasted to a mere variation or waiver of a term of a continuing lease. Expenditure incurred obtaining a variation or waiver of a term of a lease falls for consideration under section 160ZT.
5. For the purposes of this Ruling, only the surrender of leases of land and buildings is considered.

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## Ruling

### **Tax consequences for a lessee who derives a lease surrender receipt**

#### ***Section 6-5***

6. 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) from disposing of a lease acquired for the purpose of profit-making by sale; or
- (c) as part of a profit-making transaction.

Otherwise the lease surrender receipt is of a capital nature.

#### ***Part IIIA***

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 indexed cost base of the lease (including any premium paid by the lessee on the grant of the lease).

8. A lessee is able to claim 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 wholly or principally for gaining or producing assessable income (paragraph 160Z(9)(d)).

### **Tax consequences for a lessee who makes a lease surrender payment**

#### ***Section 8-1***

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

10. Generally, a lessee makes a lease surrender payment to dispose of an onerous lease that is a capital asset and consequently the payment is of a capital nature and not deductible under section 8-1.

11. The primary effect of the lessee making a lease surrender payment is to secure the disposal of a capital asset, being the lease. The lease surrender payment is therefore of a capital nature because the expenditure relates to the profit-making structure of the lessee's

business or income producing activity. Although a lessee who makes a lease surrender payment also obtains release from an onerous rental obligation, the payment is still of a capital nature despite the fact that the rental obligation would have been deductible under section 8-1.

12. If a lessee carries on a business of entering into and surrendering leases, a lease surrender payment is of a revenue rather than a capital nature.

### ***Part IIIA***

13. A lessee who makes a lease surrender payment cannot include the amount of the payment in the cost base of the lease disposed of as an incidental cost of disposal under subsection 160ZH(7).

### **Tax consequences for a lessor who derives a lease surrender receipt**

#### ***Section 6-5***

14. 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) from the acceptance of the lease surrender where the lease was granted with a purpose of profit-making from the surrender of the lease; or
- (c) as part of a profit-making transaction.

Otherwise the lease surrender receipt is of a capital nature.

### ***Part IIIA***

15. A payment to a lessor to accept the surrender of a lease is assessable under the present and former subsection 160M(7), as the surrender of a lease is an act or transaction that takes place in relation to an asset, and an event that affects an asset. The relevant asset is the land of the lessor. The lessor's reversionary interest in the land changes to an unencumbered freehold. Subsection 160M(7) applies irrespective of when the lease was originally acquired by the lessee.

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## **Tax consequences for a lessor who makes a lease surrender payment**

### ***Section 8-1***

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

17. Generally, 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, namely the surrender of the lease, the payment is of a capital nature and not deductible under section 8-1.

18. 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 lease surrender payment is still of a capital nature because of the permanent advantage obtained by the payment.

19. If a lessor carries on a business of entering into and surrendering leases, a lease surrender payment is of a revenue rather than a capital nature.

### ***Part IIIA***

20. 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 asset. The lease is the relevant asset and the lease surrender payment is the consideration in respect of the acquisition of 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 subsections 160ZH(12) and (13), and generally includes the cost bases of the land and the lease acquired from the lessee.

### **Avoidance of double tax**

21. 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 subsection 160ZA(4) to the extent that the lease surrender receipt is assessable under section 6-5.

## **Date of effect**

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22. 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 a 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**

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### **Tax consequences for a lessee who derives a lease surrender receipt**

#### ***Is a lease surrender receipt of a lessee assessable income under section 6-5?***

##### *Receipt in the ordinary course of business*

23. A lease surrender receipt of a lessee is income according to ordinary concepts if the business of the taxpayer consists of trading in leases, or entering into and surrendering leases is a normal incident of the business. 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.

##### *Surrender of a lease acquired for the purpose of profit-making*

24. In *FC of T v. Cooling*<sup>1</sup> (*Cooling's case*) Hill J held that a lease incentive receipt was assessable income. The receipt arose from a commercial transaction that formed part of the business activity of the firm, and a not insignificant purpose of the transaction was to obtain the commercial profit by way of the incentive receipt.

25. The receipt of a lease surrender amount by a taxpayer who operates a business from leased premises can also constitute assessable income, at least to the extent that the receipt arises from a commercial transaction entered into by the taxpayer for the purpose of making a commercial profit from moving premises.

26. 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. But if a significant purpose of entering into a lease is to make a profit from its disposal or surrender, the lease surrender receipt is assessable under section 6-5.

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<sup>1</sup> (1990) 22 FCR 42; 90 ATC 4472; (1990) 21 ATR 13.

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The fact that the profit or gain is made as a result of a one-off or isolated transaction does not preclude it from being properly characterised as income provided that the transaction was entered into, and the profit was made, in the course of carrying on the taxpayer's business.<sup>2</sup>

27. In *Case 57/94*; *AAT Case 9787*<sup>3</sup> 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 when he received an amount for varying the duration of the lease term.

### *Lease surrender receipt forms part of a profit-making transaction*

28. A lease may be ventured into a profit-making undertaking in such a manner that a receipt for its surrender is assessable income under section 6-5. In *Rotherwood Pty Ltd v. FC of T*<sup>4</sup> 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 payment 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.

### *Surrender of lease as a disposal of a capital asset*

29. A disposal of a lease that occurs as an independent transaction may merely be a realisation of a capital asset that formed part of the profit yielding structure of the business of a taxpayer.

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<sup>2</sup> *FC of T v. Myer Emporium Ltd* (1987) 163 CLR 199; 87 ATC 4363; (1987) 18 ATR 693; *FC of T v. Whitfords Beach Pty Ltd* (1982) 150 CLR 355; 82 ATC 4031; (1982) 12 ATR 692.

<sup>3</sup> 94 ATC 491; (1994-95) 29 ATR 1191.

<sup>4</sup> 96 ATC 4203; (1996) 32 ATR 276.

30. In *Westfair Foods Limited v. The Queen*<sup>5</sup> 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.

***Is a lease surrender receipt of a lessee assessable under Part IIIA?***

31. Section 160ZS provides that the grant of a lease of property does not constitute a disposal of part of the property subject to the lease, but is rather a disposal of a separate asset being the lease. The cost base of the lessee acquiring the lease is determined in accordance with section 160ZH and includes the amount of any premium paid to the lessor and incidental costs of acquiring and disposing of the lease.

32. A lessee who surrenders a lease disposes of an asset. A lease can be surrendered by a reconveyance of the leasehold estate to the holder of the reversion, or by operation of law.

33. A lease surrender constitutes a disposal of an asset by the lessee under section 160M. Under section 160Z the lessee would make a capital gain if the surrender receipt exceeds the indexed cost base of the lease. The lessee would make a capital loss if the reduced cost base of the lease exceeds the surrender receipt provided that, in accordance with paragraph 160Z(9)(d), the lease was used wholly or principally for gaining or producing assessable income.

***Can former subsection 160M(7) apply to a lease surrender receipt?***

34. Usually, a lessee receives a lease surrender receipt as consideration for disposing of an asset. Former subsection 160M(7) does not apply if there was an actual disposal of an asset, because the subsection operated subject to the other provisions of Part IIIA.

35. However, there were circumstances where former subsection 160M(7) applied. In *Rotherwood Pty Ltd v. FC of T*<sup>6</sup> Carr J held at first instance that an amount of \$6 million received by a lessee, which was described as a lease surrender receipt, was assessable under former subsection 160M(7). In this case, the payment was not received for the disposal of the lease, but was really made to secure the

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<sup>5</sup> 91 DTC 5073.

<sup>6</sup> 94 ATC 4514; (1994) 29 ATR 120.

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execution of a new lease by an associate of the lessee. The execution of this new lease constituted the required act, transaction or event that affected an asset. The asset affected by the act or transaction or event was the interest of the lessor in the building or premises being leased.

36. Since 25 June 1992 subsection 160M(7) only applies if the recipient of the consideration also owns the underlying asset at the time of the act, transaction or event. Therefore, subsection 160M(7) as currently enacted would not apply in the circumstances of *Rotherwood's* case.

## **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?***

37. If a lease is surrendered and the payment is made by the lessee 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 lease surrender payment would qualify as a deduction under section 8-1 unless the payment is of a capital nature.

38. Dixon J, in *Sun Newspapers Limited and Associated Newspapers Limited v. FC of T*<sup>7</sup> (*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.'

39. In *GP International Pipecoaters Pty Ltd v. FC of T*<sup>8</sup> 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

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<sup>7</sup> (1938) 61 CLR 337 at 363; (1938) 5 ATD 87 at 96; (1938) 1 AITR 403 at 413.

<sup>8</sup> (1990) 170 CLR 124 at 137; 90 ATC 4413 at 4419 ; (1990) 21 ATR 1 at 7.

chief, if not the critical, factor in determining the character of what is paid ...'

40. 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*<sup>9</sup>). This is also so if the lease constitutes a fixed capital asset and is part of the framework or structure of the business.<sup>10</sup>

41. In *Commissioner of Inland Revenue v. McKenzies New Zealand Limited*<sup>11</sup> 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 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.'<sup>12</sup>

42. 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.<sup>13</sup>

43. 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,

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<sup>9</sup> (1927) 13 TC 216.

<sup>10</sup> 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.

<sup>11</sup> (1988) 10 NZTC 5233.

<sup>12</sup> at 5237.

<sup>13</sup> *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.

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the payment is not of a capital nature if the rental payments would have been deductible. Support for this proposition may also be provided by *Case U47*<sup>14</sup> 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.

44. In *FC of T v. Marbray Nominees Pty Ltd*<sup>15</sup> 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.'

45. We take the view that Tadgell J was limiting his remarks 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.

46. If a lessee carries on a business that involves entering into and surrendering leases as a normal incident of the business, so that recurring outlays on lease surrender payments are a part of the normal ebb and flow of the business, the payment is on revenue rather than

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<sup>14</sup> 87 ATC 326.

<sup>15</sup> at ATC 4756-7; ATR 100-101.

capital account (see *Kennedy Holdings and Property Management Pty Ltd v. FC of T*<sup>16</sup> (*Kennedy's case*)).

***What are the consequences under Part IIIA for a lessee who makes a lease surrender payment?***

47. A lessee who surrenders a lease disposes of an asset. The consideration the lessee receives for making the lease surrender payment and disposing of this asset is the lessor's acceptance of the surrender of the leasehold estate and an extinguishment of the covenants of the lease, such as the obligation to pay rent and to repair and maintain the leased property. The lessee does not receive money or property for the purposes of subsection 160ZD(1). For the purposes of Part IIIA, the lease would have been disposed of for no consideration. Consequently, paragraph 160ZD(2)(a) would apply. The taxpayer would be deemed to have received as consideration for the disposal an amount equal to the market value of the lease at the time of the surrender. However, where a lessee who was dealing at arm's length with the lessor had to make a lease surrender payment to dispose of a lease, we would accept that the lease had a market value of nil.

48. The cost base of the lease is determined in accordance with section 160ZH and includes the cost of acquiring the lease (e.g., a premium paid for the grant of the lease) and certain incidental costs of acquiring and disposing of 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 disposed of. The payment is not a cost of acquiring the asset for the purposes of subsections 160ZH(1) to (3). Nor can the payment be properly characterised as an incidental cost of disposing of an asset under paragraph 160ZH(7)(b), which limits disposal costs to, amongst other things, 'costs of transfer, including 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*

49. A lease surrender receipt of the lessor received for consenting to the surrender of the lease may be assessable income under section 6-5

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<sup>16</sup> 92 ATC 4918; (1992) 24 ATR 321.

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if received in the ordinary course of the lessor's business. This is a question of fact and degree to be determined in the particular circumstances.

50. An important consideration is the regularity with which a lessor enters into and accepts the surrender of leases. A lessor may be involved in leasing transactions with such regularity for it to be said that it is in the ordinary course of the taxpayer's business to consent to the surrender of leases. In contrast, a taxpayer who only leases a single property and derives a lease surrender receipt would not usually be assessed under section 6-5.

### *Profit-making transactions*

51. The principles outlined in paragraphs 24 to 28 apply to a lease surrender receipt of a lessor. Thus, a lease surrender receipt may be assessable under section 6-5 if a significant purpose in granting the lease was profit-making from the surrender of the lease. Likewise, if a lease surrender amount is received as part of a profit-making undertaking or arrangement, the receipt may be characterised as a revenue receipt.

52. If the receipt for consenting to the surrender of a lease does not constitute assessable income according to the above analysis, it is of a capital nature.

### ***Is a lease surrender receipt of a lessor an assessable capital gain under Part IIIA?***

53. A lessor who receives an amount for accepting a surrender of a lease does not dispose of an asset. The lessor's right to consent to the surrender of the lease is an incident of the reversion and not a separate asset. Agreeing to the surrender does not create a new asset for the purposes of subsection 160M(6).

54. However, we consider that subsection 160M(7) (both former and current) applies to lease surrender receipts of the lessor. Subsection 160M(7) requires that there be an act, transaction or event that affects an asset by reason of which the owner of the affected asset receives consideration.

55. The lessor's agreement to the surrender of the lease is an act, transaction or event affecting the lessor's reversionary interest in the property. The lease surrender receipt is received by the lessor as consideration for consenting to the lease surrender. As stated by Hill J

in *Kennedy's* case,<sup>17</sup> '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'.

56. The lessor is deemed by subsection 160M(7) to have disposed of 'an asset created by the disposal' and thus it is irrelevant whether the lease was acquired by the lessee before or after the introduction of the capital gains tax provisions. As this notional asset has a nil cost base (other than incidental costs) the lessor generally derives a capital gain equal to the lease surrender receipt.

### **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?***

57. 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 only qualifies for deduction under section 8-1 if it is not of a capital nature.

58. In paragraph 38 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.

59. Hill J considered the application of these matters in the context of a lease surrender payment made by a lessor in *Kennedy's* case.<sup>18</sup> 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.

It may be that it is correct to say that no asset is acquired by virtue of the payment, in the sense that because the surrender of the lease occurred by operation of law, there is not a conveyance of the leasehold estate to the owner of the freehold, having the consequence that the lesser estate merges in the greater. But it is not the law of Australia that it is essential for a payment to be of

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<sup>17</sup> at ATC 4923; ATR 326.

<sup>18</sup> at ATC 4921; ATR 324-325.

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a capital character that there be the acquisition by the payer of some asset ...

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 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.'

60. Accordingly, we take the view that if 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.

61. If a lessor carries on a business that involves entering into and surrendering leases as a normal incident of the business, so that recurring outlays on lease surrender payments are a part of the normal ebb and flow of the business, the payment is on revenue rather than capital account (see *Kennedy's* case).

### ***What are the Part IIIA consequences for a lessor who makes a lease surrender payment?***

62. A lessor who obtains the surrender of a lease, acquires an asset for capital gains tax purposes.

63. 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 in 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*).<sup>19</sup>

64. 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

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<sup>19</sup> (3rd ed) Volume 23 at paras 1412 to 1414; (4th ed) Volume 27 at paragraph 444.

allowable deduction under section 51 of the 1936 Act because it was of a capital nature.

65. 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*.<sup>20</sup> 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*<sup>21</sup>).

66. 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.'

67. 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 capital gains tax purposes, the lessor acquires an asset being the lease and is able to include the lease surrender payment in the cost base of that asset.

68. When a lease is surrendered to a lessor who owns the land, the lease merges into the land.<sup>22</sup> 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.'

69. The law on merger was summarised by Cozens-Hardy LJ in *Capital and Counties Bank Ltd v. Rhodes*<sup>23</sup>:

'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,

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<sup>20</sup> (1905) 4 CLR 89; 13 ALR 58; 7 SR (NSW) 184.

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

<sup>22</sup> *Burton v. Barclay* (1831) 7 Bing 745 at 746.

<sup>23</sup> [1903] 1 Ch 631 at 652.

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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.'

70. 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.

71. 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.<sup>24</sup> 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*,<sup>25</sup> 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.

72. The cost base of the merged asset is calculated in accordance with subsections 160ZH(12) and (13) and generally includes the original cost bases of the lessor in the reversion and leasehold.

73. 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

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

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

<sup>25</sup> [1973] 1 NSWLR 216.

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| <b>Lessee derives lease surrender receipt</b>   |   |
|---|---|
| <b>Assessable s6-5?</b>   | <b>Part IIIA</b>  |
| <p>Yes, if:</p> <p>(a) receipt in ordinary course of business of trading in leases</p> <p>(b) lease acquired for profit-making</p> <p>(c) receipt as part of profit-making transaction.</p> <p>Otherwise a capital receipt.<br/>(Paras 6, 23 - 30)</p>                          | <p>Capital gain (if receipt exceeds indexed cost base); or</p> <p>capital loss (if reduced cost base exceeds receipt) provided lease was used in producing assessable income.</p> <p>(Paras 7 - 8, 31 - 36)</p> |
| <b>Lessee makes lease surrender payment</b>   |   |
| <b>Deductible s8-1?</b>   | <b>Part IIIA</b>  |
| <p>Generally not, as a capital outgoing (cf on revenue account if taxpayer in business of entering into and surrendering leases).<br/>(Paras 9 - 12, 37 - 46)</p>   | <p>Not included in cost base of lease (no capital loss).<br/>(Paras 13, 47 - 48)</p>  |
| <b>Lessor derives lease surrender receipt</b>   |   |
| <b>Assessable s6-5?</b>   | <b>Part IIIA</b>  |
| <p>Yes, if:</p> <p>(a) receipt in ordinary course of business of trading in leases</p> <p>(b) surrender accepted where lease granted to profit from the surrender</p> <p>(c) part of profit-making transaction.</p> <p>Otherwise a capital receipt.<br/>(Paras 14, 49 - 52)</p> | <p>Capital gain under s160M(7).<br/>(Paras 15, 53 - 56)</p>   |

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| <b>Lessor makes lease surrender payment</b>  |   |
|--|---|
| <b>Deductible s8-1?</b>  | <b>Part IIIA</b>  |
| Generally not, as a capital outgoing (cf on revenue account if taxpayer in business of entering into and surrendering leases).<br>(Paras 16 - 19, 57 - 61) | Forms part of cost base of land.<br><br>(Paras 20, 62 - 73) |

**Detailed contents list**

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

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## **Your comments**

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76. If you wish to comment on this Draft Ruling, please send your comments by: 10 February 1998

to:

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## Commissioner of Taxation

10 December 1997

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- capital gains
- capital payments
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