IT 2317 - Income tax : deductibility of prepaid rent

TAXATION RULING NO. IT 2317

INCOME TAX : DEDUCTIBILITY OF PREPAID RENT

F.O.I. EMBARGO: May be released

REF H.O. REF: 86/1962-0 DATE OF EFFECT: Immediate

B.O. REF: DATE ORIG. MEMO ISSUED:

F.O.I. INDEX DETAIL

REFERENCE NO:	SUBJECT REFS:	LEGISLAT. REFS:
I 1209476	PREPAID RENT	51(1)

PREAMBLE This ruling deals with the decision of the Full Federal Court (Fisher, Wilcox and Jackson JJ) in FCT v. James N. Creer (86 ATC 4318; 17 ATR 548).

FACTS 2. This was an appeal by the Commissioner from a decision of the Supreme Court of NSW (reported 85 ATC 4104; 16 ATR 246) which allowed a deduction under sub-section 51(1) of the Income Tax Assessment Act for "rent" and fees paid for advice in respect of the taxpayer's income tax affairs.

3. The taxpayer was in 1977 a solicitor carrying on his professional practice. In March 1977 he had sought advice as to the avenues open to him to reduce his income tax liabilities. The possibility of leasing income producing property and paying rental therefor in advance was suggested. In April-May 1977 he sought residential premises which he could lease from the owners and sub-lease to tenants. He intended at all times that a family company (of which he was a director and in the shares of which he held the sole beneficial interest) would purchase the properties subject to the head leases to himself.

4. By June the taxpayer had located four units which would suit his purposes. The total selling price of the units was $212,000. Mr Creer proposed to the owners that they accept a "package" whereby he would lease the units for five years, paying the bulk of the rental in advance and his family company would purchase the property at a price which was the difference between $212,000 and the amount of prepaid rent. Thus, on 30 June 1977, the taxpayer entered the lease agreement with an amount of $63,800 payable on that day. On 1 July 1977 the family company and the owner of the units exchanged contracts of sale and purchase. The sale and purchase was completed on 29 July 1977. The taxpayer had also entered, on 28 July 1977, a three month sub-lease of the four units to another company, with rent payable monthly in advance commencing 29 June 1977.

5. In his return of income for the year ended 30 June 1977 the taxpayer returned the income from the sub-lease and claimed the amount of rent paid in advance as a deduction in terms of sub-section 51(1). He also claimed a deduction for the fees

paid for advice. The Commissioner disallowed the deductions on the basis that the taxpayer had made payments of a capital nature. The taxpayer successfully appealed to the Supreme Court of NSW where it was held that the payment under the lease was not an outgoing of a capital nature and was deductible under sub-section 51(1). The deduction relating to the advice fees was also allowed. The Commissioner then appealed to the Full Federal Court.

The Decision of the Full Federal Court

6. It was agreed at the hearing that the deduction for advice fees would stand or would fall according to the decision regarding the "rent". The Full Federal Court found that the amount paid under the lease was a capitalised sum. It was of a capital nature and not deductible under sub-section 51(1). This conclusion was drawn from a construction of the lease agreement between the taxpayer and the owner of the units. The fact that the payment was described as "rent" was not determinative of its true nature: FCT v. South Australian Battery Makers (1977-78) 140 CLR 645. The 'total rent', whether payable as one lump sum or by instalments, was not rent 'accruing per die in diem' or as a 'periodic outlay' covering use of the premises for 'periods commensurate with the payments'. Whether or not the outgoing was on revenue or capital account was determined with the assistance of the statement of Dixon J in Sun Newspapers Ltd and Associated Newspapers Ltd v. FCT (1938-39) 61 CLR 337 at 363.

7. Wilcox J also made observations on the character of the advantage sought by the taxpayer and the relevance of purpose for sub-section 51(1). He referred to remarks of Brennan J in Magna Alloys and Research Pty Ltd v. FCT (1980) 33 ALR 213 at 218-219, in finding that, as the expenditure 'was in every sense a voluntary act of the taxpayer', it is relevant to have regard to his purpose in determining whether that expenditure should be characterised as being upon capital or revenue account. His Honour found that, as the taxpayer could have achieved all his stated purposes in entering the arrangement without resort to prepaid leases, it is plain that the only reason for entering into the leases was the desire to secure a taxation advantage. The decisions of the Federal Court in Ilbery (1981) 38 ALR 172 and Ure (1981) 38 ALR 237 were cited with approval.

8. Wilcox J also rejected the argument that the taxpayer's collateral purpose in entering the arrangement to obtain for his family company the freehold title at a reduced price was not relevant. Counsel for the taxpayer relied on the decision in the Battery Makers Case to support that proposition. However, his Honour pointed out that the facts of this case, particularly the degree of control exercised by the taxpayer as director and sole beneficial shareholder of the family company, distinguished it from the Battery Makers Case, referring to dicta from Gibbs ACJ at p.655.

9. The Court was not required to consider further

submissions by the Commissioner that the arrangements were fiscally a nullity and that section 260 operated to void the arrangements as against the Commissioner.

RULING

10. There are two elements in the decision of the Federal Court which warrant comment. The first is that it is necessary to go behind the description given to an outlay to ascertain the true nature of the payment. Where, as here, prepayment of outlays is made, an examination must be made to ensure that the payment truly accrues day by day and that the payment reflects a periodic outlay for use of property (in the case of rent), for the use of money (in the case of interest), or for the provision of services (in the case of fees) for periods which are commensurate with the payment. It does not matter that the payment may be made by instalments, as in this case, to give some semblance of recurrence if the true nature of the outlay is that it is a capitalised sum paid to secure use or enjoyment of an asset.

11. Should the prepaid outlay, on close examination, be seen to satisfy the test above so that it might not be possible to characterise it as a capital payment then it is necessary to have regard, as did the Federal Court in this case and in Ilbery's Case, to the purpose for which the prepaid outlay is made. If the prepayment is explicable for no reason other than to secure a taxation advantage then no deduction should be allowed. Where several purposes may be revealed then apportionment would have to be considered as in Ure's Case. There is no authority which would permit a prepaid amount which is made for wholly deductible purposes to be allowed over the period to which the prepayment relates rather than in the year when the expenditure is incurred (made). The decision of the Supreme Court in FCT v. Solling and FCT v. Pepper 85 ATC 4518, 16 ATR 753 is an example of authority to the contrary effect (see Taxation Ruling No.IT 2237).

12. Consideration would also have to be given to reliance on the fiscal nullity doctrine, section 82KJ, section 260 or Part IVA where appropriate.

COMMISSIONER OF TAXATION

17 June 1986

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