IN THE COURT OF APPEAL OF NEW ZEALAND

I TE KŌTI PĪRA O AOTEAROA

CA505/2017
[2018] NZCA 296

BETWEEN	EASY PARK LIMITED Appellant
AND	COMMISSIONER OF INLAND REVENUE Respondent

Hearing: 21 March 2018

Court: French, Cooper and Asher JJ

Counsel: G J Harley and R L Goss for Appellant
A B Goosen and S K Jameson for Respondent

Judgment: 7 August 2018 at 3 pm

JUDGMENT OF THE COURT

A The appeal is dismissed.

B The appellant must pay the respondent costs for a standard appeal on a band A basis and usual disbursements.

REASONS OF THE COURT

(Given by Asher J)

Introduction

[1] The question of whether a receipt is to be treated as of a revenue nature or a capital nature for the purposes of income tax has been central to many tax judgments, and it is central to the case before us. It arises in the context of a payment by a tenant

to a landlord for the surrender of a lease. The background facts can be summarised shortly.

Background

[2] The appellant, Easy Park Ltd (Easy Park), was incorporated in August 2002. It was formed for the sole purpose of undertaking commercial rental property investments. Easy Park has never had any employees and never occupied any premises. Its affairs appear to have been run by a Wellington company director, Marlene Stirling, on behalf of the interests of a family based in Melbourne.

[3] In 2003 Easy Park acquired two commercial buildings in Wellington. Since then Easy Park's business has consisted of leasing those two properties. One is situated in Petone. The other is a four-storey building situated at 312 Lambton Quay (the Whitcoulls Building) in Wellington's central business district. It is the lease of the Whitcoulls Building that gives rise to the present dispute.

[4] When Easy Park purchased the Whitcoulls Building it was subject to a lease to Whitcoulls Group Ltd (WGL) of levels 1, 1A and 2. Easy Park purchased the Whitcoulls Building, subject to the lease to WGL, for $7.7 million. The lease was for a term of 12 years and three months commencing on 1 June 2003. The initial annual rent was $966,012 plus GST. WGL was responsible for the payment of insurance. Levels 3 and 4 were untenanted at the date of acquisition. On 21 February 2011 Easy Park leased levels 3 and 4 of the Whitcoulls Building to the Lifestyle Gym.

[5] On 17 February 2011 WGL was placed into voluntary administration. The administrators of WGL sold its business and assets to Whitcoulls 2011 Ltd (W2011). W2011 then took occupation of the Whitcoulls Building, initially without an assignment of the lease to WGL. In June 2011 W2011 publicly announced that it would be vacating the Whitcoulls Building.

[6] In August 2011 WGL assigned its lease to W2011 with effect from 21 June 2011. At that stage the remaining term of the lease was three years and three months. Easy Park and W2011 entered into negotiations for early termination of the lease in November 2011. They agreed on an amount of $1.1 million to be paid by

W2011 to Easy Park for early surrender (the lease surrender payment). On 7 February 2012 the parties entered into a deed of surrender of lease providing for a surrender date of 30 June 2012. The lease surrender payment was paid on 14 February 2012.

[7] In the meantime, in March 2011 the Wellington City Council had given notice to Easy Park that the Whitcoulls Building was earthquake prone and had to be strengthened by 29 March 2015, a date later corrected to 29 March 2025.

[8] Easy Park decided it was necessary to carry out the earthquake strengthening before it re-leased the building. In August 2012, after unsuccessful negotiations with a supermarket chain, Easy Park reached an agreement in principle to lease levels 1, 1A and 2 to clothing retailer Hallenstein Glassons Ltd (Glassons). The lease to Glassons was to commence six weeks after practical completion of the strengthening work. An agreement to lease was signed on 5 December 2012. The lease term was nine years. The annual rent was $1.1 million.

[9] On 27 November 2012 Easy Park entered into a deed of surrender of lease with the Lifestyle Gym, thereby terminating the lease of levels 3 and 4. Easy Park obtained vacant possession of the Whitcoulls Building on 28 February 2013 and commenced earthquake strengthening. Those works were completed in September 2013 and Glassons commenced its lease on 30 September 2013. Level 4 was leased to Harrison Grierson in November 2014. Level 3 was and remains vacant.

[10] In its income tax return for the year ended 31 March 2012, Easy Park treated the receipt of the lease surrender payment as a non-taxable capital amount. The covering letter to the Commissioner of Inland Revenue (the Commissioner) dated 14 September 2012 explicitly drew attention to the tax treatment of the lease surrender payment.

[11] The Commissioner disagreed and assessed the surrender payment as being business income subject to income tax in the sum of $308,000. The Commissioner also imposed a shortfall penalty of $30,800 (10 per cent).

[12] The position taken by the Commissioner was predictable. In a public ruling (BR PUB 09/06) (the Ruling) made under s 91D of the Tax Administration Act 1994 in 2006, the Commissioner had stated that lease surrender payments received by a landlord who is in the business of leasing property would be treated as taxable income.[1] Such payments are income derived from business under s CB1(1) of the Income Tax Act 2007 (the ITA). That section provides:

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

[13] The Ruling recognised one exception. Where a lease is of such significance to the landlord's business that its surrender constitutes the loss of a "structural asset", a payment received upon surrender will be a capital amount.

[14] The ITA has since been amended to provide explicitly that a lease surrender payment is income in the hands of the recipient.[2] However, these provisions do not apply to the payment in this case, which was received before the amendments took effect.

High Court

[15] In the High Court Ellis J concluded that the lease surrender payment was a revenue and not a capital receipt in Easy Park's hands.[3]

[16] Ellis J determined that a lease surrender payment made by a tenant is "usually" capital in the hands of the tenant because the lease itself is a capital asset.[4] But she did not agree that this meant that the lease was necessarily a capital asset in the hands

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1 The legal effect of a public ruling is that where the ruling applies and a taxpayer has applied taxation law in accordance with the ruling, the Commissioner must likewise apply taxation law in relation to the person and the arrangement in accordance with the ruling: Tax Administration Act 1994, s 91DB(1).

2 Income Tax Act 2007, s CC 1C (effective from 1 April 2013).

3 *Easy Park Ltd v Commissioner of Inland Revenue* [2017] NZHC 1893.

4 At [90(a)].

of the landlord. Easy Park's core and only business was commercial leasing.[5] Therefore:[6]

> [T]he lease is not part of [Easy Park's] underlying business structure and is not only indirectly connected with producing revenue. Rather, the lease is the very mechanism which generates profit for the company; it is Easy Park's core business.

[17] Therefore, the payment was income in nature. From the perspective of a commercial lessor such as Easy Park, the reversion of one of its leasehold interests must "almost by definition" be temporary, as indeed it proved to be.[7] It did not create an asset or advantage of an enduring nature. The revenue-producing asset that was the subject of the lease could be, and was, made the subject of another lease.[8]

[18] The Judge observed (without deciding) that there may be two possible exceptions to this. First, if the lease had been surrendered near the beginning of a very long term.[9] Second, if the interest that was returned to Easy Park as a result of the surrender was so damaged or different from the original leasehold interest that had been granted, that Easy Park could not easily enter into a new lease for the building on broadly similar terms. However, the Judge considered that neither exception applied in this case.[10]

[19] Therefore, Ellis J upheld the Commissioner's classification of the lease surrender payment as taxable income. However, the Judge quashed the Commissioner's imposition of a shortfall penalty of $30,800, finding that the tax position taken by Easy Park was not "unacceptable".[11] The question of the shortfall penalty does not arise on appeal.

General principles

[20] Under s CB1 of the ITA, income of a person includes an amount the person derives from business, unless that amount is capital in nature. "Income" and "capital"

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5 At [93].
6 At [80].
7 At [82].
8 At [92].
9 At [83].
10 At [82]–[85].
11 At [95]–[97].

are not defined in the ITA. Whether a receipt is income or capital has been left to the courts to decide in the particular circumstances of each case. There is no single formula or bright-line rule.

[21] The governing approach in New Zealand is summarised by the observations of Lord Pearce in *BP Australia Ltd v Commissioner of Taxation of the Commonwealth of Australia*, adopted by this Court in *Commissioner of Inland Revenue v Thomas Borthwick & Sons (Australasia) Ltd*:[12]

> The solution to the problem is not to be found by any rigid test or description. It has to be derived from many aspects of the whole set of circumstances some of which may point in one direction, some in the other. One consideration may point so clearly that it dominates other and vaguer indications in the contrary direction. It is a commonsense appreciation of all the guiding features which must provide the ultimate answer. Although the categories of capital and income expenditure are distinct and easily ascertainable in obvious cases that lie far from the boundary, the line of distinction is often hard to draw in borderline cases; and conflicting considerations may produce a situation where the answer turns on questions of emphasis and degree. That answer:
>
> > "depends on what the expenditure is calculated to effect from a practical and business point of view rather than upon the juristic classification of the legal rights, if any, secured employed or exhausted in the process":
>
> *per* Dixon J in *Hallstroms Pty Ltd v Federal Commissioner of Taxation*. As each new case comes to be argued felicitous phrases from earlier judgments are used in argument by one side and the other. But those phrases are not the deciding factor, nor are they of unlimited application. They merely crystallise particular factors which may incline the scale in a particular case after a balance of all the considerations has been taken.

[22] The enquiry into whether a receipt is revenue or capital is intensely fact-specific. Therefore in approaching the authorities we acknowledge the oft-cited caution of Richardson J in *Commissioner of Inland v McKenzies (NZ) Ltd*:[13]

> … the capital income field is an intellectual minefield in which the principles are elusive and analogies are treacherous.

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12 *BP Australia Ltd v Commissioner of Taxation of the Commonwealth of Australia* [1966] AC 224 (PC) at 264–265 (footnotes omitted); and *Commissioner of Inland Revenue v Thomas Borthwick & Sons (Australasia) Ltd* (1992) 14 NZTC 9,101 (CA) at 9,103.

13 *Commissioner of Inland Revenue v McKenzies (NZ) Ltd* [1988] 2 NZLR 736 (CA) at 741.

Authorities

[23] Both parties agree that there are no New Zealand authorities on the tax treatment of a lease surrender payment received by a landlord, and very few overseas authorities on the issue. Ellis J identified what she called "two interrelated streams" of relevant authorities.[14] The first stream concerns payments made to or by a lessee on the acquisition or surrender of a lease. The second stream concerns lump sums paid or received in relation to the creation or termination of contracts not relating to interests in land.

Payments to or by a lessee

[24] This line of authority begins with the decision of the King's Bench in *Cowcher v Richard Mills and Co Ltd*.[15] In that case a fishmonger leased a shop with a lease term of 14 years. The lease was due to expire in 1923. However the business was not profitable and in 1916 the lease was surrendered in consideration for a sum that was paid by instalments for the next five years. Those sums were duly paid until 1921, when the lessor accepted a payment of £600 in satisfaction of all further liability. That £600 sum was held to be a capital payment by the fishmonger lessee, and was therefore not deductible.[16]

[25] In *Mallett (Inspector of Taxes) v Staveley Coal and Iron Co Ltd* two mining leases were surrendered in return for a payment made to the lessor.[17] The first lease was for a term of 63 years from 1882, the second for 21 years from 1919. The leases were surrendered in 1923. The Court of Appeal held that the payments were capital in nature and were therefore not deductible by the lessee. Like Ellis J, we note the following statement by Lawrence LJ:[18]

> It must be borne in mind that [the lessee's] trade does not consist of acquiring mining leases and selling those mining leases. The Company's business is that of colliery proprietors, and its trade consists of the winning and the selling of coal. For the purposes of carrying on that trade it has acquired numerous leases, including the two leases in question in this case. Those two leases, to my mind, clearly constitute a part of the fixed capital assets of the Company,

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14 *Easy Park Ltd v Commissioner of Inland Revenue*, above n 3, at [50].
15 *Cowcher v Richard Mills and Co Ltd* (1927) 13 TC 216 (KB).
16 At 221.
17 *Mallett (Inspector of Taxes) v Staveley Coal and Iron Co Ltd* [1928] KB 405 (CA).
18 At 421–422.

> and none the less so because they were acquired without the payment of any cash premium.

[26] *Greyhound Racing Association (Liverpool) Ltd v Cooper (Inspector of Taxes)* concerned the taxability of a payment made to a lessor as consideration for the early surrender of a lease of a race track it owned.[19] When the lessee went into liquidation the lessor agreed to the surrender of the lease on the condition that a new company was formed to take over the lease of the track. The lessee was also required to pay the lessor a sum equal to the difference between the old and new rents. Lawrence J found that the receipt was nothing more than a lump sum payment in place of future rent and was therefore income in the hands of the lessor.[20] The Judge also said:[21]

> [I]n my opinion the licence here in question was not an agreement which related to the whole structure of the appellant company's business, nor was it a fundamental organisation of their activities … The payment of a percentage on gross receipts here was simply a means of arriving at the rent to be paid for the use of what, it is true, was in fact the company's only capital asset, but it did not prevent the company from acquiring other capital assets or from carrying on its business in connection with such assets in any way it pleased.

[27] Next is the decision of the House of Lords in *Regent Oil Co Ltd v Strick (Inspector of Taxes)*.[22] Mr Harley for Easy Park described this as the overarching and governing authority. In that case the House of Lords had to determine whether lump sum payments by an oil company to retailers for exclusivity arrangements were of a capital nature. The retailers leased their premises to Regent Oil in return for the lump sum payment and a nominal rent, with a sublease back by Regent Oil to the retailers, also at a nominal rent. The Court concluded the lump sum payment was of a capital nature. Lord Wilberforce stated:[23]

> Next, as regards the nature of the asset or advantage gained. There are possibly two ways of regarding this. The first is to treat the payment as made for a lease of from five years to 21 years, ie, for a legal estate in land; the second, which I prefer, and which fits most closely to what Dixon J said in the *Hallstroms* case, is to treat it as made for the granting of a lease which was (as part of the single bargain) to be subject to a sublease containing an exclusivity covenant by the sublessee with provisions making that covenant effective. So regarded, the payment was for a solid recognisable asset, evidently (to my

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19 *Greyhound Racing Association (Liverpool) Ltd v Cooper (Inspector of Taxes)* [1936] 2 All ER 742 (KB).

20 At 744.

21 At 744.

22 *Regent Oil Co Ltd v Strick (Inspector of Taxes)* [1966] AC 295 (HL).

23 At 350 (footnotes omitted). A different approach was adopted by Lord Reid at 315–316.

> mind) of a capital nature. It was transferable, in a limited market no doubt, but in that market it was valuable: it was a source or foundation for the earning of profits, through orders for petrol to be placed under it: it can fairly be described as a piece of fixed capital which is to be used in order to dispose of circulating capital.

[28] Lord Wilberforce reached a similar conclusion in *Tucker (Inspector of Taxes) v Granada Motorway Services Ltd* where he held that a payment by a tenant to amend an onerous 50-year lease was of a capital nature.[24] The lease terms became onerous as a result of government increases in tobacco taxes, which adversely affected the turnover-based rent. His Lordship said:[25]

> I think that the key to the present case is to be found in those cases which have sought to identify an asset. In them it seems reasonably logical to start with the assumption that money spent on the acquisition of the asset should be regarded as capital expenditure. Extensions from this are, first, to regard money spent on getting rid of a disadvantageous asset as capital expenditure and, secondly, to regard money spent on improving the asset, or making it more advantageous, as capital expenditure.

[29] In *McKenzies* this Court found that a lease surrender payment in relation to a lease with 38 years to run was a capital expense and therefore not deductible by the lessee.[26] Richardson J began by considering the character of the asset involved:[27]

> The finding by Tompkins J, not challenged on appeal, is that the lease was itself a capital asset of the company. 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, as in the case of most taxpayers, the lease was part of the profit making structure of the business.

[30] The Judge reasoned that, unless other countervailing factors are present, a lump sum payment made in consideration of the surrender of a lease held on capital account ought to be regarded as an expenditure of capital:[28]

> [I]n an uncomplicated case the characterisation of the asset acquired or disposed of will determine the character or quality to be attributed to the costs of acquisition or disposal, as the case may be. Just as moneys spent on the acquisition of a capital asset are prima facie regarded as capital expenditure, so too the proceeds of the disposal of a capital asset or the costs of its disposal where it has a negative value should in the ordinary course have the same character.

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24 *Tucker (Inspector of Taxes) v Granada Motorway Services Ltd* [1979] 1 WLR 683 (HL).
25 At 686.
26 *Commissioner of Inland Revenue v McKenzies (NZ) Ltd*, above n 13.
27 At 741.
28 At 741–742.

> If, as here, the lease is a capital item, then in an uncomplicated case where a lump sum payment is seen to be the cost of disposing of that capital item, the expenditure involved ought to be regarded as capital expenditure. The interest of the lessee confers reciprocal rights and obligations. The lessee has the right to possession and the obligation to make the rental payments and otherwise perform the terms and conditions of the lease. 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. Unless there are other complicating factors present which lead to a different conclusion, a lump sum payment made in consideration of the surrender of a lease held on capital account ought to be regarded as an expenditure of capital.

[31] Finally, in *Commissioner of Inland Revenue v Wattie*, an accountancy firm received a lump sum payment to induce their entry into a lease at an above-market rent.[29] The Privy Council found that the payment was capital in nature. Although the lump sum was calculated to compensate for the above-market rent, it could not be attributed to a particular year. Lord Nolan reasoned:[30]

> The crucial question is whether in all the circumstances the payment or receipt can properly be attributed to a particular year. The question is crucial because income tax is charged annually upon the income or profits of each year. If the payment or receipt cannot properly be brought into the income tax reckoning for a particular year then (apart from special statutory provision) it cannot be brought into that reckoning at all.

Sums paid or received in relation to the creation or termination of a contract

[32] We begin this line of authorities with *British Insulated and Helsby Cables Ltd v Atherton*, a case concerning the deductibility of a lump sum paid to establish the nucleus of a pension fund for employees of a company.[31] Viscount Cave LC elucidated the following principle:[32]

> [W]hen an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital.

The payment was held to be of a capital nature and not deductible by the payer or employer.

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29 *Commissioner of Inland Revenue v Wattie* [1999] 1 NZLR 529 (PC).
30 At 539.
31 *British Insulated and Helsby Cables Ltd v Atherton* [1926] AC 205 (HL).
32 At 213–214.

[33] That principle was applied in *Anglo-Persian Oil Co Ltd v Dale* where the taxpayer had appointed agents to manage their oil and petroleum business in Persia in return for commission payments.[33] Later the taxpayer made a lump sum payment to extract itself from the agency agreement. It was held that the payment in question did not bring into existence any asset, and could not properly be said to have brought into existence an advantage for the enduring benefit of the company's trade.[34] The sum was held to be deductible by the payer. Lawrence LJ said:[35]

> It is not open to doubt that under ordinary circumstances where a trader, in order to effect a saving in his working expenses, dispenses with the services of a particular agent or servant, and makes a payment for the cancellation of the agency or service agreement, such a payment is properly chargeable to revenue; it does not involve any addition to or withdrawal from fixed capital; it is purely a working expense.

This principle has come to be known as the "identifiable asset test".

[34] *Van Den Berghs Ltd v Clark (Inspector of Taxes)* concerned the taxability of an amount received following termination or surrender of a contract, as opposed to the deductibility of a payment in those circumstances.[36] The taxpayer company received an amount in consideration for the termination of a number of profit-pooling agreements 13 years in advance. The House of Lords determined the receipt was capital in nature. Lord Macmillan reasoned that the surrendered agreements went to the whole structure of the taxpayer's profit-making apparatus:[37]

> The three agreements which the appellants consented to cancel were not ordinary commercial contracts made in the course of carrying on their trade; they were not contracts for the disposal of their products, or for the engagement of agents or other employees necessary for the conduct of their business; nor were they merely agreements as to how their trading profits when earned should be distributed as between the contracting parties. On the contrary the cancelled agreements related to the whole structure of the appellants' profit-making apparatus. They regulated the appellants' activities, defined what they might and what they might not do, and affected the whole conduct of their business.

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33 *Anglo-Persian Oil Co Ltd v Dale* [1932] 1 KB 124 (CA).
34 At 147–148.
35 At 139–140.
36 *Van Den Berghs Ltd v Clark (Inspector of Taxes)* [1935] AC 431 (HL).
37 At 442.

[35] The taxability of a lump sum termination payment received in exchange for the surrender of a contract was also in issue in *Commissioner of Inland Revenue v Thomas Borthwick & Sons (Australasia) Ltd*.[38] Richardson J observed that the long-term supply and marketing contract in question was of fundamental significance to the taxpayer's operations.[39] It was part of the framework the taxpayer used to generate profit. Relying on *Van Den Berghs*, Richardson J found that the contract was a capital asset, therefore the lump sum for its early termination was received on capital account.[40]

[36] Finally in *Birkdale Service Station Ltd v Commissioner of Inland Revenue* this Court held that the question of whether a payment for an asset is received as capital or income turns on the nature of the asset in the hands of the seller.[41] That case concerned lump sum payments made to the appellants by Mobil Oil (New Zealand) Ltd in connection with their entry into exclusive supply agreements. The payments were held to be revenue in the hands of the appellants because, by entering into the agreements, the appellants had not changed the structures of their existing business and had not foregone any existing advantage.[42]

The submissions

[37] Mr Harley's submissions rested on a key underlying premise: that the lease to WGL and later W2011 was a subset of Easy Park's freehold interest in the Whitcoulls Building itself. The purchase price for the land paid by Easy Park, $7.7 million, included consideration for the lease to the then anchor tenant, WGL. In other words, the price paid was a composite consideration for the building, *subject to the existing lease*. Mr Harley submitted that it follows logically that the Whitcoulls Building and the lease to WGL were part of the same identifiable capital asset purchased by Easy Park.

[38] Mr Harley submitted that interests in land, whether freehold or leasehold, are about as far in capital territory as it gets for most firms, whether landlords or tenants.

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38 *Commissioner of Inland Revenue v Thomas Borthwick & Sons (Australasia) Ltd*, above n 12.
39 At 9,105.
40 At 9,105.
41 *Birkdale Service Station Ltd v Commissioner of Inland Revenue* [2001] 1 NZLR 293 (CA) at [53].
42 At [76].

Therefore, when a firm purchases land and buildings already subject to leases with tenants, the price paid for that asset is inherently capital and the leasehold is part of the landowner's business structure. Any amount received upon disposal of that asset is therefore also capital in nature. Applying the identifiable asset test approved in *Regent Oil*, the payment received in exchange for the surrender of the lease is a payment for the extinguishment of part of a capital asset. Therefore, the receipt is capital in nature. In effect, the lease surrender payment operated as an adjustment of the purchase price paid for the original asset, being the Whitcoulls Building as well as the lease to WGL, to reflect the loss of the lease.

[39] Mr Goosen for the Commissioner rejected Mr Harley's contention that the lease to WGL formed part of the interest in land acquired upon purchase of the Whitcoull's Building. Under the agreement for sale and purchase, the property purchased was the fee simple and the price paid was for the fee simple only. That Easy Park would not have purchased the building without a lease in place does not change that legal arrangement.

[40] Mr Goosen emphasised the need to determine the issue by reference to the nature of the taxpayer's business. For Easy Park, a company in the business of leasing commercial premises, the lease was a revenue asset in the nature of trading stock. When considered from a practical and business point of view, the payment was made to compensate Easy Park for the loss of rental, which is indisputably income.

[41] As an alternative argument, Mr Harley submitted that the termination of the lease to WGL had a profound and permanent effect going to the very core of Easy Park's business, indicating that the payment was capital in nature. Mr Harley submitted that Easy Park faced serious financial loss when the lease was surrendered and had to rely on shareholder support to remain solvent. The Whitcoulls Building could not be re-let without expenditure of almost $9 million on earthquake strengthening. Moreover, the lease to Glassons following the earthquake strengthening was less favourable and required Easy Park to meet the cost of insurance, unlike the previous lease to WGL.

[42] In response, Mr Goosen submitted that the termination of the lease did not alter Easy Park's capital asset, the Whitcoulls Building. Therefore, the structure of the business remained the same. When the lease was terminated Easy Park was able to use the Whitcoulls Building to generate profit by entering into a new lease with another lessee.

Analysis

[43] We deal first with the core submission advanced by Mr Harley, that is the proposition that the lease to WGL was part of the capital asset acquired by Easy Park when it purchased the freehold in the Whitcoulls Building.

[44] Under the sale and purchase agreement, Easy Park purchased the freehold in the Whitcoulls Building. That freehold is clearly a capital asset. Whilst the existence of the lease is noted, Easy Park contracted to purchase the "fee simple" for "one lump sum" of $7.7 million. Contrary to Mr Harley's submission, we do not consider that the lease to Whitcoulls can be "tacked on" to the capital asset, being the underlying land, by virtue of the lease being in place when the property was purchased. Easy Park did not acquire a leasehold interest in land. It acquired a freehold estate that was subject to a lease. The owner of the leasehold interest was WGL and later W2011.

[45] We accept that the existence of the lease was an important part of the business case for purchasing the Whitcoulls Building and Easy Park would not have purchased the building without it. However, that cannot alter the underlying legal arrangement, which provided for the payment of a purchase price in respect of the fee simple only. We note the following general observations of Richardson J in *McKenzies*:[43]

> While it may not be appropriate to allow the intricacies of the law of property to dominate the interpretation and application of tax legislation where the objects, concepts and thrust may be quite different, it is well settled that the true nature of a transaction must be ascertained by reference to the legal arrangements actually entered into and carried out and taking into account surrounding circumstances, and the documents themselves may be brushed aside only if and to the extent that they are shams or the legislation itself so requires.

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43 *Commissioner of Inland Revenue v McKenzies (NZ) Ltd*, above n 13, at 742.

[46] The nature of a receipt for income tax purposes depends on what the amount received was calculated to effect from a practical business point of view. We refer to the following statement of Richardson J in *AA Finance Ltd v Commissioner of Inland Revenue*:[44]

> Whether gains produced in a business are revenue or capital depends on the nature of the business and the relationship of the transactions producing the gain to the conduct of the business. … A transaction may be part of the ordinary business of the taxpayer or, short of that, an ordinary incident of the business activity of the taxpayer although not its main activity. A gain made in the ordinary course of carrying on the business is thus stamped with an income character.

[47] Easy Park's sole business was leasing commercial properties. It generated income in the form of rent for those properties. That rent is indisputably income. The lease surrender payment in the hands of Easy Park essentially had the same character as the payment of rent. It was a lump sum made on account of the rent foregone by the landlord. From a practical business point of view, the payment was income.

[48] This is not to suggest that, because the amount of the early surrender payment may have been determined by reference to rent lost, it was necessarily received as revenue. The authorities are clear that the character of a receipt is not to be determined by the measure or method used to quantify the payment.[45]

[49] We consider that the termination of the lease and the associated receipt, although unwelcome, constituted part of the ordinary business activities of Easy Park. Easy Park is a commercial lessor. The early termination of lease contracts and payments in compensation for such are part and parcel of that business. Ultimately, Easy Park's profit-making structure went unchanged. The termination of the lease did not affect the underlying capital asset, the Whitcoulls Building. The leasehold interest and right to possession reverted to Easy Park upon termination, meaning that it could, and did, find a replacement lessee. We agree with Ellis J that the lease surrender was

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44 *AA Finance Ltd v Commissioner of Inland Revenue* (1994) 16 NZTC 11,383 (CA) at 11,391.

45 *Regent Oil Co Ltd v Strick*, above n 22, at 349; and *Commissioner of Inland Revenue v Wattie*, above n 29, at 537–538.

simply an ordinary if unwanted incident of Easy Park's core and only business of commercial leasing.[46]

[50] The authorities relied upon by Mr Harley are distinguishable. Mr Harley relied primarily on *Regent Oil*. He described this as a "landlord payments" case. We agree with Mr Goosen that this is a misdescription. The premium in that case was paid by Regent Oil as lessee of the retailer's premises under the head lease. It is therefore a lessee payment case. In the hands of the lessee, the lease was a capital asset, being a part of the underlying profit-making structure of the business.[47] In the present case, the payment is received by Easy Park as lessor. In the hands of a lessor engaged exclusively in the business of commercial leasing, such as Easy Park, the lease was held on revenue account.

[51] *McKenzies*, also relied upon by Mr Harley, looked at the same issue in the present case from the perspective of the lessee. The lease in question was for warehouse premises from which goods were transferred to the taxpayer's retail stores. It was not part of the lessee's trading stock, but rather formed part of the profit-making structure of the business.[48] In contrast, the present case concerns a lessor whose sole business is commercial leasing.

[52] In *Wattie*, the premium received by the accountancy firm to induce its entry into an onerous lease was found to be capital in nature. Lord Nolan noted:[49]

> [I]t was common ground before Their Lordships that the $5m was not a receipt arising from Coopers and Lybrand's ordinary business operations which consist, of course, in the practice of the accountancy profession.

In the present case the receipt arose from Easy Park's ordinary business operations.

[53] We note the Canadian case of *Monart Corp v Minister of National Revenue*, in which the taxpayer received a lease surrender payment for the cancellation of a lease six years early.[50] It was held that the payment was profit derived in the ordinary course

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46 *Easy Park Ltd v Commissioner of Inland Revenue*, above n 3, at [88].
47 *Regent Oil Co Ltd v Strick*, above n 22, at 350–351.
48 *Commissioner of Inland Revenue v McKenzies (NZ) Ltd*, above n 13, at 741.
49 *Commissioner of Inland Revenue v Wattie*, above n 29, at 535.
50 *Monart Corp v Minister of National Revenue* [1967] CTC 263 (Ex).

of the lessor's business of leasing commercial property, and was therefore revenue in nature.[51]

[54] We also reject Mr Harley's argument that the financial impact of the termination was such that it affected the structure and core of Easy Park's business. Mr Harley's submissions on this point conflate the consequence of the surrender of the lease with the costs Easy Park incurred to carry out earthquake strengthening. We accept that the cost of that work threatened Easy Park's solvency, and it was forced to rely on shareholder support. However, it was Easy Park's choice as to whether to conduct earthquake strengthening upon surrender of the lease. We accept that it was sensible for Easy Park to do so in order to give it the greatest chance of securing a new tenant. However, it does not follow that the lease surrender was the cause of the cost of the earthquake strengthening work. During the completion of the restoration work, Easy Park secured a new tenant without even needing to advertise the property. That is unsurprising, given its size and location.

[55] The first tax year in which rental income was earned during the whole year after the work was completed was the year ended 31 March 2015. In that year Easy Park received rental income of $1.1 million from Glassons compared to rental income of $1,161,097 from W2011 in the year ended 31 March 2012 (the last year before the earthquake strengthening work impacted rental income). Accordingly, apart from having to pay insurance on the building (a cost previously borne by WGL and then W2011) Easy Park's business continued after the earthquake work as before.

Result

[56] The appeal is dismissed.

[57] The appellant must pay the respondent costs for a standard appeal on a band A basis and usual disbursements.

Solicitors:
Chapman Tripp, Wellington for Appellant
Crown Law Office, Wellington for Respondent

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[51] At 271.