LEASE INCENTIVE PAYMENTS AND CAPITAL GAINS TAX PROVISIONS

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In a line of recent decisions (collectively referred to in this article as the "post-Cooling decisions"), it was held that lease incentive payments were inherently capital in nature.

This article examines the implications of characterising lease incentive payments as capital. It starts off with a cursory review of the basis on which this characterisation is founded, and then embarks on an extensive analysis of the role of the capital gains tax ("CGT") provisions in assessing such receipts.

The relevant CGT rules which provide the framework for the analysis are covered in three stages:- prior to June 1992, after the 1992 amendments to overcome the result in Hepples v FC of T 91 ATC 4808, and after the 1998 rewrite of the CGT provisions as part of the Tax Law Improvement Project ("TLIP"). To place the analysis in context, the article adopts a historical evaluation of the pre-1998 regime regarding the CGT treatment of lease incentive payments. Its significance lies in the fact that the pre-1998 regime focuses on the rules prior to June 1992 and the subsequent legislative amendments in June 1992 in response to the Hepples decision. The focus on the pre-1998 regime is seen as significant, because of detailed judicial scrutiny and the administrative position adopted by the Australian Taxation Office ("ATO") in its rulings.

Since the post-1998 regime is yet to be tested by the courts, the experiences gained from the implementation of the previous regime are an invaluable guide in assessing the efficacy of the post-1998 regime. In evaluating the post-1998 regime, considerable attention is devoted to the potential treatment of lease incentive payments under the rewritten CGT rules in the Income Tax Assessment Act 1997 (Cth) ("ITAA97") with a view to ascertaining their efficacy in bringing such payments into the tax net

1. INTRODUCTION

Ever since lease incentive payments became a justiciable issue, they have always eluded being assessed under the CGT provisions. This presented no problems as the Full Federal Court in *FC of T v Cooling*[1] invoked the "extraordinary transactions" principle as the basis for bringing such payments into the income net. This principle enunciated in *FC of T v The Myer Emporium Ltd*[2] established the importance of profit-making purpose in assessing gains derived from isolated transactions.

The effect of Cooling was subsequently formalised into the administrative practice of the ATO in *Income Taxation Ruling* IT 2631 which dealt with the tax treatment of various forms of lease incentives.[3]

The authority of *Cooling* received a set-back in a line of recent decisions which reassessed its tenor, extensively distinguished it, and held that lease incentive payments were inherently capital in nature.[4] These decisions are collectively referred to in this article as the "post-*Cooling* decisions". Much has been written on the implications of these decisions in the treatment of lease incentives as

[1] 90 ATC 4472 ("*Cooling* (FFC)").

[2] 87 ATC 4363 *("Myer").*

[3] In *Income Taxation Ruling* IT 2631, paras 1-3, the Commissioner sets out the nature and diversity of lease incentives offered under such arrangements.

[4] *Lees & Leech Pty Ltd v FC of T* 97 ATC 4407 *("Lees & Leech"); Selleck v FC of T* 97 ATC 4856 ("*Selleck* (FFC)"); *Montgomery v FC of T* 98 ATC 4120 *("Montgomery"); CIR (NZ) v Wattle & Anor* (1998) 18 NZTC 13,991 *("Wattie").*

ordinary income.[5] For this reason, any consideration of this matter would fall outside the chosen focus of this article.

This article examines the implications of characterising lease incentive payments as capital. Following a cursory review of the basis on which this characterisation is founded, an extensive analysis of the role of the CGT provisions in assessing such receipts is then embarked upon. Some attention is devoted to an analysis of the pre-1998 regime regarding the CGT treatment of lease incentive payments. Its significance is borne out by the fact that the pre-1998 regime has been subjected to detailed judicial scrutiny and administrative consideration in ATO rulings. Since the post-1998 regime is yet to be tested by the courts, the experiences from the implementation of the previous regime would be an invaluable guide in assessing the efficacy of the post-1998 regime. In evaluating the post-1998 regime, considerable attention will be given to the potential treatment of lease incentive payments under the rewritten CGT rules in the ITAA97 with a view to ascertaining the efficacy of the current rules in bringing such payments into the tax net.

2. CHARACTERISATION OF LEASE INCENTIVE PAYMENTS

In the post-*Cooling* decisions, the courts emphasised the inherent capital nature of lease incentive payments. This characterisation of lease incentive payments was rationalised on a number of grounds:

- Such payments constituted a premium paid in consideration of a prospective lessee's decision to accept the burdens (along with the benefits) of the proposed lease. Effectively these payments were intended to induce prospective tenants to enter into leases. In *Selleck v FC of T,*[6] Beaumont J described the agreement to pay such premiums or incentives as a separate and collateral arrangement which stood apart from and *necessarily* preceded the operation of the lease itself. The incentive payment was an incident of the agreement for lease rather than of the lease instrument itself. The need to find new premises for the new firm was a capital occasion. In his Honour's opinion, premiums paid by a prospective lessor to a prospective lessee were in reality indistinguishable from the reverse case as what was being dealt with in both cases was access to the lease.
- Lease incentive payments represented the sale price for a substantial and enduring detraction from pre-existing rights, namely the pre-existing right of not being bound to a long term lease. To this extent they bore a similarity to amounts received by a trader in consideration of the trading restriction in *Dickenson v FC of T*[7] Lump sums received in consideration of an agreement to restrict one's activity were capital in nature.
- The transaction of obtaining a lease was essentially capital in nature, as the lease brought into existence an asset of an enduring benefit to the lessee's business (the "business entity" test enunciated by Dixon J in *Sun Newspapers Ltd v FC of T*[8] applied). In such cases, obtaining the lease constituted an activity which was connected with the structure of the taxpayer's business.
- In *Lees & Leech Pty Ltd v FC of T*,[9] a payment made to a lessee by a lessor in consideration of fitting out premises was characterised by Hill J as a partial reimbursement of capital expenses incurred in installing the fixtures in question.

These reasons support the general proposition that a contribution to capital cannot be income. This proposition was followed in a number of

[5] See eg, H Ashiabor, "Lease Incentives: Disentangling the Myer Web" (1998) 2(2) *The Tax Specialist* 73; N Bellamy and S Barkoczy, "When will Lease Incentives be of an Income Nature?" (1998) 1(1) *Journal of Australian Taxation* 14.
[6] 97 ATC 4856 ("*Selleck* (FFC)").
[7] (1958) 98 CLR 460 *("Dickenson").*
[8] (1938) 61 CLR 337, 359.
[9] 97 ATC 4407.

earlier UK and Australian cases which suggested that payments received by taxpayers that were directly related to their capital expenditure, were capital in nature.[10]

3. IMPLICATIONS OF THE CHARACTERISATION OF LEASE INCENTIVE PAYMENTS AS CAPITAL

The fact that lease incentive payments are inherently capital in nature does not preclude them from assessability. Rather, an analysis of the impact of the post-*Cooling* decisions reveals that they clarified the circumstances in which capital receipts, such as lease incentive payments, could be brought into the income net under the "extraordinary transactions" principle. In the process some of these decisions drew attention to the flawed basis on which this principle was applied in *Cooling.* These decisions also had the effect of casting doubt on the accuracy of para 8 of *Income Taxation Ruling* IT 2631 which stated that all lease incentive payments received in the context of the relocation of business premises were income.[11] Finally, in characterising lease incentives as being inherently capital in nature, these decisions exposed the narrow base on which the assessability of lease incentives were founded. The potential tax planning opportunities presented by this vulnerability in the law cannot be underestimated.

It is against this background that the need arises to consider the effectiveness of alternative bases for assessing such payments. In both *Selleck* and *Montgomery v FC of T,*[12] the Courts raised other possible scenarios in which lease incentive receipts could be brought into the income net. These dealt with situations in which the receipts could be assessed either under the anti-avoidance provisions, or where the receipt of premiums constituted a regular occurrence in the taxpayer's business.[13] In the writer's considered view, these measures do not adequately deal with the fundamental problems posed by the characterisation of lease incentive payments as capital.

The post-*Cooling* decisions primarily dealt with the question whether the amount received was income or capital. So far as post 19 September 1985 transactions are concerned, however, the characterisation of a receipt as being on capital account is just an intermediate step in the process of determining whether the transaction in question has the potential of generating CGT consequences. Relating this to the specific context of lease incentive payments, the issue then is whether the receipt of moneys by a lessee from a lessor in consideration of entering into a lease creates any scope for the applicability of CGT as the lessee would be creating rights, namely the obligation to pay rent, which are enforceable by the lessor under the terms of s 104-135 of the ITAA97.

A satisfactory resolution of this issue requires an analysis of the role played by the predecessors to s 104-35 in relation to the assessability of lease incentive payments.

4. LEASE INCENTIVES: POTENTIAL CGT TREATMENT − AN EVALUATION

Addressing the potential impact of the CGT regime on the assessability of lease incentive payments requires an examination of three distinct periods commencing from the introduction of the CGT regime in 1985. These periods are:

(a). The pre-1992 regime: This period deals with the original formulation of ss 160M(6) and M(7) of the ITAA36 prior to 25 June 1992. Essentially, these provisions deemed a disposal of an asset to have occurred where there was a disposal of an asset as a means of activating liability to CGT.

[10] *IRC v Coia* (1959) 38 TC 344; *McLaren v Needham* (1960) 39 TC 37; *Case* B63, 70 ATC 300; *Case* D14, 72 ATC 74 and *Case* D30, 72 ATC 177.
[11] Ashiabor, above n 5, 78.
[12] 98 ATC 4120.
[13] *Selleck* (FFC) 97 ATC 4856, 4877; *Montgomery* 98 ATC 4120, 4139.

(b) The post-1992 regime: This covers legislative amendments enacted to rectify the inadequacies of the pre-1992 regime which were identified by the Full Bench of the High Court in *Hepples v FC of T.*[14] These amendments came into effect after 25 June 1992.

(c) The TLIP regime: This regime comprises the re-written CGT rules which replace Pt IIIA of the ITAA36. The rules came into effect on 1 July 1998.

4.1 The Pre-1992 Regime

The CGT rules in their original formulation introduced the concept of deemed disposal of assets as one of the factors which could activate the operation of its provisions.

Where contractual rights were concerned, the relevant deeming provisions were set out in ss 160M(6) and (7) of the *Income Tax Assessment Act 1936* (Cth) ("ITAA36"). Section 160M(6) in particular was drafted with such obscurity that the construction difficulties it presented led Hill J to observe in his majority judgment of the Full Federal Court in *Cooling* that "[e]ven those used to interpreting the utterances of the Delphic oracles might falter in seeking to elicit a sensible meaning from its terms".[15] Section 160M(6) provided:

> A disposal of an asset that did not exist before the disposal, but is created by the disposal, constitutes a disposal for the purposes of this Part but the person who so disposes of the asset shall be deemed not to have paid or given any consideration, or incurred any costs or expenditure, referred to in paragraph 160ZH ... in respect of the asset.

Section 160M(7) on the other hand applied where consideration was received for an act, transaction or event which had taken place in relation to an asset.

The illustrative examples provided in the *Explanatory Memoranda* indicated that it was in the contemplation of the legislators that it would cover payments dealing with contractual rights.

In *Cooling v FC of T,*[16] Spender J refused to apply former ss 160M(6) or (7) to assess a solicitor on an amount paid to him when a service company associated with his firm entered into a lease.

On appeal, the Full Bench of the Federal Court unanimously held that the payment was assessable as ordinary income and that s 160M(6) had no application as that provision was confined to situations in which proprietary rights were created out of, or over existing assets in circumstances where the asset affected by the right continued to exist. The rights created under the guarantee were not proprietary rights carved out of, or over existing assets.

The Full Court's application of s 160M(7) on the other hand proved more contentious. Lockhart and Gummow JJ in deciding that the operation of s 160M(7) was relevant in these circumstances, said that it was sufficient for the purposes of that provision for an act, transaction or event to have occurred in relation to an asset, and that consideration was received as a result of that act, transaction or event. Both judges then concluded that the recipient of the consideration did not need to own the asset. Against this background, their Honours identified the asset affected by the act, transaction or event as the lessor's building. Hill J, on the other hand, in a forceful dissenting opinion stated that to consider s 160M(7) by reference to an asset of a person other than the taxpayer, amounted to turning the policy of the legislation on its head.

In *Hepples,* the assessability of a payment received by the taxpayer for giving a restrictive covenant to his employer was in issue. The similarity between this case and *Cooling* was that there was no pre-existing asset of the taxpayer to which the covenant related. The issue therefore

[14] 91 ATC 4808 ("*Hepples* (HC)")
[15] *Cooling* (FFC) 90 ATC 4472, 4488.
[16] 89 ATC 4731 ("*Cooling* (FC)").

was, whether a pre-existing asset for the purposes of s 160M(7) could belong to another person—in this case the taxpayer's former employer.

The response of the majority of the Full Federal Court[17] (Gummow and Lockhart JJ, Hill J dissenting) to this issue was in the affirmative, with their Honours identifying the relevant assets to include the trade secrets, trade connection and goodwill of the taxpayer's former employer.

When the matter came up on appeal before the Full Bench of the High Court, only Deane J disagreed with the conclusion of the Full Bench of the Federal Court, and held that the asset had to belong to the recipient of the money or other consideration. Dawson, Toohey and Gaudron JJ all held that s 160M(7) was applicable as the pre-existing asset could be that of the taxpayer's former employer. McHugh J, although agreeing that the asset need not belong to the taxpayer, held that s 160M(7) was inapplicable. Brennan J (with whom Mason CJ agreed) left this question open. The balance of opinion, therefore, clearly favoured the view that the pre-existing asset need not belong to the recipient of the money or other consideration.

In *Paykel v FC of T,*[18] Heerey J concluded that the High Court's decision in *Hepples* stood for the proposition that a payment by an employer to an employee in consideration of the latter's covenant not to compete after the termination of his or her employment did not come within the purview of the former s 160M(7).[19] His Honour however considered that he was bound by the High Court's decision even though the *ratio decidendi* was unclear.

In *Callow v FC of T*[20] on the other hand, Kiefel J held that in spite of the fact that four members of the High Court decided that the asset need not be owned by the taxpayer, those members did not constitute the majority. In the Court's opinion, since the circumstances of the case before it were distinguishable from *Hepples,* it was entitled to revisit the matter all over again. In so doing, the Court adopted the stance of Hill J in *Cooling* and Deane J in *Hepples* and held that the asset had to belong to the taxpayer.

In the wake of the decision of the Full High Court in *Hepples,* major amendments which came into operation on 26 June 1992, were effected to ss 160M(6) and (7) as well as the definition of an asset in s 160A of the ITAA36. These amendments were intended to streamline these provisions in an effort to address their shortcomings which were uncovered in the *Cooling* and *Hepples* decisions.

4.2 The Post-1992 Regime

To place the post-1992 CGT treatment of lease incentives into perspective, it would be instructive to examine the scope of the amendments to the provisions in question. To overcome the judicial stipulation that "assets" contemplated in the former s 160A only applied to proprietary rights, the scope of the amended s 160A was widened to include rights that were not property in the recasted definition of an asset.

The revamped s 160M(6) set out the circumstances in which ss 160M(6)-(6D) would apply. Essentially, s 160M(6) enabled these provisions to come into effect whenever a person created an asset which was a form of incorporeal property in another person. Although "incorporeal asset" was not defined in the ITAA36, the *Explanatory Memorandum* described it to include all intangible assets, such as rights under a contract, patents and goodwill. Section 160M(6) was also expressed to apply "subject to the

[17] *Hepples v FC of T* 90 ATC 4497 ("*Hepples* (FFC)").
[18] 94 ATC 4176.
[19] See also *Taxation Ruling* TR 95/3, paras 12-14 on the application of ss 160M(6) and (7) of the ITAA36 to restrictive covenants and trade ties.
[20] 97 ATC 4350.

provisions of this Part". This meant that not all incorporeal assets came within its purview as the creation of some incorporeal assets were dealt with in other, more specific provisions.[21]

In the case of transactions which came within the ambit of these amended provisions, ss 160M(6A) and 160U of the ITAA36 together set out the CGT consequences for the creator of the relevant asset, whilst ss 160M(6B) and 160U of the ITAA36 in similar fashion dealt with the corresponding implications to the acquirer. Both sets of combined provisions spelt out the implications to the relevant parties from two perspectives:

(a) where the transaction occurred within a contractual setting; and

(b) in any other case.

Since lease incentive payments invariably occur in a contractual context, the analysis of the relevant sections will only focus on the potential CGT consequences where the transaction occurs in a contractual setting.

4.2.1 Consequences to the Creator

Where the asset in question was created under a contract, ss 160M(6A) and 160U(6)(a) provided that the person creating the asset (the creator) was deemed to have acquired the asset immediately before the time of making the contract and to have simultaneously disposed of the asset to the person in whom it was vested, at the time the contract was entered into.

The cost base of the asset to the creator therefore only included incidental costs of creation. Because the disposal was treated as having occurred soon after creation, practical difficulties existed in distinguishing incidental costs of acquisition from incidental costs of disposal. In effect only non-deductible incidental costs of creating assets such as stamp duty, legal and registration costs were included in the incidental costs of disposal: ss 160ZH(7A) and (7B) of the ITAA36.

Where no consideration was received for the deemed disposal of the asset (in effect, for creating the asset), the rule in s 160ZD(2)(a) of the ITAA36, deeming market value of the asset to have been received, was overriden. Effectively, this meant that persons disposing of assets were not deemed to have received market value consideration for the disposal.

The capital gain which accrued to the creator was computed by reference to any amount received by the creator for creating the asset, less incidental costs. The operation of s 160M(6A) could not be ousted just because the creator had neither received any consideration nor incurred any incidental costs in creating the asset. In such cases, however, the creator neither made a capital gain nor a capital loss.

4.2.2 Consequences to the Acquirer

Under ss 160M(6B) and 160U(6), the person in whom the asset was vested ("the acquirer") was taken to have acquired it from the creator and to have commenced to own it, at the time the contract was entered into: s 160(U)(6)(a)(i). Where no consideration was provided for the acquisition of the asset, s 160ZH(9) of the ITAA36 did not apply. In practical terms, this meant that the acquirer was not treated as having acquired the asset for its market value in these circumstances.

Even if ss 160M(6) and (6A) did not apply to deem the creator to have made a capital gain, the acquirer was still taken to have acquired the asset. In this way, s 160M(6B) ensured that there was an acquisition on the part of the person in whom the asset was vested. In such a case, a capital gain or capital loss could arise on a disposal of the asset under the other provisions of Pt IIIA (for example,

[21] Examples of incorporeal asset creations that are dealt with by other provisions of the ITAA36 include a declaration of trust under which the beneficiary is absolutely entitled to the asset: ITAA36, s 160M(3)(a); an allotment of shares in a company: ITAA36, s 160M(5)(a); an issue of units in a unit trust by the trustee: ITAA36, s 160(M)(5)(aa); the granting of an option: ITAA36, s 160ZZC; licenses in respect of industrial property (such as rights over patents, copyright and registered designs); ITAA36, s 160ZZD and lease variation payments: ITAA36, s 160ZT.

upon its expiry in terms of s 160M(3)(b) of the ITAA36, or a capital gain if there was an act, transaction or event in respect of the asset to which s 160M(7) applied).

To overcome the limitations presented by the "carve-out" theory from a pre-existing asset which was read as a pre-condition to the interpretation of formers 160M(6), s 160M(6C) expressly provided for the application of s 160M(6) regardless of whether or not the asset was created out of, or in connection with an existing asset. It was also immaterial to the operation of s 160M(6) that the creator owned anything or disposed of anything at the time the asset was created (whether it was a pre- or post-CGT asset).

Like its predecessor, transactions which potentially came within the purview of s 160M(6) were set out in a rather comprehensive illustrative list, in the accompanying *Explanatory Memorandum.*

The amended s 160M(7) on the other hand, was much more diminished in its scope when compared to its predecessor. Its operation was confined to situations in which an act, transaction or event took place in relation to an asset owned by the taxpayer (but not necessarily affecting that asset adversely, beneficially or otherwise) and the taxpayer had received or was entitled to receive consideration by reason of the act, transaction or event in question.[22] The limited scope of this provision was confirmed in *Taxation Ruling* TR 95/3, para 82 which indicated that post-June 1992 transactions would not be caught by s 160M(7) unless the asset was owned by the taxpayer. To this extent therefore, the amended s 160M(7) represented an enactment of the dissenting views of Hill and Deane JJ, as its operation was confined to situations where the pre-existing asset belonged to the taxpayer receiving the consideration. Although the ITAA36 was silent on the meaning of the word "ownership", Kevin Burges has suggested that "the word 'owner' was most likely to be construed in a somewhat non-technical sense to encompass in an appropriate case all of the beneficial owner, lessee, hirer, or other ownership relation".[23]

Other features of the amended s 160M(7) were that:

- The consideration given for the act, transaction or event, had to be in return for refraining from exercising a right where the asset was a right or alternatively for the use or exploitation of the asset.
- The act, transaction or event was treated as a disposal of an asset created by the disposal which was owned by the owner of the asset immediately before the disposal.
- Apart from the incidental costs relating to the disposal of the asset, the asset was treated as having been acquired at no cost by the owner of the asset.
- The consideration on such a disposal was the consideration or entitlement passing to the person who was deemed to have disposed of the asset.

4.2.3 Potential CGT Implications of Lease Incentive Payments under the Post-1992 Regime

In spite of its broad scope, it was unlikely that the revamped s 160M(6) provided an adequate framework for assessing lease incentive payments. In the first place, because a lease was probably a corporeal asset, it fell outside the purview of s 160M(6) which was expressly restricted to the creation of assets which were not corporeal property. Secondly, since s 160ZS of the ITAA36 was a code which dealt with the treatment of leases under Pt IIIA, the fact that it was silent on the subject of lease incentives meant that they could not be taxed under another provision. This meant

[22] The express language of the amended s 160M(6) provided for its overriding effect over s 160M(7). Effectively, this left very little scope (if any) for s 160M(7) whose opening paragraph expressed its operation to be "subject to the other provisions of this Part".

[23] K Burges, "The Reborn Twins", (1994) Paper 4, *Taxation Institute of Australia,* NSW Division Intensive Seminar on CGT, 18 November 1994, para 7.5.

that there was no scope for s 160M(6) to apply where lease incentives were concerned. This issue, it has been argued, was not addressed by the majority of the Full Bench of the Federal Court in *Cooling* when they applied the former s 160M(7).[24]

Another area which highlighted the limitations of the amended CGT rules in assessing lease incentive payments arose where the receipt of the incentive payment occurred in circumstances analogous to *Cooling*. Of particular interest was the question of the partner's potential exposure to CGT in circumstances in which the partner received a lease incentive payment and yet no incorporeal rights were created, such as giving a guarantee to the lessor that a service company would perform its obligations or entering into a sub-lease with the service company. In that event, it was highly improbable that the operation of s 160M(6) would be attracted for the reasons mentioned in the preceding paragraph. Further, s 160M(7) whose application in its amended form could only be activated where the consideration was received by a person by reason of an event in relation to an asset owned by that person could not apply either, as there was no relevant asset which could be identified as belonging to the partner.

In spite of these limitations of ss 160M(6) and (7) however, a possibility existed that the lessor (as the creator of the asset) could be exposed to CGT liability by virtue of s 160D of the ITAA36, the constructive receipts provision. The stakes became much higher if as a result of the operation of the "extraordinary transactions" principle, the partner happened to be assessed under s 6-5 of the ITAA97 as well. In that event, there was a real risk that double taxation would arise which could not be relieved by s 160ZA(4) of the ITAA36. This would have been the case because the double tax relief mechanism in s 160ZA(4) could only be activated where the incidence of the double tax fell on the same taxpayer.

The potential exposure to CGT liability was also relevant when considering the assessability of lease incentives granted on the commencement of a business. In *Income Taxation Ruling* IT 2631, para 10, the Commissioner indicated that whilst a one-off payment to a taxpayer entering into a lease to commence an entirely new business was unlikely to be income, it would nevertheless be assessable as a capital gain by virtue of the former s 160M(7).[25] It was rather curious therefore that the Commissioner in an apparent disregard for his own admonition to taxpayers sought to assess the taxpayer in *Selleck* (where the merger brought an entirely new business into existence) under the "extraordinary transactions" principle, and not treat the payment as a capital receipt (there was no scope for the potential operation of CGT in that case as the assets in question were acquired before 20 September 1985). Again in view of the reasons canvassed earlier on, it is doubtful whether incentive payments received in these circumstances would have come within the purview of the amended s 160M(6).

4.3 The TLIP Regime

The rewritten CGT rules, (which replace Pt IIIA of the ITAA36) contained in Pts 3-1 and 3-3 of the ITAA97, came into effect from 1 July 1998.

The guide to the new rules is set out in Div 100. The main operative rules are prescribed in Div 102. Section 102-20 provides that a capital gain or capital loss arises only if a "CGT event"[26] happens and a gain or a loss is made at the time of the event. Section 102-25(1) sets out the procedure for ascertaining whether a CGT event (with the exception of either CGT events D1 and H2) is applicable to a particular set of circumstances. Each event is tailored with a specific application in mind. Taxpayers are therefore required to choose the most appropriate event in any of the following situations:

(a) where the potential exists for more than one event to impact on a transaction; or

[24] Lehmann & Coleman, *Taxation Law in Australia* (5th ed, 1998) 270.
[25] In the light of the residual scope of the amended s 160M(7), the appropriate provision would be s 160M(6). (Post-1992).
[26] "CGT event" is defined in ITAA97, s 995–1 as any of the events described in ITAA97, Div 104. Division 104 contains 36 CGT events.

(b) where the only CGT events which have any bearing on the transaction are either CGT events D1 or H2.

The CGT events are set out in Div 104. The unique feature of Div 104 is that it dispenses with the notion of disposal of assets which was central to the operation of Pt IIIA and replaces it with the concept of a CGT event. The problems with the approach adopted in the ITAA36 were that the CGT provisions applied to many events which did not involve the disposal of an asset, yet that regime through a deeming process treated those events as a disposal. This deeming of something to be what it was not, obscured the true scope of the tax and led to a complex and highly artificial set of consequential deemings that often frustrated and misled even experienced users of the law.

For the avoidance of doubt, the provisions of Div 104 are further complemented by s 100-25(1) which provides:

> Most CGT events involve a CGT asset .... However many CGT events are concerned directly with capital receipts and do not involve a CGT asset.

In effect, the introduction of the notion of "CGT event" in the ITAA97 means that in most cases the activation of the CGT regime will focus on capital receipts and not necessarily with the disposal of assets. This ties in with the dispensation of the cumbersome deeming rules under the old regime. On the face of it, the CGT event approach has much to commend it as receipts from extraordinary transactions are likely to be assessed even if they do not satisfy the requirements of the *Myer* principle. The implications for lease incentive payments are that with the emphasis of the new regime being focussed on capital receipts neither their characterisation as capital nor the absence of a profit will preclude their assessability under the CGT rules. In theory, this means that if the scenarios in the post-*Cooling* decisions were re-enacted post-June 1998, they would be caught under the rewritten rules.

In practice, however, things do not appear to be all that straightforward. The cases and interpretive rulings issued by the ATO reflect the fact that lease incentives can take various forms. Consequently, it is form rather than the character of the receipt which is determinative of the issue in such situations. The ensuing analysis therefore examines the scope of the different CGT events and their potential impact on lease incentive payments.

The departure of the new rules from the excessive deeming in the ITAA36 has enabled the rewritten rules to describe the CGT consequences of particular events in a more direct manner.

CGT event D1 (s 104-35) which replaces ss 160M(6) and 160M(6A) deals with the creation of contractual or other rights in another entity. Unlike s 160M(6), CGT event D1 does not expressly require the creation of an asset, nor does it expressly confine its application to "non-corporeal" property. On the contrary, it achieves a similar result by applying where contractual, other legal, or equitable rights are created in another entity. The timing of this event for the purposes of ascertaining CGT liability is either when the contract is entered into or when the other right is created.

The legislation provides the following example to illustrate how this provision is intended to operate:

> You enter into a contract with a club to play football only with that club for the next 2 seasons. The club pays you $20,000 for this. You have created a contractual right in favour of the club. If you breach the contract, the club has a contractual right to sue you.

Section 104-35(3) provides that a capital gain is realised where the "capital proceeds" from creating the right exceeds the "incidental costs" incurred in relation to that event whereas a capital loss is realised in the converse situation. The computation of the capital gain or capital loss in

such cases is therefore similar to what prevailed under the post-1992 regime as discussed earlier on in this article. In the ITAA97, the following example is provided to illustrate how this potential liability will arise:

> To continue the example, if you paid your lawyer $1,500 to draw up the contract, you make a capital gain of $20,000 - $1,500 = $18,500.

It is quite clear from the terms of s 104-35 and the accompanying illustrative examples that lease incentive payments would potentially come within its purview. Indeed in *Selleck,* the Court likened lease incentive payments to amounts received by a trader in consideration of the trading restriction in *Dickenson.* The similarities lay in the fact that while the amount received by the taxpayer in *Dickenson* in consideration for his agreement to sell only one particular brand of petroleum products was held to be on capital account, the firm in *Selleck* received a payment, as it were, in consideration of its agreement to deal with a particular landlord. Effectively, those transactions represented the sale price for a substantial and enduring detraction from pre-existing rights namely, the pre-existing right of not being bound to a long term lease. Again in *Dickenson,* Dixon CJ[27] in chacterising the receipts as capital, stated that because the payments were intended to secure a monopoly for its (Shell) products, it effectively modified the structure of the appellant's business.

In the specific case of the lease incentive decisions being considered in this article, the "substantial and enduring detraction from pre-existing rights" were apparent from the long-term nature of the lease agreements which had been executed between the parties. In *Montgomery,* the law firm received the lump sum incentive payment in return for its agreement to enter into the lease of the premises for an initial period of 12 years with an option to have it renewed for a further term of six years. Again in *Cooling,* the firm received a lump sum of $162,000 as an incentive to move to new rented premises in return for a 10 year lease entered into by the firm's service company. Then, in *CIR v Wattie,*[28] the incentive payment of $NZ5 million was received by Coopers and Lybrand in return for its agreement to lease six floors for a minimum period of 12 years, and the lease could not be assigned during that period.

"CGT event D1" clearly transcends the ambit of its predecessors in that it appears that it would apply whenever contractual obligations are created. If this is the case, it can potentially lead to rather disturbing outcomes such as the scenario that Spender J illustrated in dismissing a similar argument raised in *Cooling*:[29]

> If the submission on behalf of the Commissioner is correct, it means that in every situation in which, on the suffering of an obligation, a correlative right springs into existence, there is a capital gain. If a person were to borrow $100,000 from a bank, that person incurs an obligation to repay it. There springs into existence in the bank an asset which did not exist prior to the transaction; that is, the rights of the bank under the loan agreement. On that analysis, sec. 160M(6) would require a borrower to pay tax on the sum borrowed as a capital gain.[30]

To forestall this possibility from occurring, the legislators expressly incorporated s 104-35(5)(a) into the ITAA97 to avoid any doubt. This subsection, excludes the operation of CGT event D1 if the right (that is, the obligation to repay) is created under a money-lending contract.

CGT event H2 (s 104-155) replaces s 160M(7), as it deals with receipts for acts, transactions or events relating to the taxpayer's CGT asset. The emphasis in s 104-155(1)(a) to the effect that CGT

[27] Ibid (1958) 98 CLR 460, 474.
[28] (1998) 18 NZTC 13991.
[29] (FC) 89 ATC 4731, 4743.
[30] Similar concerns were also canvassed in Hill J's majority judgment of the Full Federal Court in *Cooling* (FFC) 90 ATC 4472, 4488-4499.

event H2 happens if "an act, transaction or event occurs in relation to a CGT asset that you own ...", indicates that this provision is unlikely to apply to lease incentive receipts for the same reasons raised earlier in this article in relation to the post-*Hepples* amendments to s 160M(7).

This conclusion is reinforced by the accompanying example which illustrates the circumstances in which CGT event H2 will apply. The operation of s 102-25 would therefore preclude the application of CGT event H2 to lease incentive payments.

The central role played by the notion of assets and disposals under the old regime meant that it was inadequately suited to handling transactions which fell outside its "straight jacket" approach. For instance, if the relevant transaction giving rise to the lease incentive payment was entered into prior to 20 September 1985, thereby insulating the transaction from CGT, there could still be a further asset which had to be considered. If a premature termination of the lease agreement occurred, giving rise to an entitlement to compensation, that right would have constituted an asset within the meaning of s 160A. The tax implications in situations of this nature, where a transaction was entered into pre-1985 but the right to compensation arose on or after 20 September 1985, was unclear under the old regime as its provisions were silent on their treatment. The views of the Commissioner on this matter were not known either.

This obscurity in the law has been eliminated to a large extent by the introduction of the notion of a CGT event in the ITAA97. Section 100-25(1) in particular overcomes this perceived problem by providing that while CGT events generally involve an asset, most events are directly concerned with capital receipts and would therefore not involve a CGT asset.

The receipt in question (that is, the compensation for the premature termination of the lease agreement) therefore, is most likely to fall within the ambit of CGT event D1. This would be the case because the payment of the compensation would for all practical purposes be equivalent to the contractual remedy that the plaintiff would be seeking in the example provided in the legislation to illustrate the operation of s 104-135.

4.3.1 Post-Cooling Decisions and the TLIP Regime

Assuming that the facts in the post-*Cooling* decisions were re-enacted post-June 1998, how would they be treated under the new rules?

In *Draft Taxation Determination* TD 98/D8, the Commissioner addressed the CGT consequences of a lessee incurring capital expenditure on improvements to leased property.[31] Paragraph 2 of the draft determination provides that if the lessee owns the improvements, the cost base of the improvements includes the amount of capital expenditure incurred in making the improvements. Under the terms of this paragraph, on the happening of a CGT event to the improvements, the amount of any capital proceeds received will determine whether a capital gain or loss is made.

Paragraph 2 of the draft determination bears a striking similarity to the essential facts in *Selleck.* In that case, the lessor had agreed to pay a cash lease incentive of $1,066,000 to assist the lessee (a reconstituted partnership, brought into existence as a result of a merger of 2 law firms) to finance the cost of fitting out the premises in question upon the relocation of their business. Under the terms of the agreement, ownership of the fit-out would pass to the lessee. The installation of the fit-out was financed from the firm's operating account, relying on an overdraft from the Westpac Bank to the extent that its expenses exceeded cash on hand. The overdraft was extended during the fit-out period to accommodate the additional expenses the firm incurred. The incentive payment was applied to reduce the overdraft with the bank, but the increased value of the firm's assets following

[31] Since this draft determination deals with property in general, it is much wider than its predecessors *Taxation Determination* TD 46, *Taxation Determination* TD 47 and *Taxation Determination* TD 48 which dealt with the CGT implications of lessee's improvements to land.

the incentive payment (reflected eventually in the value of the fit-out) was accounted for by the firm by crediting the capital account to partners. When cash was available, it would be possible to distribute the cash as returns from the capital account.

Upon the completion of the fit-out, which cost $2.5 million in total, the firm sold it to Westpac for $1.5 million and leased it back. The proceeds of sale were used to make a distribution of $1.06 million to the partners of the firm. The Commissioner assessed partners on their share of the incentive payments.

At first instance,[32] Drummond J held that the $1.06 million was income in the hands of the partners as the gain was generated from a commercial transaction which was entered into by the firm for a number of purposes, a not insignificant one being to make a gain.

In reversing Drummond J's decision on appeal, the Full Federal Court held that it was impossible to draw the inference that the firm regarded the offer of a cash contribution to the fit-out as giving it the opportunity to make a substantial cash distribution to the partners. The firm's only purpose in entering into the lease was to obtain premises from which the reconstituted partnership could conduct its practice. Accordingly, the firm did not have the relevant profit-making purpose at the time it entered into the lease and the payment could not therefore be assessed as ordinary income.

If the facts in *Selleck* were re-enacted after June 1998, it would appear that the sale and lease-back transaction would technically bring the firm's ownership of the fit-out to an end within the contemplation of CGT event C2 in s 104-25; at least this appears to be the tenor of para 2 of *Draft Taxation Determination* TD 98/D8. CGT event C2 happens if a taxpayer's ownership of an intangible CGT asset ends *inter alia* because it expires or is redeemed, cancelled, released, discharged or surrendered. If a lease is treated as a corporeal asset as argued earlier in this article, then it would appear that s 104-25 would not be activated, as CGT event C2 only applies to intangible CGT assets.

Where lease incentive payments are used by lessees to finance the installation of fit-outs and the ownership passes onto them, it would appear that CGT event C2 would be brought into play if the lease is terminated upon expiration, surrender, etc. In that event, s 104-25 would require the lessee to include the amount incurred in installing the fit-out in the cost base of the terminated lease. In computing the cost base or reduced cost base in such situations, however, ss 110-25(8) and 132-5 do present certain problems.

Section 132-5, on the one hand, provides for the inclusion of any recoupments received by the lessee from the lessor in consideration of any capital expenditure incurred by the former in making the improvements to the leased property, as the fourth element of the cost base or reduced cost base. However, s 110-25(8), on the other hand, appears to preclude a lease incentive payment from forming part of the cost base to the extent that it is characterised as a capital receipt. Applying the principles of statutory construction, it would appear that s 132-5 being the more specific provision would prevail over the general provision (s 110-25(8)).

If the fit-out qualifies as depreciable plant owned by the lessee, it would be excluded from the second and third elements of the cost base by virtue of s 110-25(7).

In considering the long term nature of leases executed pursuant to the receipt of a lease incentive amount,[33] it is arguable that on the expiration of the lease, there is a possibility that

[32] *Selleck v FC of T* 96 ATC 4903 ("*Selleck* (FC)").

[33] In *Cooling* the incentive payment was made in return for a 10 year lease entered into by the firm's service company. In *Wattie* the payment from the lessor was subject to the lessee agreeing to lease six floors for a minimum period of 12 years during which the lease could not be assigned. *Montgomery* dealt with a long term lease which locked the firm's service company for an initial period of 12 years with an option to renew for a further six years.

the cost of fit-outs would either have been fully recouped by the lessee, or may only have a nominal book value, as a result of the impact of the depreciation provisions.[34]

In the light of the foregoing, considerble care needs to be exercised in ascertaining the cost base where the lease is terminated in the circumstances contemplated by CGT event C2.

Paragraph 4 of *Draft Taxation Determination* TD 98/D8 also appears to cover the situation which occurred in *Lees & Leech.* One of the issues which the Court addressed in that case was whether ownership of the fit-out had any relevance in determining its assessability to the lessee. Hill J was of the opinion that no gain could possibly accrue to the lessee if the improvements to the premises resulted in the fixtures becoming the property of the landlord. After a thorough review of the law on fixtures, his Honour concluded that even though the non-demountable items were "tenant's fixtures", the impracticability of removing them on the expiration of the lease meant that they formed part of the realty and therefore passed with the land. In effect they became part of the landlord's property. The Court then held that because the partial reimbursement was contingent upon the lessee effecting the improvements to the property, it would be overstretching the facts to say that the lessee derived or made a gain.

Draft Taxation Determination TD 98/D8 codifies this aspect of the decision into the administrative practice of the ATO by providing that:

> 4. If the lessee does not own ... the improvements, but the capital expenditure is incurred by the lessee to increase the value of the lease and is *reflected in the state or nature of the lease* at the time of its disposal, subsection 110-125(5) allows for the expenditure incurred to be included in the cost base of the lease to the lessee. If *any part of the lessee's expenditure is recouped* and the amount of the recoupment received is not included in the lessee's assessable income, subsection 110-25(8) precludes the amount from forming part of the cost base of the lease.
>
> 5. On expiry or termination of the lease, CGT event C2 happens to the lease and the amount of capital proceeds, if any, will determine whether a capital gain or loss is made by the lessee (see, in particular section 116-75). (Emphasis added)

5. CONCLUSION

Apart from characterising lease incentive payments as being inherently capital in nature, the post-*Cooling* decisions have clarified the position that such payments will only be assessed as ordinary income where the requirements of the *Myer* principle have been met. A common thread which ran through all these cases was the fact that the absence of either a realised profit or a profit-making purpose failed to convert what was a capital receipt into income under that principle.

In view of the change in direction by the courts from the position articulated in *Cooling*, this article has demonstrated the inadequacy of the obscure rules of the old regime (in the pre-and post-1992 era) in dealing with the challenges presented. The convergence of these factors exposed the narrow base on which the assessability of lease incentives would have been founded in the wake of the post-*Cooling* decisions.

The introduction of the notion of a CGT event under the rewritten rules has meant that in most cases the activation of the CGT regime will focus on capital receipts and not necessarily with the disposal of assets. This ties in with the dispensation of the cumbersome deeming rules under the old regime. On the face of it, the CGT event approach has much to commend to it as receipts from extraordinary transactions are likely to be assessed even if they do not satisfy the requirements of the *Myer* principle. The

[34] *Income Taxation Ruling* IT 2631, para 27.

implications for lease incentive payments are that since the emphasis of the new regime is on capital receipts, characterising them as capital will not affect their assessability. To this extent the rules appear to broaden the narrow base for assessing incentive payments, which were exposed in the aftermath of the post-*Cooling* decisions.

The fact that lease incentives can be presented in various forms further complicates the issue, as form rather than the character of the receipt often determines the appropriate tax treatment. This outcome is apparent from the decided cases as well as in *Income Taxation Ruling* IT 2631. The analysis of the impact of CGT event C2 on lease incentive payments further highlights how this issue manifests itself under the rewritten rules.

The analysis of s 140-35 (CGT event D1) demonstrates how this provision represents a considerable improvement on the treatment of lease incentive payments, when compared with the rules which operated under the previous regime. The vulnerability of CGT event D1 ironically lies in its strength, namely the rather wide terms in which it is couched. In the writer's opinion, this feature of CGT event D1 opens up an entirely new horizon as it potentially brings most contractual relations into the CGT net. This raises questions as to whether this was the outcome that the TLIP team or the legislators contemplated. If the experience of the old s 260 of the ITAA36 which was also drafted in rather wide terms is any guide at all, there is a danger that the courts might be inclined to construe s 140-35 narrowly in an effort to avoid the unintended consequences of its operation.

While the re-written rules reflect a substantial improvement to its predecessors, there are still pockets of grey areas embedded within it which are largely attributable to some of the uncertainties about their operation discussed in this article. It would therefore be of considerable interest to see how the courts would address these uncertainties whenever the opportunity presents itself for the rules to be tested against the assessability of lease incentives.

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