Chapter 10

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A case for reform

Current arrangements are uncertain and inconsistent

10.1 The taxation of leases over non-wasting assets (such as leases of land) and other rights (such as franchise fees) raises many of the same generic issues as were discussed in respect of leases over wasting assets in Chapter 9. However, in many cases where depreciable assets are not involved the benefits associated with a lease or right are often less well defined. This calls for some different approaches from those set out in Chapter 9.

10.2 There is also a difficult borderline between selling the rights to an appreciating asset and selling the asset itself. In the context of a regime which taxes capital gains on realisation, there is a need to consider in what circumstances the granting of a right over the asset should give rise to a realisation of prior capital gains.

A strategy for reform

Adopt a new framework for taxing leases over non-wasting assets and other rights

10.3 Similar issues arise relating to the structuring of payments for leases over non-wasting assets and other rights as were discussed in Chapter 9, in terms of the ability to structure payments relative to the benefits obtained from the right in order to obtain tax benefits.

10.4 However, the current taxation of rights also disadvantages taxpayers who make up-front payments for rights such as franchise fees, indefeasible rights of use over assets such as telecommunication cables and lease premiums for leases of land.

10.5 With these rights, the grantor is taxed on the up-front payment when received, but the grantee is able to deduct the expenditure only as a capital loss at the end of the right. Other right payments (such as prepayments of lease rentals) are deductible by the grantee over the period of the right, but the grantor is still taxed on any up-front payment on receipt.

- Cameo 10.1 sets out the current tax treatment of a right where the expenditure is deductible only at the end of the right.

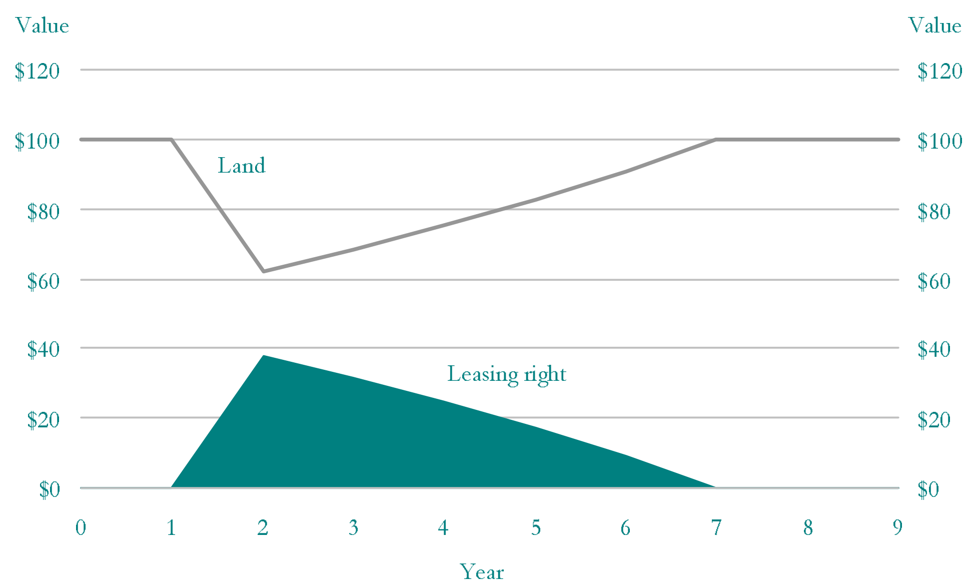
10.6 The tax treatment of such right payments does not accord with the income flows under the right. In other cases, benefits can be obtained from

structuring the right payments, so they no longer accurately reflect the flow of benefits under the right. This can give rise to tax deferral opportunities.

10.7 Figure 10.1 sets out the income flows associated with a right such as a five year lease over land, where the only payment is at the beginning of the right.

10.8 In the first year of the right (year two in the figure) the value of the asset to the grantor falls by the value of the right, but this is offset by the up-front payment. Given that the sale of the right does not involve the realisation of any accrued gains or losses there is no income to the grantor. In subsequent years the value of the asset to the grantor increases as the return of the use of the asset comes nearer. The change in the grantor's income in each year as a result of granting the right is that increase in the value of the asset, less the income from the asset which is forgone by the grantor as a result of granting the right.

Figure 10.1: Five year lease over land



10.9 From the point of view of the grantee, the income in each year is the income from the right less the decline in the value of the right. The value of the right to the *grantee* is the net present value of the benefits from the right less the value of future payments. This is the 'mirror' of the change in the value of the underlying asset to the *grantor*. In this example, where the only payment made is at the beginning of the right, the value of the right to the grantee declines over the period of the right. Cameo 10.1 sets out the current treatment of a transaction of this kind.

10.10 Cameo 10.2 demonstrates that recognising these changes in value as income of both the grantor and grantee as they occur corrects the current treatment of up-front payments in cases such as franchise fees and indefeasible rights of use. It also removes the scope to derive tax benefits from the structuring of the payments over other leases and rights outlined in Chapter 9

in relation to wasting assets. This ensures that the net present value (NPV) of the transaction before tax, calculated using a before tax rate of return, is equal to the NPV after tax calculated using an after-tax rate of return.

Cameo 10.1: Taxation bias against certain rights

All figures in dollars

			Grantee				Grantor			
Year	Right payments	Benefits	Before-tax cash flow	Taxable income	Tax	After-tax cash flow	Before-tax cash flow	Taxable income	Tax	After-tax cash flow
2	37.91	0.00	-37.91			-37.91	37.91	37.91	13.65	24.26
3	0.00	10.00	10.00	10.00	3.60	6.40	-10.00	-10.00	-3.60	-6.40
4	0.00	10.00	10.00	10.00	3.60	6.40	-10.00	-10.00	-3.60	-6.40
5	0.00	10.00	10.00	10.00	3.60	6.40	-10.00	-10.00	-3.60	-6.40
6	0.00	10.00	10.00	10.00	3.60	6.40	-10.00	-10.00	-3.60	-6.40
7	0.00	10.00	10.00	-27.91	10.05	20.05	-10.00	-10.00	-3.60	-6.40
NPV	**$37.91**	**$37.91**	**$0.00**			**-$1.23**	**$0.00**			**-$2.41**
IRR			**10.00%**				**10.00%**			

Cameo 10.1 illustrates how the current tax treatment is biased against certain leases and rights, because the expenditure is deductible (or able to be offset against capital gains) only at the end of the right, while the grantor is taxed on the up-front payment on receipt. Examples of such rights include: franchises, franchise renewals, radio communication licences, and indefeasible rights of use (such as over a telecommunications cable).

In this illustration, the grantee receives $10 per annum from the right. The grantor is shown as having a negative cash flow of $10 per annum reflecting the income forgone from the asset. The grantee makes one up-front payment for a five year right, equal to the present value of future benefits at the beginning of the right ($37.91).

The grantee and grantor are both assumed to have tax rates of 36 per cent. The grantor is taxed on the payment for the right when received up front. This is despite the fact that the payment received by the grantor for the right is equal to the immediate loss in value of the underlying asset — with no net change in the grantor's overall wealth at that time. As shown in Figure 10.1, the value of the underlying asset increases over the five years as the grantor gets closer to recovering the use of the asset. Ideally the grantor should be taxed on that increase in value year by year.

For the grantee the loss in value of the right is not recognised for taxation purposes until it is disposed of. Ideally, the payment should be deductible over the period of the right, consistent with the decline in value of the right to zero over that period as shown in Figure 10.1.

Cameo 10.2: A possible framework approach to taxing leases and other rights over non-wasting assets

All figures in dollars

Year	Right payments	Benefits	PV of future payments	PV of future benefits	Change in PV of payments	Change in PV of benefits	Change in the value of the right
2	37.91	0.00	0.00	37.91		37.91	37.91
3	0.00	10.00	0.00	31.70	0.00	-6.21	-6.21
4	0.00	10.00	0.00	24.87	0.00	-6.83	-6.83
5	0.00	10.00	0.00	17.36	0.00	-7.51	-7.51
6	0.00	10.00	0.00	9.09	0.00	-8.26	-8.26
7	0.00	10.00	0.00	0.00	0.00	-9.09	-9.09
PV	**$37.91**	**$37.91**					

	Grantee				Grantor			
Year	Before-tax cash flow	Taxable income	Tax	After-tax cash flow	Before-tax cash flow	Taxable income	Tax	After-tax cash flow
2	-37.91	0.00	0.00	-37.91	37.91	0.00	0.00	37.91
3	10.00	3.79	1.36	8.64	-10.00	-3.79	-1.36	-8.64
4	10.00	3.17	1.14	8.86	-10.00	-3.17	-1.14	-8.86
5	10.00	2.49	0.90	9.10	-10.00	-2.49	-0.90	-9.10
6	10.00	1.74	0.62	9.38	-10.00	-1.74	-0.62	-9.38
7	10.00	0.91	0.33	9.67	-10.00	-0.91	-0.33	-9.67
NPV	**$0.00**			**$0.00**	**$0.00**			**$0.00**
IRR	**10.00%**				**10.00%**			

Cameo 10.2 illustrates the same basic situation as set out in Cameo 10.1, where there is an up-front payment for a right such as a franchise fee or indefeasible right to use. Again the grantor is shown as having a negative cash flow of $10 per annum reflecting the income forgone from the asset.

Under this approach the grantee is taxed on the net receipts from the right and on the change in the value of the right that arises from changes in the future benefits and payments, and receives a deduction for the right payments made each year. The grantor is taxed on any right payments received each year less the change in the value of the right. He has also forgone the income from the asset for the period of the right and this effect is reflected as negative income in the example above. For example the grantor's income in year 2 is the $10 income from the asset forgone plus the $6.21 fall in the value of the right.

Key policy issues

10.11 In considering possible options to implement the framework illustrated in Cameo 10.2 as a means for taxing rights, it is important that the approaches are relatively easy to apply, and do not impose high compliance costs on taxpayers, especially in the majority of cases where the payments are not structured in order to obtain unwarranted tax benefits.

10.12 Possible exclusions from the need to apply the framework approach would be crucial in this regard. In essence, where the structure of payments for rights 'reasonably approximates' the structure of benefits then there is no need to calculate the changing value of payments and benefits, as these will offset each other, and the overall effect will be approximately zero.

10.13 This means that many ordinary rights, such as leases of land and property where the rent is paid annually, could be excluded from the treatment of rights.

10.14 Contracts where the total value of payments is small could similarly be excluded, on the basis that this would reduce the compliance costs for taxpayers with contracts where there is a small overall scope for obtaining benefits from structuring payments.

10.15 Such rights would simply be taxed on the basis of ordinary income principles.

10.16 Rights which would qualify as outside an accruals regime would likely have one or more of the following characteristics:

- low net present value of rights payments;
- short length; and
- little deviation between the value of services provided per period and the right payment.

10.17 Applying the framework approach would improve the treatment that taxpayers receive in the cases where up-front right payments are assessable to the grantor but not deductible at the same time to the grantee.

10.18 The example in Cameo 10.2 assumes that the benefits of the right in each year are known. This is frequently not the case. One approach could be to assume that the benefits are distributed equally over the period of the right, and that the total benefits could be derived from the total payments made under the right.

10.19 However, where the actual income profile differed significantly from this assumption, this would both create structuring opportunities in some situations, and disadvantage taxpayers in others.

10.20 For example, under a right to extract timber from land, bringing forward the benefits relative to the payments by extracting the timber early would be equivalent to rear weighting the payments. This would create significant tax benefits where the grantor has a higher tax rate than the grantee, but disadvantage taxpayers where the grantor has a lower tax rate than the grantee.

10.21 Two possible approaches to address uncertainties about future benefits are discussed below.

What approaches could be used to deal with different kinds of rights?

The 'implicit benefits' approach

10.22 With some rights, although the distribution of the benefits over the period of the right will generally not be known in advance, these benefits can be determined after the event, and progressively as at the end of each year.

10.23 For example, in the timber example outlined above, it would be possible to determine each year the value of the timber removed as a proportion of the payment for the right. This would allow calculation of the change in the value of future benefits from the right to be calculated.

10.24 Where the benefits that are obtained from a right can be separately identified, these rights could be taxed on the basis of the expected benefits which are implicit in the payments that are being made for the right, less the actual benefits which have already been realised. For example, the 'implicit benefits' approach could be used in relation to rights such as the right to remove timber from land.

10.25 Under the 'implicit' benefits approach, the change in value of the future benefits is estimated on the basis of the increase in the value of future benefits that is implicit in the total value of payments made, accrued at the appropriate interest rate, less any benefits actually realised. Further details on the implicit benefits approach are shown in Cameo 10.3.

The 'deemed benefits' approach

10.26 For many rights it will not be possible, even after the event, to identify separately the income that has been derived from the right. As a result, it will not be possible to apply the implicit benefits approach. Examples of such rights include franchises and other business licences, where the income from the right cannot be separated from the general returns from the business.

10.27 Where the income from the right cannot be separately identified after the event there is, presumably, no opportunity to levy tax based on the actual change in the value of future benefits and future payments.

10.28 One option would be to allow the grantee straight line amortisation of the present value of payments under the right. The grantee would then be taxed on the basis of his or her income from the right plus any increase in the value of the right less any payments for the right. This approach deems that the benefits from the right are equal in all periods. Further details of this 'deemed benefits' approach are given in Cameo 10.4.

10.29 The 'deemed benefits' approach could be used in relation to the estimated $300 million of expenditure on rights (such as franchise fees and indefeasible rights to use property such as telecommunication cables) which are currently not deductible except as a capital loss (see Chapter 8).

10.30 The costs to revenue of applying the deemed benefits approach to these rights are estimated at $70 million by 2003-04 (36 per cent company tax rate).

Could the proposed framework apply to rights arising from service and other contracts?

10.31 Identical opportunities for structuring of payments exists where there are prepayments (or delayed payments) made under a service contract, as with leases. Where the purchaser pays for the service in advance or after delivery of the service (or the timing of the payment differs from the benefits from the service) an implicit loan exists between the parties, which creates scope for structuring tax benefits.

10.32 A comprehensive approach to prepayments and delayed payments would seek to bring these implicit interest payments to account for both parties. This would allow the service provider to continue to benefit from any available accelerated capital allowances, but remove the scope for tax benefits from structuring the payments.

10.33 The practicalities of determining where the timing of the benefits of a service contract differs from the timing of the payments will be straightforward in many cases (for example, where a standard service is provided every period but the payments are rear weighted) but may be quite difficult in other cases. Where differences in the timing of payments and benefits can be identified then a similar approach to that used for removing the benefit of structured payments under leases could be used.

Cameo 10.3: Implicit benefits taxation

All figures in dollars

Year	Right payments	Actual benefits	PV of future payments	PV of implicit benefits	Change in PV of payments	Change in PV of benefits	Change in value of the right
0			100.00	100.00			
1	40.21	0.00	69.79	110.00	-30.21	10.00	40.21
2	40.21	0.00	36.55	121.00	-33.23	11.00	44.23
3	40.21	48.66	0.00	84.44	-36.55	-36.56	0.00
4	0.00	48.66	0.00	44.23	0.00	-40.21	-40.21
5	0.00	48.66	0.00	0.00	0.00	-44.23	-44.23
PV	**$100.00**	**$100.00**					

	Grantee				Grantor			
Year	Before-tax cash flow	Taxable income	Tax	After-tax cash flow	Before-tax cash flow	Taxable income	Tax	After-tax cash flow
0								
1	-40.21	0.00	0.00	-40.21	40.21	0.00	0.00	40.21
2	-40.21	4.02	1.45	-41.66	40.21	-4.02	-1.45	41.66
3	8.45	8.44	3.04	5.41	-8.45	-8.44	-3.04	-5.41
4	48.66	8.44	3.04	45.62	-48.66	-8.44	-3.04	-45.62
5	48.66	4.43	1.59	47.06	-48.66	-4.43	-1.59	-47.06
PV	**$0.00**			**$0.00**	**$0.00**			**$0.00**
IRR	**10.00%**			**6.40%**	**10.00%**			**6.40%**

Cameo 10.3 illustrates taxation of a right where the lessee's annual revenue from the right is known at the end of each year. An example would be where a right is granted to take timber from another person's land. In this case it is possible to identify the benefits from the right at the end of each year when the value of timber removed from the land is known.

In this illustration, the grantee is assumed to make equal payments which have a net present value of $100, over the first three years of the right. The implicit benefits treatment assumes that the present value of future benefits is equal to the present value of future payments at the beginning of the right ($100). This example has been constructed so that the actual benefits from the right (the net receipts from the right) are generated equally in the last three years, and the net present value of benefits equals the expected benefits. The grantee and grantor are both assumed to have tax rates of 36 per cent.

The income of the grantee is the net receipts from the right less actual right payments, plus the change in the value of the right (equal to the change in the value of future benefits less the change in the value of future payments for the right). The taxable income of the grantor is the mirror image — the payments received for the right less the change in the value of the right.

The calculation of the change in the implicit benefits of the right requires some explanation. At a prevailing interest rate of 10 per cent the NPV of the benefits from the right are assumed to be $110 at the end of year 1 reflecting 10 per cent growth on the original NPV of the value of payments for the right. This approach is followed for year 2 as well. For year 3 the change in implicit benefits is calculated as a 10 per cent increase over the value at the end of year 2 less the actual benefits from the right in that year. This approach is followed in years 4 and 5 as well. It results in the value of the benefits from the right being taxed as they accrued and a neutral tax outcome.

Cameo 10.4: Deemed benefits taxation

All figures in dollars

Year	Value of asset	Right payments	Benefits	Amortisation of the right	PV of payments	Change in PV payments
0	100.00				37.91	
1	100.00	15.24	10.00	7.58	26.46	-11.45
2	100.00	15.24	10.00	7.58	13.86	-12.60
3	100.00	15.24	10.00	7.58	0.00	-13.86
4	100.00	0.00	10.00	7.58	0.00	0.00
5	100.00	0.00	10.00	7.58	0.00	0.00
	PV	**$37.91**	**$37.91**			

	Grantee				Grantor			
Year	Before-tax cash flow	Taxable income	Tax	After-tax cash flow	Before-tax cash flow	Taxable income	Tax	After-tax cash flow
0					-100.00			-100.00
1	-5.24	-1.37	-0.49	-4.75	15.24	11.37	4.09	11.15
2	-5.24	-0.23	-0.08	-5.16	15.24	10.23	3.68	11.56
3	-5.24	1.03	0.37	-5.62	15.24	8.97	3.23	12.02
4	10.00	2.42	0.87	9.13	0.00	7.58	2.73	-2.73
5	10.00	2.42	0.87	9.13	100.00	7.58	2.73	97.27
NPV	**$0.00**			**$0.14**	**$0.00**			**-$0.13**
IRR	**10.00%**			**6.82%**	**10.00%**			**6.37%**

Cameo 10.4 illustrates taxation of a right where it is not possible, even after the event, to identify separately the income that has been derived from the right. An example is a franchise licence.

In this illustration, the grantee makes equal payments over the first three years of the right, with a present value of $37.91. The deemed benefit methodology essentially assumes that the present value of benefits from the right is equal to the present value of payments at the beginning of the right ($37.91) and that the benefits are spread equally over the period of the right. The grantee and grantor are both assumed to have tax rates of 36 per cent and the underlying asset is assumed to have a constant value.

The net receipts from the right are shown in a separate column as 'benefits' in the illustration. It is not necessary to identify separately the net receipts, as long as they are included somewhere in the grantee's taxable income. The grantee receives a deduction for amortisation of the right (on a straight-line basis — in this case $7.58 per annum over 5 years), for the right payments made each year but is assessed on any fall in the value of future payments. Similarly, the grantor is taxed on the right payments received each year plus the change in the value of the right (which is deemed to be the amortisation of the right less the fall in value of the future payments). As straight line amortisation of the right is only an approximation to the change in value of the right implicit in the assumed benefits, the above example would result in the grantee gaining 14 cents after tax at the grantor's expense if the assumed benefits were in fact accurate.

Should some sales of rights be treated as the realisation of assets?

10.34 Another issue for consideration is when rights should be treated as the realisation of the underlying asset (that is, realisation of the future economic benefits derivable from the asset). A realisation based system needs to recognise a realisation of pre-existing gains where there is an effective disposal of the asset.

10.35 The granting of some rights is virtually equivalent to the full realisation of the relevant asset. For example:

- a 100 year lease of land is almost identical to a sale of the land; and
- the granting of distribution rights in a film may constitute an effective disposal of the rights in the film.

10.36 There can be effective realisation even if payments for a right are spread over the period of the right. In substance, the grantor can sell the future benefits from the underlying asset and receive in exchange a financial asset from the grantee. An analogy can be drawn with the situation where one asset is sold and a financial asset is purchased, which is clearly a realisation event. In both situations, the owner is selling the future benefits from use of the asset in exchange for a stream of certain financial payments from the grantee.

10.37 Without an appropriate recognition of in substance realisations, taxpayers would be able to avoid tax by issuing rights over an asset rather than selling the asset outright. However, it would be inappropriate to deem the full value of an asset to be realised every time a right is granted over that asset. Doing so would create a disincentive to grant short term rights over assets which have gained in value and an incentive for taxpayers to grant short term rights over assets which have lost value.

10.38 Issues also arise in relation to the realisation of value which may have been created by the grantor prior to the granting of a right, as a result of expenditure which was deductible. For example, advertising expenditure may create value associated with a brand name, which underlies rights subsequently granted. If there was no realisation on the granting of the right, there could effectively be no taxation of the benefits of this deductible expenditure.

10.39 Two main options for dealing with the realisation problem are to deem a partial realisation of the asset based on the proportion of the asset which has been realised through the right, or a full realisation of the asset if the proportion of the asset which is realised is greater than a threshold amount.

10.40 Both options would require a valuation of the underlying or the residual asset at the time the right was issued.

Option1: The partial realisation approach

10.41 One option is to deem a partial realisation of the underlying asset on the granting of a right if the present value of right payments is greater than a specified minimum proportion of the value of the underlying asset.

10.42 In this case, any gain or loss from the partial realisation of the asset would be taxable in the year the right is granted. Granting of rights which realise less than the specified proportion of the value of the asset (say 10 per cent) could be excluded from such a rule.

10.43 For example, 50 per cent of a $100 asset, with a cost base of $60, might be realised through the granting of a right for a payment of $50. In this case, the realisation adjustment which would be made on the granting of the right would be to include $20 as assessable income ($50 minus $30).

10.44 The cost base of the remaining asset given the existence of the right, would be the cost base of the half of the asset not deemed to be sold via the issuing of the right. As the right progressed the reductions in the value of the right would need to be reflected in an increase in the cost base of the asset. Consequently once the right expired the cost base of the asset would be $80. This is in fact equal to the original cost base of $60 plus the $20 capital gains income assessed at the time the right was issued. This is an appropriate outcome.

Option 2: The threshold realisation approach

10.45 An alternative option would be to have a single higher 'threshold' test, in which the realisation of more than a given proportion of the value of an asset is deemed to represent the full realisation of the asset. For example, if more than 50 per cent of the value of the asset is realised then this would be treated as a full realisation of the value of the asset.

10.46 This option would need to have some anti-avoidance rules to prevent taxpayers realising successive amounts through a series of rights which were below the threshold. There would also be problems where realisations that were below the threshold took place, as unless changes were made to the cost base, tax would be avoided on the sale of the remaining asset.

10.47 As a result, the same adjustment to the cost base of the remaining asset would need to be made as was outlined in relation to the partial realisation option, whether or not the realisation was above the threshold.

10.48 Accordingly the only savings of this approach in terms of compliance costs or complexity would come from fewer assets being affected, due to the higher threshold, but this would be at the expense of a less neutral outcome.