Chapter 8

TOWARDS A NEW POLICY FRAMEWORK FOR LEASES AND RIGHTS

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A case for reform

What is a lease or right?

8.1 Leases and rights are essentially arrangements for transferring some or all of the benefits of ownership of an asset from the owner to the recipient of the lease or right. The following kinds of rights contracts are covered by the discussion:

- leasing and similar contracts which provide rights over physical assets, for example, leases of equipment;
- contracts giving rights over intangible assets, such as spectrum licences and rights in films, patents, copyright and industrial designs;
- indefeasible rights of use over assets, such as telecommunication cables;
- profits á prendre, that is, a right to take a product such as standing timber from another person's land;
- contracts for services;
- restrictive covenants; and
- rights to receivables arising from 'rights' contracts, for example, lease receivables.

8.2 Chapters 8-10 deal with income and payments associated with contracts where rights are granted over the use of physical and intangible business assets. Rights under financial transactions are covered in Chapters 5-7. The taxation treatment of rights that are trading stock, such as software produced or developed for sale, is covered in Chapter 3.

How are leases and rights taxed at present?

Complexity and inconsistency

8.3 The current law does not tax receipts and expenditure associated with leases and rights on a consistent basis.

8.4 Reflecting the lack of a consistent treatment, the current taxation of leases and other rights contracts tends to emphasise legal form over economic substance. Existing rules are a complex mixture of ordinary income tax concepts and specific statutory rules. This means that similar transactions can receive differing tax treatments.

8.5 Overall, because tax value often differs considerably from changes in commercial value, and because the tax treatment of leases and rights contracts is based on the form rather than the substance of the arrangement, the following problems exist:

- both law and administration are complex, providing inconsistent and inappropriate treatment through different outcomes for broadly similar transactions. Complexity and inconsistency are contrary to the national objective of simplification identified in *A Strong Foundation*; and
- some taxpayers are being significantly disadvantaged by the current tax treatment, while other taxpayers are able to obtain significant tax advantages at the expense of the wider community. Both outcomes distort the choice of particular forms of business arrangements, so that tax considerations interfere with the way in which investment funds are allocated purely as a result of tax considerations. This is inconsistent with the *optimal growth* and *equity* objectives for business taxation also identified in *A Strong Foundation*.

Some examples

8.6 Lump sum payments for the granting of some rights are taxed immediately (for example, a lease premium is a taxable capital gain) whereas others are spread over the period of the contract (for example, payments for services).

8.7 There are different tax treatments for lease premiums (usually treated as capital), lease surrender payments (treated as income) and lease incentive payments (usually treated as income, but in some instances as capital), although in substance each has similar characteristics.

8.8 A number of specific legislative rules attempt to deal with specific problems, for example, advance payments, that the present structure of the tax law could not otherwise deal with. These add legislative and administrative complexity.

8.9 As discussed further below, taxation arrangements relating to leases and other rights involving tax exempt entities and offshore entities are complex (and can have severe effects).

Tax biases against certain leases and rights

8.10 The tax treatment of some types of leases and rights significantly disadvantage some taxpayers, as a consequence of the tax value diverging from the commercial value of the arrangement. This causes distortions against

particular forms of business arrangement, and interferes with the way in which investment funds are allocated.

8.11 Lump sum payments for the granting of some rights are taxed immediately on receipt, but are not deductible to the grantee except as a capital loss on the termination of the right — for example, up-front lease premiums paid for leases of land.

8.12 Expenditure on some rights, such as franchise fees and indefeasible rights to use property such as telecommunication cables are similarly not deductible except as a capital loss. It is estimated annual total payments of around $300 million on fixed life intangible rights are not deductible except as a capital loss.

Tax benefits from the use of leases and other rights

8.13 By contrast, significant tax benefits can be obtained from some leases and rights, because the tax value diverges from the commercial value of the arrangement. These create distortions in favour of particular forms of business arrangement and interfere with the most efficient allocation of funds.

8.14 These tax benefits arise through the following mechanisms:

- structuring payments;
- transfer of tax preferences; and
- lease assignments.

Benefits from structuring payments

8.15 Where the parties have different tax rates, the current tax treatment of lease or right payments advantages some taxpayers relative to others where the payments are structured differently from the cost to the grantor of providing the asset.

8.16 Many leases and rights have annual payments which do not reflect the benefits received in the year from the services provided (for example, where payments for the service flow from an asset do not match interest forgone and economic depreciation of that asset). Where the value of annual payments and the benefits differ, the difference will have to be refected in later years. That is, if the payments are less than the benefits obtained in the early years, payments in future years will need to be correspondingly greater to compensate.

8.17 Structuring the payments for leases and rights to differ in this way from the cost of providing the asset creates tax advantages which can be shared between the parties. Such benefits are not available to other taxpayers. For example, where a lessee has a lower tax rate than a lessor, tax benefits can be generated by 'rear weighting' lease payments as the lessor gains more by

deferring tax payments than the lessee loses through tax deductions being deferred.

8.18 Cameo 8.1 shows that there can be tax benefits from constant payment structures, which are common in relation to leasing. The benefits are greater if more aggressive payment structures are adopted.

8.19 The capacity to reduce tax through structured payments distorts the finance choice between leasing and other forms of asset financing. It can also distort the broader business choice between undertaking activities 'in-house' and outsourcing the activity to another entity.

8.20 Similar tax benefits can also arise in relation to pre-payments and delayed payments for assets. Economically, a payment in advance or arrears creates an implicit loan between the parties because, in either case, one is in debt to the other. Existing rules which spread pre-payments for services over 13 months or more address this to a limited extent, but do not affect, for example, pre-payments or delayed payments relating to capital assets that are taxed only on disposal.

Transfer of tax preferences

8.21 If the tax base is in line with economic income, the value of an asset to a taxable investor is equal to that of a tax exempt investor. This result arises because the tax system reduces all income and expenditures in proportion to the tax rate and the after-tax discount rate is reduced by the same proportion. In these circumstances the net present value of any investment to a taxable investor and a tax exempt investor is identical.

8.22 If the tax system is not based on economic income, then the value of an investment to a taxable investor will be higher or lower than for a tax exempt investor. For example, accelerated depreciation would make the value of any investment subject to accelerated depreciation higher for the taxable investor than for the non-taxable investor. In practice, this will result in the price of such assets being bid up so that the tax exempt investor has to pay more for them than would be the case in the absence of accelerated depreciation. That is, granting accelerated depreciation for an asset discourages investment in those assets by tax exempt or low tax entities.

8.23 Tax exempt or low tax entities would have an incentive to offset this disadvantage by attempting to obtain access to the benefits of any tax preferences such as accelerated depreciation. Leasing and rights are mechanisms which can be used to obtain access to these benefits.

- The current law contains specific provisions (section 51AD and Division 16D of the 1936 Act) which are designed to prevent such access for tax exempts under arrangements by which they have effective 'use or control' of assets owned by taxable entities.

- However tax loss companies remain able to access tax preferences through leases and similar arrangements.

8.24 Cameo 8.2 shows how a tax loss company (and a tax exempt to the extent permitted) can obtain access to the benefits of tax preferences such as accelerated depreciation through leasing or, alternatively, a contracting arrangement for the use of another entity's assets. Constant lease payments are assumed. In this discussion paper, generating tax benefits from accessing tax preferences through leasing and other rights is called *tax-preferred* leasing.

8.25 A significant policy issue is whether tax preference transfer should be allowed to tax exempt entities. As noted above the existence of tax preferences discourages them from investing in some assets. This investment distortion could be removed by permitting tax preference transfer. However, there may be a significant cost to revenue. This issue is discussed in greater detail in Chapter 9.

Lease assignments

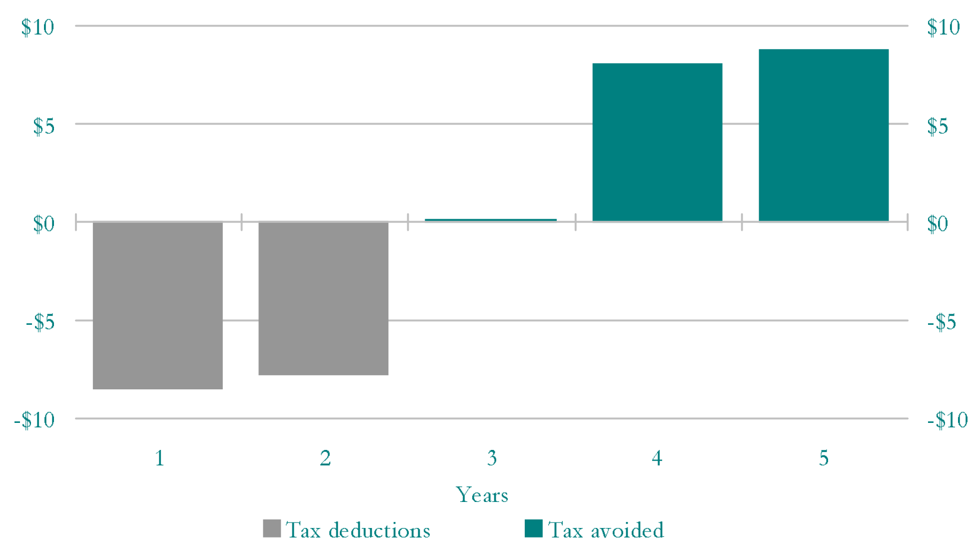
8.26 There is considerable scope for generating unwarranted tax benefits under the current treatment of leases as a result of high tax rate entities *assigning* (or selling) leases , along with associated debt liabilities to tax exempt or low tax rate entities, when capital allowances relating to the leased plant have been substantially exhausted.

8.27 The tax benefits from lease assignments arise because all of the accelerated depreciation allowances are deducted (at high marginal tax rates) in the early part of the lease, but tax is not paid on the lease income generated in the latter part of the lease because the assignee is in tax loss or is tax exempt. An essential element of lease assignments is the capacity to avoid a balancing charge when the interest in the leased asset is disposed of.

- Figure 8.1 is a stylised illustration of the tax profile of a finance lease over 5 years. Large deductions are generated in the early years, but the lease would normally become tax positive as the capital allowances decline. However, lease assignments ensure that little or no tax is paid at the tax positive end, as the assignee is not subject to tax.
- Cameo 8.3 shows the tax benefits from lease assignments where there is accelerated depreciation.

8.28 Existing provisions in the tax law, such as Part IVA and Division 9C of 1936 Act, do not appear to be effective in dealing comprehensively with lease assignments.

Figure 8.1: Tax profile of an assigned finance lease



Tax exempt leasing

8.29 The ability of tax exempt entities to engage in leasing and similar arrangements is restricted by section 51AD and Division 16D, which operate to deny tax benefits to those who provide property to tax exempt entities, such as public utilities.

8.30 These provisions were introduced to prevent tax exempt entities from accessing tax preferences by entering into contracts with taxable entities for the use of assets.

8.31 Section 51AD applies to property predominantly financed by non-recourse debt which is leased to, or 'effectively controlled' by, an end user which:

- is a tax exempt entity;
- is a non-resident and uses the property outside Australia; or
- previously owned the asset (for example, sale and lease back).

8.32 In applying section 51AD, non-recourse debt is broadly defined as debt where the creditor's rights against the debtor in the event of default are legally or effectively limited to the financed property.

8.33 Section 51AD is severe in its application, because it disallows completely deductions relating to the property, while all the income remains taxable. It applies to arrangements which have features of both operating and finance leases.

Cameo 8.1: Structuring lease or right payments

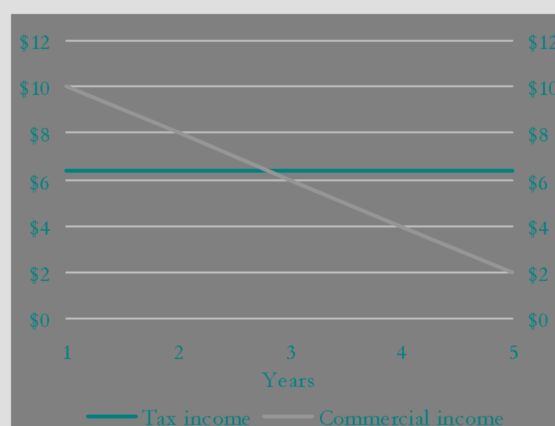
All figures in dollars

Year	Lease payments	Net receipts from asset	Value of asset	Economic depreciation	Interest on value of asset	Cost of finance	Lessee: Before-tax cash flow
0			100				
1	26.38	30	80	20	10	30	3.62
2	26.38	28	60	20	8	28	1.62
3	26.38	26	40	20	6	26	-0.38
4	26.38	24	20	20	4	24	-2.38
5	26.38	22	0	20	2	22	-4.38
						NPV	**$0.00**
						IRR	**10.00%**

Year	Lessor: Before-tax cash flow	Taxable income	Tax	After-tax cash flow
0	-100.00			-100.00
1	26.38	6.38	2.30	24.08
2	26.38	6.38	2.30	24.08
3	26.38	6.38	2.30	24.08
4	26.38	6.38	2.30	24.08
5	26.38	6.38	2.30	24.08
NPV	**$0.00**			**$0.35**
IRR	**10.00%**			**6.53%**

Cameo 1 demonstrates how tax benefits arise from structuring the payments under a contract for use of an asset in a way that does not match the cost of the lessor providing the asset. In this example a tax loss entity (lessee) enters into a contract to lease an asset owned by a taxable company (lessor) with a tax rate of 36 per cent. Payments are assessable to the lessor and deductible to the lessee. The lessor buys a $100 asset and leases it out to a tax loss entity. The asset is assumed to produce sufficient income to cover the lessor's cost of providing the asset (economic depreciation plus interest). Usually lease payments are constant; however, constant payments are below the lessor's cost of providing the asset (economic depreciation plus interest) in the earlier years, and above the lessor's cost of providing the asset in the later years.

In terms of tax payable, delaying payments reduces the present value of tax payable by the lessor, and as the lessee is in tax loss the deferral of its deductions does not produce an offsetting increase in the present value of tax payable. The lessor receives a return of 6.53 per cent from delaying tax payable, while the lessee is no worse off from the delaying of deductions.



Under a neutral tax system a before-tax rate of return of 10 per cent and a 36 per cent tax rate will produce an after-tax rate of return of 6.40 per cent. The structuring of the lease payments has enabled the lessor to improve the after-tax rate of return by deferring tax payments. The problem is exacerbated if the payments are more abusively structured. Under a neutral tax system the increase in the value of the lease resulting from the lease payments in the early years being less than the benefits from the asset would be included in the taxable income of the lessor. In these circumstances the after-tax rate of return to the lessor will be 6.40 per cent no matter how the lease payments are structured.

Cameo 8.2: Transfer of tax preferences

All figures in dollars

Year	Lease payments	Net receipts from asset	Value of asset	Economic depreciation	Accelerated depreciation	Lessee: Before-tax cash flow
0			100			
1	26.38	30	80	20	40	3.62
2	26.38	28	60	20	40	1.62
3	26.38	26	40	20	20	-0.38
4	26.38	24	20	20	0	-2.38
5	26.38	22	0	20	0	-4.38
					NPV	**$0.00**
					IRR	**10.00%**

Year	Lessor			
	Before-tax cash flow	Taxable income	Tax	After-tax cash flow
0	-100.00			-100.00
1	26.38	-13.62	-4.90	31.28
2	26.38	-13.62	-4.90	31.28
3	26.38	6.38	2.30	24.08
4	26.38	26.38	9.50	16.88
5	26.38	26.38	9.50	16.88
NPV	**$0.00**			**$2.58**
IRR	**10.00%**			**7.48%**

Cameo 8.2 demonstrates how the benefits of tax preferences can be accessed by a low tax entity through leasing or otherwise using an asset under contract. The example is the same as in Cameo 8.1, except that depreciation allowances are accelerated. The lessor receives the accelerated depreciation deductions and is assessed on the payments. The lessee also makes the same lease payments as in Cameo 8.1.

With the accelerated depreciation deduction the lessor receives a return of 7.48 per cent, a tax benefit of $2.58 in net present value terms. This is above the economic return of 6.40 per cent that would be available elsewhere. This benefit can be shared with the lessee through lower payments. In this way the tax loss entity or the tax exempt can access the benefits of accelerated depreciation. If the tax loss entity purchases the asset outright it cannot access the

accelerated depreciation deductions until some future time when it has sufficient taxable income. A tax exempt can never access the benefits of accelerated depreciation directly, but as noted earlier can be disadvantaged by its availability to taxpaying entities.

Cameo 8.3: Lease assignments

All figures in dollars

Year	Lease payments	Net receipts from asset	Value of asset	Economic depreciation	Accelerated depreciation	Before-tax cash flow Lessor	Before-tax cash flow Lessee
0			100				
1	26.38	30	80	20	40	-3.62	3.62
2	26.38	28	60	20	40	-1.62	1.62
3	26.38	26	40	20	20	0.38	-0.38
4	26.38	24	20	20	0	2.38	-2.38
5	26.38	22	0	20	0	4.38	-4.38
					NPV	**$0.00**	**$0.00**
					IRR	**10.00%**	**10.00%**

	Loan			**If not assigned**		**If assigned in Year 3**	
				Lessor		Lessor	
Year	Outstanding principal	Principal repayments	Interest repayments	Tax	After-tax cash flow	Tax	After-tax cash flow
0	100						
1	80	20	10	-8.50	4.88	-8.50	4.88
2	60	20	8	-7.78	6.16	-7.78	6.16
3	40	20	6	0.14	0.24	0.14	0.24
4	20	20	4	8.06	-5.68	0.00	0.00
5	0	20	2	8.78	-4.40	0.00	0.00
				NPV	**$2.58**		**$10.24**

Cameo 8.3 illustrates assignment of a lease contract. The lease is initially between two taxable entities and is then assigned to a tax exempt. The taxable company takes out a $100 loan to buy an asset. The company then leases the asset. In the presence of accelerated depreciation, or rear weighting of lease payments, the tax deductions exceed the assessable income of the company in the earlier years. As such, the lease generates tax losses that can be used to offset other income. In the later years the lease generates taxable income and a corresponding tax liability.

The company and tax exempt can mutually benefit by the taxable company assigning the lease to the tax exempt entity when the lease generates tax liabilities. This involves a tax exempt taking over the ownership interest in the asset and becoming responsible for the loan payments. This illustration assumes that no payment is made when the lease is assigned. The assignor obtains the tax losses generated in the early years of the lease while subsequent lease payments are sheltered from tax because of the assignee's tax preferred status.

When the taxable company does not assign the lease, the company receives a tax benefit of $2.58 in net present value terms from participation in the arrangement, which is due to the acceleration of depreciation allowances and constant lease payments. When the lease is assigned the tax benefit increases to $10.24 in net present value terms. If the arrangement was taxed under a neutral tax system, the net present value, calculated at the after-tax rate of return of 6.40 per cent would be zero.

8.34 While always criticised for its severe impact, section 51AD has become more problematic because of privatisation and outsourcing of government functions that were not contemplated when it was first conceived.

8.35 Division 16D applies in respect of a 'qualifying arrangement' where section 51AD does not apply and where there is 'use or effective control' by an end user who is:

- a tax exempt public body; or
- a person who uses the property outside Australia to produce income not subject to Australian tax.

8.36 Division 16D denies capital allowances to the owner of the property and treats lease payments as repayments of principal and payments of interest. Division 16D does not apply to other tax exempt entities, such as certain clubs or businesses operated by charities. A Division 16D qualifying arrangement is broadly similar to a finance lease.

8.37 Both section 51AD and Division 16D are complex in their application, in that the operation of the 'effective control' test necessarily requires a degree of judgment on the part of the tax authorities, especially in relation to arrangements where the tax exempt remains involved to a greater or lesser extent in decisions relating to the arrangement. However, section 51AD is more controversial because the complexity is exacerbated by the severity of its application.

A strategy for reform

Develop an integrated framework — moving tax value closer to commercial value

8.38 The strategy for reform is to tax leases and rights more in line with changes in value of the associated assets and liabilities, subject to practical considerations, so that tax outcomes are unaffected by the timing of payments. In addition, there is a need to deal with tax preferences in an appropriate manner.

Key policy issues

How would annual changes in the value of leases and rights be taxed?

8.39 The comprehensive income tax base outlined in *A Strong Foundation* as a fundamental design principle for the business tax system would, if applied in relation to leases and other rights, include changes in the current value of all rights on a market-to-market basis.

8.40 In practice, valuation and cash flow considerations prevent the literal application of such an approach. Secondly, taxing leases and other rights on a fully comprehensive basis would not be appropriate where there are significant departures from comprehensive income taxation elsewhere in the tax system. Doing so would eliminate intended tax preferences and create a strong bias against leases and other rights. Thirdly, the existence of tax preferences such as accelerated depreciation and the taxation of many gains on realisation mean that eliminating those benefits under leasing and right arrangements would create a serious distortion against the use of leasing and rights.

8.41 A practical alternative which would be an improvement over the current system might involve taxing the annual change in value on the basis of expected income flows, and taxing other gains on realisation.

8.42 Where tax preferences exist in the tax system generally, there are two central issues in attempting to move closer to a comprehensive income tax system in the taxation of leases and right:

- taxing changes in the expected annual value of these assets and liabilities so that tax outcomes are unaffected by the timing of payments; and
- determining when the granting of a lease or right should be associated with a transfer of tax preferences such as accelerated depreciation or the benefit associated with the taxation of gains on realisation.

8.43 The expected future benefits from a lease or other right is an asset to the grantee, while the stream of payments is a liability, and vice versa for the grantor.

8.44 By including expected changes in the value of these assets and liabilities in the tax base, tax outcomes would not be affected by changes in the way that payments (and benefits) are structured:

- this would prevent some taxpayers gaining benefits at the expense of the general community (and hence improve equity) and avoid distorting the way in which resources are allocated;
- it would also deal with the situation whereby around $300 million of annual expenditure on some rights does not receive any deduction, except as a capital loss, again improving equity and the way in which resources are allocated; and
- an integrated approach to taxing annual changes in the benefits and payments for leases and other rights would also considerably reduce the complexity of the law and administration associated with the many different treatments of leases and rights which currently exist.

8.45 As discussed below, changes in the annual value of benefits under a lease or other right can be estimated in a number of ways, depending on the nature of the right. Where depreciable assets are the subject of the transaction, effective life depreciation can be used as a proxy for the annual change in the value of the benefits from the lease or right.

8.46 On the payments side, the value of the liability to the grantee and the corresponding asset of the grantor would depend on the future stream of payments associated with the lease or right and the appropriate rate of interest. This would change from year to year, reflecting payments being made.

8.47 For many leases and rights the future stream of benefits is known with a high degree of certainty. In other cases they would need to be estimated. In conjunction, some assumptions would need to be made about the appropriate interest rate. The details of this methodology are discussed in Chapters 9 and 10.

8.48 Chapter 9 discusses the issues associated with the taxation of leases and similar arrangements involving the use of depreciable assets, where the transfer of the benefits of accelerated depreciation is a key issue.

8.49 Chapter 10 then discusses the taxation issues associated with other leases and rights, where the transfer of the benefits associated with the taxation of assets on realisation is an important issue.

How could key integrity issues be addressed?

8.50 In many cases the apparent substance of an investment can be altered by entering into a separate, but connected, transaction. The returns from an investment can be structured in such a way that a significant part of the investment is repaid under a transaction that is not incorporated in, but is nevertheless associated with, a contract relating to the use of an asset.

8.51 Contracts relating to the use of an asset can also be combined with options to buy or sell the asset to change the distribution of the risks and benefits associated with the arrangements, and changing equity risk in an arrangement into a debt position. This can radically affect the extent to which lessors and lessees bear the economic risks and benefits relating to arrangements.

8.52 The period of the contract is also an important variable in determining whether the stated nature equates with the substance of the arrangement. If payments are made up-front, there would be scope for tax deferral under many of the options discussed if the contract period does not properly reflect the period over which economic benefits under the contract are being provided.

8.53 Any new tax laws which sought to properly measure the income from a lease or other rights contract therefore would need to ensure that:

- all economic returns under the relevant contract and under connected arrangements were included in the measurement of income;
- where tax preference transfer is restricted, if the value of a wasting asset was hedged under a connected arrangement so as to eliminate or reduce the investor's equity risk in the asset, any transfer of tax preferences that otherwise might be available would be reduced commensurately; and
- the period over which income from a lease or other right is measured is not greater than the period over which the grantee obtains the economic benefits under the arrangement.

What transitional arrangements would apply?

8.54 Any new measures relating to the taxation of leases and rights raises the question of transitional arrangements.

8.55 It would be impractical to apply any new rules to existing arrangements entered into before the commencement date. Many of the options discussed are not sensibly capable of being applied to existing transactions, such as options associated with tax preference transfer. In other cases, retrospective application would alter expected commercial outcomes and impose significant compliance costs.