Chapter 9

# LEASES AND SIMILAR ARRANGEMENTS OVER WASTING ASSETS


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# A case for reform

## The current approach lacks a clear conceptual framework

9.1 Chapter 8 outlined that present arrangements for taxing leases and similar arrangements provide opportunities for tax deferral through structuring the payments in a way that differs from the cost of providing the services of the underlying asset.

9.2 A consistent approach to the taxation of leases and similar arrangements needs to recognise that leases are part of a seamless spectrum of arrangements in which the services of depreciable assets can be provided, ranging from outright ownership, to leases, and then to different forms of service contracts.

9.3 There are varying definitions of what constitutes a lease. Narrowly defined it requires the 'exclusive possession of an asset', although section 51AD also includes the broader notion of a 'right to use property'. Many arrangements which are within the ambit of section 51AD and Division 16D are in fact not leases at all, but are service contracts where assets are 'effectively controlled' by the tax exempt.

9.4 A policy design principle outlined in *A Strong Foundation* is that economic transactions having the same substance should be taxed similarly, irrespective of their form. Consequently, in addition to leases, this chapter focuses on service contracts that are, in substance, broadly similar to leases.

9.5 In economic terms, leases are arrangements which allow the *use of assets* to be separated from their *ownership*. Such separation enhances economic efficiency, ensuring more productive use of assets and an improved allocation of risks.

9.6 In practice, leasing arrangements involve a spectrum of possible degrees of separation of asset use from asset ownership as between the lessee and the lessor. Choices along the spectrum would ideally be little influenced by taxation.

9.7 The tax treatments of leases and loans differ only in the following respect: whereas the full lease payments are assessable to the lessor and deductible to the lessee, for a loan only the interest is assessable to the lender and deductible to the borrower.

9.8 As illustrated in Chapter 8, leasing and loans would provide the same after-tax outcomes under two conditions:

- capital write-offs match the economic loss of asset value; and

- those costs of asset use are charged for under the lease as they occur, period by period.

9.9 In these circumstances, the tax equivalence of leasing and loans would apply irrespective of the tax rates applying to the lessee and lessor — in particular, whether the lessee happened to be a tax-exempt government agency (or a tax-loss private sector entity) rather than a taxpaying entity would have no tax consequences. As a further consequence, the transfer of depreciation allowances between lessor and lessee also has no tax consequences.

9.10 Chapter 8 demonstrated, however, that where either depreciation allowances are accelerated or the pattern of actual asset charges reflected in the lease rentals differs over time from the pattern of economic asset charges, leasing arrangements can produce quite different outcomes from the equivalent after-tax loan outcomes. In such cases, tax rate differences are then important and the taxation arrangements to apply to leasing must then make important choices about the transfer of tax benefits and the acceptable variations in the pattern of lease payments.

9.11 Such issues, moreover, have a wider compass when leasing is considered in conjunction with service contracts having similar economic effects to leasing. An important objective is to design a tax system which does not set up sharp boundary lines, with resulting tax discontinuities, as transactions move along the spectrums separating asset use from asset ownership or leases from services contracts or other rights in general.

# Reform options

9.12 Where wasting assets are involved, changes in the annual value of benefits to a lessee under a lease or similar arrangement can be approximated by effective life depreciation of the underlying asset.

9.13 On the payments side, the change in the value of the liability to the lessee and the corresponding asset to the lessor can be measured equivalently either by the change in the net present value of the future payments under the arrangement, or by the interest on the loan under a ‘sale and loan’ approach. The sale and loan approach is generally the standard method which is used internationally in relation to leases, but both approaches produce identical results.

9.14 A key issue associated with taxing leases over depreciable assets is whether taxpayers should be permitted to use leases to transfer tax preferences, especially the benefits of accelerated depreciation. Tax loss entities and tax exempts cannot access the benefits of tax preferences directly, but can do so through leasing and similar service arrangements.

# Option 1: Taxation of leases without transfer of tax preferences

## The 'sale and loan' approach

### *Application to lease payments*

9.15 If tax preference transfer is not to be generally permitted, leases of depreciable assets can be taxed using a sale and loan treatment, in which the depreciation allowances are allocated to the lessee.

9.16 Under the sale and loan methodology, the asset is deemed to be sold to the lessee at the commencement of the lease, and a loan made from the lessor to the lessee equal to the value of the leased asset less any up front payments made by the lessee.

- Interest on the outstanding implicit loan is deductible to the lessee and assessable to the lessor. At the end of the lease or right, the underlying asset, if it is returned by the lessee, is deemed to be repurchased by the lessor for the value of the asset at that time.

- Where the lease agreement specifies the annual lease payments the implicit interest rate in the agreement can be used in calculating the loan. In other cases an appropriate market rate would need to be chosen.

9.17 This treatment of leases prevents the transfer of tax benefits associated with structuring of payments (see Cameo 9.1). It gives the benefits of tax preferences to the lessee, and tax exempt entities therefore gain no benefit from these tax preferences. Tax loss entities would be denied any immediate benefit but could carry the extra deductions forward to offset against future profits (see Cameo 9.2).

### *Application to service contracts payments*

9.18 With service contracts which are 'similar' to leases there are the same opportunities for structuring payments and for passing on tax preferences. For example where a service provider uses an asset solely to provide services to a particular customer the only difference to a lease is that other services, apart from those of the asset, such as labour, are provided as part of the package.

## Cameo 9.1: Effect of sale and loan on structuring of payments

All figures in dollars

| | | | | | | Lessee | Taxable lessee |
|---|---|---|---|---|---|---|---|
| Year | Lease payments | Net receipts from asset | Value of asset | Economic depreciation | Interest on value of asset | Before-tax cash flow | After-tax cash flow |
| 0 | | | 100 | | | | |
| 1 | 26.38 | 30 | 80 | 20 | 10 | 3.62 | 3.62 |
| 2 | 26.38 | 28 | 60 | 20 | 8 | 1.62 | 1.75 |
| 3 | 26.38 | 26 | 40 | 20 | 6 | -0.38 | -0.18 |
| 4 | 26.38 | 24 | 20 | 20 | 4 | -2.38 | -2.17 |
| 5 | 26.38 | 22 | 0 | 20 | 2 | -4.38 | -4.24 |
| | | | | | **NPV** | **$0.00** | **$0.00** |
| | | | | | **IRR** | **10.00%** | **6.40%** |

| | Implicit loan | | | Lessor | | | |
|---|---|---|---|---|---|---|---|
| Year | Outstanding principal | Principal repayments | Interest repayments | Before-tax cash flow | Taxable income | Tax | After-tax cash flow |
| 0 | 100.00 | | | -100.00 | | | -100.00 |
| 1 | 83.62 | 16.38 | 10.00 | 26.38 | 10.00 | 3.60 | 22.78 |
| 2 | 65.60 | 18.02 | 8.36 | 26.38 | 8.36 | 3.01 | 23.37 |
| 3 | 45.78 | 19.82 | 6.56 | 26.38 | 6.56 | 2.36 | 24.02 |
| 4 | 23.98 | 21.80 | 4.58 | 26.38 | 4.58 | 1.65 | 24.73 |
| 5 | 0.00 | 23.98 | 2.40 | 26.38 | 2.40 | 0.86 | 25.52 |
| | | | **NPV** | **$0.00** | | | **$0.00** |
| | | | **IRR** | **10.00%** | | | **6.40%** |

Cameo 9.1 demonstrates how the sale and loan approach removes any tax benefits from structuring payments differently from the cost of the lessor providing the asset or service. In this example, a tax loss company enters into a contract to lease a $100 asset from a company with a tax rate of 36 per cent.

The asset is assumed to produce net receipts sufficient to cover the lessor's cost of providing the asset (economic depreciation plus interest). The circumstances are the same as in Cameo 8.1 in Chapter 8 which demonstrated that the constant lease payments delivered a tax deferral benefit to the lessor.

A sale and loan treatment would recast the arrangement as the sale of an asset and the simultaneous granting of a loan to the lessee. The lease payments in any year are split into a notional repayment of principal and a payment of interest. The lessor is assessed on the implicit loan interest and the lessee can deduct the implicit interest and depreciation. As the calculations above demonstrate this approach results in the lessor earning the neutral after-tax rate of return of 6.40 per cent. That is, the advantages of tax deferral are removed. A taxable lessee would also earn an after-tax rate of return of 6.40 per cent.

## Cameo 9.2: Preventing tax preference transfer through sale and loan approach

All figures in dollars

| | | | | | | Lessee | Taxable lessee |
|---|---|---|---|---|---|---|---|
| Year | Lease payments | Net receipts from asset | Value of Asset | Economic depreciation | Accelerated depreciation | Before-tax cash flow | After-tax cash flow |
| 0 | | | 100 | | | | |
| 1 | 26.38 | 30 | 80 | 20 | 40 | 3.62 | 10.82 |
| 2 | 26.38 | 28 | 60 | 20 | 40 | 1.62 | 8.95 |
| 3 | 26.38 | 26 | 40 | 20 | 20 | -0.38 | -0.18 |
| 4 | 26.38 | 24 | 20 | 20 | 0 | -2.38 | -9.37 |
| 5 | 26.38 | 22 | 0 | 20 | 0 | -4.38 | -11.44 |
| | | | | | **NPV** | **$0.00** | **$2.23** |
| | | | | | **IRR** | **10.00%** | |

| | Implicit loan | | | Lessor | | | |
|---|---|---|---|---|---|---|---|
| Year | Outstanding principal | Principal repayments | Interest repayments | Before-tax cash flow | Taxable income | Tax | After-tax cash flow |
| 0 | 100.00 | | | -100.00 | | | -100.00 |
| 1 | 83.62 | 16.38 | 10.00 | 26.38 | 10.00 | 3.60 | 22.78 |
| 2 | 65.60 | 18.02 | 8.36 | 26.38 | 8.36 | 3.01 | 23.37 |
| 3 | 45.78 | 19.82 | 6.56 | 26.38 | 6.56 | 2.36 | 24.02 |
| 4 | 23.98 | 21.80 | 4.58 | 26.38 | 4.58 | 1.65 | 24.73 |
| 5 | 0.00 | 23.98 | 2.40 | 26.38 | 2.40 | 0.86 | 25.52 |
| | | | **NPV** | **$0.00** | | | **$0.00** |
| | | | **IRR** | **10.00%** | | | **6.40%** |

Cameo 9.2 demonstrates how the sale and loan approach also removes the benefits from transferring tax preferences, such as accelerated depreciation allowances. The example is the same as in Cameo 9.1, except that depreciation allowances are significantly accelerated. The lessor is denied the benefits of accelerated depreciation as taxable income is simply the implicit interest. If the lessee was a tax exempt entity, the depreciation deductions (which are now taken by the lessee) would be irrelevant.

The 'sale and loan' approach would therefore deny the benefit of the accelerated depreciation to the tax exempt lessee. On the other hand, if the lessee is taxable it would obtain access to accelerated depreciation deductions (see 'Taxable lessee: After tax cash flow' column above). Tax loss companies would be unable to gain immediate access to tax preferences through leasing but could access them if they were later to become profitable.

9.19 The fact that a service provider has access to accelerated depreciation means that lower prices can be charged, and so tax exempt and tax loss entities can benefit from the accelerated depreciation in much the same way as is the case with leases. But the fact that they are purchasing the services of the asset rather than gaining control of the asset itself, and that the services of the asset are just part of the package, would make it complex to devise a generic treatment which was relatively simple and clear in its application. It would also serve little purpose in most cases where both entities are on the same tax rate.

9.20 Current provisions of the law, section 51AD and Division 16D, attempt to do this in relation to service arrangements involving tax exempts and experience with those provisions illustrate the difficulties. Appendices B and C discuss this issue in more detail.

## Option 2: Taxation of leases with transfer of tax preferences

### The 'tax-preferred leasing' approach

9.21 Tax preference transfer can be achieved in relation to leases by what is known as 'tax preferred leasing'.

9.22 A tax preferred leasing treatment enables the lessee to obtain the full value of accelerated depreciation, while still eliminating the potential to obtain unwarranted tax benefits through payments structuring such as through rear weighting of lease payments.

9.23 This can be achieved by allowing the lessee depreciation allowances based on effective life only. The lessor would be allowed the difference between accelerated depreciation deductions and allowances based on effective life. This would allow the lessor to pass some or all of the benefits of accelerated depreciation to the lessee via lower lease payments. Note that the difference between accelerated and effective life depreciation is positive in the early years of an asset's life but negative in later years. That is, in the later years of the lease the lessor will be getting a negative deduction. An example of tax preferred leasing is shown in Cameo 9.3.

9.24 For a taxable lessee this approach provides access to effective life depreciation through the tax system and to the benefits of accelerated depreciation to the extent that lessors reflect these in lower lease payments. Given that a taxable lessee could access the full benefits of accelerated depreciation by purchasing the asset directly, leasing would only be a competitive option if lessors passed on the majority of these benefits. Tax loss companies and tax exempts would access the benefits of accelerated depreciation through the lower lease payments.

### *Imposition of a balancing charge*

9.25 An outstanding question relates to the imposition of a balancing charge should the lessee change during the life of the asset. The current tax treatment does not impose a balancing charge when lessees stop leasing assets, but does impose a balancing charge when owners sell assets. In the presence of accelerated depreciation, this provides a tax benefit in favour of leasing rather than owning assets, where those assets are only used for a short period of their life.

9.26 Imposition of a balancing charge at the end of each lease would require valuation of the asset but would ensure neutrality for the lessee between owning the asset and leasing the asset.

# *Key policy issues*

## Should tax preference transfer be permitted?

9.27 Tax loss entities are currently generally able to access the benefits of accelerated depreciation through leasing, although anti-avoidance rules limit tax preference transfer in some circumstances.

9.28 However, tax exempt entities are effectively prohibited from doing this in many situations by section 51AD and Division 16D. Allowing tax preference transfer on a consistent basis across entities would mean that tax exempt entities would be able to gain access to the benefits of accelerated depreciation.

9.29 Conversely, prohibiting tax preference transfer on a consistent basis across entities would essentially maintain the status quo for tax exempt entities but mean that tax loss entities which are currently able to use leases to gain immediate access to these benefits would no longer be able to do so. They may still be able to access these benefits to some extent if they become profitable at a later date.

9.30 The major arguments *in favour* of allowing tax preference transfer generally to all entities through leases in relation to domestic use of assets are based upon:

- making the benefits of accelerated depreciation available equally to all entities;
- the potential for improving investment efficiency and competitive neutrality; and
- reducing complexity of the tax system.

9.31 Arguments *against* allowing tax preference transfer generally with leasing are based upon:

- the resulting finance bias in favour of leasing; and
- the cost to revenue.

9.32 The benefit of accelerated depreciation to a lessor depends on their marginal tax rate; the higher the marginal tax rate the higher the benefit. Under current arrangements this provides some incentive for high marginal tax rate taxpayers to become lessors. This would be even more the case under arrangements which facilitated tax preference transfer, particularly if margins between the company tax rate and the top personal rate are increased.

## The case for allowing tax preference transfer through leasing

### *Making the benefits of accelerated depreciation available to all entities*

9.33 Allowing tax preference transfer generally would mean that the benefits of accelerated depreciation would be available equally to all entities. The judgment as to whether this is appropriate or not comes back, in part, to the rationales for allowing accelerated depreciation. The possible rationales for providing accelerated depreciation were discussed in Chapter 2.

9.34 If these reasons are sufficient to justify the across the board provision of accelerated depreciation, exclusion of tax exempts would need to be argued on the basis that one or more of these reasons does not apply. In terms of the arguments set out in Chapter 2:

- the externalities associated with investment are probably as high, or higher, in areas where tax exempts are typically involved (such as infrastructure) than investment generally;
- the risks associated with investments undertaken by tax exempts are probably much the same as for investments undertaken by other entities; and
- international competitiveness is much less relevant in the case of domestic tax exempt entities, who by definition only invest in Australia.

### *Improving investment efficiency and competitive neutrality*

9.35 Section 51AD and Division 16D limit access to tax preferences by tax exempt entities. Where section 51AD and Division 16D apply, tax exempt entities are therefore at a competitive disadvantage relative to taxable entities in terms of their ability to invest in assets where there are tax preferences, such as accelerated depreciation.

## Cameo 9.3: Allowing tax preference transfer

All figures in dollars

| Year | Lease payments | Net receipts from asset | Value of asset | Depreciation of the lease | Accelerated depreciation | Lessee: Before-tax cash flow | Taxable lessee: After-tax cash flow |
|---|---|---|---|---|---|---|---|
| 0 | | | 100 | | | | |
| 1 | 25.54 | 29.04 | 80 | 19.36 | 40 | 3.50 | 3.50 |
| 2 | 25.54 | 27.11 | 60 | 19.36 | 40 | 1.57 | 1.69 |
| 3 | 25.54 | 25.17 | 40 | 19.36 | 20 | -0.37 | -0.17 |
| 4 | 25.54 | 23.23 | 20 | 19.36 | 0 | -2.30 | -2.10 |
| 5 | 25.54 | 21.30 | 0 | 19.36 | 0 | -4.24 | -4.10 |
| **NPV** | **$96.81** | **$96.81** | | | | **$0.00** | **$0.00** |
| **IRR** | | | | | | **10.00%** | **6.40%** |

| | Implicit loan | | | Lessor | | | |
|---|---|---|---|---|---|---|---|
| Year | Outstanding principal | Principal repayments | Interest repayments | Before-tax cash flow | Taxable income | Tax | After-tax cash flow |
| 0 | 96.81 | | | -100.00 | | | -100.00 |
| 1 | 80.95 | 15.86 | 9.68 | 25.54 | -10.96 | -3.94 | 29.48 |
| 2 | 63.51 | 17.44 | 8.10 | 25.54 | -12.54 | -4.52 | 30.05 |
| 3 | 44.32 | 19.19 | 6.35 | 25.54 | 5.71 | 2.06 | 23.48 |
| 4 | 23.22 | 21.11 | 4.43 | 25.54 | 23.79 | 8.57 | 16.97 |
| 5 | 0.00 | 23.22 | 2.32 | 25.54 | 21.68 | 7.81 | 17.73 |
| | | | **NPV** | **-$3.19** | | | **$0.00** |
| | | | **IRR** | **8.74%** | | | **6.40%** |

Cameo 9.3 demonstrates how the tax preferred leasing treatment allows the lessor to pass on the benefits of accelerated depreciation to the lessee while still denying any tax benefits from structuring of payments. In this example, a tax loss company leases a $100 asset owned by a company with a tax rate of 36 per cent. The lessor is assumed to have passed on all the benefits of accelerated depreciation through lower lease payments.

Using the 'sale and loan' approach, the lessor is deemed to make a loan to the lessee equivalent to the net present value of lease payments, which is less than the cost of the asset, reflecting the passing on of the benefits of accelerated depreciation. The lessor's taxable income is the implicit interest received less the difference between accelerated depreciation and the depreciation of the lease assigned to the lessee. This allows the lessor to pass the benefits of accelerated depreciation on to the lessee. The income of a taxable lessee would be calculated as net receipts from the asset less implicit interest less the depreciation of the lease.

9.36 This counter-intuitive result can best be understood by recognising that tax preferences are equivalent to subsidies for investment in particular assets compared with neutral taxation of economic income. If this subsidy was delivered via a direct payment it is not clear that it would be structured so as to discriminate between taxable and tax exempt purchasers. However, as this subsidy is delivered through the tax system, it is not available to tax exempt entities.

9.37 The subsidy to the taxable entities means that they can pay a price for an investment or seek a rate of return from an investment which is uneconomic in before-tax terms but will be profitable after tax. In order to compete, a tax exempt entity would have to accept an uneconomic rate of return.

9.38 As a result of this competitive disadvantage, section 51AD and Division 16D also encourage tax exempt entities to enter into complex (and potentially economically wasteful) arrangements purely in order to avoid the impact of the arrangements. Where there are significantly accelerated depreciation allowances, tax exempt entities will attempt to structure around the provisions. This can be achieved either through shifting the mix of risks and benefits from that which would otherwise be adopted, or by entering into complex arrangements which meet the terms of the provisions but where, in substance, many of the risks and benefits of ownership remain with the tax exempt entity.

9.39 It is arguable that the national objectives of *economic growth, equity and simplification* identified in *A Strong Foundation* would be better served if domestic tax exempts chose the most appropriate combination of public sector and private sector provision (and distribution of risks and benefits) without being influenced by tax factors.

### Reducing complexity

9.40 As outlined earlier in this chapter, it is not possible to deny all forms of tax preference transfer due to the myriad ways in which the services of a capital asset can be purchased. At one extreme is the outright purchase of an asset and at the other is the purchase of the output of a similar asset from a third party. The spectrum in between these extremes includes leasing of the asset and varying degrees of contracting out the operation of the asset.

9.41 For example, a mining company in tax loss could own and operate its excavation equipment. Alternatively it could lease that excavation equipment from a leasing company. Another alternative would be for it to pay a separate excavation company to perform the necessary excavation activities. If tax preference transfer were not allowed via leasing then the mining company could always move to contracting out its excavation activities to ensure access to the full value of tax preferences over excavation equipment.

9.42 Should it be decided to limit tax preference transfer then a line must be drawn which distinguishes those arrangements where tax preferences may be transferred. Such a distinction cannot be easily made, and inevitably creates legislative complexity, taxpayer uncertainty and compliance costs.

9.43 The complexity of such provisions as they apply under sections 51AD and Division 16D were discussed in Chapter 8.

9.44 The practical difficulties of drawing such a line in the service provision spectrum are discussed in more detail in the implementation section below. Such complexities are one argument in favour of allowing tax preference transfer more generally.

## The case against allowing tax preference transfer

### *Preventing a bias in favour of leasing*

9.45 If tax preference transfer was allowed then leasing and similar arrangements would become a preferred form of financing for tax exempt and tax loss entities. They would be the best way for low tax entities to gain access to tax preferences, and hence would be preferred over other forms of asset financing.

9.46 However, it is likely that the economic costs of this finance distortion would be low. This is because drawing up a rights contract (such as a lease) need not impose significant additional costs on taxpayers compared with outright purchase of the relevant asset.

- This suggests that these costs are likely to be small relative to the costs of the bias in investment decisions which would occur if tax preference transfer is not permitted.

### *Assessing the cost to revenue*

9.47 The major tax exempt users of depreciable plant and equipment are government bodies or public trading enterprises. The revenue implications of allowing transfer of tax preferences for Commonwealth government bodies would simply be a transfer within the Commonwealth sector. However, allowing transfer of tax preferences in respect of State and Local government bodies would have net revenue implications.

9.48 The Commonwealth and State governments have an in-principle agreement to subject public trading enterprises to tax equivalent regimes in the interests of competitive neutrality. Once this arrangement is in place such enterprises, on one level, will face the same incentives as taxable bodies in terms of impact of tax preferences on investment decisions.

9.49 However, State and Local governments would still be better off if their public trading enterprises accessed the tax preferences through leasing arrangements as the lower lease payments would be financed at the expense of Commonwealth revenues. Under a tax equivalent regime the tax preferences accessed directly by a public trading enterprise would be reflected in lower tax equivalent payments to the State government.

9.50 There is a strong trend by State and Local governments and associated bodies towards contracting out or privatising activities. This is motivated by a number of reasons but does have the effect of moving activities from the tax exempt to the taxable sector and so giving them access to tax preferences. This is increasing the revenue costs of tax preferences such as accelerated depreciation and, of course, decreasing the potential cost of allowing tax preference transfer to tax exempt entities.

9.51 Nevertheless, the revenue implications of allowing tax exempts to engage in tax preference transfer are potentially substantial. Each year State, Territory and Local government public trading enterprises and general government directly invest approximately $5.5 billion in depreciable equipment. An additional $5.5 billion is invested in non-dwelling construction, and while only part of this is depreciable plant, there would be a substantial cost to revenue if this equipment was instead leased to take advantage of accelerated depreciation allowances.

9.52 In the most extreme case where, if permitted, tax exempts would lease all new assets which attract capital allowances rather than own them directly, the cost to revenue (assuming the current level of tax preferences) would be around $480 million per annum by 2003-04 (36 per cent company tax rate). This assumes that around $8 billion of current annual public investment in depreciable assets would instead be leased. This cost to revenue would, of course, be less to the extent that not all new assets would be leased in order to gain access to the tax preferences, especially in the early years. The costing also assumes that tax preference transfer would only be permitted in relation to new assets.

9.53 The cost to revenue of allowing tax preference transfer would be reduced to the extent that the level of tax preferences was reduced. For example, if accelerated depreciation was removed there would be no significant cost to revenue of allowing tax preference transfer.

### *Negotiating offsetting reductions in transfers from the Commonwealth to the States would be difficult*

9.54 In theory the Commonwealth, State and Local governments could come to an agreement whereby the Commonwealth allowed tax preference transfer to tax exempts but was compensated by State and governments for the

revenue loss in respect of their entities. Such an agreement would have its own complexities and the Review is not in a position to comment on its feasibility.

### *Revenue implications of removing all restrictions on tax preference transfer with taxable entities*

9.55 Although taxable entities are widely able to engage in tax preference transfer through leasing and service arrangements, there are some restrictions associated with the need to meet Australian Taxation Office (ATO) rulings relating to 'genuine' leases, such as the need for lessors to have at least 20 per cent equity where they engage in leveraged leasing.

9.56 In addition, a recent court ruling in the *Bellinz* case, disallowed deductions relating to a tax preference transfer arrangement, where the purported 'lessor' was found not to meet the eligibility criteria for being an owner of the asset for depreciation purposes. The *Bellinz* principles could also apply to other cases.

9.57 As a result, if all restrictions on tax preference transfer between taxable entities were removed, there would be additional costs to the revenue over and above those identified above in relation to tax exempts. These revenue costs would need to be taken into account in any decision about extending the existing scope for tax preference transfer between taxable entities.

## Issues associated with overseas use of assets

9.58 Where an Australian based lessor leases depreciable assets to an overseas end user, the benefits of Australia's accelerated depreciation can be passed to the lessee. If the purpose of accelerated depreciation is to increase the level of activities using those assets within Australia then this outcome is inappropriate. While it might be argued that such arrangements would boost the sales of Australian produced capital goods the accelerated depreciation would be equally available for goods produced overseas which are leased to offshore entities by Australian lessors.

9.59 The 'sale and loan' approach outlined earlier to prevent tax preference transfer would deny depreciation deductions to the lessor and make them available to the lessee. However, they would not be accessible by a lessee not subject to Australian tax. This would effectively prevent the transfer of Australian tax preferences to overseas lessees.

9.60 Where Australian businesses (such as airlines and shipping firms) are the end user of assets used overseas to generate taxable income in Australia, they would be able to access tax preferences in relation to these assets in the normal way.

9.61 However, in a world of increasingly globalised operations, it can be difficult to say when an Australian business is no longer the 'end user' of an asset, but has transferred 'use of the asset' to an overseas entity. For example, where an aircraft was used for most of the time as part of the operations of an overseas airline, it may be appropriate to deem that the Australian airline was no longer the end user, but had instead leased the aircraft.

## If tax preference transfer is restricted, in what circumstances should this apply?

9.62 As discussed previously, leasing and similar arrangements are part of a spectrum ranging from full ownership of an asset at one end to utilisation of services without any ownership risk at the other. If it was decided to prohibit tax preference transfer, an important issue is what particular arrangements the prohibition should apply to and how could the boundary line be drawn.

9.63 Issues relating to leasing are discussed initially below. In relation to service agreements, the discussion relating to service contracts that are similar to leases is restricted to the situation where tax exempts are involved. As outlined earlier, attempting to prohibit tax preference transfer in relation to service contracts between taxable entities would be extremely complex, and would serve little purpose in the majority of cases where both entities are on the same tax rate.

### Leasing

9.64 Two broad models exist for applying sale and loan treatment on a consistent basis across entities in respect of leases.

- To apply the regime only to finance leases, and not to operating leases. This would apply the regime only to leases where the lessee is in substance the economic owner of the asset. This model has been followed in New Zealand and the United States.
- To apply the regime conceptually to all leases, with exclusions based on value and categories of equipment. This model has been followed in Canada.

#### *Option 1: Apply the leasing regime to finance leases only*

9.65 Finance leases generically exist where 'substantially all the risks and benefits incident to ownership' are passed to the lessee. The Australian accounting standard AASB 1008 '*Accounting for Leases*' indicates that the effective passing of substantially all the risks and benefits would normally be presumed where a non-cancelable lease is either for a period of at least 75 per cent of the effective life of the asset, or where the net present value

(NPV) of the payments is at least 90 per cent of the fair value of the leased asset. However, the tests are guidelines only. To provide both robustness and greater certainty, the definition of a finance lease for tax purposes would need to be more specific than occurs in accounting standards.

9.66 New Zealand has recently amended its leasing code so that it will apply only to 'finance' leases. In so doing, New Zealand has narrowed its previous leasing code which applied to 'specified leases', a broader category which also included some operating leases. The United States also effectively has similar provisions.

9.67 Potential advantages of drawing a distinction between finance and operating leases are that such a regime:

- transfers tax preferences only in cases where the lessee is in substance overwhelmingly the economic owner of the asset; and
- broadly corresponds with the treatment contemplated by the current Australian accounting standard.

9.68 Against this, there are disadvantages with this model.

- In practice there is a continuum between finance and operating leases. Distinguishing between operating and finance leases necessarily involves subjectivity and gives rise to a high degree of complexity.
- The distinction between operating and finance leases ignores the fact that operating leases give rise to economic assets and liabilities on the part of the lessee, and that operating leases and finance leases differ only in the extent of these assets and liabilities created rather than being different in nature. This argument has been supported by a Working Group on accounting for leases that has included representatives from a number of international accounting standard setting bodies.
- Many finance leases can be restructured, in reality or appearance, as operating leases to suit the financial and taxation goals of the parties. For example, leases of major capital equipment in the United States such as aircraft are largely undertaken under leases that qualify as operating leases and hence avoid the leasing rules. There are concerns that the shift towards operating leases which has followed the tax distinction between operating and finance leases in the United States may reflect a simple restructuring of the form of the lease while there has been little change in the substance.
- As a result, such a provision may introduce considerable complexity into the tax system while not necessarily making a significant difference, in substance, to the tax effectiveness of leasing as a means of financing assets.

### Option 2: Apply the leasing regime potentially to all leases, but with significant exclusions

9.69 Alternatively, a leasing regime could be applied to all leases of more than one year (both finance and operating leases), but with significant exclusions applying on the basis of materiality.

9.70 For example, the Canadian leasing regime applies to all leases, subject to exclusions based on:

- where the period of the lease is less than one year;
- where the value of the asset is less than $25,000; and
- broad categories of leased equipment, such as most office equipment and furniture and electronic data processing equipment with a value of less than $1 million.

9.71 The advantages of this model are that:

- it avoids all the difficult issues with the boundary between operating and finance leases associated with Option 1;
- by having extensive exceptions for small value leases, the regime focuses on assets where the greatest scope for tax preference transfer is likely to lie; and
- accounting standard setters both in Australia and internationally are considering moving towards accounting standards that require companies to include all economic assets and liabilities arising under lease contracts.

9.72 Potential disadvantages of this model essentially mirror the advantages of the previous model:

- it transfers tax preferences in cases where the lessee may not be the predominant economic owner of the asset; and
- it is not entirely consistent with current accounting treatment in Australia.

9.73 Overall, the complexity associated with the first option of including only finance leases, the continuum that exists between finance and operating leases, and the direction that accounting standards appear to be moving in, all suggest that the second option may be a more appropriate basis for a leasing regime to apply across all entities.

9.74 Further details on accounting standards in relation to leases are given in Appendix A.

9.75 The estimated revenue impacts from implementing a leasing regime based on Option 2 are dependent on a number of factors, most importantly,

the degree of accelerated depreciation. If accelerated depreciation was removed, the gain to revenue from Option 2 would be around $30 million by 2003-04 (36 per cent company tax rate). This reflects the benefit from restricting the scope for tax deferral through structuring lease payments. Conversely if accelerated depreciation was retained in its present form the revenue gain could be around $420 million by 2003-04 (36 per cent company tax rate).

## Similar arrangements involving tax exempts

9.76 Section 51AD and Division 16D currently restrict tax preference transfer under arrangements similar to leases where the 'lessee' is a tax exempt entity. If such 'similar arrangements' involving tax exempts are not included in a provision similar to the leasing measure, it would significantly reduce the scope of the restriction on tax preference transfer, resulting in much of the cost to revenue identified earlier.

9.77 Many of the issues associated with section 51AD and Division 16D have arisen in relation to contracts that are not strictly leases, but are essentially service agreements. Examples include toll roads, public hospitals and prisons.

9.78 However, even if it is considered appropriate to deny tax exempts the benefits of tax preferences in relation to (some) service arrangements that are similar to leases, there is no need for the current draconian section 51AD, as long as a potential problem of structured non-payment of non-recourse finance is addressed. 'Sale and loan' treatment of arrangements that are included in a general tax exempt provision would eliminate this potential problem. Comprehensive debt forgiveness would also address the problem more generally. The issues are discussed in more detail in Appendix B.

9.79 As a result, there is only a need to consider the case for a generalised tax exempt provision covering 'similar arrangements' (such as the current Division 16D), in which the tax preference transfer and timing benefits are addressed through sale and loan treatment.

9.80 Section 51AD applies to all domestic tax exempts, whereas Division 16D only applies to public tax exempts. One issue is therefore which tax exempts should be covered by such a generalised tax exempt provision.

### *What should a tax exempt provision cover?*

9.81 In considering which arrangements should be covered by a tax exempt provision, two main aspects are likely to be raised:

- the degree to which the economic risks and benefits in the relevant asset lie with the tax exempt entity; and
- which arrangements that are 'similar' to leases the rules should extend to.

9.82 Experience with the current section 51AD and Division 16D suggests that the application of such a provision would inevitably be complex and lead to some uncertainty, because of the difficulty of demarcating between those arrangements which would be subject to the provision and those which would not. Appendix C discusses these issues in more detail.

## How should lease assignments be addressed?

9.83 If tax preference transfer through leasing is not permitted, the application of sale and loan treatment to leases would eliminate the ability to obtain unintended tax benefits relating to the assignment of leases created after the introduction of any new leasing provision. However, there may still be some scope to assign leases which were excluded from a new leasing provision. As leases are assigned a number of years after the leases have been created, at the end of the 'tax negative' period of the lease, pre-existing leases could continue to be assigned for years to come.

9.84 The taxation benefits of assigning leases would be considerably reduced if assignors were subject to balancing adjustment rules which apply when depreciated assets are disposed of.

9.85 However, assignors have been able to avoid tax on the balancing adjustment by taking advantage of a rollover rule which applies where there is only a partial change in the ownership of an asset (such as a change in the interests of the partners in a partnership). Chapter 14 proposes changes to the tax arrangements for partnerships which would prevent such outcomes, especially in relation to new leases.

9.86 Proposed changes to debt forgiveness discussed in Chapter 6 and to the consolidation of entities discussed in Chapters 25-29 could also help to address this problem.

9.87 In terms of a separate measure to address the assignment of existing leases, a viable approach would be to tax as income the value of the benefit derived through the assignor being relieved of the obligation to service the associated debt obligations. A common element in a lease assignment is that only the cash proceeds of the assignment are treated as a taxable consideration.

9.88 A lease assignment provision which addressed this problem directly would tax as income to the assignor both the monetary and non-monetary benefits derived in connection with the assignment, including any debt or other obligations effectively assigned to or assumed by another party.

9.89 Lease assignments may occur through the assignment of an interest in an entity such as a special purpose company whose principal activity is holding particular leased property. To ensure that the provision is effective, it would also apply to the transfer of an interest in such an entity, whose

principal activity is holding the leased property. The taxation amount would be adjusted to ensure an appropriate outcome by taking account of the remaining tax value.

9.90 This measure is estimated to result in revenue gains of around $170 million by 2003-04 (36 per cent company tax rate), on the assumption that the level of assignments of pre-existing leases is not affected by proposals to address debt forgiveness and consolidation of entities.

Appendix **A**

# *Accounting standards in relation to leases and service contracts*


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## Leases

### Current treatment

A.1 Drawing a distinction between finance and operating leases (along the lines of Option 1 in the text) would be consistent with existing accounting requirements in Australia, under Australian Accounting Standard AASB 1008 'Accounting for Leases', and internationally.

A.2 Under existing accounting requirements, for finance leases the lessee must:

- recognise at the beginning of the lease term an asset and a liability equal in amount to the present value of the minimum lease payments;
- allocate the minimum lease payments between an interest expense and reduction in the lease liability; and
- depreciate the leased asset under AASB 1008.

A.3 For finance leases the lessor must recognise:

- at the beginning of the lease an asset (lease receivable) equal in amount to the present value of the minimum lease payments and the unguaranteed residual value of the asset at the end of the lease; and
- lease finance revenue over the term of the lease to achieve a constant rate of return on the carrying amount of the lease receivable.

A.4 AASB 1008 defines minimum lease payments to mean the rental payments over the remainder of the lease term, including the amount of any bargain purchase option, premium, and guaranteed residual value, but excluding any rental relating to the reimbursement of executory costs and any contingent rentals.

A.5 The standard does not refer to the treatment of options to renew or cancel leases. However, the concept underlying the determination of minimum lease payments on initial recognition of a finance lease is that it should include only those amounts relating to the non-cancelable term of the lease that can be determined reliably and for which the lessee has a present obligation at the inception of the lease. Accordingly, the cost of an option to renew or cancel a finance lease and the additional obligation for rentals that would arise if the option to renew was exercised would not, under existing accounting practice, be included in the measurement of the asset and liability recognised at the beginning of a finance lease.

A.6 The accounting principles embodied in AASB 1008 do not distinguish the accounting treatment on the basis of an entity's taxation status or the country of use of the leased asset. Accordingly, taxation arrangements involving a different treatment for tax exempts and for overseas use of assets would result in an inconsistency with the accounting treatment.

## Possible direction of change

A.7 The alternative of treating all leases as involving some transfer of control over assets (more along the lines of Option 2) would be consistent with the accounting principle represented by the conceptual framework in Statement of Accounting Concepts SAC 4 'Definition and Recognition of the Elements of Financial Statements'.

A.8 This approach would also be consistent with the direction that accounting for leases appears to be heading both in Australia and internationally.

A.9 A Working Party comprising representatives from Australia, Canada, New Zealand, the United Kingdom, the United States and the International Accounting Standards Committee considers that 'risks and benefits incident to ownership' criteria currently applied for identifying finance leases should be abandoned. Instead, the Working Party considers that most material lease contracts, whether classified currently as finance or operating leases, create rights (to use the leased item) and obligations (to pay for the use of the leased item) which should be recognised as assets and liabilities.

A.10 Under this approach, the asset and liability recognised at the inception of a lease are measured as the present value of the minimum obligations under the lease contract.

A.11 The overall effect of the proposed approach is that many leases presently characterised as operating leases would be capitalised to the extent of the minimum obligations under the lease. Conversely, the assets and liabilities recognised in respect of some leases presently characterised as finance leases may be reduced under the proposed approach because the rights and obligations capitalised under the new approach would not necessarily correspond to the minimum lease payments as defined in current accounting standards.

A.12 The Working Party considers that minimum obligations should include the following:

- minimum contracted rentals;
- residual value guarantees where transfer of economic benefits in settlement is probable; and
- amounts payable in respect of cancellation options.

A.13 In the case of a lease that contains a renewal option, measurement of the initial assets and liabilities under the approach favoured by the Working Party would not include the additional obligation for rentals that would arise if the option to renew was exercised and the lease extended for a further term, even if at the inception of the lease it was considered probable that the option would be exercised. Therefore, assets and liabilities are recognised only in respect of the non-cancelable term of the lease and in respect of the cost of the option. The cost of the option is viewed as a pre-payment in relation to the renewal period. Therefore, if the lease is continued the option asset would be replaced by a lease asset restated to reflect the new non-cancelable lease term, and the lease liability would be similarly restated. If the lease is cancelled, the carrying value of the option would be expensed at that time.

A.14 However, the Working Party also considers that if there is no genuine possibility that a renewal option will fail to be exercised, its exercise should be assumed and the additional assets and liabilities that would result from its exercise would be recognised at the beginning of the lease.

A.15 The Working Party also considers that the minimum obligations on initial recognition of a lease should not include rentals contingent on future use or performance and contingent liabilities in respect of residual value guarantees. However, lease assets and liabilities would be remeasured where contingent rentals cease to be contingent and become obligations.

A.16 Unlike the Canadian model on which Option 2 is based, the approach favoured by the Working Party does not include exclusions based on the period of the lease, the value of the leased asset, or the broad category of the leased equipment.

## Accounting principles and executory contracts

A.17 Existing accounting standards do not address accounting for executory contracts, such as contracts for the future delivery of services or the future delivery of assets.

A.18 It is understood that the accounting treatment for executory contracts is being considered by the Working Party. The Working Party currently proposes that lease contracts should be distinguished from executory contracts on the basis of physical delivery of the leased item.

A.19 Australia, Canada, New Zealand, the United Kingdom, the United States and the International Accounting Standards Committee have established a long term project to consider the accounting treatments for executory contracts. There are currently two views on how executory contracts should be accounted for.

A.20 One view is that there is a net forward contract under which there may be assets and liabilities at the time of locking into an executory contract. This is based on the notion that the contract comprises a put option and a call option. This approach would require the options to be valued on a net basis, such that, for example, an asset and a gain would be recognised for a contract under which the entity has locked in a 'good deal'. The alternative view is that set-off occurs at the inception of an executory contract such that no amount is recognised until delivery of the asset or the provision of services.

Appendix B

# *Assessing the need for a separate non-recourse tax exempt provision*


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## What issue is the provision designed to address?

B.1 As discussed in Chapter 8, section 51AD applies to leases and similar arrangements which are financed using non-recourse finance, and has severe effects where it applies, as all deductions are denied while the income is still assessable.

- Division 16D would apply to many of these arrangements if non-recourse finance was not being used. Division 16D has a much less severe impact, as the payments are reconstructed as interest and the repayment of a loan, and capital allowances are denied to the taxable entity.
- Section 51AD is also broader than Division 16D, in that it also covers operating leases and also sale and lease back of assets. In the absence of non-recourse finance, such arrangements involving tax exempts would not be subject to any specific restrictions.

B.2 Against that background, a key question is whether, and why, a separate provision is required for leases and similar arrangements involving

non-recourse finance, over and above provisions which apply where non-recourse finance is not used.

- An additional question, if such a provision is required, is whether it needs to have the same drastic effects as section 51AD.

B.3 The only reason which can be identified for the continuing separate existence of section 51AD in relation to domestic tax exempts appears to be a potential problem of structured non-payment of non-recourse finance.

B.4 As a result, as long as this issue of structured non-payment is addressed, there appears to be no need for section 51AD to continue to exist, in relation to domestic tax exempts, nor for any other provision which has the same drastic effects as the current section 51AD.

B.5 Non-recourse leases and similar arrangements can be used as a disguised form of asset purchase by low tax entities, if the finance is provided by the 'purchaser' and it is always intended that the finance will not be repaid. This could potentially generate substantial tax benefits comparable to those gained through lease assignments. This is not to say that this is the main (or even a common) reason for using non-recourse finance. However, consideration needs to be given to this potential problem.

B.6 A non-recourse loan is a loan where the lender's rights against the borrower in the event of default are legally or effectively limited to the financed property. If the loan payments cannot be made then the lender cannot recoup more than is realisable from the property. Non-recourse loans result in the lender sharing some of the risk of the investment with the borrower.

B.7 Cameo B.1 shows how the potential problem of structured non-payment of non-recourse finance can lead to large tax benefits.

## How else might structured non-payment of non-recourse finance be addressed?

### Option 1: Under existing anti-avoidance legislation

B.8 Some existing anti-avoidance provisions may assist in preventing the use of structured non-payment of non-recourse finance. However, they are variable in their effect.

B.9 Part IVA may be triggered in some cases of structured non-payment of non-recourse finance. However, while extreme cases of structured non-payment of non-recourse finance may constitute tax avoidance under Part IVA, this is less clear where there is only partial structured non-payment of the debt.

## Option 2: Under suggested tax reform measures

B.10 A number of possible reforms could be considered that may reduce tax abuse through structured non-payment of non-recourse finance. These include sale and loan taxation of leases and similar arrangements to limit tax preference transfer, comprehensive debt forgiveness provisions and consolidation.

### *Sale and loan taxation to limit tax preference transfer*

B.11 Sale and loan treatment of leases and similar arrangements which restrict tax preference transfer would eliminate the ability to use structured non-payment of non-recourse finance to minimise tax, as long as the interest rate used in the tax calculations is the same as the cost of the finance.

B.12 Under sale and loan treatment, the tax benefit that the lessor obtains through interest deductions in relation to the non-recourse finance which will never be repaid is matched by deemed implicit interest income under the lease arrangement. This is illustrated in Cameo B.2.

### *Debt forgiveness*

B.13 In the example in Cameo B.2, part of the problem is the lack of comprehensive debt forgiveness provisions. If the debt forgiven were assessable to the taxable company then the benefits of the arrangement would be significantly lower. The taxable company would be assessed on the debt forgiven, which would offset the depreciation deductions received.

B.14 However, there can still be tax benefits as depreciation deductions are received during the term of the arrangement and the forgiven debt would only be assessable at the end of the arrangement. To the extent that the interest deductions are greater than the actual time value of money and the debt forgiveness provisions come into effect after the asset has reached the end of its useful life, then there are incentives to continue using structured non-payment of non-recourse finance where there are debt forgiveness provisions in place.

## Cameo B.1: Structured non-payment of non-recourse loans

All figures in dollars

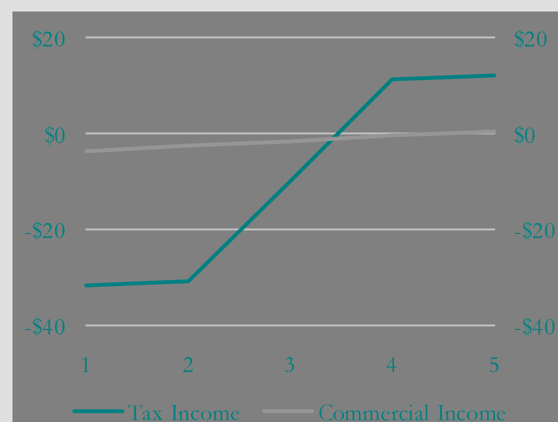
| Year | Lease payments | Net receipts from asset | Value of asset | Economic depreciation | Accelerated depreciation | Before-tax cash flow Lessor | Lessee |
|---|---|---|---|---|---|---|---|
| 0 | | | 100 | | | | -100 |
| 1 | 18.19 | 30 | 80 | 20 | 40 | -1.81 | 31.81 |
| 2 | 18.19 | 28 | 60 | 20 | 40 | -0.81 | 28.81 |
| 3 | 18.19 | 26 | 40 | 20 | 20 | 0.19 | 25.81 |
| 4 | 18.19 | 24 | 20 | 20 | 0 | 1.19 | 22.81 |
| 5 | 18.19 | 22 | 0 | 20 | 0 | 2.19 | 19.81 |
| | | | | | **IRR** | **10.00%** | **10.00%** |

| Year | Outstanding principal | Principal repayments | Interest repayments | Lessor Tax | Lessor After-tax cash flow |
|---|---|---|---|---|---|
| 0 | 100 | | | | |
| 1 | 90 | 10 | 10 | -11.45 | 9.64 |
| 2 | 80 | 10 | 9 | -11.09 | 10.28 |
| 3 | 70 | 10 | 8 | -3.53 | 3.72 |
| 4 | 60 | 10 | 7 | 4.03 | -2.84 |
| 5 | 50 | 10 | 6 | 4.39 | -2.20 |
| | | | | **NPV** | **$17.41** |

Cameo B.1 illustrates the use of structured non-payment of non-recourse finance by a tax exempt (government or overseas) entity to gain tax benefits. Where a tax exempt purchases an asset outright the income earned from the investment would not be assessable but the investment would not attract accelerated depreciation deductions. However, a tax exempt can provide a non-recourse loan to a taxable company as a disguised form of asset purchase, enabling the same investment to attract not only accelerated depreciation allowances but also interest deductions.

In this case the tax exempt provides a non-recourse loan of $100 to a taxable company, and the taxable company purchases a $100 asset which it leases to the tax exempt. Only fifty per cent of the principal is ever intended to be repaid. The taxable company is able to charge lower payments, as in effect it has already received half the payment via the non-recourse loan.

The cameo illustrates the case where all the benefits of the arrangement go to the taxable entity and the tax exempt is in the same position as if it had purchased the asset outright. The taxable company gains significantly, as it has lower assessable payments and access to deductions for depreciation and interest costs.




The tax benefits are significant at $17.41 in net present value terms. These benefits may be shared with the tax exempt through a further reduction in lease charges to the tax exempt. The structure of the arrangement ensures non-payment as the value of the collateral (the contracted asset) is increasingly becoming less than the outstanding value of the loan.

## Cameo B.2: The effect of sale and loan on structured non-payment

All figures in dollars

| Year | Lease payments | Net receipts from asset | Value of asset | Economic depreciation | Accelerated depreciation |
|---|---|---|---|---|---|
| 0 | | | 100 | | |
| 1 | 18.19 | 30 | 80 | 20 | 40 |
| 2 | 18.19 | 28 | 60 | 20 | 40 |
| 3 | 18.19 | 26 | 40 | 20 | 20 |
| 4 | 18.19 | 24 | 20 | 20 | 0 |
| 5 | 18.19 | 22 | 0 | 20 | 0 |

| | Explicit loan | | | Implicit loan | | |
|---|---|---|---|---|---|---|
| Year | Outstanding principal | Principal repayments | Interest repayments | Value of loan | Principal repayment | Interest repayments |
| 0 | 100 | | | 0.00 | | |
| 1 | 90 | 10 | 10 | 1.81 | -1.81 | 0.00 |
| 2 | 80 | 10 | 9 | 2.80 | -0.99 | 0.18 |
| 3 | 70 | 10 | 8 | 2.89 | -0.09 | 0.28 |
| 4 | 60 | 10 | 7 | 1.99 | 0.90 | 0.29 |
| 5 | 50 | 10 | 6 | 0.00 | 1.99 | 0.20 |

| | Lessee | Lessor | | | |
|---|---|---|---|---|---|
| Year | Before-tax cash flow | Before-tax cash flow | Taxable income | Tax | After-tax cash flow |
| 0 | -100.00 | | | | |
| 1 | 31.81 | -1.81 | 0.00 | 0.00 | -1.81 |
| 2 | 28.81 | -0.81 | 0.18 | 0.07 | -0.88 |
| 3 | 25.81 | 0.19 | 0.28 | 0.10 | 0.09 |
| 4 | 22.81 | 1.19 | 0.29 | 0.10 | 1.09 |
| 5 | 19.81 | 2.19 | 0.20 | 0.07 | 2.12 |
| **NPV** | **$0.00** | **$0.00** | | | **$0.00** |
| **IRR** | **10.00%** | **10.00%** | | | **6.40%** |

Cameo B.2 demonstrates how the sale and loan treatment removes any tax benefits from structured non-payment of non-recourse finance. This example is the same as Cameo B.1. The sale and loan approach would recast the lease arrangement as the sale of an asset and the simultaneous granting of a loan to the lessee. However, as there is an additional (explicit) loan from the lessee to the lessor the implicit loan between the two parties is initially zero.

The implicit loan increases when the loan payments (principle and interest payments on the explicit loan) made to the lessee are greater than the lease payments made to the lessor. The lessor is taxed on interest received from the implicit loan. As the calculations demonstrate this approach results in the lessor earning the appropriate after-tax rate of return of 6.4 per cent. The tax benefits from structured non-payment of non-recourse finance are also removed if the lessee is a taxable entity.

Note that there is no need to explicitly address the non-payment of remaining $50 of the non-recourse loan as the lower lease payments charged by the lessor effectively constitute repayment and the proposed tax treatment ensures that they are treated appropriately for tax purposes.

### *Consolidation with debt forgiveness*

B.15 An additional problem is that debt forgiveness provisions are only effective to the extent that the taxable company has sufficient assets to cover its tax liabilities. If the company has no other assets and is a subsidiary of a another company then the benefits from structured non-payment of non-recourse finance can be passed to the parent company while the subsidiary would be unable to pay any debt forgiveness liability. In these cases consolidation would remove this ability to avoid the impact of the debt forgiveness provisions.

### *Crimes (Taxation Offences) Act with debt forgiveness*

B.16 The *Crimes (Taxation Offences) Act 1980* combined with comprehensive debt forgiveness provisions may be effective in addressing this problem of subsidiaries avoiding the debt forgiveness provisions. Debt forgiveness provisions would mean that investors structuring large unpayable tax liabilities may trigger prosecution under the Act. The severe penalties under the Act have deterred the more blatant forms of tax evasion which prompted its introduction.

## Conclusion

B.17 The problem of structured non-payment of non-recourse finance would be addressed where sale and loan treatment is applied to prevent tax preference transfer, but would also be reduced where effective comprehensive debt forgiveness measures exist.

Appendix C

# *Design issues in formulating a tax exempt provision for arrangements which are similar to leases*

C.1 Based on experience with section 51AD and Division 16D, it would be unwise to attempt to restrict tax preference transfer between taxable and tax exempt entities on the basis of which entity 'controls' the relevant asset. Rather, any tests should try to determine to what extent the tax exempt entity's participation is one of equity in the assets, that is, to what extent it has the equity risks and benefits in the asset. However, it can be difficult with many arrangements to determine where the risks and benefits of economic ownership lie.

C.2 One issue is which arrangements should be subject to a test of the risks and benefits of economic ownership, on the basis that they are 'similar to leases'. One option is to include all service arrangements which involve the use of capital assets above a certain threshold value.

C.3 The other issue is to decide what criteria should be used in determining when a tax exempt has sufficient of the equity risks and benefits of the arrangement to justify denying tax preference transfer. Possible options include:

- including only those arrangements which are broadly 'similar' to finance leases;
- including those arrangements where the tax exempt has the 'predominant' or majority interest in the underlying asset;
- including all 'similar' arrangements, subject to specific exclusions on a comparable basis to a leasing code which was broadly based on the Canadian system; or
- denying deductions in proportion to the interest held by the tax exempt entity.

C.4 Under the *first option*, service agreements involving tax exempts could be included in such a provision on the basis of whether the risks and benefits of ownership had been 'effectively transferred' to the tax exempt entity, as broadly happens now under Division 16D.

C.5 However, this may suffer from the same problems that a similar leasing provision would have, which were outlined in the chapter in the discussion on leasing options :

- it would lead to 'bright line' problems, where small changes in the distribution of risks and benefits cause a large change in tax outcomes; and
- might easily be structured around, while still leaving the tax exempt entity bearing the large majority of the risks and benefits of ownership.

C.6 These problems may be reduced to some extent by developing a judgmental test based on a list of indicative factors which could be used to determine when an arrangement was in substance broadly akin to the provision of debt finance to the tax exempt entity.

C.7 Some factors which could be relevant to developing such a test could include where:

- the entity seeking to deduct capital allowances is a financier;
- cash flows under the arrangement seek to repay that entity a principal sum expended in constructing or acquiring the asset plus an investment return on that sum;
- there is an observable finance period;
- ownership or ultimate possession of the asset is likely to go to the tax exempt entity; and
- the tax exempt entity is able to make ongoing commercial decisions about the services provided by the asset that affect profitability.

C.8 Specific arrangements which might qualify under such a test might include longer term operating leases, outsourcing services by using assets owned by a private sector entity, service contracts under which a private sector entity is paid a fee for specific services, or direct purchase of the output of a privately owned asset by a tax exempt entity in order to provide public services.

C.9 This would not be a simple matter. There are potentially many ways in which, say, a tax exempt entity could utilise assets in providing public services to citizens and, in so doing, obtain indirect access to the tax benefits of capital allowances.

C.10 Such a test would necessarily be imprecise and lead to uncertainty. It would still suffer from the problem that arrangements could be structured to avoid meeting the tests, although the tax exempt entity still had the predominant interest in the arrangement.

C.11 A *second option* is therefore to base the test on when the tax exempt has the 'predominant' (or majority) interest in an arrangement, on the basis that where the tax exempt has the majority interest in assets it should be required to take the capital allowances, so effectively denying them to taxable entities involved in the arrangement. The capital allowances of course have no value to the tax exempt.

C.12 A *third option* is that, if a leasing regime broadly based on the Canadian regime was adopted, the treatment of 'similar arrangements' could be aligned with the leasing regime. Such an option would essentially include all service contracts where the tax exempt was, in substance, 'using' the services of a capital asset through a service arrangement similar to an operating lease. This would include many instances where the tax exempt did not have a predominant interest in the underlying asset. For example, contracts relating to the provision of hospital services and prisons could be included on such a basis, and such a provision would be much more extensive in its application than the current section 51AD and Division 16D.

C.13 A *fourth option* is to develop an 'at risk rule' where the amount of capital allowances which could be taken by the taxable entity would be reduced by the proportion of the economic risks and benefits as held by the tax exempt, or the extent to which the taxable entity was 'at risk'. However, this would also have a much more extensive application than the current section 51AD and Division 16D, in that tax preference transfer would be (partially) restricted in cases which currently are not affected by section 51AD and Division 16D. In addition, it would be difficult to determine the relevant proportion of the risk and benefits which are held by the tax exempt.

C.14 In considering the appropriate form a tax exempt provision should take, consideration would also need to be given to ensuring that opportunities did not exist to obtain unwarranted tax benefits by effectively assigning interests in an arrangement to a tax exempt, after tax preferences had been taken by a taxpayer.

- Assigning interests to tax exempts, in relation to arrangements where tax preference transfer was not restricted (because the provision did not meet the test for restricting tax preference transfer) would generate tax benefits similar to those outlined in Chapter 8 in relation to lease assignments.
- However, if the arrangement was not a lease, it would not be covered by the lease assignment measure outlined earlier.

C.15 The difficulties identified above demonstrate the demarcation complexity associated with attempting to implement a policy of prohibiting tax preference transfer in relation to tax exempts.

C.16 In summary, rules designed to limit tax preference transfer where tax exempts engage in arrangements which are 'similar to leasing' would be

very complex and, at the margin, produce uncertainty, reflecting the difficulty of making judgments about the nature of the tax exempt's involvement in arrangements.