The Secretary
Review of Business Taxation
The Treasury
Parkes Place
PARKES ACT 2600

Dear Dr Preston

Attached is a submission from the Australian Society of Certified Practising Accountants relating to *A Platform for Consultation* and leases and similar arrangements.

We have no objection to the submission being released publicly in its entirety.

I have also mailed this letter and the submission to you today. If you wish to contact me about the submission, my telephone number is (03) 9606 9701.

Yours sincerely

Paul Drum
Senior Tax Counsel
16 April 1999

A Platform for Consultation - Leases and similar arrangements

Introduction

The RBT outlines the policy issues regarding the tax treatment of leases and service contracts over wasting assets.[1] However, the majority of the discussion relates to the leasing of assets as the treatment of service contracts, and is considered in the discussion[2] to be too complex to deal with in the same way as leases. Accordingly, our comments have been largely limited to tax treatment of leases as known in the technical sense (as. a chattel bailment) and not service contracts. The exception to this is the later discussion of service arrangements with tax exempt entities.

Essentially, four broad policy issues are raised.

a) Should tax preference transfer be permitted in any circumstance;

b) If tax preference transfer is to be permitted, what type of tax-payers or groups should it apply to;

c) If tax preference transfer is to be restricted by deeming a lease to be a sale and loan ("the sale and loan approach"), to what type of transactions (ie. types of leases) should the sale and loan approach apply to; and

d) Treatment of "leasing" and service arrangement to tax exempts.

After the executive summary, we deal with each of these policy issues in turn.

[1] Review of Business Taxation, A Platform for Consultation, Chapter 9

[2] Review of Business Taxation, op cit., p. 238.

Executive Summary

A summary of our recommendations is as follows:

- To ensure investment efficiency, tax preference transfer via leasing should be permitted in the appropriate circumstances;

- It may be appropriate to not permit tax preference transfer to non-residents and private and domestic users for policy reasons (where the lessee is using it directly for private and domestic purposes). However, the restriction in relation to private use needs to be reviewed given the likely disproportionate compliance cost and potential prejudice to small business;

- Where tax preference transfer is to be permitted via leasing the current legal substance approach should continue. The tax preferred leasing approach is not justified due to the compliance burden;

- If tax preference transfer is to be restricted, it should be via a finance lease regime;

- Domestic tax exempts should be able to (indirectly) access tax preferences. In view of the revenue neutrality requirement, the cost of this submission may need to be shared between the State and Federal Governments and the private sector;

- There is no need for a separate "non recourse debt" provision dealing with tax preference transfer to tax exempts even if tax preference transfer is to be restricted;

- If a restriction on tax preference transfer to tax exempts is to apply then the criteria used to determine which arrangements are impacted should be a dominant or majority interest in the underlying assets approach;

- For prohibition on tax preference transfer to be triggered, the legislation should seek to remove the tax preferences in the private sectors hands and not (as is currently the case in Section 51AD) eliminate all deductions; and

- Any change to leasing should be prospective only. In particular, variation to existing arrangements will require consideration. Further, leases under Master Leases for smaller value assets such as cars should be grandfathered.

Should Tax Preference Transfer be Permitted

The following discussion is based on the premise that tax preferences in some form still exists. Whether or not this will be the case after tax reform, it is agreed that it is necessary to set up the leasing rules to accommodate potential tax preferences which may be introduced under future governments.

We believe that it is clearly demonstrated that tax preference transfer via leasing is appropriate to achieve economic efficiency and competitive neutrality in respect of the costs of assets amongst business tax payers[3]. Accordingly, we submit that tax preference transfer should be allowed in appropriate circumstances.

Recommendation: To ensure investment efficiency, tax preference transfer via leasing should be permitted in the appropriate circumstances;

In relation to what are "appropriate circumstances" we understand that the two main circumstances or factors which have been mentioned in discussions with the RBT Consultative Forum, are the type of entity involved in the transaction and the type of transaction. We discuss both of these below.

Which Entities Should Participate in Tax Preference Leases

We accept that there are certain entities or categories of entities which may not be appropriate to participate in tax preferred leasing. Many of these are accommodated in ad hoc provisions under the existing income tax legislation and practice (eg. the treatment of leasing to non-residents under Section 51AD and Division 16D). We discuss below the major categories of entities as discussed in the focus group:

i) Lessors. We accept that for policy reasons it may not be acceptable for individuals to be lessor participants in tax preferred leasing. This is the administrative policy of the ATO currently through IT2051. Accordingly, tax preferred leasing may need to be restricted to where the lessor is a corporate carrying on a business of leasing (including a partnership of corporates who carry on the business of leasing). The exact bounds of this restriction requires further analysis.

ii) In relation to lessees, we discuss the major categories below:

   a) Non residents. We accept that as a general rule, tax preferred leasing should not be permitted between an Australian resident lessor and a non-resident lessee. This effectively mirrors the current arrangements by virtue of section 51AD and Division 16D.

   b) Private and domestic use. We agree that tax preferred leasing may not be, from a policy perspective, acceptable where the lessee is using the asset for private or domestic use. We note that in relation to assets provided to employees such as "company cars" the lessee being, the company, is not using the asset for private or domestic purposes. Accordingly tax preferred leasing should be permitted in these cases. The taxation of any benefit of the company providing a "company car" to the employee should be dealt with under the FBT or ordinary income tax provisions in relation to the employee.

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[3] Review of Business Taxation, op cit., Chapter 9 at pages 239-240.

Accordingly, tax preferred leasing should only be prohibited where the lessee is using the asset for private or domestic purposes directly. As it is likely that the scale of leasing for private use is not significant and the probable compliance burden, particularly on small business, of recharacterisation as a sale and loan is significant we would need to review the practicalities of implementing such a prohibition before agreeing to its implementation

c) Tax Loss Entities. We see no reason why an entity which has tax losses should not be able to access the benefits of tax preferences indirectly through tax preferred leasing. The arguments in relation to asset allocation and investment efficiency apply equally to tax loss entities as to taxable entities.

d) Taxable Entities. Obviously where tax preferred leasing is to be available, taxable lessees should be able to access it.

e) Tax Exempts. The RBT recognises for the efficient allocation of assets, ideally tax exempt entities should be allowed to access tax preferences through tax preferred leasing[4]. However, we accept that there are special issues with this particularly the revenue cost as tax preference transfer is not available to tax exempt entities currently. Accordingly we have discussed this under a separate sub-heading dealing with tax exempt leasing and 51AD in particular.

Recommendation: It may be appropriate to not permit tax preference transfer to nonresidents and private and domestic users for policy reasons (where the lessee is using it directly for private and domestic purposes). However, the restriction in relation to private use needs to be reviewed given the likely disproportionate compliance cost and potential prejudice to small business;

How should "Tax Preference" Transfers be Allowed to be Transferred via Leases

Essentially this is a choice between the current approach ("the legal substance approach") and the Tax Preferred Leasing approach discussed at pg. 238 of A *Platform for Consultation.*

The main difference between the two approaches is that Tax Preferred Leasing eliminates tax payment structuring opportunities. Whilst this is a legitimate policy objective, given the limited scope and financial impact of such structuring, we believe that the likely compliance burden of the tax preferred leasing approach is not justified.

Accordingly, we submit that the current legal substance approach should continue where tax preference transfer is to be permitted.

Recommendation: Where tax preference transfer is to be permitted via leasing the current legal substance approach should continue. The tax preferred leasing approach is not justified due to the compliance burden.

To What Transactions Should the Sale and Loan Approach Apply To ?

If it is decided that tax preferences should not be transferred via 1easing transactions", to some types of entities at least, the question remains what types of "lease transactions" should be affected.

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[4] Review of Business Taxation, op cit., at pages 240 and 242.

The RBT also recognises essentially the tax benefits of ownership should be available to the entity which bears the substantial risk and benefits of ownership[5]. Accordingly, this would ideally be the best test. It is recognised that this test is sometimes difficult to apply in practice as has been, to some extent, the accounting experience in relation to leasing rules such as those in **ASRB** 1008. However, those issues tend to be at the margin and a great majority of the leases are readily classifiable.

Accordingly we believe that the prohibition of tax preference transfer, if it is to apply, should be restricted to finance leases where the majority of risk and benefits of ownership have been transferred. Guidelines similar to those in ASRB 1008 should be applied to determine what a finance lease is.

However, it is recognised that if the recommendations above are accepted and that (ignoring tax exempts which are dealt with in more detail below), only non-residents and private and domestic users are to be restricted then the Canadian approach of treating all leases (with "significant" exceptions for particular categories of leases) to such entities may be able to be justified on the grounds of simplicity, but only in that circumstance.

Recommendation: If tax preference transfer is to be restricted, it should be via a finance lease regime.

Tax Exempt Leasing and Section 51AD

As Chapter 9 recognises (at page 242) in principle, if tax preferences exists, there would be a more efficient allocation of assets to allow tax exempts to access these tax preferences

through leasing or "service contract" type arrangements. Accordingly, we would support the removal of Section 51AD and Division 16D.

However, it is recognised that in context of tax neutrality of the reform proposals, the removal of the current prohibition of tax preference transfer to exempt entities would be significantly expensive viz a viz the current situation.

It has been suggested that the revenue neutrality viz a viz the Federal Government could be achieved via revenue allocations between the State and Federal Government (ie. the States effectively "give back the financial impact of the tax preference transfers). However this appears a little simplistic as:

a) assuming the private sector transferred back the full benefit of the tax preference transfer to the States, if the State was simply to hand that back to the Federal Government then little appears to have been achieved (compared to say the state owning the asset and "renting" to the private sector); and
b) in practice the private sector may not pass back the full benefit of the tax preference transferred (but would take a "cut”). Accordingly the states may not be in a position to transfer back the full benefit of the tax preferences in any case.

Whilst it is agreed that the State could bear some of the burden of the "revenue loss" of this tax reform option, other sources may need to be found. Two likely alternative sources are:

a) The Private Sector

[5] Review of Business Taxation, op.cit., chapter 9.

Whilst it is agreed that the restrictions on tax preference transfers to the State Government has resulted in State goods and services (eg. schools and hospitals) being relatively more expensive (and accordingly, less being "produced") the corollary appears to be that the private sector, having the full benefit of tax preferences and competing for resources with the State Government, are building too many, say, factories and office towers. Accordingly, some of the burden may need to be borne by the private sector in terms of tax payments via the nominal tax rate or the effective tax rate through such things as tax preferences.

Note this is the private sector in general not simply the private sector entities which may enter into leasing or service arrangements with tax exempt entities.

b) the efficiency dividend of having activities previously carried on by tax exempts carried on by the private sector in a taxable environment. This will not only be the anticipated efficiency gains and increased profit in respect of that activity when conducted by the private sector but also the fact that any profits previously earned by that activity would not have been within the Federal tax net and would have given rise to no Federal Income Tax. Accordingly, over time at least, there should be an increase in Federal revenue by bringing activities into the private sector.

We recognise that the removal of the prohibition against tax preference transfer to domestic tax exempt entities raises some fairly complex technical and administrative issues (such as Federal state financial relationships). Accordingly, this area probably requires more detailed analysis before implementation.

We note for completeness that we are only discussing tax preference transfer to domestic tax exempts and not to non-resident offshore use.

Recommendation: Domestic tax exempts should be able to (indirectly) access tax preferences. In view of the revenue neutrality requirement, the cost of this submission may need to be shared between the State and Federal Governments and the private sector;

Non Recourse Debt and Tax Exempts

We agreed at the focus group with the discussion in Appendix B that there is no compelling need for a separate provision dealing with arrangements involving nonrecourse debt and tax exempts. Accordingly, even if it is decided to restrict tax preference transfers to tax exempts, effectively Section 51AD and Division 16D can be combined and in the non-recourse debt requirement in Section 51AD removed.

e) Domestic tax exempts should be able to (indirectly) access tax preferences. In view of the revenue neutrality requirement, the cost of this submission may need to be shared between the State and Federal Governments and the private sector;

Recommendation: There is no need for a separate "non recourse debt" provision dealing with tax preference transfer to tax exempts even if tax preference transfer is to be restricted.

What Criteria Should be in a Test Prohibiting Tax Preference Transfer to Tax Exempts

The first question is what transactions (leases or other arrangements) should "trigger" the prohibition on tax preference transfer to tax exempt.

At the outset we note that it would be appropriate to have a de minimus rule to ensure that arrangements only having a small amount of capital assets are excluded from any prohibition on tax preference transfer in respect arrangements involving tax exempts. Obviously there would need to be a aggregation provision to ensure that transactions were not simply divided up into small arrangements.

In relation to what criteria should be used to determine whether tax exempt has a sufficient equity risk and benefit in respect of the arrangement, we consider the preferred approach is to include those arrangements where the tax exempt has the dominant or majority interest in the underlying assets. A set of criteria should be set out in the legislation to provide objective review points in determining whether the provision applies. We consider that the criteria in Item 2602 and TR 96/22 as well as ASR13 1008, could be used as useful starting points in setting put these criteria.

We note that the test should be framed as to whether the tax exempt has the predominant interest in the underlying asset and not a test to prove that the "private sector" does have the dominant interest.

Recommendation: If a restriction on tax preference transfer to tax exempts is to apply then the criteria used to determine which arrangements are impacted should be a dominant or majority interest in the underlying assets approach; and

What Result Should Happen if a Prohibition on Tax Preference Transfer is Triggered

Both Chapters 8 and 9 recognise that the current 51AD has a severe affect which effectively places a veto on transactions irrespective of other commercial and policy merits of doing the transaction. This is because the provision denies all tax deductions in relation to depreciation and financing and not simply the "advantage" obtained from doing the tax preference transfer.

A sale and loan approach is appropriate for lease type transactions. However for service arrangements is often impossible to recharacterise the arrangement as a sale and loan.

Whilst this area requires more work, it is suggested that a potential solution is to seek to deny the tax preferences or tax advantages sought to be transferred by the arrangement. The ASCIA suggest that this could be done by:

a) Denying the tax preferences to the private sector entity. This would mean denying the accelerated component of the depreciation (whilst allowing the private sector the effective life depreciation) and where investment and development allowance incentives are available, these would also be denied.

b) In relation to finance type costs, these could be put on a cash payment basis, rather than when incurred to ensure that there is no manipulation of payment arrangements in the financing.

Recommendation: For prohibition on tax preference transfer to be triggered, the legislation should seek to remove the tax preferences in the private sectors hands and not (as is currently the case in Section 51AD) eliminate all deductions.

Transitional Issues

Any change to leasing should be prospective only. In particular, variation to existing arrangements will require consideration. Further, leases under Master Leases for smaller value assets such as cars should be grandfathered.

Recommendation: Any change to leasing should be prospective only. In particular, variation to existing arrangements will require consideration. Further, leases under Master Leases for smaller value assets such as cars should be grandfathered.