TR 1999/D5 - Income tax and fringe benefits tax: taxation consequences of certain motor vehicle lease novation arrangements

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Draft Taxation Ruling
Income tax and fringe benefits tax: taxation consequences of certain motor vehicle lease novation arrangements

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Preamble

Draft Taxation Rulings (DTRs) represent the preliminary, though considered, views of the Australian Taxation Office.
DTRs may not be relied on by taxation officers, taxpayers and practitioners. It is only final Taxation Rulings which represent authoritative statements by the Australian Taxation Office of its stance on the particular matters covered in the Ruling.

What this Ruling is about

1. This Ruling contains the Commissioner's opinion on certain motor vehicle lease novation arrangements. These arrangements involve the novation (or transfer) by an employee to an employer of some of the obligations under a motor vehicle lease. These are frequently known as partial novations. The Ruling describes the consequences of such arrangements for both non luxury cars and luxury cars. The Ruling does not deal with any Capital Gains Tax consequences of these arrangements.

2. The Ruling should be read in conjunction with Taxation Ruling IT 2509, which also deals with motor vehicle lease novation arrangements.

Class of person/arrangement

3. The class of persons this Draft Ruling applies to is employers and employees who are parties to motor vehicle finance and/or operating lease novation arrangements.

Definitions

4. A **novation** is a tripartite arrangement whereby the three parties agree to change the relationships of the parties regarding all or some of the rights and obligations in a motor vehicle lease and/or sub-lease entered into between two of the parties.

5. **Partial novation** is an industry expression that describes a novation (transfer) of a finance lease payment obligation. A partial novation may also occur where there exists both a finance lease and a sub-lease.

6. **Full novation** is a novation (transfer) of all the rights and obligations in a finance lease or in a finance lease and sub-lease arrangement.

7. **Split full novation** is a novation (transfer) of the right to use a motor vehicle and some of the obligations (i.e., the lease payment obligation) in a finance lease.

Previous Rulings

8. Draft Taxation Determination TD 98/D6 is withdrawn on the release of this draft Taxation Ruling.

Ruling

The effect of novations

Full novations

9. In a full novation and a split full novation the lease payment obligations are transferred to the employer. Accordingly, there are no income tax consequences for the employee during the period when the employer makes the lease payments.

10. The employer in the novated lease is entitled to a deduction for lease expenses where the vehicle is used in the business or provided to an employee as part of a salary packaging arrangement. In the case of a luxury car the deduction is based on an accrual amount and depreciation subject to the luxury car depreciation limit.

11. A car benefit arises under the *Fringe Benefits Tax Assessment Act 1986* (FBTAA) where the employer is lessee of a car that is provided for the private use of the employee or associate of the employee.

Partial novations

12. There has been some considerable doubt about the tax consequences of partial novations. Where the partial novation occurs in the context of the creation of a sub-lease, the sub-lessor is in receipt of a benefit under that sub-lease and is assessable on the value of that benefit. Where no sub-lease exists no income benefit is derived by the employee.

13. The partial novation can be compared to the split full novation. Both the split full novation and partial novation arrangements seek to achieve a transfer to the employer of the obligation to make the lease payments during the period of the employee's employment. Different contractual expressions are used to achieve this end. In many partial novation documents, however, it is not always clear if there has been a novation of the entire lease or only that part which contains the obligation to make the lease payments. While the intentions of the parties may be a relevant consideration to assist in the interpretation of the agreements, they are not always apparent.

14. In both partial and split full novations the employer obtains the lease payment obligations, either directly from the lessor or under the sub-lease from the employee. While the nature of the legal relationships differ the practical legal obligations are similar.

Partial novations entered into before and on 17 June 1998

15. In view of the commonly understood purpose and intention of these partial lease payment novation arrangements, the Commissioner accepts partial novation arrangements entered into before and on 17 June 1998 as full novations. Any existing sub-lease in these arrangements has no function for tax purposes.

16. Where the sub-lease is ineffective because there has been a full novation or is not present as part of the arrangements, the employee is not assessable on any income under these arrangements.

17. Further, in these circumstances, as the car is provided to the employee or associate, only a car benefit arises under the FBTAA.

Partial novations entered into after 17 June 1998

18. Partial novations entered into after 17 June 1998 have the following income and fringe benefits tax consequences.

Non-luxury cars

19. The employee is assessable on the benefit received as sub-lessor at the time the lease payment obligations are transferred under a partial novation. The income or benefit is calculated by reference to the value, equivalent to the lease payments, of the consideration received. That consideration is the promise by the employer to make rental payments directly to the financier in lieu of payments to the employee under the sub-lease between the employer and the employee.

20. A deduction is not available to the employee under section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997) in non-luxury

motor vehicle partial novations where the lease payments are contractually made by the employer directly to the finance provider. In these circumstances, the employee no longer has the contractual obligation for the lease payment liabilities and does not make the payments.

Luxury cars

21. When this novation involves a luxury motor vehicle the employee is the notional owner as sub-lessor in the sub-lease between the employee and the employer for the purpose of Schedule 2E, Division 42A of the *Income Tax Assessment Act 1936* (ITAA 1936) (luxury car rules).

22. The employee is assessed on the accrual amount of the notional loan in this luxury motor vehicle novation. The accrual amount is calculated by reference to the consideration for the granting, by the employee to the employer, of the right to possession or use of the motor vehicle. That consideration is equal to the amount of the lease payment obligation transferred to the employer.

23. A deduction is not available to the employee in a luxury motor vehicle partial novation. An employee, as sub-lessee, can claim a deduction only to the extent to which a deduction is allowable to the lessee under other provisions of the Act.

Fringe benefits tax

24. In partial novations a residual benefit may arise under the FBTAA where all that occurs is the transfer to the employer of the lease payment obligations of the employee. A car benefit arises where the employer provides the car for the private use of the employee or associate of the employee.

Division 16D

25. Division 16D has no application to the types of arrangements covered by this Draft Ruling.

Date of effect

26. This Draft Ruling applies to luxury car and non-luxury car partial novation arrangements entered into up to and after 17 June 1998 (the date on which our view of these arrangements was first expressed in Draft Taxation Determination TD 98/D6).

27. This Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to or to any private rulings on arrangements covered by this Draft Ruling that were entered into up to the date of issue of this Draft Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Explanations

The effect of novations

Full novations

28. Full novation arrangements occur where the employee takes out a finance lease for a car. The employee may then sub-lease the car to his/her employer. The finance lease (and sub-lease where one exists) is novated in full to the employer. The employer becomes the lessee and all the rights and obligations of the lease and any sub-lease are transferred to the employer. The finance lease and any sub-lease are rescinded (contractually extinguished) and replaced by a new novated lease arrangement. The employer becomes the lessee for this novation period.

29. In a full novation and a split full novation the lease obligations are transferred to the employer. Accordingly, there are no income tax consequences for the employee during the period when the employer makes the lease payments.

30. The employer becomes the lessee under the novated lease and is entitled to a deduction for lease expenses where the vehicle is used in the business or provided to an employee as part of a salary packaging arrangement. In the case of a luxury car the deduction is based on an accrual amount and depreciation, subject to the luxury car depreciation limit in section 42-80 of the ITAA 1997 (section 57AF of the ITAA 1936).

31. On the happening of a terminating event, such as the payment of the last lease payment under the novated lease or employment termination, a further novation may occur. Under the further novation the employer's subsisting rights and obligations are novated to the employee. The employee becomes lessee and is able to take this lease to another employer.

32. A car benefit arises under Division 2 of the FBTAA in these novations where the employer provides the car for the private use of the employee or associate of the employee.

Partial novations

33. A partial novation is where the employee takes out a finance lease for a car, then enters into a novation of the lease payment obligations which are transferred to the employer. The employee then sub-leases the car to the employer who becomes a sub-lessee. A partial novation may also occur where there is no sub-lease and the novation takes the form of a transfer of the lease payment obligations of the finance lease to the employer. In both cases no direct payments are received by the employee; however, the employer agrees to accept a novation of the finance lease payments obligations. In the sub-lease version, the novation of the lease payments are in lieu of the obligation to pay rent under the sub-lease. The sub-lessee agrees to pay the lease payments direct to the finance provider. The employer is able, by virtue of the rights it acquires as sub-lessee, to make the car available for the private use of the employee. Because the car is provided by the employer it is accepted that a car benefit arises. The arrangements are specified to continue only for so long as the employee is employed or the last lease payment is made. On the cessation of employment, for example, the arrangements are unwound and both the sub-lease and the novation are terminated. In that circumstance the (now ex) employee therefore resumes the role as lessee and the employer has no further responsibility for the vehicle.

34. The taxation outcomes of certain novation arrangements have been known since 1989. However, some of the taxation consequences may have been confused with the intention of previously published advice. This confusion generally revolves around whether or not both the lease and the sub-lease (where one existed) were novated in full. In the advice it was contemplated that the employee would not remain as lessee and not retain part of the original lease conditions. Further, it was not contemplated that the sub-lease would remain in existence.

35. There has been some considerable doubt about the tax consequences of partial novations. Where the partial novation occurs in the context of the creation of a sub-lease, it may be said that the sub-lessor is in receipt of a benefit under that sub-lease and is assessable on the value of that benefit. Where no sub-lease exists, no income benefit is derived by the employee.

36. The creation of the sub-lease calls for an analysis of the nature of the benefit enjoyed by the sub-lessor (the employee). In some arrangements, the sub-lessor foregoes the right to income under the sub-lease in exchange for the employer's agreement to accept the transfer by novation of the lease payment obligations contained in the lease between the financier and the employee. In other arrangements, the sub-lease is entered into as an element of the part novation and with no mention of sub-lease income. As the sub-lease is designed to mirror the rights and obligations inherent in the finance lease, it is

apparent that the sub-lessor has, in fact, foregone lease income equal to the value of the lease payments made by the employer direct to the financier.

37. The partial novation can be compared to a split full novation. Split full novations occur where the finance lease rights and obligations are split between the employer and employee without a sub-lease. The right to use or possession of the motor vehicle and other obligations, for example the lease payment obligations, are novated to the employer. Further, the residual value obligation is novated to the employee or otherwise dealt with between the employee and the finance provider.

38. Both the split full novation and partial novation arrangements seek to achieve a transfer to the employer of the obligation to make the lease payments during the period of the employee's employment. Different contractual expressions are used to achieve this end. In many partial novation documents, however, it is not always clear if there has been a novation of the entire lease or only that part which contains the obligation to make the lease payments. While the intentions of the parties may be a relevant consideration to assist in the interpretation of the agreements, they are not always apparent. In both types of novations, the employer ends up with a lease of the vehicle and the lease payment obligations either directly from the lessor or under the sub-lease from the employee. The nature of the legal relationships differs; however, the practical legal obligations are similar.

Partial novations entered into before and on 17 June 1998

39. In view of the commonly understood purpose and intention of these partial lease payment novation arrangements, the Commissioner accepts partial novation arrangements entered into before and on 17 June 1998 as full novations. If a sub-lease exists in these arrangements it has no effect for income tax purposes. Where the sub-lease is ineffective because there has been a full novation or is not present as part of the arrangements, the employee is not assessable on any income under these arrangements.

40. Further, in these circumstances whether or not a sub-lease exists, only a car benefit arises under the FBTAA.

Partial novations entered into after 17 June 1998

41. Partial novations entered into after 17 June 1998 have the following income and fringe benefits tax consequences.

Non-luxury cars

42. The employee is assessable on the benefit received as sub-lessor (section 21 of the ITAA 1936) at the time the lease payment obligations are transferred under a partial novation. The employee is assessed on the income derived where both the head lease and sub-lease exist (section 25 of the ITAA 1936, section 6-5 of the ITAA 1997). The income or benefit is calculated by reference to the value, equivalent to the lease payments, of the consideration received. That consideration is the promise by the employer to make rental payments directly to the financier in lieu of payment to the employee under the sub-lease between the employer and the employee.

43. Section 8-1 of the ITAA 1997 (subsection 51(1) of the ITAA 1936) does not allow a deduction to the employee for lease payments made by the employer to the finance company in a partial novation, as no expense has been incurred or paid by the employee. In these novations, the employer enters into a novation where it makes the lease payments direct to the finance provider. The employee no longer has the legal obligation to make the lease payments. Likewise, as the expense is not incurred by the employee, section 51AF of the ITAA 1936 has no application.

Luxury cars

44. The leased luxury car rules in Schedule 2E, Division 42A of the ITAA 1936 apply to certain partial novations where the employee enters into a sub-lease with his/her employer. As the rules apply to sub-leases, they deem the employee and employer to have entered into a notional sale and acquisition transaction. On the grant of the sub-lease the employee, as sub-lessor, is taken to have made a loan to the employer as sub-lessee. Subdivision 42A-B assesses the employee on the accrual income as a result of this loan.

45. However, in these partial novations a deduction is not available to the employee as lessee because the lease payments are made by the employer. Under these rules the lessee is entitled to a deduction for accrual amounts only to the extent that the lease payments, apart from Division 42A, are deductible. The employer makes the lease payments directly to the finance provider. In these circumstances, as section 8-1 of the ITAA 1997 does not allow a deduction, no deduction is available to the employee under subsection 42A-50(3) of the ITAA 1936.

Alternative view – partial novations

46. An alternative view on partial novations suggests that the employee has no entitlement to receive sub-lease rentals from the

employer. There is no entitlement because the arrangements never provided for the employer to make sub-lease rentals to the employee, or because the employee has foregone the right to such rentals as part of the lease payment novation arrangement. Thus, the making of the lease payments by the employer to the finance company is in satisfaction of a legal obligation novated to the employer, not an obligation of the employee.

47. We do not accept this alternative view if the right to use the vehicle in this novation is transferred under the sub-lease, as consideration will usually be given in return. In our view, the employer has entered into a contract with the finance company to make lease payments. The transfer of this obligation is part of the tripartite agreement between finance company, employer and employee. Part of the agreement involves the employee agreeing to sub-lease the vehicle to the employer. The circumstances of the agreement indicate that consideration for entering into the sub-lease is the contract whereby the employer makes the rental payments. The value of the consideration is equal to the value of that obligation, which, in this case, equals the amount of the lease payments payable under that contract. If, in substance, there is consideration for the sub-lease, moving from employer to employee, this indicates that a benefit is enjoyed by the employee. We consider that, in the context of an employer/employee relationship, the benefit represents income derived by the employee.

Alternative view - luxury cars

48. In relation specifically to luxury cars, an alternative view suggests that, as there are no 'lease payments' in respect of the sub-lease, there can be no 'implicit interest rate' and no 'accrual amount' that could be included in the employee's assessable income under section 42A-35.

49. We do not consider this to be the case. The sub-lease has been entered into as a direct result of the novation of the payment obligations. The transfer of those obligations is, therefore, the 'other consideration', the existence of which satisfies the definition of 'lease' (section 42A-115). Although the sub-lessor has not directly received the regular monthly payment, it has enjoyed the benefit of that payment being made. Therefore, the transfer of the obligation is 'other consideration' received by the sub-lessor. We consider that 'other consideration' is the value of the contract entered into by the employer to meet the lease payment obligations, which equates to the lease payment paid or payable by the employer and is the accrual amounts assessable to the employee as sub-lessor in the sub-lease.

Fringe benefits tax

50. A residual benefit or a car benefit arises under the FBTAA in partial novation arrangements. A residual benefit arises where all that occurs is the transfer of the lease payment obligation, as we consider that this transfer is in respect of employment. These residual fringe benefits are treated as being received during the period the employer makes the lease payments. A car benefit arises where the employer provides the motor vehicle for the private use of the employee or associate of the employee.

Division 16D

51. Division 16D is designed to prevent transfers of tax benefits in arrangements involving exempt public bodies. Division 16D has no application to the types of arrangements covered by this Draft Ruling.

Detailed contents list

52. Below is a detailed contents list for this Draft Ruling:

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Your comments

53. If you wish to comment on this Draft Ruling, please send your comments by Friday, 18 June, 1999 to:

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Previous draft:
TD 98/D6

Related Rulings/Determinations:
IT 2509; TD 95/63; TD 98/D6

Subject references:
- FBT motor vehicle
- lease financing
- lease residual values
- luxury vehicles
- novation
- residual fringe benefits
- sub-leasing
- termination of leases
- vehicle leasing and hire

Legislative references:
- ITAA36 21
- ITAA36 25

- ITAA36 51(1)
- ITAA36 57AF
- ITAA36 Sched 2E, Div 42A
- ITAA36 Sched 2E, Subdiv 42A-B
- ITAA36 42A-35
- ITAA36 42A-50(3)
- ITAA36 42A-115
- ITAA36 Div 16D
- ITAA97 6-5
- ITAA97 8-1
- ITAA97 42-80
- FBTAA Div 2

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