IT 2051 - Leveraged lease transactions

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TAXATION RULING NO. IT 2051

LEVERAGED LEASE TRANSACTIONS

F.O.I. EMBARGO: May be released

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PREAMBLE The purpose of this Taxation Ruling is to set out the basic views of the Australian Taxation Office on the minimum standards with which leveraged lease transactions must comply if they are to be accepted under the income tax law.

2. It is necessary to keep in mind that, in a press statement of 30 March 1983 (Statement No. Tax 83/2), the Minister for Finance foreshadowed legislation in relation to certain leveraged lease arrangements. The proposed legislation will deny all otherwise allowable income tax deductions attributable to the ownership of plant in leveraged lease transactions involving the use of:

- overseas plant by non-residents;
- existing plant already in use with the lessee; and
- plant leased to tax exempt (including public authority) bodies.

Effectively therefore, this ruling applies to leveraged lease transactions other than those to be covered by the projected legislation.

3. A leveraged lease transaction as it has become known to this office, is one in which a partnership of companies or other taxpayers acquires plant which it leases for a term of years to a lessee and where, by reason of the "leverage" obtained from the borrowing of a substantial non-recourse loan (or a similar arrangement), the members of the partnership are not effectively at risk for any more than a relatively small part of the funds used to acquire the plant. The lenders' security for the substantial amounts lent to acquire the plant is limited to the subject plant or to the rentals payable by the lessee.

4. There are significant tax deferral benefits available to lessor partners in a leveraged lease transaction. The income tax deductions available to the partnership in the early years of the lease by way of depreciation, investment allowance, interest on borrowed moneys etc., are greater than the amount of rentals received. Each partner's share of the resultant

partnership income tax losses is available for deduction against income that the partner derives outside the partnership. In later years of the lease the partnership tax results turn from loss to profit and the partners bear tax on their profit share. Over the entire period of the lease aggregate partnership profits will generally equal and sometimes exceed, aggregate losses. In some cases the effect of the investment allowance deduction produces a situation where aggregate losses exceed aggregate profits.

5. The principles expressed in this Ruling have been framed in the light of Taxation Office consideration of a number of actual and projected leveraged lease transactions. That experience has revealed instances where participants have sought by adaptation of more standard features of leveraged lease transactions to maximize the tax deferral advantages. Such endeavours led to consideration of the extent to which, under the general income tax law, the leveraged lease partnership (and hence the partners) was or might have been failing to include as assessable income all that the law requires or was or might have been seeking allowable deductions greater than the law allows.

6. Beyond that, and in a situation where tax deferral benefits to a leveraged lessor in any event will represent a substantial part of the lessor's effective return on its own (non-leveraged) investment, there may be a question whether Part IVA of the Income Tax Assessment Act would apply i.e., whether it would be concluded that a lessor's participation had attaching to it a sole or dominant purpose of obtaining a tax benefit.

7. Against this background it would be expected that future leveraged lease transactions should observe the requirements set out hereunder.

RULING Lease Agreement

8. An agreement may be accepted for income tax purposes as a lease, as distinct from a purchase agreement, only if the lessee does not, either during the term of the lease or at its end, have an obligation, right or option to purchase the plant. It would correspondingly be unacceptable if the obligation, right or option were to be given to an associate of the lessee or the lessor had a right or option to require the lessee or an associate to purchase. Any right in the lessee to nominate a third party purchaser would be examined to ensure that it did not amount to an arrangement for purchase.

9. An agreement for the lessee to have obligations, rights or options to lease the plant for extended further periods, and the terms of any such extension, would also be examined to determine whether the entire arrangement really amounts to a purchase of the plant.

Debt Equity Ratio

10. It is expected that lessors themselves contribute, so

as to be fully at risk for, at least 20 per cent of the cost of the plant. The contribution may be made pro-rata with debt where plant is being installed and paid for over time.

Sharing of profits and losses

11. Partnership profits and losses are to be shared year by year in the same proportions as partners' capital contributions.

Partnership accounting period

12. Where partners in a leveraged lease partnership have common accounting periods the return of income for the partnership should be furnished for the same accounting period.

13. In some leveraged lease transactions the partners do not share common accounting periods. A partnership accounting period which differs from the accounting period of one or more of the partners presents a number of problems in the application of the income tax law. As a general proposition, in this situtaiton a partnership accounting period which corresponds to that of the majority partner will be approved. It will be a condition of approval, however, that the partners whose accounting periods do not coincide with that of the partnership must include in the returns of income for their accounting periods the appropriate share of the net income or loss of the partnership attributable to their accounting periods.

Cost of plant

14. Income tax deductions for depreciation on leased plant and investment allowance will be based on a cost figure that does not include any capitalised interest charges. Nor, where the cost is funded from overseas borrowings, would the cost include the capitalised cost of any hedging contracts entered into by the partnership to avoid foreign exchange gains or losses.

Rental Structure

15. In a number of leveraged lease transactions examined in this office rent has not been payable for periods ranging from 6 months and longer after the commencement of the lease agreement. In other cases the rental in the early stages of the lease has been considerably lower than in later periods. The structuring of rentals in either of these ways in unacceptable. As a general rule it would be expected that, once plant has been installed or commissioned ready for use, full rental would be payable. In practice this means that the total rental payable under the lease would be payable in equal amounts over the term of the lease - pro-rata in the first year where that year is less than a full year of income. There may be leases where, for one reason or another, annual rentals in early years exceed those in later years. Rentals structured in this way would normally be acceptable.

16. Exception would not be taken to an appropriately

reduced rental for an initial period during which the subject plant is being progressively installed. Nor would exception be taken to variations in lease rentals to reflect market fluctuations in the interest payable by the partnership on borrowings to acquire the plant or to reflect exchange gains or losses arising from the repayment by the partnership of foreign borrowings and the payment of interest thereon.

17. Where rentals are payable in arrears it will be expected that the partnership will return as assessable income for a year the amount of rent that has been earned during the year, i.e., the assessable income for a year will include rentals accrued at the end of the year.

Residual Value

18. It is standard practice for the amount of rent to be calculated, insofar as it is designed to cover the cost of the plant, on the basis of the difference between the plant's cost and its assessed residual value at the end of the lease. Accordingly, the larger the residual value, the smaller would be the lease rentals. The residual value should represent a fair estimate of the market value of the plant at expiration of the lease.

Advances by Lessee

19. Once a residual value has been determined and rentals structured accordingly, it would be expected that the residual value would only be payable at the expiration of the term of the lease and not in the form of prior advances or loans.

20. A leveraged lease should not involve any arrangement for the lodging by the lessee with the lessors of security deposits or for the lessee to make any kind of advance to the lessors. This requirement would extend to any indirect arrangements having much the same practical effect as an advance by the lessee to the lessor.

21. No objection would be taken, however, where the lessee enters into back-to-back loan arrangements with the lessor on identical terms and conditions that apply to an existing loan between the lessee and a third party lender where that loan had been raised originally by the lessee to purchase the plant.

Premature termination of lease

22. If the lessee has a right to terminate the lease on payment of an amount to the lessors - for example, once the tax-loss phase of the partnership's life has passed - the amount so paid would be treated as assessable income of the partnership. Similarly amounts received by partners for an assignment of partnership interests would also constitute assessable income of the recipients.

Interest

23. Interest on moneys borrowed to produce assessable income is incurred, and thus allowable as an income tax deduction, when it becomes due and payable. However, transactions under which more than what would normally be a year's interest is sought to be deducted in one year - or more than an appropriate portion where the first income year is not a complete year - will not be acceptable. Transactions which will not be acceptable will include those where the whole of the interest applicable to a loan is payable by instalments before any principal repayments are to be made, where the residual value is such that it effectively postpones repayment of principal or a substantial part of it, until the expiration of the lease, and where interest is capitalised back into a loan in any year because, inter alia, rental is insufficient to meet commitments under the loan.

General matters

24. There are other aspects of leveraged lease arrangements which do not lend themselves to a specific guideline but which, if encountered in practice, may tend to a conclusion that the arrangement has a dominant purpose of obtaining a tax benefit.

25. In this category is a situation where the partners are persons (particularly individuals) whose normal business activities do not include the lending of money or the leasing of property.

Requests for Official Expressions of Opinion

26. The time for official consideration of the extent to which a particular leveraged lease transaction measures up in terms of the general income tax law and Part IVA is, of course, when it becomes necessary to make an assessment of the taxable income and of the tax payable by the persons concerned. It is only then that the income tax law can be applied to the actual facts. To this extent an opinion on the likely income tax consequences of a projected transaction cannot be binding.

27. Requests for official expressions of opinion about proposed leveraged lease transactions should be addressed in the first instance to the office of the Deputy Commissioner of Taxation at which the lessor partnership would be required to lodge its returns of income. Such requests will be given consideration once there has been supplied to the relevant office all the information indicated in the attachment to these guidelines.

28. Where a leveraged lease transaction has been structured strictly according to this Ruling and does not have other unusual features it will not be necessary to seek an expression of opinion from this office prior to the execution of the relevant documents. Subject to the reservation expressed in paragraph 26 above and to a copy of the executed documents being forwarded with the first return of the partnership, it may be expected that the leveraged lease transaction will be acceptable to the office.

COMMISSIONER OF TAXATION
29 July 1983

APPENDIX

ATTACHMENT

INCOME TAX : LEVERAGED LEASE TRANSACTIONS

Information to be provided with request for official expressions of opinion on proposed leveraged leases.

1. LESSEE

(a) Full name.

(b) Place of incorporation and residence.

(c) Taxation Office at which lessee lodges returns of income and lessee's file number.

(d) Place of operations at which the lessee proposes to use the equipment to be leased.

(e) If the arrangements are to be a sale and lease back advise the date on which the equipment was first used or is proposed to be first used by the lessee and/or by any associate of the lessee.

2. EQUIPMENT TO BE LEASED

(a) Advise the sequence of events, including dates, relating to the ordering, delivery and construction, if any, of the equipment.

(b) Provide a schedule of the equipment showing each item, its cost, its depreciation rates and the amount of its cost qualifying as eligible investment allowance expenditure.

(c) A break-up of costs will be necessary where costs exceed amounts payable to suppliers and construction contractors.

(d) The proposed residual value and whether it has been determined in accordance with the Ruling.

3. LESSOR PARTNERSHIP

(a) Full name of the partnership.

(b) Full names of the partners, their balance dates and the amount of equity to be contributed by each.

(c) Advise nature of each partner's normal business operations.

(d) File number of each partner and the office at which

the partner lodges returns of income.

(e) The amount of debt, equity and the debt equity ratio.

(f) A statement of annual partnership losses and profits over the term of the lease, including details of rental, depreciation, interest, investment allowance and other deductions.

(g) A statement setting out details of all cash flows, under dates, forming part of or associated with the leasing arrangements, supported by explanations of any cash flows that do not enter into the calculation of partnership losses or profits or partners' taxable incomes.

4. BORROWINGS

(a) A schedule of borrowings including dates and the amount of each draw down.

(b) A schedule of proposed repayments of principal and payments of interest, including dates.

(c) Rates of interest.

(d) Where a lessee to lessor loan is involved (paragraph 12 of the ruling) details as in (a), (b) and (c) above should be provided in respect of the reciprocal loan between the lessee and lender.

(e) Where overseas borrowings are involved detail arrangements for hedging or off-setting possible exchange gains or losses.

5. DOCUMENTS

(a) A set of all the documentation involved, duly completed, should be provided.

(b) Advise expected date of execution.

(c) The period of the lease.

(d) Draw attention to any provisions in the documents that may have a bearing on income tax considerations, e.g. options or rights in the lessee or an associate to purchase.

(e) If any matter is not in accordance with the Ruling a full statement of the reasons why the matter should be accepted.