TR 98/21 - Income tax: withholding tax implications of cross border leasing arrangements

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Taxation Ruling
Income tax: withholding tax implications of cross border leasing arrangements

other Rulings on this topic

IT 28; IT 2051; IT 2236; IT 2519; IT 2594; IT 2660; TD 93/187; TD 94/20; TR 95/30

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Preamble

*The number, subject heading, and the **Class of person/arrangement**, **Ruling** and **Date of effect** parts of this document are a 'public ruling' in terms of Part IVAAA of the **Taxation Administration Act 1953** and are legally binding on the Commissioner. Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.*

*[**Note:** This is a consolidated version of this document. Refer to the Tax Office Legal Database (http://law.ato.gov.au) to check its currency and to view the details of all changes.]*

What this Ruling is about

Class of person/arrangement

1. This Ruling explains the withholding tax issues that arise in cross border equipment leasing arrangements in respect of payments made by an Australian resident lessee to a non-resident lessor. In particular, the Ruling explains:

(1) the relationship between section 128AC and subsection 128B(5A) of the *Income Tax Assessment Act 1936* (the Act) and their effect on payments made under cross border leases; and

(2) other issues that are ancillary to the application of the withholding tax provisions such as:

(a) the meaning of the term 'equipment' in paragraph (b) of the subsection 6(1) definition of 'royalty'; and

(b) the meaning of the terms 'hire-purchase agreement', 'all, or substantially all of the effective life of the equipment', and 'effective life' in the section 128AC definition of 'relevant agreement'.

2. Two main types of leasing agreements are the subject of this Ruling. In the first, existing equipment which is already in use in Australia is the subject of a series of sale and/or leasing agreements. In the second, new equipment is acquired for use by an Australian resident taxpayer and then made subject to a series of sale and/or leasing agreements. In each case, the economic effect of the transaction is that the original owner who is using or acquiring the equipment ends up with the business risks associated with its use and is in a position to control its ultimate disposition. It also receives a cash payment for its participation in the arrangements. The cash payment represents a share of tax benefits obtained through the sale/leasing arrangements under the law of a foreign country or countries.

3. This Ruling considers the application of the withholding tax provisions to arrangements which are in effect the purchase or repurchase of equipment by an Australian resident. These arrangements are entered into to provide financial benefits to Australian resident participants. The Ruling also considers the case where there is a financing element.

4. This Ruling does not deal with the question of ownership for the purposes of the capital allowance entitlements under the Act.

Cross references of provisions

5. This Ruling refers to the definition of 'royalty' in subsection 6(1) of the Act. Subsection 995-1(1) of the *Income Tax Assessment Act 1997* (the 1997 Act) adopts the same definition of the word 'royalty' as the Act does.

Date of effect

6. This Ruling applies to years commencing both before and after its date of issue. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Ruling

Relationship between section 128AC and subsection 128B(5A) for cross border equipment leasing arrangements

7. Where it is clear from the outset that the purchase or repurchase of the equipment is paramount, payments made under a cross border equipment leasing transaction are not subject to equipment royalty withholding tax under subsection 128B(5A) of the Act. The paramount purpose of a transaction is to be decided by having regard to all the surrounding circumstances and commercial consequences of the transaction (such as the passing of the incidents of ownership and economic risks to the lessee and other matters). Where an instalment payment under a hire-purchase agreement in respect of the type of arrangements covered by this Ruling contains an implicit interest component, that interest component is subject to interest withholding tax in accordance with section 128AC.

8. Conversely, where the main object of the transaction in the context of cross border leases is hire, even where the hirer has an option to purchase the equipment, royalty withholding tax under subsection 128B(5A) applies.

9. Applying the principle outlined in **paragraph 7** above, payments under terms purchase (instalment sales) of equipment, which in legal terms are conditional sales of the equipment, are also not subject to royalty withholding tax under subsection 128B(5A). Any implied interest component of the instalment payments made under the agreement is subject to interest withholding tax in accordance with section 128AC.

10. Similarly, payments under leases for the life of the equipment (i.e., leases which are for all, or substantially all, of the effective life of the equipment), where the incidents of ownership and economic risks are passed to the lessee and the value of the remaining interest in the equipment at the end of the term of the lease is negligible or worthless, are also not subject to royalty withholding tax under subsection 128B(5A). Where royalty withholding tax is not applicable, the implicit interest component, if any, of the rental payments is subject to interest withholding tax in accordance with section 128AC. In other cases, the rental payments are subject to equipment royalty withholding tax.

Application of Part IVA of the Act

11. The ATO will consider the application of Part IVA if:

(1) what could reasonably be expected to have been a royalty is altered by a scheme into a purchase type payment; or

(2) a lease transaction which could reasonably be expected to have involved a financing element is structured in such a way as to avoid section 128AC.

Part IVA would not apply to the Examples set out in this Ruling.

Explanations

12. Cross border leasing arrangements are typically very complex. They usually consist of a number of agreements which are interconnected and interdependent (in the sense that one would not occur without the other). Some of the agreements may specify that the law governing their interpretation is the law of a foreign country. The rights and obligations of the parties will be determined according to whatever law is applicable under conflict of laws principles, but the Australian tax consequences of the existence of those rights and obligations must be determined according to Australian law.

13. A full analysis of the legal ramifications of the overall arrangement may involve complex questions of interpretation of the agreements including issues of conflict of laws. It is also recognised that cross border leasing techniques constantly change. For these reasons, it is not possible to be definitive in this Ruling about the Australian legal and tax consequences of all variants of cross border leases. What the Ruling does provide is an interpretation of the interest and royalty withholding tax provisions as they operate in relation to cross border leases.

14. At the end of the Ruling are two Examples which are discussed below. It is not intended that the principles in this Ruling be limited to these particular Examples.

Application of royalty tax provisions to cross border leasing arrangements

15. The *Taxation Laws Amendment Act (No 5) 1992* introduced a final withholding tax of 30% (subject to any reduction agreed on a reciprocal basis in a tax treaty) on royalties paid to non-residents under subsection 128B(5A) in place of the existing assessment basis of taxation.

16. Prior to 1992, royalties within the definition of 'royalty' were taxed by assessment and not by way of final withholding tax, although from 1986 there were specific provisions in Part VI of Division 3B of the Act by which the payer of royalties was obliged to deduct from the royalties amounts sufficient to cover the tax that would ultimately be assessed. The 1968 legislation referred to in **paragraph 21** below not

only introduced a definition of 'royalty' but also a source rule in section 6C of the Act so that, in general terms, a royalty paid by a resident to a non-resident was deemed to be sourced in Australia and hence assessable to the non-resident recipient under subsection 25(1) of the Act.

17. The 1992 amendments continued to treat machinery and equipment rentals as royalties. However, an equipment leasing royalty (i.e., a royalty covered by paragraph (b) of the definition of 'royalty' or 'royalties' in subsection 6(1) of the Act) paid under pre-18 August 1992 contracts continued to be assessed under the old regime by virtue of the transitional provisions of subsection 82(1) of the 1992 Amendment Act.

18. Subsection 128B(5A) imposes a liability to pay withholding tax on a non-resident person deriving income that consists of a royalty. The subsection applies by virtue of subsection 128B(2B) to income that is derived by a non-resident during the 1993-1994 year of income or a later year of income and that consists of a royalty that:

(1) is paid to the non-resident by a resident of Australia and is not an outgoing wholly incurred by the Australian resident in carrying on business in a foreign country through a permanent establishment ; or

(2) is paid to the non-resident by another non-resident and is an outgoing in carrying on business in Australia through a permanent establishment of the second named non-resident.

19. The word 'royalty' is defined in subsection 6(1) to include, so far as is relevant to this Ruling:

> '... any amount paid or credited, however described or computed, and whether the payment or credit is periodical or not, to the extent to which it is paid or credited, as the case may be, as consideration for:
>
> (a) ...
>
> (b) the use of, or the right to use, any industrial, commercial or scientific equipment;'.

A payment which is a royalty subject to tax under subsection 128B(5A) is exempt income by virtue of section 128D.

20. Therefore, the application of the royalty withholding tax provisions in the context of cross border leases that are the subject matter of this Ruling depends on the payment being for 'the use of, or the right to use' equipment that is 'industrial, commercial or scientific equipment'.

21. Although the current withholding tax regime for royalties is of recent origin, the definition of royalty traces back to amendments

made to the Act in 1968 by the *Income Tax Assessment Act 1968*. These amendments incorporated by reference the definition of 'royalty' in the Australia – United Kingdom tax treaty signed on 7 December 1967 (the former UK tax treaty). The definition in that treaty referred to 'payments of any kind to the extent to which they are paid as consideration for the use of, or the right to use, any ... industrial, commercial or scientific equipment ...'. The explanatory memorandum (EM) to the Bill introducing these changes stated at pages 60-61 that the purpose was to adopt the meaning of royalties as understood in the new tax treaty with the United Kingdom (which in turn used the concept that had developed in international tax treaty law) which was considerably broader than the understanding of the undefined term royalty in Australian law (for example, the case of know-how).

22. The Victorian Supreme Court held in *Sherritt Gordon Mines Limited v. FC of T* 76 ATC 4130, (1976) 6 ATR 344 (subsequently affirmed in the High Court of Australia (1977) 137 CLR 612; 77 ATC 4365; (1977) 7 ATR 726) that the technique of incorporation by reference was not apt to extend the definition to payments by an Australian resident to a Canadian resident (as the former UK tax treaty only applied to payments by Australian residents to UK residents). The *Income Tax Laws Amendment (Royalties) Act 1976* amended the definition by expressly including the words quoted from the former UK tax treaty with the variations that 'payments of any kind' was expanded to 'any payment, whether periodical or not, and however described or computed' and that lettered subparagraphs were introduced dividing up the different categories of payments covered. The EM explained at page 3 that the purpose of the Bill was 'to re-express the law so as to make it clear in relation to payments to residents of all overseas countries that the law requiring payment of tax on royalties is to operate in the way intended when the 1968 amendments were made'. Specifically in relation to the definition, it was said at page 3, '[t]he re-expressed provision will not change the meaning of the term in practice ...'. Hence, it is clear that the same result was intended to be produced as in the tax treaty definition.

23. Following the decision in *Aktiebolaget Volvo v. FC of T* (1978) 78 ATC 4316, (1978) 8 ATR 747, in which it was held that the new definition did not apply to amounts credited as opposed to paid, the introductory words of the definition were adjusted to their current form quoted in **paragraph 19** above. Again, this change was not intended to produce any variation in the types of amounts covered by paragraph (b) of the subsection 6(1) definition of 'royalty' – it is described as 'technical' in the EM at page 5. Additional paragraphs covering different types of amounts have been added by the legislation following that case and subsequently, but without any suggestion that they impinge upon the meaning intended by the paragraph relating to equipment leasing.

24. It is, therefore, concluded that the provision in the definition of 'royalty' covering equipment leasing is intended to have the same meaning as the equivalent part of the definition in the former UK tax treaty which has been adopted in some of Australia's subsequent comprehensive tax treaties.

25. Paragraph 9 of the Commentary on Article 12 of the *1977 Model Double Taxation Convention on Income and on Capital* (OECD Model) concerning the taxation of equipment leasing under the royalties definition in the OECD Model states:

> 'A clear distinction must be made between royalties paid for the use of equipment, which fall under Article 12, and payments constituting consideration for the sale of equipment, which may, depending on the case, fall under Articles 7,13,14 or 21. Some contracts combine the hire element and the sale element, so that it sometimes proves difficult to determine their true legal import. In the case of credit sale agreements and hire purchase agreements, it seems clear that the sale element is the paramount use, because the parties have from the outset agreed that the ownership of the property in question shall be transferred from one to the other, although they have made this dependent upon the payment of the last instalment. Consequently, the instalments paid by the purchaser/hirer do not, in principle, constitute royalties. In the case, however, of lend-lease, and of leasing in particular, the sole, or at least the principal, purpose of the contract is normally that of hire, even if the hirer has the right thereunder to opt during its term to purchase the equipment in question outright. Article 12 therefore applies in the normal case to the rentals paid by the hirer, including all rentals paid by him up to the date he exercises any right to purchase.'

26. The case referred to in the last sentence would cover a situation where there was a lease and an option to purchase under which the purchase price was not related to an implicit financing of the purchase of the equipment. Thus (in the absence of other indications), the purchase at the market price of the equipment at the time of exercise of the option without application of part of the previous rental payments towards the purchase price suggests that payment of the purchase price does not have a financing element. It also suggests that the rentals under the lease were for the use of the equipment and thus within the royalty definition. This example is not intended to express a view about other situations. The critical element in the passage in distinguishing lease from purchase is that 'the parties have from the outset agreed that ownership of the property in question shall be transferred from one to the other'.

27. This paragraph does not appear in the current OECD Commentary because the reference to equipment leasing was dropped from the OECD Model Convention definition of 'royalty' in 1992. Equipment leasing continues, however, to be covered in many of Australia's tax treaties in accordance with the 1977 version of the OECD Model as Australia's reservation in paragraph 39 of the current OECD Commentary on Article 12 indicates.

28. Australian courts have indicated on a number of occasions that the OECD Commentary is relevant to the interpretation of Australia's tax treaties (*Thiel v. FC of T* (1990) 171 CLR 338; *Lamesa Holdings BV v. FC of T* 97 ATC 4229; (1997) 35 ATR 239, at first instance, confirmed on appeal 97 ATC 4752; (1997) 36 ATR 589 but without reference to this point). The ATO considers that the OECD Commentary on the Royalty Article of the 1977 Model Convention is also relevant to the royalty provisions in the domestic law to the extent to which they have clearly been derived from tax treaties as evidenced by the legislative intention and policy contained in the relevant EMs. The ATO, therefore, adopts the distinction drawn in paragraph 9 of the Commentary quoted above as applicable to the interpretation of the definition of 'royalty' in subsection 6(1) of the Act quoted in **paragraph 19** above as it relates to equipment leasing. While consideration needs to be given in cases of incorporation of definitions and words from other contexts to their operation in the particular statute in question, the legislative history set out above confirms that the legislature intended to use the equipment leasing reference in the subsection 6(1) definition in the tax treaty sense.

29. It is to be noted that the distinction between lease and sale drawn in paragraph 9 of the 1977 OECD Commentary on Article 12 relates specifically to equipment leasing. In the case of payments for the use of intangible property dealt with in the definition of royalty (patents, copyright, trade marks, know how, etc.), the distinction between use and sale is more difficult to draw and a broad meaning is given to use in Australia to cover all forms of exploitation (Taxation Ruling IT 2660 at paragraph 16; compare current OECD Commentary on Article 12 at paragraphs 12-14).

Transactions where paramount purpose is one of purchase

30. Factors considered relevant to the question of whether the paramount purpose of the transaction is one of purchase are listed below. In considering these factors, which are not exhaustive, the transaction must be looked at in its entirety including its legal nature, and the surrounding circumstances and commercial consequences. The factors listed are not of equal weight and it is not necessary that any particular number of them must be present in any particular case. As well as relating to the risks of ownership, the factors are relevant to the question whether actual ownership can ultimately pass to the lessee or there is a lease for life, which is an essential part of determining if the paramount purpose of the transaction is one of purchase or not.

31. The factors are:

(1) Whether the lessee has a call option or equivalent over the equipment.

(2) Whether the lessor has a put option or equivalent over the equipment.

(3) When any purchase option is exercisable and whether the exercise is effectively irrevocable.

(4) Whether the equipment is specially adapted to the special requirements of the lessee.

(5) Whether the equipment is likely to have any value to another person on the expiration of the lease if the lease is not for the life of the equipment.

(6) Whether the lease term is for the life of equipment so that the equipment is likely to have no or an insignificant market value at the end of the lease.

(7) Which party bears the financial risks associated with the funding of the equipment.

(8) Whether there are security arrangements in relation to payments under the lease and what is their nature.

(9) How the residual value (if any) is calculated.

(10) Whether an up front payment or payments satisfies the payment obligations of the lessee and whether such payment is effectively irrevocable.

32. By way of some examples of how these factors are relevant, the mere existence of a put option will usually not be sufficient on its own to indicate a paramount purpose of purchase. Conversely, a put option which is deep in the money at the outset of the transaction points, in the absence of countervailing factors, to a purchase. Similarly, an in the money call option is likely to be indicative of purchase. The lodging of security deposits with the lessor or the making of an advance to the lessor by the lessee may indicate that financial risks are with the lessee and be indicative of purchase. Residual value may indicate which party bears the risk of loss or opportunity for gain on the disposal of the equipment at the end of the lease term. A residual value which is likely to be well below market value at the end of the lease may point to purchase while a residual value based on the market value of the equipment at the end of the lease suggests that risk remains with the lessor.

Industrial, commercial or scientific equipment

33. The word 'equipment' is not defined in the Act nor in the treaty context from which it is drawn. Paragraph 18 of IT 2660 states that in the context of the definition of 'royalty' in paragraph (b), the term 'equipment' does not have a narrow meaning and includes such things as machinery and apparatus.

34. It has been put to the ATO in the case of cross border leases covered in this Ruling that the term 'equipment' as a matter of ordinary language imports something ancillary to or part of a greater whole. This view was rejected by the House of Lords in *Coltman and Anor v. Bibby Tankers Ltd* [1988] AC 276; [1987] 3 All ER 1068. *Coltman* was discussed by O'Bryan and Ashley JJ in May*ne Nickless Ltd v. FC of T* 91 ATC 4621; (1991) 22 ATR 198. There seems to be tacit approval by both O'Bryan and Ashley JJ by their reference to *Coltman* that an entirety can be equipment. Common to both cases is the fact that the meaning of the term 'equipment' was determined according to the context in which the word appeared.

35. The context of the definition of 'royalty' includes a requirement that the equipment be 'industrial, commercial or scientific'. These descriptors do not connote that equipment must be ancillary and cannot be an entirety. In *Coltman*, the vessel was seen as being

'business equipment', and the armoured vehicles in May*ne Nickless* were seen as being 'industrial'.

36. The term 'equipment' is also used in the permanent establishment definition in most of Australia's tax treaties. The context in this case likewise indicates that equipment can be an entirety, e.g., Article 5(4)(b) of the tax treaty with Spain which refers to 'a structure, installation, drilling rig, ship or other like substantial equipment'. In *Case H106* (1957) 8 TBRD 484, the term 'equipment' in the phrase 'substantial equipment' was given a broad meaning.

37. It has also been put to the ATO that if the types of property in question in particular cross border leases are equipment, they are not aptly described as 'industrial, commercial or scientific'. *The Macquarie Dictionary* (third edition) defines the terms 'industrial', 'commercial' and 'scientific' as follows:

> '**industrial** ... of or relating to, of the nature of, or resulting from industry or productive labour ... engaged in an industry or industries ... designed for use in industry';
>
> **commercial** ... of, or of the nature of, commerce ... engaged in commerce ... preoccupied with profits or immediate gains ... (of a vehicle) used primarily for carrying goods for trade, or paying passengers';
>
> **scientific** ... of or relating to science or the sciences ... occupied or concerned with science'.

The dictionary definitions of the corresponding nouns, namely, industry, commerce and science are equally of wide import.

38. The two OECD Reports in relation to equipment leasing, 'The Taxation of Income Derived from the Leasing of Industrial, Commercial or Scientific Equipment' and 'The Taxation of Income Derived from the Leasing of Containers' (in *Trends in International Taxation*, 1985) indicate a broad meaning of the phrase used in the then OECD Model Convention royalty definition (see paragraphs 10, 12 and 21 of the former, and paragraphs 13 and 40 of the latter). See also *London Displays Company NV v. Commissioner of Internal Revenue* 46 TC 511 where payments by Madame Tussauds's Wax Museums Inc for the display of wax figures and settings owned by the taxpayer company were held to be royalties for the use of industrial, commercial or scientific equipment.

Application of interest withholding tax under section 128AC to cross border leasing arrangements

39. Interest withholding tax in its current form was introduced in 1968. Interest was originally defined to include 'an amount in the nature of interest' in subsection 128A(1) of the Act. Since then, the concept of interest has been considerably widened through various deeming provisions to cover the increasing variety of transactions used for financing beyond the traditional loan at interest. One such provision is section 128AC.

40. Section 128AC was introduced by the *Taxation Laws Amendment Act (No 2) 1986*. The EM to that Act states that the section was to strengthen the application of the interest withholding tax provisions in relation to financing by way of hire-purchase and similar arrangements (at page 1). The mischief to be remedied was the loss of revenue by the use of non-traditional methods of finance where a resident enters into a hire-purchase agreement or finance lease arrangement with a non-resident (at page 9). These arrangements were becoming more common as alternative means of financing the purchase of plant or equipment from overseas. The EM recognises the dual purpose served by the agreements in question, namely, purchase and financing the purchase. Consistent with this objective, the section deemed that part of the hire payments that were equivalent to interest in the financing arrangement to be interest for withholding tax purposes.

41. Thus in the case of a typical hire-purchase transaction, the terms charges (the amount by which the total of the instalments exceeds the market value of the equipment) are taxed as interest under section 128AC (see the definition of 'total interest' in subsection (1)). The interest element is distributed among the instalment payments under the 'rule of 78'. Under this method, the number of payments is summed and treated as the denominator; the numerator being the payment number in descending order. Thus, if there are 12 payments to be made under the hire-purchase agreement, the interest element in the first payment is 12/78 of the total interest, in the second payment 11/78, etc., (12 + 11 + 10 + 9 + 8 + 7 + 6 + 5 + 4 + 3 + 2 + 1 = 78). The rule is stated slightly differently but to the same effect in the subsection 128AC(1) definition of 'formula interest'. Although only part of each payment is thus subject to the interest withholding tax, subsection 128AC(7) provides that the tax is taken to be paid on the whole of it for the purpose of section 128D with the result that the whole payment is then exempt income (this is the mechanism by which the tax is made final with respect to the whole payment).

42. The financing arrangements covered by section 128AC are those that fall under the definition of 'relevant agreement'. The term is defined in subsection 128AC(1) as meaning:

'... an agreement entered into after 16 December 1984, being:

(a) a hire-purchase agreement; or

(b) a lease or any other agreement relating to the use by a person of property owned by another person, being a lease or agreement under which:

(i) the lessee or person using the property is entitled to purchase or require the transfer of the lease property or property subject to the agreement on the termination or expiration of the lease or agreement; or

(ii) the lease term or term of the agreement is for all, or substantially all, of the effective life of the lease property or property subject to the agreement;'

Relationship of interest withholding tax under section 128AC and royalty withholding tax under subsection 128B(5A) in cross border leasing arrangements

43. The history of the royalty withholding tax provisions suggests that Australian law adopted the distinction drawn in the OECD interpretation of the definition of 'royalty' in relation to equipment leasing quoted in **paragraph 25** above. Thus, the position when section 128AC was introduced was that in the case of hire-purchase where the paramount purpose is manifestly the purchase of the equipment, by the hirer exercising the purchase option, the instalment payments were regarded as falling outside the definition of 'royalty' and were thus not subject to tax by assessment as royalties. However, the instalment payments were subject to tax by assessment under normal principles provided such payments were sourced in Australia.

44. In the case of a lease with an option to purchase where the hirer did not intend from the outset to exercise the option, the instalment payments constituted royalties and were subject to tax by assessment, or a final withholding tax pursuant to the changes made by the 1992 Amendment Act.

45. The history of section 128AC and of the royalty withholding tax provisions indicate that section 128AC was designed to levy interest withholding tax on the interest component of non-traditional forms of financing for the purchase of equipment, such as hire-purchase and similar agreements where the transaction was one of financing and the element of purchase of the equipment was paramount. On the other hand, the royalty withholding tax provisions in subsection 128B(5A) would apply to cases where the element of lease and not purchase of equipment was paramount (as in the example in **paragraph 26** above).

46. Determining whether the agreement is one of financing, one of purchase (except in the case of a lease for life), or one of hire is crucial to the application of either section 128AC or subsection 128B(5A). In this context, the relationship between the two provisions is best explained by considering a number of scenarios that can arise reflecting the financing and purchase requirements.

A. Lease with option to purchase where the purchase of the equipment is financed by the lessor and the paramount purpose of the transaction is the purchase of the equipment by the lessee

47. In this case, the lessee ordinarily has the right to use the equipment together with possession or the right to possession as well as the right to purchase the equipment at or before the end of the term of the lease. Hire-purchase agreements are an example of the class of agreements that may fall under this category. Payments made under leases falling within this category are subject to interest withholding tax on the interest component under section 128AC and not subject to the royalty withholding tax under subsection 128B(5A).

B. Lease with option to purchase where there is no financing element and the paramount purpose of the transaction is the purchase of the equipment by the lessee

48. The legal rights as regards use, possession and the right to purchase in the main are the same as those in category (a) above. However, the purchase of the equipment in this case is not being financed by deferred instalment payments but rather is effected by a prepayment. The principle contained in paragraph 9 of the OECD Commentary would take the prepayment outside the royalty withholding tax provisions. Further, as there is no financing element in the arrangement, the prepayment would not give rise to an interest withholding tax liability under section 128AC.

C. Lease with option to purchase where the paramount purpose of the transaction is hire and not purchase of the equipment by the lessee

49. In this context, up until the option is exercised the paramount purpose of the payments under the lease, having regard to paragraph 9 of the OECD Commentary, would be for the hire of the equipment and thus subject to royalty withholding tax under subsection 128B(5A). The lack of an intention to purchase would in practical terms mean that in this case there is not an element of financed purchase in the lease, and accordingly, there is no liability for interest withholding tax under section 128AC.

D. Lease for effective life with a financing element

50. The very nature of a lease for life means that the purchase of the equipment in the legal sense is irrelevant. However, generally speaking, many of the incidents of ownership and the economic risks associated with the equipment are transferred to the lessee under these leases. Further, because such leases are for all or nearly all of the life of the equipment, the residual value left in the equipment at the end of the lease may either be negligible or worthless.

51. While paragraph 9 of the OECD Commentary does not specifically deal with leases for life, these leases having regard to their characteristics as mentioned above are in substance equivalent to a purchase, and therefore, are regarded as falling outside the royalty withholding tax provisions in accordance with the distinction drawn in the OECD Commentary.

52. This analysis is consistent with leases for life being specifically covered in section 128AC(1) subparagraph (b)(ii) of the definition of 'relevant agreement' in subsection 128AC(1). Where there is a financing element associated with the in-substance purchase of the equipment, payments under these leases will be subject to interest withholding tax on the interest component in accordance with the provisions of section 128AC.

E. Lease for effective life with no financing element

53. A lease for life would generally include a financing element (**paragraph 50 to 52** above). However, where a lease for life involved a prepayment which does not include a financing element, the prepayment is not subject to interest withholding tax under section 128AC or to royalty withholding tax under subsection 128B(5A).

F. Terms purchase (instalment sales)

54. Terms purchases as contemplated by section 128AC and explained in the EM would normally involve a financing element. Terms purchase agreements constitute a conditional sale of the equipment in the sense that title to the equipment does not pass until payment of the final instalment and this ordinarily coincides with the term of the agreement. These agreements clearly fall within subparagraph (b)(i) of the definition of 'relevant agreement' in subsection 128AC(1) as being an agreement under which the person using the property can require the transfer of the property subject to the agreement on the termination or expiration of the agreement. The

financing element of the payments under these agreements would be subject to interest withholding tax under section 128AC.

55. As term purchases are conditional sales, they would be outside the scope of the royalty withholding tax under subsection 128B(5A) where the common intention of the parties at the outset was the purchase of the equipment. Further, if a terms purchase does not involve a financing element, then interest withholding tax under section 128AC will also not apply.

Alternative view

56. The distinctions made above in the context of the scenarios ***A*** to ***F*** produce a coherent and generally complementary operation of subsection 128B(5A) and section 128AC. The distinctions and conclusions reached in respect of each category reflect the history and object of the two sections and the discussion of the law as appears under the various headings in this Ruling.

57. However, it has been put to the ATO by way of an alternative view that section 128AC is a specific provision and that its terms provide an exclusive code for the taxation of cross border leasing arrangements of the type falling within the definition of 'relevant agreement'. The basis of that contention is the rule of statutory construction expressed in the maxim *Generalia specialibus non derogant*, namely, that provisions of general application give way to specific provisions when in conflict (see: *Goodwin v. Phillips* (1908) 7 CLR 1; *Saraswati v. R* 100 ALR 193; *Butler v. Attorney-General (Vic)* (1961) 106 CLR. 268). The maxim is also applicable to the resolution of internal conflicts between sections within the same Act.

58. The rule is a subsidiary rule of statutory construction which may often be usefully applied in considering the intention of the Legislature. But the existence of the maxim does not relieve a Court from the duty of determining the intention of the Legislature which is to be found by ascertaining the mischief to be remedied and from a consideration of the wording of an Act and extraneous circumstances (see *Lukey v. Edmunds* (1916) 21 CLR 336 and *Project Blue Sky Inc. v. Australian Broadcasting Authority* 153 ALR 490).

59. A consideration of the circumstances in which the maxim has been applied by the courts will not necessarily lead to the conclusion that on the facts of the Examples section 128AC prevails over subsection 128B(5A) on the basis that the former is special while the latter is general. In the first place, it has to be shown that the provisions operate inconsistently and, secondly, it is arguable that subsection 128B(5A) is itself a special provision. Each provision must be construed according to its own subject and its own terms (see: *Bank Officials' Association* (*South Australian Branch) v. Savings*

Bank Of South Australia (1923) 32 CLR 276; *Associated Minerals v. Wyong Shire Council* 4 ALR 353; *Fonteio v. Morando Bros. Pty Ltd* [1971] VR 658; *Lukey* and *Butler*).

60. Furthermore, inconsistency between sections are only likely to arise where the facts of a case meet all of the terms and conditions of the two sections. On the facts of the Examples, no inconsistency would arise because the effect of the prepayment does not permit the provisions of section 128AC to operate. It has also been suggested that if section 128AC is to operate to exclude the application of subsection 128B(5A), some amount, even a nominal amount of interest, is necessary so that section 128AC has some actual operation. It is considered that the inclusion of an amount of interest does not advance that alternative argument, as the conclusion from the historical context approach which we have adopted is that the two sections are not mutually exclusive but have an independent application. In our view, the historical context approach provides a better solution to the problem consistent with the legislative intention of the two sections.

Legal characterisation of cross border leasing arrangements

61. It follows from the reasoning above that it is necessary to characterise the cross border leasing arrangements in order to determine which, if any, of subsection 128B(5A) or section 128AC applies.

62. In characterising the cross border lease, the first question is whether the lease or purchase element is paramount. If the lease element is paramount, the royalty withholding tax provisions will apply. If the purchase element is paramount, royalty withholding tax provisions do not apply.

63. The next question then is whether the transaction has a financing element which attracts interest withholding tax under section 128C. If there is no financing element, then there is no interest withholding tax under that section.

64. The background to section 128AC, as set out in **paragraphs 39 to 42** above, suggests that the section should be interpreted broadly to catch all leasing transactions in which the purchase element is paramount and which have a financing element. This view supports the taking of a broad approach in interpreting the definition of 'relevant agreement' in section 128AC. In any event, if it is possible to avoid that section in a case where a financing element is present, Part IVA may still be applicable to prevent the avoidance of interest withholding tax (**paragraph 106** below).

65. From a legal perspective, the question of whether an agreement incorporating a lease amounts to a hire-purchase agreement with a financing element, a sale, a lease simpliciter or something else is a question of interpretation of the agreement in each case to be determined by looking not only at the documentation but also at other facts which are relevant in the applicable law in determining the rights created by the agreement. Examples of cases where courts applied these principles include:

(1) a 'lease' being classified as a hire-purchase agreement (*Thorn-L & M Appliances Pty Ltd v. Claudianos* [1970] Qd R 141);

(2) a 'hire-purchase agreement' being a contract of sale (*City Motors (1933) Pty Ltd v. Southern Aerial Super Service Pty Ltd* (1961) 106 CLR 477);

(3) a 'hire-purchase agreement' being a loan arrangement with the hire-purchase agreement serving as a security (Bill of Sale) for the loan (*Polsky v. S And A Services* [1951] 1 All ER 185);

(4) a sale followed by a hiring back with an option to purchase being a loan arrangement with the 'hire-purchase agreement' serving as a Bill of Sale (*Price v. Parsons* (1935-1936) 54 CLR 332) and *North Central Wagon Finance Co. Ltd v. Brailsford and Anor* [1962] 1 All ER 502);

(5) a 'lease' being a sale and purchase of the equipment (*McEntire v. Crossley Bros Ltd* [1895-9] All ER Rep 829);

(6) a re-financing transaction being a genuine sale and 'hire-purchase' back, and not a loan (*Stoneleigh Finance Ltd v. Phillips and Ors* [1965] 1 All ER 513 and *Kingsley v. Sterling Industrial Securities Ltd* [1966] 2 All ER 414).

66. In these cases, the transactions still had legal effect albeit different in nature from the name which the parties gave to them. It is also possible in the particular circumstances of a case for the courts to conclude that a transaction has no legal effect (*Bennett v. Griffin Finance* [1967] 1 All ER 515 and *Snook v. London & West Riding Investments Ltd* [1967] 1 All ER 518). It is assumed in the discussion below that the courts would not conclude that the cross border leases covered by this Ruling are of no legal effect, although this depends on the facts and circumstances of the particular case.

67. The tax implications that may arise in relation to arrangements whose true legal characterisation falls within the categories of sale, loan or something else not involving a lease or financing element are

outside the scope of this Ruling (except to note that if the agreement is interpreted as an outright sale with immediate payment, there is no possibility of a withholding tax liability arising under subsection 128B(5A) or section 128AC).

68. On the basis that the true legal characterisation of the agreement in question is as a lease, the next step on the view set out above is to decide whether the paramount purpose of the arrangement is one of purchase or one of lease.

69. Where the paramount purpose of the arrangement is the purchase of the equipment and there is no financing element, the result will also be that the payment by the end user is not a royalty nor is it in part equivalent to interest. Neither subsection 128B(5A) nor section 128AC produce any levy of withholding tax. The Examples provide instances of this. The benefits (e.g., fees, profits from the transaction) received by the Australian resident participant should, however, be included in its assessable income.

What constitutes a hire-purchase agreement in section 128AC

70. The term 'hire-purchase agreement' is not defined for the purposes of the definition of 'relevant agreement' in section 128AC. The definitions of the term in other sections of the Act do not apply a consistent meaning to the term and so are likely to be only of marginal use in the interpretation of section 128AC (e.g., subsection 51AD(1) and section 42A-115 of Schedule 2E). Although the 1997 Act contains a definition of 'hire-purchase agreement' in subsection 995-1(1), this definition is not applicable to section 128AC of the Act (see subsection 995-1(2) of the 1997 Act).

71. Outside the Act, we can distinguish a number of different sources for the meaning of hire-purchase:

(1) the traditional meaning emerging from the early cases in which it was necessary for judges to decide on the rights of the parties before legislative intervention occurred (e.g., *Helby v. Matthews and Anor* [1895] AC 471);

(2) the Hire Purchase Acts enacted by the UK and the Australian States and Territories which contain a broad definition necessary to give effect to their consumer protection purpose; and

(3) the general modern commercial use of the term.

72. In *Warman v. Southern Counties Car Finance Corporation Ld W J Ameris Car Sales (Third Party)* [1949] 2 KB 576, Finnemore J, described the incidents of a hire-purchase transaction as follows at 582:

> 'A hire-purchase agreement is in law, an agreement in two parts. It is an agreement to rent a particular chattel for a certain length of time. If during the period or at the end of the period the hirer does not wish to buy the chattel he is not bound to do so. On the other hand, the essential part of the agreement is that the hirer has the option of purchase, and it is common knowledge – and I suppose, common sense – that when people enter into a hire-purchase agreement they enter into it not so much for the purpose of hiring, but for the purpose of purchasing, by a certain method, by what is, in effect, deferred payments, and that is done by this special kind of agreement known as a hire-purchase agreement, the whole object of which is to acquire the option to purchase the chattel when certain payments have been made.'

The statement by His Honour recognises two basic ingredients of a hire-purchase agreement, namely, the paramount purpose of purchasing and the financing element of hire-purchase (purchasing by deferred payments).

73. The EM to the *Taxation Laws Amendment Act (No 2) 1986* states at page 37 that section 128AC will apply to 'charges paid by a resident under a hire-purchase or similar contract, such as a 'term purchase' or 'lease with option to purchase' agreement'. The EM treats a 'term purchase agreement' as a separate agreement to a hire-purchase agreement. This language may suggest that hire-purchase is to be understood in the sense of a bailment (lease) plus an option, and not to include a term purchase.

74. On the other hand, section 128AC has some affinity with the definition in the Hire Purchase Acts (which include a term purchase agreement within the definition of hire-purchase) in that it is seeking to reach financing structured in bailment (lease) form. While the second element of the definition of 'relevant agreement' can be explained as ensuring that variations on the traditional concept are caught, there is no reason why the words 'hire-purchase' should not themselves be given a broad meaning consistent with the legislative purpose of collecting interest withholding tax on the implicit interest element in lease transactions with a financing element. Further, the traditional concept, being only a shorthand used by judges, is subject to evolution over time like any judge made construction. In the ATO's view, the term as used in section 128AC should be given a broad meaning which is consonant with the modern usage of the term. The consequences of this view are spelt out under the following headings.

Existence of an owner at time of delivery

75. In *Karflex Limited v. Poole* [1933] 2 KB 251 and *Mercantile Union Guarantee Corporation Limited v. Wheatley* [1938] 1 KB 490

it was held that it was an implied condition of a hire-purchase agreement that the bailor was the owner of the goods at the time of delivery. This view was followed in *Warman* and more recently in *Barber v. NWS Bank plc* [1996] 1 All ER 906. Recent Australian authority has questioned this view as being too narrow in the modern commercial context; *Richards v. Alliance Acceptance Co Ltd* [1976] 2 NSWLR 96 per Mahoney JA, *Australian Guarantee Corporation Ltd and Anor v. Ross* (1983) 2 VR 319 per Young CJ.

76. It is obvious from the facts in the Examples that the relevant Cayman company as Sublessor is not an owner at the time of the constructive delivery of the equipment under the Sublease with the Owner. Therefore, on the *Karflex* line of authority, it could be argued that the Sublease cannot be characterised as being a hire-purchase agreement. The ATO considers that such a view would unduly restrict the operation of section 128AC in many financing situations, and, therefore, shares the doubts expressed in the recent Australian decisions that this limitation currently applies to the understanding of what is a hire-purchase agreement for the purposes of that section. In modern commerce, it is not uncommon to have a series of transactions dealing with the same equipment including subbailments (subleases). For the purposes of section 128AC, an interpretation of hire-purchase, where there is a transfer of risks and an intention at the outset to exercise the purchase option which would exclude the operation of the section where there is a subbailment, would unduly restrict its ambit.

Nature of option to purchase

77. As already noted, the understanding of hire-purchase has changed with the passage of time, and nowadays at least in a commercial sense the term usually refers to a case where it is the intention of the hirer to exercise the option (see the quotes from the 1977 OECD Model Convention Commentary and *Warman* above). For the purpose of the Examples, it is assumed as a fact that it is the intention of the parties to exercise the relevant options to secure the passage of title, and that the original owner has control over the ultimate disposition of the equipment. If this is not so, the paramount purpose of the transaction may be that of hire.

78. In *R v. RW Proffitt Ld* [1954] 2 QB 35, it was held that a hiring agreement with an option to purchase if certain legislation was passed was not within the Hire-Purchase Act definition. This case and others have been taken as authority for the following propositions:

(1) the option to purchase under a hire-purchase agreement must be unfettered, unqualified and absolute;

(2) the exercise of the option to purchase must be capable of passing title to the equipment by virtue of the agreement *under* which the option was granted;

(3) the agreement must confer on the hirer a present right to buy the equipment or a present right by virtue of which title in the goods might pass; and

(4) the accrual of such a right must not depend upon an event which might or might not happen. The time for judging whether title will pass under the agreement is the time when the agreement is entered into.

79. The decision was distinguished in *Kay's Leasing Corporation Pty Ltd v. Fletcher and Anor* (1964) 116 CLR 124, where the definition in the Hire-Purchase Act was applied liberally to prevent circumvention of the Act. In the ATO's view, a modern court would not necessarily impose such restrictions on the hire-purchase concept in relation to an interrelated series of transactions, where the owner is in a position to control the exercise of a series of options and obtain unencumbered ownership of the equipment.

80. *Proffitt* is a special case in that the contingency was not only outside the control of the bailee but also the accrual of the option right did not arise by virtue of the agreement, and was based on an event which might or might not happen. However, the call options in the Examples are structured in such a way that the Owner/Sublessee can control the exercise of the various options further up the chain. On the other hand, transactions involving a put option and no call option would not be regarded as falling within the definition of 'hire-purchase agreement'.

The financing element of a hire-purchase agreement

81. The significance of the financing element in a hire-purchase transaction for the purposes of section 128AC has been referred to above. In the Examples, the use of the equipment, and the risks associated with use remain with the Owner. The Owner starts off with legal ownership and, because of the option to purchase contained in the Sublease, it is for all practical purposes able to operate as if it retained ownership in the equipment. The parties intend from the outset that legal ownership will return to the Owner. Apart from the fee, the economic position of the Owner does not change and as there is a prepayment, there is no financing element in the transactions as regards the Owner. It can hardly be said, in view of the prepayment, that the purpose is one, in terms of *Warman*, of purchasing by a certain method by what is in effect deferred instalment payments. If, as is usually the case, there is no financing element in the transactions considered in this Ruling, the ATO considers that the transactions do

not constitute hire-purchase for the purposes of section 128AC. For a financing element to be present, there needs to be a passage of time before all the necessary payments under the Sublease are made. In the absence of such deferred payments, the ATO considers that the Sublease is in substance a repurchase of the equipment without any element of financing of the repurchase. However, if there is a financing element, section 128AC would apply.

82. The conclusion that the Sublease in the Examples should not be characterised as a hire-purchase for the purposes of section 128AC does not necessarily lead to the application of subsection 128B(5A). Where the paramount purpose of the transactions is one of purchase, it is outside the ambit of subsection 128B(5A).

Lease of specified kind: paragraph (b) of definition of 'relevant agreement'

83. The second part of the definition of 'relevant agreement' in subsection 128AC(1) is more specific than the general terms of the first part. This part of the definition encompasses three types of transactions: term purchases (instalment sales); leases with an option to purchase; and leases for the life of the equipment. The 1977 OECD Commentary quoted in **paragraph 25** above makes clear that a term purchase, whose essential element is that of purchase, is not a lease giving rise to royalty income. However, a lease with an option to purchase where there is no intention at the outset to exercise the option or of the kind referred to in the example in **paragraph 26** above, would in the view of the ATO not fall within the hire-purchase agreement part or the second part of the definition of 'relevant agreement'.

84. There is also the requirement that the 'entitlement to purchase' and the lessee's ability to 'require the transfer of the property' be under the agreement in question. Likewise, in relation to a lease for life, the term of the lease or agreement is the term under that lease or agreement and not under some other lease or agreement.

85. In the case of leases where the lessor has a put option and the lessee has no call option it is considered that the arrangement would not fall within section 128AC(1) subparagraph (b)(i) of the definition of 'relevant agreement'. This is because a put option gives the lessee no entitlement to purchase or other rights requiring the transfer of the property at the termination or expiration of the lease.

86. On the other hand, for the purposes of the royalty withholding tax provisions the test is whether the paramount purpose of the transaction is one of purchase or not. Leases with put options are more likely to attract royalty withholding tax because it is the lessor who is in the position to control the ultimate disposition of the

equipment and not the lessee. A transaction in which the lessor has a put option may nonetheless satisfy this test (see **paragraphs 30-32** above).

87. If it is concluded that the paramount purpose is purchase so that royalty withholding tax does not apply, it follows from what has been said in **paragraphs 83-85** that section 128AC will not apply even if there is a financing element in the transaction. In such a case the ATO will consider the application of Part IVA, in particular section 177CA, to collect interest withholding tax on the interest element in the transaction.

Use by a person of property owned by another person

88. The prefatory words of paragraph (b) of definition of 'relevant agreement' refer to the use by a person of property owned by another person. The Sublease in the first Example fails to meet this requirement because the Owner under the Sublease is also the user of the equipment. In the second Example, the property is actually sold by the Owner, hence there is nothing to prevent this part of the definition of 'relevant agreement' applying to the equipment.

Is the Sublease 'a lease ... under which the lessee ... is entitled to purchase or require the transfer of the ... property ... on the termination or expiration of the lease ...'

89. The Sublease in the Examples seems to constitute a form of bailment with an option to purchase rights under the immediately preceding agreement which in turn may lead to the purchase of the equipment. In this case, the bailment could fall within subparagraph (b)(i) of the definition of 'relevant agreement'. That subparagraph refers to title to the equipment passing *under* the agreement in question. On the facts of the Examples it could be argued that the exercise of the option to purchase given to the Owner under the Sublease of the contractual interests that the Sublessor has under the Lease does not *per se* 'entitle' the Owner 'to purchase or require the transfer of the property ... on the termination or expiration' of the Sublease. This is because the Owner needs to exercise other options under separate agreements, namely, in the first Example the purchase options under the Lease, Head Lease and Hire-Purchase Agreement, before it becomes entitled or can require the transfer of the property to it. The ATO is of the view that it is not necessary to read 'agreement' as excluding reference to the other documents besides the Sublease in the context of composite arrangements such as those outlined in the Examples. The transactions under consideration in this Ruling often operate under a master agreement and the various

agreements cross refer to each other (see also paragraphs 257 and 258 of TR 94/14).

90. An alternative argument in respect of the first Example is that none of the agreements from the Sublease to the Head Lease either singularly or cumulatively achieves entitlement at the relevant time, because of the time gap for the exercise of the purchase option under those agreements and the Hire-Purchase Agreement. This argument is based on *Butterworth v. Kingsway Motors Ltd* [1954] 1 WLR 1286 and *Patten v. Thomas Motors Pty Ltd* [1965] NSWR 1457.

91. *Butterworth* and *Patten* stand for the proposition that where a hire-purchase agreement is completed by paying out, the completion inures for the benefit of assignees of the agreement or of buyers of the equipment even though the paying out is effected after the assignments or purchases. However, if the assignments or purchases terminate before the title is fed, arguably no validation can occur. *Patten* also recognises that the effect of the principle of feeding the contract is such that upon discharge of the hirer's obligations under a hire-purchase agreement title in the equipment passes to the hirer for a *scintilla temporis* (nanosecond) and then instantaneously passes along the line of succession until it vests in the last assignee or purchaser. Any time gap occurring in the second Example as a result of the option to purchase under the Sublease being exercised before the option to purchase under the Lease is exercised would thus fall within this principle if both of the options are exercised on the same day.

92. Even if this problem could be overcome by ensuring a coincidence in the passing of title by exercising the options to extend the terms of the Sublease, Lease and Head Lease, subsection 128AC(4) treats an option to extend the term of a lease as a variation of the terms of the lease and this in turn is treated as a new 'relevant agreement' under subsection 128AC(3).

Leases for all, or substantially all, of the effective life of the equipment

93. Clearly, the types of agreements thus far dealt with that fall within the definition of 'relevant agreement' in subsection 128AC(1) have, as their main objective, the acquisition of legal title in the equipment. But, in relation to the category in subparagraph (b)(ii) (a) (lease for all, or substantially all, of the effective life of the equipment), title to the equipment may not pass. However, the common feature of all such agreements is that they confer on the lessee the incidents of ownership – the use and enjoyment of equipment for all, or substantially all, of its effective life and the economic risks associated with ownership. In essence they are all finance type leases in contrast to an operating lease (see Australian Accounting Standards *AAS17*

(superseded by Accounting Standard *AASB 117*), major elements of which are adopted in Part III Division 16D of the Act).

94. The standard adopted in subparagraph (b)(ii) of the 'relevant agreement' definition is that the lease be for 'all, or substantially all' of the effective life of the equipment. A similar expression, namely, 'the whole, or substantially the whole' was considered in *Turner v. Official Trustee In Bankruptcy* (1996) 71 FCR 418 where the Federal Court said at 422 that 'whilst 'substantial', when it appears alone, might refer to a contribution of significance, here it derives its meaning from 'the whole', the expression which it qualifies'. The Federal Court likened the expression to mean 'nearly all'. It is considered that the reference here to 'substantially all' is referring to *de minimis* cases where almost all of the residual value left in the equipment is negligible or worthless.

Meaning of 'effective life'

95. Although, the term 'effective life' is not defined in section 128AC, one approach is to adopt the meaning popularly understood in the context of depreciation around the time when section 128AC was introduced. Thus, effective life in the context of section 128AC should be understood in terms of the physical useful life of equipment. The relevant time from which the effective life is to be measured is when the equipment is first used. This approach produces a result which supports the legislative purpose of bringing within the scope of section 128AC financing transactions associated with what is in substance a transaction intended to transfer the practical benefits of ownership.

Legal effect of prepayment of rent under section 128AC

96. If the Sublease comes within the definition of 'relevant agreement' in section 128AC, it becomes necessary to consider the legal effect of the single payment (often referred to in the Sublease as a prepayment) to see what, if any, tax it may attract under the section.

97. The prepayment under the Sublease in the Examples reflects the market value of the leased equipment. The agreements provide that the prepayment satisfies in full the obligation of the hirer to pay rent in the future and that the hirer has no further obligation to pay the rent under the agreement. The prepayment is calculated by reference to periodic rental payments and actuarially discounted to a present value amount. The agreements stipulate and in some cases specifically tabulate the obligation for periodic rental payments. It has been put to the ATO that the effect of the prepayment under the Sublease is that

there are no periodic rental payments and no interest component involved and, therefore, section 128AC has no application.

98. In order to evaluate this argument, it is necessary to consider the legal effect of the prepayment under the Sublease. The prepayment of a future obligation does not necessarily prevent the accrual of the obligation to pay rent. The effect in a particular case depends on the terms of the contract and the application of the general law regarding bailment (leases). These matters are raised in the decisions of the High Court of Australia in *The Australian Guarantee Corporation Limited v. Balding* (1930) 43 CLR 140 and *HJ Wigmore & Co Ltd v. George Harold Rundle and Ors* (1930) 44 CLR 222 which are considered to stand for the following propositions: the effect of a prepayment is to discharge the obligation to pay rent as and when it arises; and a debt, in the context of a hire-purchase agreement, can only arise in respect of past hire, for without the accrual of a debt, the prepayment would have no legal effect unless the prepayment evidences a sale.

99. On one view, the effect in terms of subsection 128AC(5) may be that an attributable agreement payment is made at the time the obligation is discharged. The expression 'attributable agreement payment' is defined in subsection 128AC(1) to mean, so far as is relevant, 'so much of any payment made or liable to be made ... as represents consideration for the use ... of the ... property'. As soon as the obligation to make a rental payment arises under the agreement, there exists a liability of an amount equal to the rental payment. The discharging effect of the prepayment is to effect a payment of that liability.

100. The provisions of section 128AC, inter alia, are primarily concerned with subjecting to interest withholding tax the implicit interest contained in the periodic rental payments. It is the periodic rental payments *liable to be made* under the relevant agreement that constitute an attributable agreement payment and not the prepayment. The prepayment, however, effects in a sense a deemed payment of the periodic rental payments as and when they fall due. Thus, there would be a withholding tax liability arising over the period of the Sublease under section 128AC. The ATO considers that this could be one possible outcome.

101. However, in relation to the Sublease outlined in the Examples, the ATO considers that they are not within the principle of *Balding's* case, which applies to those agreements where there is no certainty that the particular rent obligations will arise. The hirer under *Balding* type agreements has the right to terminate the agreement at any time by its early completion or by returning the equipment, and this feature prevents any prepayment from operating to legally defease the rent obligations. Under the Sublease considered in the Examples, there is no similar right in the Owner and thus there is no reason why the

prepayment should not legally discharge the obligations to pay rent immediately on its payment.

102. Indeed in the way some of the Subleases are expressed, it may be doubted whether there is any separate obligation to pay rent apart from the obligation to make the prepayment. That is to say, the prepayment is the only payment required to be made and it does not defease legally or otherwise an obligation to make other payments. The outcome in particular cases will depend on the precise terms of the agreements in question.

103. The nature of the transactions in the Examples supports the conclusion that no tax is payable under section 128AC. If there is no financing element in the transaction, then there should not be any deemed interest. As already noted the lack of a financing element generally means that there may be no relevant agreement in any event so that the question whether section 128AC does not apply or applies and produces a nil result becomes moot.

104. The prepayment of the obligation to pay rent does not touch other cases of defeasance payments which may be made to avoid withholding tax. Amendments were made to the Act in 1997 to clarify that a payment in defeasance of an obligation to make a series of interest payments is itself interest. Similarly, a payment in defeasance of payments which are royalties subject to subsection 128B(5A) is treated as subject to withholding tax either through interpretation of the withholding provisions or by the application in suitable cases of Part IVA to withholding tax avoidance. If a relevant agreement with a genuine financing element were to have the obligations with respect to the future implicit interest element in the payments defeased some time after the agreement had been in operation (leaving the obligation with respect to the implicit principal element intact), a similar result may be expected.

Application of Part IVA

105. The *Taxation Laws Amendment Act (No 2) 1997* extends the application of Part IVA to schemes aimed at avoiding withholding tax. Under section 177CA the amount on which withholding tax payable under section 128B is not paid is termed a tax benefit for the purposes of Part IVA. The criteria that must be satisfied before the scheme is one to which Part IVA applies, are outlined in section 177D. They apply, without alteration, to section 177CA in the same way as they apply to section 177C and are highly dependent on the facts of each case.

106. If what could reasonably be expected to have been a royalty, hire arrangement or operating lease is altered by a scheme to look like a purchase type payment, or if a lease transaction which could reasonably be expected to have involved a financing element were structured in such a way as to avoid section 128AC but which remains in substance a financing transaction, the ATO will consider the application of Part IVA.

107. Where its terms are satisfied, Part IVA is equally applicable to international transactions which seek to avoid Australian tax as to purely domestic transactions. It does not apply directly to schemes to avoid foreign tax.

108. While Australia takes its international obligations in the tax area under treaties and as part of its membership of the OECD and other organisations very seriously, the ATO does not seek to determine if particular transactions constitute inappropriate avoidance of tax in another country. That is a matter for the tax authorities of the other country to determine. Australia will, however, provide whatever assistance is necessary to other tax authorities in accordance with its obligation under tax treaties (particularly in the area of exchange of information).

109. It is considered that Part IVA would not apply to the Examples set out below.

Examples

Example 1

110. The facts may be summarised as follows:

(1) The equipment has an effective life of 50 years;

(2) The equipment has a market value at the time of entering the cross border leasing arrangement of $100 million;

(3) The Owner of the equipment is a resident of Australia;

(4) All other parties are non-residents;

(5) The first transaction is a lease with purchase option (for ease of reference called the Hire-Purchase Agreement) between the Owner and the Hirer, a Cayman Island company (Cayman 1). The Hire-Purchase Agreement is for a period of 40 years with an option to renew for a further 5 years. The Hirer has an option to purchase (PO) the equipment at the end of the term of the Hire-Purchase Agreement;

(6) The Hire-Purchase Agreement provides for the prepayment of all lease rentals payable and the purchase option price at the time of entering into the agreement. Actuarially calculated, the prepayment works out to be the same as the market value of the equipment, namely $100 million. The agreement provides that the prepayment of the purchase option price does not constitute the exercise of the purchase option;

(7) Cayman 1 enters into a Head Lease as Head Lessor with a US Trust as Head Lessee. The Head Lease is for a period of 35 years with an option to renew for a further period of 5 years. The Head Lease also gives the US Trust an option to purchase Caymans 1's interests in the Hire-Purchase Agreement. There is also a prepayment of a substantial part of the lease rentals amounting to $80 million. Cayman 1 uses the $80 million together with loan funds of $20 million borrowed from another Cayman Island company (Cayman 2) to finance the prepayment of $100 million to the Owner;

(8) The US Trust in turn enters into a Lease as Lessor with Cayman 2 as Lessee. The period of the Lease is for a term of 35 years with an option to renew for a further period of 5 years. The Lease gives Cayman 2 an option to purchase the US Trust's interests under the Head Lease. The purchase option is exercisable at the end of the Lease term. Periodic fixed rental payments are made under the Lease for the first 5 years and towards the end of the Lease term;

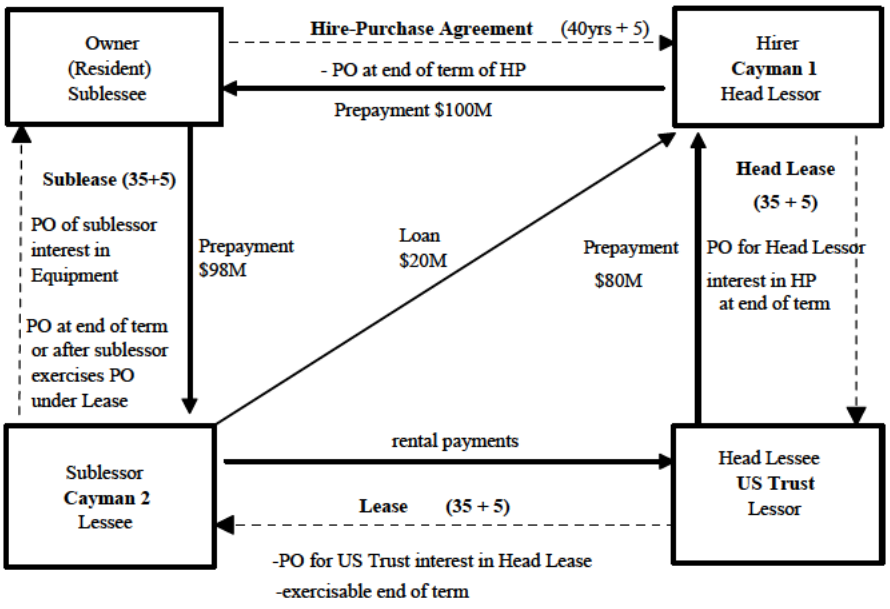
(9) Cayman 2 as Sublessor then enters into a Sublease with the Owner as Sublessee. The period of the Sublease is for a term of 35 years with an option to renew for a further 5 years. The Sublease gives the Owner an option to purchase the interests of Cayman 2 in the Lease. The option is exercisable at the end of the Sublease term or at any time after Cayman 2 has exercised its option to purchase the interests of the US Trust under the Head Lease;

(10) There is a prepayment of the lease rentals as well as the purchase option amounting to $98 million. Upon making the prepayment, the Sublessee has no further obligation to pay any rent or purchase option price. The Sublease provides that the prepayment of the purchase option does not constitute the exercise of the purchase option;

(11) The Owner/Sublessee retains possession of the equipment with effectively the same risks as it had before the transactions were entered into. It intends from the outset to exercise the option under the Sublease and to procure the exercise of all the other options under the other leases as it is entitled to do under the various documents evidencing the transaction; and

(12) There is no entitlement on the part of the Sublessee/Owner to return the equipment at any time before the expiration of the term of the Sublease or for the early completion of the Sublease.

OFFSHORE LEASING - EXAMPLE 1



PO: purchase option **HP: hire-purchase**

Example 2

111. The facts may be summarised as follows:

(1) The equipment is acquired new from a United States manufacturer for $100 million by an Australian resident (the Owner);

(2) The equipment has an effective life of 15 years;

(3) The Owner immediately sells the equipment to a US Trust for the same price as it purchased the equipment ($100 million);

(4) The purchase by the US Trust is financed by a mix of debt and equity obtained by the US Trust;

(5) The US Trust enters into a Lease with a purchase option as Lessor of the equipment with a Cayman Island Company (Cayman Limited) as Lessee. The lease is for a period of 15 years with regular lease rental payments. The Lessee will be obligated to exercise its purchase option under the Lease solely at the Owner's direction;

(6) Cayman Limited enters into a Sublease with a purchase option as Sublessor of the equipment with the Owner as Sublessee. The Sublease is for a period of 15 years;

(7) The Owner makes a prepayment of the lease rentals and purchase option price. Upon making the prepayment the Sublessee has no further obligation to pay any rent or purchase option price. The Sublease provides that the prepayment of the purchase option does not constitute the exercise of the purchase options. The prepayment works out to be the same as the market value of the equipment, namely, $100 million;

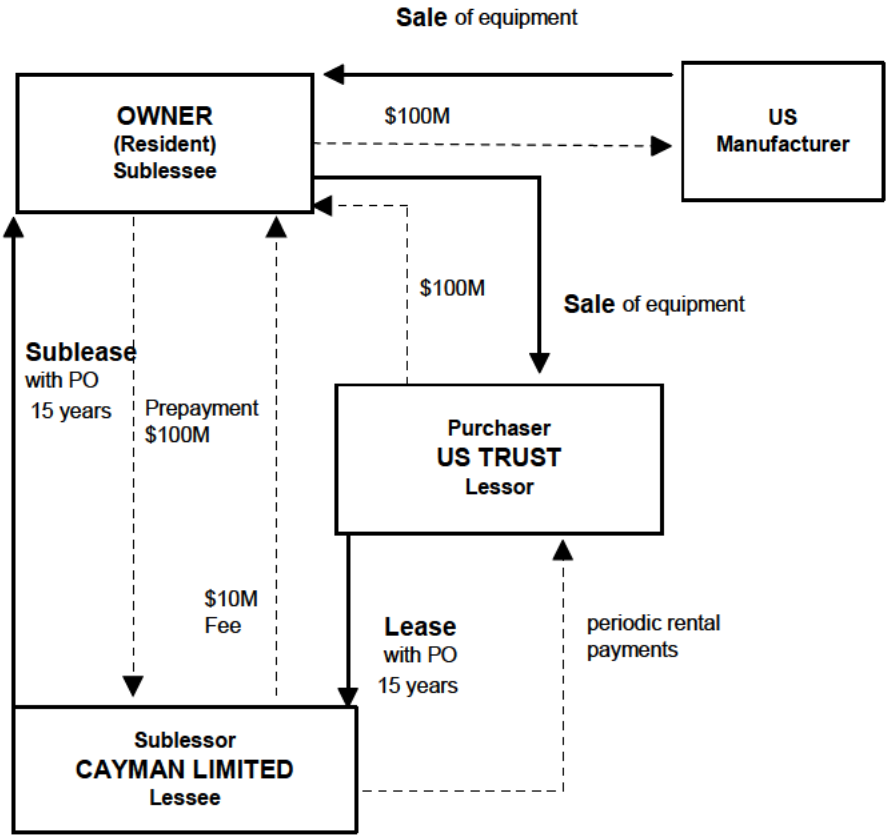
(8) A fee is paid to Owner amounting to 10% of the value of the equipment. This fee represents the Owner's share of the tax benefits arising from the purchase and sale of the equipment in the US;

(9) The Owner/Sublessee retains possession of the equipment with effectively the same risks as it had before the transactions were entered into. It intends from the outset to exercise the option under the Sublease and to procure the exercise of the option under the Lease;

(10) There is no entitlement on the Sublessee to return the equipment at any time before the expiration of the Sublease or for the early completion of the Sublease; and

(11) The original purchase of the equipment by the Owner is financed out of Owner's own funds.

OFFSHORE LEASING - EXAMPLE 2



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