


TR 94/D25 - Income tax: interpretation of Division 16D - restrictions applying to certain non-leveraged finance leases to exempt public bodies or for overseas use

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Draft Taxation Ruling

Income tax: interpretation of Division 16D - restrictions applying to certain non-leveraged finance leases to exempt public bodies or for overseas use

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What this Ruling is about

1. This Ruling provides guidance on the interpretation of certain aspects of Division 16D of Part III of the Income Tax Assessment Act 1936. In broad terms, Division 16D treats certain non-leveraged finance leases and similar arrangements as though they were loans by the lessor to enable the lessee or end-user to acquire the leased property.

2. The provisions apply where the property is used by a government or tax-exempt public body or by a person who uses the property outside Australia to produce exempt income (section 159GH). A finance lease to which the Division applies is broadly one under which all, or substantially all, the risks and benefits of property ownership are transferred from the lessor to the lessee.

3. Section 159GG in Division 16D contains a number of tests to determine whether an arrangement is a finance lease or similar arrangement for the purposes of determining whether the arrangement is a qualifying arrangement. The Division applies to qualifying arrangements unless excluded by exercise of the Commissioner's discretion under subsection 159GG(4).

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4. In particular, this Ruling provides assistance to interpret these tests in relation to:

- (a) whether the definition of the terms 'arrangement' and 'arrangement payment' in section 159GG includes a sub-lease arrangement;
- (b) interpretation of the term 'payment portion' for purposes of the test in paragraph 159GG(1)(c);
- (c) what constitutes 'repairs' in terms of subparagraph 159GG(1)(a)(iv);
- (d) some factors which the Commissioner considers relevant in exercising the discretion in subsection 159GG(4) when considering whether to treat an otherwise qualifying arrangement as a non-qualifying arrangement;
- (e) the meaning of effective life in paragraph 159GG(1)(b), in particular in relation to second hand property; and
- (f) the effect of the application of the Division on costs relating to the non-assessable component of the arrangement payments.

Ruling

Terms 'arrangement' and 'arrangement payment'

5. The definition of 'arrangement' is wide enough to encompass the whole of an arrangement between a lessor, lessee and sublessee for the use, control and/or disposal of the relevant property.

6. Accordingly, in the following circumstances, where:

- a building is erected by a developer;
- the building is financed by way of a sale and long term leaseback arrangement with a third party property investor (lessor) who purchased the building from the developer; and
- the building is subleased by the lessee to a number of tenants including an exempt public body;

the lessor/owner is regarded as a party to the arrangement by which the exempt public body subleased part of the building. If any of the qualifying conditions in section 159GG are satisfied, the arrangement comes within the scope of Division 16D.

7. The 'arrangement payments' in such a situation are the payments made to a party who would otherwise be entitled to depreciation **or other deductions for capital expenditure** in relation to the property used by the tax-exempt public body.

The term 'payment portion'

8. The term 'payment portion' refers to both the capital and interest component of a payment.

9. The term enables 'arrangement payments' to be apportioned between the part relating to property to which the Division might apply and the balance of the payment. This may occur where:

- (a) only part of the costs of or capital expenditure on the property would, apart from this Division, **give rise to deductions**; or
- (b) the payment includes a component which is not attributable to the cost of, or capital expenditure on, the property.

An example of category (a) would be a lease over a building and land or a lease over a building only part of **the capital expenditure on** which qualifies for a Division 10D deduction.

10. In these circumstances, the total payment must be apportioned.

Repairs

11. The repairs test in subparagraph 159GG(1)(a)(iv) is satisfied where the end-user of a property is liable for repairs. Maintenance work may involve repairs. However, where that test is only satisfied because the end-user is required to carry out minor maintenance and no other test is satisfied, it is expected that the Commissioner would exercise the discretion under subsection 159GG(4) to treat the arrangement as a non-qualifying arrangement.

12. **The repairs test is also satisfied where the end-user is liable to meet repair costs to the extent that they are not covered by any insurance, for example if the insurance company will not pay the first \$500 or will not cover some types of accident. Also, if the lessor is not required to repair the property under the contract, the end-user may in fact be liable to carry out or pay for any repairs if the lessor refuses to do so.**

The Commissioner's discretion

13. Subsection 159GG(4) provides the Commissioner with a discretion to treat an otherwise qualifying arrangement as a non-qualifying arrangement. To quote the Explanatory Memorandum:

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'By virtue of sub-section 159GG(4), an arrangement that would otherwise be a qualifying arrangement is not to be taken to be a qualifying arrangement in certain circumstances - that is, where the Commissioner, having regard to the circumstances which result in the arrangement being a qualifying arrangement and any other relevant circumstances, considers it unreasonable that the arrangement should be treated as a qualifying arrangement. The Commissioner might, for example, consider that, in all the circumstances, a short-term hiring arrangement in respect of property should not be treated as a qualifying arrangement even though that property was acquired by an associate of the hirer within 12 months of the expiration of the hiring arrangement.'

14. It is inappropriate to bind the exercise of this discretion. Each case must be decided on its own merits and on all of the circumstances relevant to the arrangement.

15. It is not possible to say that the discretion will generally be exercised if only one test is satisfied or that it will generally not be exercised if two, three or more tests are satisfied. The circumstances of a particular case might warrant the refusal to exercise the discretion even if only one test was satisfied, or the exercise of the discretion even if several tests are satisfied.

16. In considering the exercise of the discretion regard will generally be had to the following factors, although none of them are necessarily determinative of the matter.

- If the arrangement involves a finance lease, as defined for accounting purposes, it is less likely that the discretion will be exercised.
- If the lessee bears the risks and benefits of ownership of the property it is less likely that the discretion will be exercised. In this context, to quote the accounting standard, 'the risks of property ownership include those associated with unsatisfactory performance, obsolescence, idle capacity, losses in realisable value and uninsured damage or condemnation of the property; the benefits include those obtainable from use of the property and gains in realisable value.'
- If it is likely that the lessee will either acquire the asset at the end of the lease or be able to continue using the asset at the end of the lease, it is less likely that the discretion will be exercised.
- If the rental payments are not commercial, it is less likely that the discretion will be exercised.

- If the arrangement is a financing arrangement, it is less likely that the discretion will be exercised.

17. Characteristic features of a financing arrangement are:

- **The arrangement has the same economic effect as a loan.**
- **The entity trying to claim depreciation or other deductions for capital expenditure does not bear the risks of ownership, in that it will receive back the cost of the asset via lease payments, a compensation payment, a guaranteed residual value and/or any sale proceeds on the disposal of the asset at the end of the lease.**
- **Usually the lease payments are calculated in the same way as loan payments, as if the cost of acquiring or constructing the asset had been lent to the lessee.**
- **The entity trying to claim depreciation does not have physical possession of the asset.**

This description is not meant to be all-inclusive. It is possible that an arrangement which does not contain these characteristics may also be a financing arrangement.

18. The discretion will not be exercised simply on the basis that the 90% test would not be satisfied if the present value of the lease payments, rather than their absolute value, was taken into account. The legislation specifically contains an absolute value rather than a present value test.

19. It has been argued that the discretion should be exercised where there is no tax benefit transfer. The Second Reading Speech indicated that the arrangements which would be covered by the legislation involved a passing of some of the tax benefits from the lessor to the lessee in the form of lower lease rentals. However, when discussing the measures in more detail, the Speech said that the measures would apply to property leased under a finance lease. The return of tax benefits is not a specific requirement of the legislation. The discretion will not be exercised solely on the basis that the lease payments to the end-user have not been reduced because the lessee has passed the tax benefits of ownership of the property to the lessor.

20. It can be expected that the discretion will be exercised if there is a lease of a building or part of a building to a tax-exempt entity where:

- **the lease is an ordinary commercial lease;**
- **the lessor carries risks and benefits of ownership;**

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- **there is no option to purchase, agreement to transfer or other arrangement under which the lessee will be able to acquire the property;**
- **the lessee can walk away from the property at the end of the lease without having to make any further payments in relation to the property, other than normal commercial requirements such as repairing any damage caused by the lessee or returning the property to bare floor status; and**
- **the arrangement does not have any other characteristics which indicate that the lessee should be treated as the owner of the asset.**

21. Several cases which raised the question of the exercise of the discretion are set out in the examples section below.

Effective life

22. The ATO has been asked what effective life means in Division 16D in applying the tests of a qualifying arrangement to items of second hand property.

23. For the purposes of Division 16D, the effective life of property at a particular time is defined in subsection 159GE(1) as the Commissioner's estimate of effective life after that time assuming that the property is maintained in reasonably good order and condition. The relevant time from which the effective life is measured is the commencement of the arrangement period. Accordingly, if the arrangement is a lease in respect of second hand property, the effective life for the purposes of this test is the remaining effective life of the property at the commencement of the lease.

24. It should be noted that for the purposes of calculating taxation depreciation allowances, section 54A specifies that the effective life of second hand plant must be estimated as if the item was new. (This ensures that the depreciation claimed on a diminishing value basis is not more favourable to second-hand than to new items) That rule is not applicable to effective life as defined in subsection 159GE(1).

Effect on costs

25. When Division 16D applies to an arrangement, a proportion of each arrangement payment, representing the notional principal amount, may be treated as non-assessable by the operation of subsection 159GK(1). The ATO has been asked whether, when the

Division applies, a proportion of the costs relating to the non-assessable amount becomes not deductible under subsection 51(1).

26. The answer is no. We consider that the otherwise deductible costs of an arrangement to which Division 16D applies relate wholly to the assessable notional interest amount. No deduction will be denied under subsection 51(1) merely because the amount in question relates to the notional principal amount. **This view was formerly expressed in Taxation Determination TD 94/2 which is superseded by this Ruling and withdrawn.**

Date of effect

27. 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 a 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).

Explanations

28. Section 159GG in Division 16D prescribes a number of tests to determine what arrangements are qualifying arrangements. These tests are:

- (a) whether the arrangement provides for payment of a guaranteed residual value;
- (b) whether the arrangement provides for the transfer of the property to the end-user on termination of the arrangement;
- (c) whether the end-user or an associate has or will have the right to purchase or to require the transfer of the property;
- (d) whether, where the period of the arrangement exceeds one year, the end-user is liable to carry out, or to expend money in respect of or to reimburse the owner or an associate for expenditure in respect of, repairs to the property;
- (e) whether the period of the arrangement equals or exceeds 75% (50% for real property) of the property's effective life at the time the arrangement commenced;
- (f) whether the payments to the owner are equal to or greater than 90% of the lesser of the property's cost or depreciated value when the arrangement commenced; and

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- (g) whether the ownership of the property is transferred to the end-user or an associate within one year after the arrangement ceases to be in force.

Arrangements and arrangement payments

29. The terms are defined in subsection 159GE(1). 'Arrangement' is defined to include:

- '(a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied, and whether or not enforceable, or intended to be enforceable, by legal proceedings; and
- (b) any scheme, plan, proposal, action, course of action or course of conduct whether unilateral or otherwise'.

30. Subsection 159GG(3) provides that:

- '(a) a lease to a person of property owned by another person shall be taken to be an arrangement relating to the use by the person of property owned by the other person; and
- (b) any arrangement entered into in relation to the lease referred to in paragraph (a) shall be taken to be part of the arrangement referred to in that paragraph.'

31. It has been argued that the term 'arrangement' must involve a meeting of the minds of the parties to the arrangement. This argument is not accepted. The definition of an arrangement in subsection 159GE(1) specifically includes a unilateral course of action. A requirement that there be a meeting of minds is inconsistent with this component of the definition.

32. The term 'arrangement payment' 'in relation to an arrangement relating to the use, or the control of the use, of an item of property, means so much of any payment liable to be made under the arrangement as represents consideration for any one or more of the following:

- (a) the use of the item;
- (b) the control of the use of the item;
- (c) the sale or disposal of the item.'

33. Arrangement payments may include payments made by someone other than the end-user.

34. The tests in subsection 159GG(1) must be considered if at any time there is an arrangement relating to the use by a person (the end-user) or to the control by a person of the use, of property

owned by another person who is a party to the arrangement, being property that is or includes an item of eligible property.

The term 'payment portion'

35. The term 'payment portion' is defined in subsection 159GE(1) as follows:

"Payment portion" in relation to an arrangement payment in relation to an eligible amount in relation to an item of eligible property, means so much of the arrangement payment as the Commissioner considers is attributable to the eligible amount in relation to the item of eligible property."

The Explanatory Memorandum said:

"Payment portion" means, in effect, that portion of any arrangement payment, as the Commissioner considers is attributable to the cost of, or other capital expenditure on, eligible property. The term is relevant for determining, in accordance with section 159GK, the amount of arrangement payments to be included in a taxpayer's assessable income.'

The term is also relevant to the application of the paragraph 159GG(1)(c) test which states, in effect, that a qualifying arrangement exists where the total of the 'payment portions' liable or likely to be made equals or exceeds 90% of the lesser of the cost or the depreciated value of the property."

36. It has been suggested that the term 'payment portion' as used in paragraph 159GG(1)(c) only includes the capital component of a payment. This interpretation is not correct. Apart from the point that the term was intended to cater for the possible situations outlined above, such an interpretation would be inconsistent with the operation of section 159GK, which refers to the interest amount of the 'payment portion' as the assessable amount of the arrangement payment for the purposes of Division 16D. Further, subsection 159GE(4) makes it clear that the payment portion consists of an interest amount and a notional principal amount because any difference between the interest amount and the payment portion is the notional principal amount.

Repairs

37. As outlined in paragraph 28, one of the qualifying arrangement tests in Division 16D is whether, where the arrangement exceeds one

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year, 'the end-user or an associate will be liable to carry out, to expend money in respect of or to reimburse the owner or an associate for expenditure in respect of, repairs' to the property (subparagraph 159GG(1)(a)(iv)).

38. Some doubts have been expressed whether the carrying out of minor maintenance constitutes repairs. It is clear from the Explanatory Memorandum accompanying the introduction of Division 16D in the Act that it was not intended that the repairs test would be satisfied if the end user was liable for minor maintenance only.

39. The question of what constitutes repairs has often been considered by courts and tribunals over the years. Whether or not work done constitutes repairs is a question of fact and degree. Maintenance work may involve repairs, see *W. Thomas & Co. Pty Ltd v. FC of T* (1965) 115 CLR 58, 14 ATD 78.

40. In *Thomas* Windeyer J said at **CLR 72-74 [ATD 87-88]**:

'Expenditure upon repairs is properly attributed to revenue account when the repairs are for the maintenance of an income producing **capital** asset. Maintenance involves the periodic repair of defects that are the result of normal wear and tear in operation ...

There are always some difficulties in applying in a strict way the concept of repairs ... to work such as painting that is periodically done not merely to make good defects but also to prevent defects developing. A stitch in time is as much a repair as would **[be] the nine [it saves].'**

In (1958) 9 TBRD *Case J47*, the Board of Review relied on the following definition of the word 'repair' in the *Shorter Oxford English Dictionary*:

'Restoration of some material thing or structure by the renewal of decayed or worn out parts, by refixing what has become loose or detached; the result of this.'

Pearson J. in *Day v. Harland & Wolff Ltd* (1953) 2 All E.R. 387 said:

'Work does not cease to be repair work because it is done to a large extent in anticipation of forthcoming defects or in rectification of merely incipient defects, rather than the rectification of defects which have already become serious. Some element of anticipation is included.'

Examples

Fleet leases

Example 1

41. A fleet of cars was to be leased to a tax-exempt authority. **The lessee would be responsible for the cost of repairs to the extent to which the lessor's insurance did not cover them.**

42. The lessee would be 'liable to expend money in respect of repairs'. The 90% test was also satisfied. The taxpayer was advised that the discretion would not be exercised.

Example 2

43. A fleet of cars was to be leased to a tax-exempt government entity. The lessee was to insure the vehicles **against accidental damage** and be responsible for repairs and maintenance. An excess usage penalty was to be paid by the lessee if the cars travelled more than a preset mileage, and an under usage rebate was to be paid to the lessee if they travelled less than the preset mileage. The cars were to be leased for 2 or 3 years. The cars were to be sold via a commercial dealer on the market at the end of the leases.

44. The 90% and repair test were satisfied. The discretion was exercised subject to the provisos that:

- (a) the leased property was new at the commencement of each lease;
- (b) the government entity did not retain the property at the end of the lease; and
- (c) the lessor was responsible for fair wear and tear and repairs to the property other than those due to lessee operator abuse and periodic servicing limited to minor maintenance such as basic fluid top-ups, the checking of brakes, batteries, tyres, etc, oil and filter changes and engine tuning.

Example 3

45. A fleet of cars was to be leased to a tax-exempt government department. Various options were under consideration. The taxpayer

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was advised that the discretion would not be exercised in relation to any of the proposed options.

46. Factors which militated against the exercise of the discretion, included low residual values, guaranteed residual values, provisions requiring the distribution of any excess profits made on the sale of the leased assets to the lessee, and provisions which required the lessee to pay either the present value of the remaining lease payments or a penalty sufficient to achieve the required rate of return in the event of an early termination of the lease.

Buildings

Example 4

47. Office space was leased at a market rental to a government department. The lease was a normal operating lease where the risks and benefits of ownership remained with the lessor. The lessee obtained neither rights to acquire, nor equity in, the property the subject of the lease and the lessors were not in the business of providing finance. Subsection 159GG(1)(c) (the 90% test) was the only qualifying arrangement test that was satisfied. The discretion was exercised.

Example 5

48. The following proposal was put to the ATO:

- (a) A taxpayer (A) was to acquire land.
- (b) The acquisition of the land was to be predominantly financed by way of an interest only loan from a financier (B).
- (c) A was to grant a 20 year ground lease of the land to B. The rent payable under the lease would equate with the cost of servicing the loan provided in step **(b)**.
- (d) B proposed to construct an office building on the land which would be leased to a government department for up to 20 years. The rent payable under the sublease would reflect the market rent for the area. All costs of repairs and upkeep of the building (excluding day to day maintenance costs) were to be borne by A.
- (e) At the end of 5 years B would have the right to terminate the ground lease. If this right was exercised, A would be required to compensate B for the cost of constructing the building and to repay the principal on the loan.

49. The arrangement satisfied the 90% test, and in relation to property other than the building, the 75% test. The taxpayer was advised that it was unlikely that the discretion would be exercised as, even if the lease with the government department was on commercial terms, the proposal was essentially a financing arrangement in relation to the long term use of property by a tax-exempt end-user.

Effective life

Example 6

50. Lease Co, a resident leasing company, leases an item of depreciable property to a non-resident for 5 years. Assuming that the item is 4 years old at the time of entering into the lease agreement and the effective life of the item as new is 10 years, then the remaining effective life is 6 years at the commencement of the arrangement period. The arrangement period of 5 years exceeds 75% of the remaining effective life of the item in this instance and the qualifying arrangement test is satisfied.

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- W.Thomas & Co. Pty Ltd v. FC of T. (1965) 115 CLR 58; 14 ATD 78
- Case J47 (1958) 9 TBRD 244
- Day v. Harland & Wolff Ltd (1953) 2 All ER 387

subject references

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