TR 95/D28 - Income tax: leasing - trade-ins and balloon payments

This document has been finalised by TR 98/15.

Draft Taxation Ruling
Income tax: leasing - trade-ins and balloon payments

other Rulings on this topic

IT 28; IT 196; IT 2236; IT 2395; TD 93/119; TD 93/142; TD 94/7; TD 94/20

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What this Ruling is about

Class of person/arrangement

1. This Ruling deals with several issues that arise when a taxpayer trades in a previously leased asset which was wholly used for business purposes, for a replacement asset which is leased. They are:

   (a) whether trade-in credits form part of assessable income;

   (b) whether inflated initial rental payments are acceptable;

   (c) whether the new lease is acceptable for tax purposes; and

   (d) the taxation treatment of acceptable and unacceptable leases.

2. The Ruling does not deal with the possible application of the capital gains tax provisions contained in Part IIIA of the *Income Tax Assessment Act 1936* (the Act), other than those that apply in conjunction with the depreciation provisions.

3. The contents of Taxation Determinations TD 94/7 and TD 94/20 have been incorporated into this Draft Ruling and consequently they will be withdrawn on finalisation of the Draft Ruling.

Definitions

4. The meaning of key terms used in this Ruling are as follows:

'Balloon Payment' a payment made that has the effect of reducing subsequent payments under the agreement. Such a payment is usually

made at the commencement of the lease, but can be structured into a lease at any time during the lease period;

'Prepayment' an amount to prepay rental payments that is not a balloon payment (that is, it has not had the effect of reducing subsequent payments under the agreement);

'Deposit or Down payment' a payment made to reduce the cost of the asset which is the subject of the lease. In commercial terms the lessee has an equity in the asset; the lease is for the balance of the cost of the asset after taking into consideration finance charges and the lease residual.

Ruling

Whether trade-in credits form part of assessable income

5. Where a previously leased asset is traded-in on a replacement asset, all or part of the trade-in credit is assessable under the following provisions of the Act:

(i) section 26AAB (in the case of motor vehicles); or

(ii) section 59 if depreciation was allowed or allowable to the taxpayer prior to the trade-in; or

(iii) subsection 25(1); or

(iv) the capital gains tax provisions, where applicable.

6. This will be the case even if the trade-in credit was not paid to the lessee, but was used to either reduce the cost of a replacement asset or to reduce the lease payments which would otherwise be payable on a replacement asset.

7. Only amounts which would otherwise be assessed under section 59 may be rolled over as a balancing charge to reduce the cost of other depreciable assets.

Whether inflated initial rental payments are acceptable

8. Initial inflated rental payments are acceptable where**:**

(i) a balloon payment is made that reflects the initial decrease in market value of the asset over the period covered by the payment. This form of balloon payment will be deductible in full;

(ii) a balloon payment is made in excess of the decrease in the market value over the period covered by the payment. The

deductibility of this form of balloon payment will be subject to section 82KZM of the Act; or

(iii) the payment is a prepayment of the rental instalments, without reducing the level of subsequent rental instalments, but obtaining a corresponding 'lease holiday period'. Such a payment may also be subject to section 82KZM. Section 82KZM will apply where the payment made prepays more than 13 months rental instalments. If the payment prepays 13 or less monthly instalments, section 82KZM will not apply.

Unacceptable inflated initial rental payments

9. Other forms of inflated initial rental payments are not acceptable, notably:

(i) the leasing arrangement contains a deposit or down payment, with the lease being for the balance of the cost of the asset; or

(ii) the terms of the lease agreement do not reflect current commercial practice but appear to be designed to bring about desired tax consequences for the parties, particularly where the parties are not at arm's length. The lessor party, for example, may be in a loss situation and rentals payable under the lease agreement may be significantly higher than commercial rentals to take advantage of the loss situation.

Whether the new lease is acceptable for tax purposes

10. The lease of the replacement asset will be accepted if:

(i) the residual value conforms with the table of values listed in Taxation Ruling IT 28 or Taxation Determination TD 93/142, even if it is as low as $1; or

(ii) if the residual value does not conform with the values contained IT 28 or TD 93/142, it is based on a well considered estimate of the market value in conformity with a generally accepted commercial or industrial valuation; and

(iii) for either (i) or (ii) above, the lease complies with other requirements in relation to leases, such as those contained in IT 28.

11. The lease of the replacement asset will not be accepted if:

(i) the lease does not comply with the requirements contained in IT 28 or TD 93/142; or

(ii) the residual value is reduced below an amount which would normally be acceptable for such an asset, namely, below a fair estimate of the market value of the leased asset at the end of the lease or the values set out in IT 28 or TD 93/142; or

(iii) a nominal residual value, for example $1, is determined, which is not in conformity with IT 28 or TD 93/142, but is based on an estimate of the market value of the asset at the end of the lease term. In such circumstances a nominal residual value of $1 would indicate that the lease term is for the whole or a substantial part of the useful life of the asset; or

(iv) the circumstances in subparagraphs 9(i) and (ii) above apply.

Tax treatments where a lease is acceptable

12. If the lease is acceptable, and the trade-in credit has been:

(i) used to make a balloon payment that reflects the initial decrease in market value of the asset over the period covered by the payment, a deduction is available for the inflated initial payment, in addition to any subsequent payments made in the income year; or

(ii) used to make a balloon payment in excess of the initial decrease in market value of the asset over the period covered by the payment, section 82KZM will apply to apportion the payment over the lesser of the term of the lease or 10 years. The apportioned amount will be deductible, in addition to any subsequent payments made in the income year (see Example 5 below); or

(iii) used to prepay rental payments:

(a) covering more than 13 months, a deduction will be available for the prepayment, subject to the provisions of section 82KZM, in addition to any subsequent payments made in the income year;

(b) for 13 months or less, section 82KZM will not apply (see Example 6 below).

Tax treatments where a lease is unacceptable

13. If the lease is not accepted for taxation purposes, the transaction will be treated as a purchase of the asset financed by the lessor. The lessor will be required to treat the transaction as a loan. The 'lessee' will not be allowed to claim all of the lease payments as a deduction. Two alternative treatments are available to the 'lessee':

- the cost price of the asset is depreciated and interest and other charges (of a revenue nature) are deductible in the year they are incurred (see IT 196); or
- the total actual cost of the asset, that is, the cost price plus capitalised interest, insurance, or other charges, may be depreciated.

14. It should be noted that the latter treatment is not available where the term of the agreement substantially exceeds the period over which the plant is to be written off (see Taxation Ruling IT 2236).

Date of effect

15. In relation to subparagraph (ii) of paragraph 8 of this Ruling, the Ruling only applies prospectively from 24 June 1993 being the date of release of Taxation Determination TD 93/119. Also, in relation to subparagraphs (i) of paragraph 10, and (iii) of paragraph 11 of this Ruling, the Ruling only applies prospectively from 17 March 1994 being the date of release of Taxation Determination TD 94/20. In relation to all other aspects of this Ruling, the 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

Trade-in credit assessable

Section 26AAB - trade-in of a motor vehicle

16. Section 26AAB will apply if:

- a motor car or station wagon (a car);
- has been leased;

- part or all of the lease payments have been allowed or are allowable as a deduction from the assessable income of the taxpayer;
- the lessor has disposed of the car to the lessee; and
- at a later time the lessee has disposed of the car or an interest in the car to someone else and the consideration receivable by the lessee exceeded the cost of the car to the lessee (see subsection 26AAB(1)).

17. If a car or an interest in a car is traded-in in connection with the acquisition of another asset, the consideration receivable by the lessee will be the amount by which the cost of the acquisition of that other asset was reduced and any other consideration. Thus, if the lessee received a reduction in the cost of the replacement asset or a reduction in the lease payments to be made under the new lease, the lessee would be treated as if it had received those amounts (see the definition of 'consideration receivable' in subsection 26AAB(14)).

18. The lessee, by virtue of subsection 26AAB(2), should include in its assessable income, the lowest of the following amounts:

- the difference between the consideration receivable and the price at which the lessee acquired the car (that is, the residual value);
- the amount of depreciation which the lessee would have claimed on the car (the deemed depreciation); and
- the lease payments which have been allowed or are allowable as deductions from the assessable income of the lessee.

19. The deemed depreciation is calculated on the basis that prime cost depreciation was allowable from the time that the lessor first used the property (whether for the purpose of producing assessable income or otherwise) to the time that the lessor disposed of the car. This amount is adjusted to take account of any balancing charge or deduction which the lessor would have made on the sale of the car to the lessee. If the residual value exceeds the notional written down value of the asset in the hands of the lessor, the deemed depreciation is reduced by the excess. If the residual value is less than the notional written down value, the deemed depreciation is increased by the difference.

20. Section 26AAB enables the Commissioner of Taxation to assess a profit made by a lessee who purchases a previously leased motor vehicle and sells it for a profit. However the assessable profit is limited to the lower of three amounts:

(i) the excess of consideration receivable over the cost of the property;

(ii) the lease payments claimed or claimable by the lessee; and

(iii) an amount of deemed depreciation.

In effect, section 26AAB recoups so much of the deductions allowed in respect of a lease of a motor vehicle as has been recovered by the taxpayer through the subsequent purchase and resale of the motor vehicle.

21. The lease and sale transaction will always have an overall zero tax result, as the assessable profit will never be greater than the lease payments claimed by the lessee. The lease payments are adjusted for private use in the same way that depreciation is adjusted for private usage by the owner of an asset.

22. The deemed depreciation provided for in subsections 26AAB(6), (7) and (8) is meant to reflect the depreciation which would have been claimed by the lessor, not an amount of deemed depreciation that would have been claimed by the lessee. Thus, in calculating the lessee's assumed depreciation deduction the lessee is to be treated virtually as standing in the shoes of the lessor - that is, to have used the vehicle wholly for business purposes during the period of the lease agreement, even though the lessee may have used the property partly for private purposes, and to have disposed of it at the same price as it was sold by the lessor. The net effect after any appropriate balancing adjustments, will be that the lessee is deemed to have had a net assumed depreciation allowance in relation to the vehicle over the period of the lease that is the equivalent of that which the lessor actually received.

Section 59 balancing charge

23. Where the lessee has used the asset for some time after purchasing it, and depreciation has been allowed or is allowable to the lessee, the trade-in credit will be subject to the normal depreciation provisions and the capital gains tax provisions (Part IIIA), where applicable.

24. The difference between the consideration receivable in respect of the disposal and the depreciated value of the asset, up to the amount allowed or allowable as a depreciation deduction, should be included in the assessable income of the lessee under subsection 59(2). Alternatively, the lessee may elect to 'roll-over' that amount against the cost of other assets acquired during the year or against the depreciated values of other assets (subsection 59(2A)).

25. The consideration receivable by the lessee means the sale price less the expenses of the sale.

26. If a taxpayer has traded-in an asset without receiving a cash amount for the asset, but has received either a reduction of the cost of the replacement asset or a reduction of the lease payments on the replacement asset, the money value of that consideration will be deemed to have been paid or given to the taxpayer under section 19 or section 21.

27. Any amount above the amount which will be assessable under subsection 59(2) will generally be assessable under the capital gains tax provisions. Motor vehicles of a kind covered by paragraph 82AF(2)(a), or interests in such vehicles, will not be subject to Part IIIA.

28. In *Case T54* 86 ATC 419; (1986) 29 CTBR (NS) *Case 55* and *Case W88* 89 ATC 756; (1988-1989) 20 ATR 3970, previously leased plant was acquired and used for a period of time in the business of the taxpayers. The plant was depreciated during the period of usage. In these cases, it was held that subsection 25(1) was not applicable, but any depreciation recouped was correctly assessable under subsection 59(2).

Profit assessable - subsection 25(1)

29. If the trade-in credit is not specifically assessed under either section 26AAB or section 59, the profit will be assessable under subsection 25(1).

30. The profit will be the difference between the trade-in credit and the residual value paid for the leased asset.

31. Profits arising from the trade-in of a leased asset have been held to be assessable under subsection 25(1) in the following cases: *Case C56* 71 ATC 247; (1971) 17 CTBR (NS) *Case 53*; *Case F1* 74 ATC 1; (1974) 19 CTBR (NS) *Case 19*; *Case N59* 81 ATC 304; (1981) 25 CTBR (NS) *Case 13*; *FC of T v. Reynolds* 81 ATC 4131; (1981) 11 ATR 629; *Case S34* 85 ATC 302, (1985) 28 CTBR (NS) *Case 42* and *Case X57* 90 ATC 428; (1989-1990) 21 ATR 3463.

32. Where a leased asset is traded-in, it is not always clear that the lessee, in paying the residual value under the first lease, must have acquired ownership of the first leased asset**.** It is inconsistent with the existence of a genuine lease for the lessee to be required to pay the residual value. Nevertheless, even if the lessee did not momentarily acquire ownership of the first leased asset, the profit will still be assessable. This is illustrated in the following passage from *Case S34*; *Case 42*:

> 'If I be wrong in my conclusion that ... the partnership did acquire for a few fleeting moments title to the old Volvo, I would still be of the view that the taxpayer ... was liable for assessment on her aliquot share of the ... $12,000 ... The amount then, instead of being seen as the profit emerging from the sale of the vehicle acquired for resale at a profit, is seen to be an amount paid by a motor vehicle dealer to a client emerging from a deal struck between the parties, the amount being described as a trade-in allowance though, in fact, it was not applied in reduction of the price of the new vehicle being taken on lease.'

33. The profit will be assessable even if the trade-in credit was not paid to the lessee, but was used to either reduce the cost of a replacement asset or to reduce the lease payments which would otherwise be payable on a replacement asset. In *Case S34*; *Case 42*, the profit was held to be assessable even though it was used to purchase debentures in the new finance company which were held in the taxpayer's name. Alternatively, section 21 will apply to deem the money value of any consideration to have been paid or given.

Profit assessable - CGT

34. Both of the above cases were decided on facts that arose prior to the introduction of the capital gains tax provisions into the Act. Any profit derived over and above the cost of the plant would now, except in respect of motor vehicles of a kind covered in paragraph 82AF(2)(a), be subject to the provisions of Part IIIA of the Act.

35. For Part IIIA purposes, if the asset is acquired at the completion of the lease term by payment of the residual, the asset would be acquired at that point in time.

36. In *Case X81* 90 ATC 594; (1989-1990) 21 ATR 3703, a truck was leased in January 1983. The lease agreement was in the standard form and included no express provision for the lessee to acquire the asset at the completion of the lease term. In March 1986 (after the CGT legislation was enacted) the residual was paid out for $25,722. The truck continued to be used in the taxpayer's business until May 1987 when it was sold for $72,000.

37. The question at issue was whether the excess over the cost price was subject to tax by virtue of Part IIIA.

38. It was argued on behalf of the taxpayer, that acquisition should be taken to have occurred by the operation of paragraph 160M(3)(d) and subsection 160U(7), at the time that the lessee first obtained use or possession of the asset under the lease.

39. The fact that the parties had deliberately omitted to confer upon the lessee, a right to acquire the title in the relevant asset during the term of the lease or upon its termination, was regarded as a decisive factor by the Tribunal. In such circumstances, the lease could not be regarded as a transaction pursuant to which '...title to the asset will or may pass...' to the lessee, for the purposes of paragraph 160M(3)(d).

40. The Tribunal further observed that the existence of such an entitlement would have resulted in the purported 'lease' transaction being regarded instead as one of 'hire purchase'. This aspect of the decision in *Case X81* is consistent with the Commissioner's view as expressed in Taxation Ruling IT 28.

41. It should be noted that by virtue of the provisions of subsection 160ZA(4) any capital gain derived can be reduced by any amount that has or will be included in assessable income of the taxpayer, for example, an amount of recouped depreciation included in assessable income under section 59(2).

Acceptable inflated initial rental payments

Balloon payments

42. A lease payment which is high in relation to subsequent payments under the lease will be acceptable if it merely reflects the decrease in value of an item when it is no longer new.

43. An example of this would be where a new motor vehicle is driven off the showroom floor. The vehicle immediately drops in value to reflect the value of the vehicle on the used car market. If the initial rental payment is inflated to reflect this decrease, with the other rental payments remaining constant, then the payment would be acceptable - see Taxation Ruling IT 2395.

44. In addition, a balloon payment made which results in a reduction in subsequent rental payments required during the lease term would be acceptable where the total payments, that is, the balloon payment and the rental instalments, are calculated on the basis of the total cost of the leased asset (not the cost of the asset minus the balloon payment).

45. In these circumstances the balloon payment would be deductible, subject to the provisions of section 82KZM of the Act, in addition to the reduced monthly lease payments (see Example 5 of this Ruling).

Prepayments

46. A payment made to prepay monthly rental payments, without reducing the level of subsequent rental payments, but obtaining a

corresponding 'lease payment holiday period', would be acceptable, subject to the operation of section 82KZM.

47. Section 82KZM of the Act applies to expenditure incurred in return for the doing of something under an agreement which will not be completed within 13 months after the day the expenditure was incurred.

48. Where the prepayment of lease instalments is for services that are to be provided (that is, use of the leased asset) within 13 months from the date of the payment, section 82KZM does not apply. A payment made in these circumstances would be deductible in full.

49. On the other hand, a prepayment of more than 13 monthly rental payments would be deductible subject to the provisions of section 82KZM. That is, the payment would be apportioned over the lesser of 10 years or the term of the lease.

Deposit or down payment

50. If the lease payments on the replacement asset are calculated on the cost of the replacement asset minus the trade-in credit, the lease will not be accepted for two reasons:

(i) the residual value determined under the lease will be based on the net cost of the asset, and this will not conform with Taxation Ruling IT 28 or Taxation Determination TD 93/142; and

(ii) the lessee will in essence have an 'equity' in the asset.

51. This latter concept is best explained by way of example. If the replacement leased asset was worth $80,000, and the profit on trade-in (the trade-in credit) was $40,000, the lessee could be paid a cash amount of $40,000, and then lease the replacement asset at its full value of $80,000. In these circumstances the lease payments would be the same as if no trade-in had occurred and the lease will be accepted.

52. Alternatively, the $40,000 credit might be used to reduce the 'cost' of the replacement asset, with lease payments calculated as if the newly leased asset were worth only $40,000. Normally this would mean that the lease payments would be calculated so that, over the term of the lease, they equated to $40,000 minus the residual value of the asset at the end of the lease plus interest on the difference.

53. In these circumstances, the lease would not be acceptable as the lease payments would be less than would normally be payable in a commercial lease of such an asset. Looked at another way, the lessee has already paid for part of the cost of the asset. In commercial terms, the lessee has acquired some 'equity' in the lease.

54. In this situation, the credit has in effect been used to pay for part of the cost of the asset, and the lease payments are calculated by working out the interest payable on the difference between that reduced amount and the residual value of the asset at the end of the lease.

Will the new lease be accepted?

Other tests

55. The new lease must comply with other requirements in relation to leases, such as those contained in IT 28.

Residual value too low

56. IT 28 and TD 93/142 indicate that the residual value of a leased item must either conform with the values set out in the tables contained within those documents, or be based upon a well considered and fair estimate of the likely market value of the item at the end of the lease. If the residual value of the replacement asset under the replacement lease does not conform with these guidelines, the lease will not be accepted. For example, a lease residual based on the net cost of the asset to be leased, that is, the cost of the asset net of any deposit or down payment that is made, will not satisfy this requirement.

57. Low residual values will be acceptable where the lease is for a period less than a substantial part of the useful life of the asset and the residual value conforms with:

(i) the table of values set out in IT 28 or TD 93/142; or

(ii) a well considered estimate of the market value of the asset at the completion of the lease term and the market value can be supported by evidence of the commercial reality of the value.

58. However, it is unlikely that a nominal residual value, for example $1, would satisfy the test mentioned at paragraph 57 above even where it is based entirely on the expected market value of the asset at the end of the lease. This is because a low residual value in these circumstances would indicate that the term of the lease is for the whole or a substantial part of the useful life of the asset. Where a lease is for the whole or a substantial part of the useful life of the asset, the lease is not acceptable. The lease payments will not be deductible, but the lessee will be entitled to claim depreciation and any interest components of the lease payments: *FC of T v. Ballarat & Western Victoria TV Limited* 78 ATC 4630; (1978) 9 ATR 274.

59. It should be noted that the expression 'useful life' used above, is not necessarily the same as 'effective life' as that expression is defined in section 54A for depreciation purposes. For example, the Commissioner has determined that the 'effective life' of an aeroplane is 8 years where the 'useful life' is significantly longer.

Unacceptable inflated initial rental

60. In some cases the payments under the lease are calculated on the basis of the cost of the asset minus a deposit or down payment rather than the total cost of the asset to the lessor. This is not an acceptable lease.

61. It does not matter whether the deposit or down payment is made by way of a trade-in credit or from the lessee's own source of finance.

62. If the lease contains an initial lease payment which exceeds later payments, usually known as a balloon payment, the lease may be acceptable - see paragraphs 42 to 45 above.

Inflated initial rentals and nominal later rentals

63. If the lease payments to be made during the early stages of a lease are high, while during the later years of the lease, the lease payments are low in commercial terms or purely nominal, the lease will not be acceptable. Similarly, where plant and machinery is leased for a comparatively short initial period at a high rate of rental, with a provision, or an option, for renewal at a nominal rental for a further period which corresponds with the remaining effective life of the unit, the lease will not be accepted. The periodical payments required to be made in relation to both the early or initial lease period and the subsequent nominal rental period would be commercially unrealistic as rental payments. In addition, if the lease extends or could be extended to the effective life of the unit, the lessee would be guaranteed, in effect, use of the plant and machinery for its full effective life, and the arrangement would be considered to amount to a transfer of ownership to the lessee.

64. In *FC of T v. Ballarat & Western Victoria TV Limited* supra, a TV mast had a useful life of 40 years. The taxpayer had a contractual right to use the structure for so long as the structure was physically adequate for such use. Lease payments for the first 5 to 8 years were substantial and thereafter the payments were nominal. In addition, the lease payments were equal to the cost of the asset with interest thereon at a specified rate. Jenkinson J held that the amounts were, to the extent that they were not interest, capital:

> 'From a practical and business point of view what the making of the agreement effected was the assurance to the appellant of the use of the mast for the whole of its life ... Juristic classification of the legal rights secured by the respondent - as contractual or proprietary for example - is no doubt necessarily involved in identifying the nature and the extent and the modes of enjoyment of the advantage which the respondents outlay of money is calculated to gain for it. When that determination has been achieved, regard may then in my opinion be had to practical business considerations in determining whether what has been obtained is in truth and in substance a capital asset; and I think that juristic distinctions between ownership and the interest of a licensee, or between a term of years and a period determined by the physical "life" of a structure, or between a power to use the structure only for a particular purpose and a power to use it in any way (even to destroy it at will), may legitimately be accorded more or less significance in that second determination as the legal distinction is found to be more or less relevant, from a practical and business point of view, to the distinction between acquisition of the means of production and use of them in the process of operating the "profit-earning" subject... I find little to weigh against the conclusion that the respondent's rights under the agreement secured for it a capital asset in the circumstances that those rights are not of a proprietary kind and that they are merely to use the mast' (at 4637).

Tax motivated

65. The lease will also not be acceptable if the terms of the lease agreement do not reflect current commercial practice but appear to be designed to bring about desired tax consequences for the parties, particularly where the parties are not at arm's length. The lessor party, for example, may be in a loss situation and rentals payable under the lease agreement may be significantly higher than commercial rentals to take advantage of the loss situation (see paragraph 5 of Taxation Ruling IT 2395).

Examples

Example 1: ***disposal of motor vehicle to which section 26AAB applies***

66. The facts are:

(i) a car is leased from 1 July 1992 to 1 July 1994, and is used wholly for income producing purposes by the lessee. The

car was traded-in by the lessee at the end of the lease by the lessee purchasing the car at its residual value of $15,000 and selling it for $25,000;

(ii) cost of the car to the lessor - $30,000;

(iii) lease payments allowable to lessee - $20,000;

(iv) residual value - $15,000;

(v) consideration receivable - $25,000.

67. The deemed depreciation which would have been allowable to the lessee is calculated as follows:

(i) depreciation period is 2 years;

(ii) prime cost depreciation at 15%;

so that depreciation is $9,000 ($30,000 x 15% x 2).

The deemed written down value would be $21,000.

As the lessee would be deemed to have received the residual value of $15,000 on the disposal of the car, it would have been able to claim a balancing deduction of $6,000. The deemed depreciation amount will be increased by that amount.

Deemed depreciation - $15,000.

Depreciation is $9,000.

68. Under subsection 26AAB(2), the lessee is assessable on the amount by which the consideration receivable exceeds the cost of the property to the lessee to the extent that that amount does not exceed the deemed depreciation or the allowable lease payments. In other words, the lessee is assessed on the lowest of the three following amounts:

(i) excess of consideration receivable over cost of property - $25,000 minus $15,000 - $10,000;

(ii) deemed depreciation - $15,000;

(iii) allowable lease payments - $20,000.

In this example, the lessee will be assessed on $10,000.

Example 2: ***asset acquired for its residual value and depreciated by the lessee***

69. A truck is leased and then, at the end of the lease, purchased by the lessee and used for 6 months for income-producing purposes. It is then traded-in on a replacement truck. The truck was purchased post-

26 February 1992 for its residual value of $30,000. It was traded-in for $40,000.

70. The taxpayer elected to depreciate the truck using the diminishing value method using the 30% depreciation rate for the 6 month period.

Depreciation allowable - $30,000 x 30% x 50% - $4500.

Written down value - $25,500

71. As the consideration received on the disposal of the truck exceeded the truck's written down value, the $4,500 will be assessable under subsection 59(2), or may be rolled over against other depreciable assets under subsection 59(2A).

72. The remaining $10,000 profit will be taxable under the capital gains tax provisions. As the asset was acquired by the taxpayer less than 12 months prior to the disposal, the cost base will not be indexed for inflation.

Example 3: ***treatment of profit on non-motor vehicle trade-in***

73. An asset which is not a motor vehicle was leased for 3 years and then traded-in on a replacement asset which is also leased. The lessee is paid $4,000 in cash for the first leased asset. $2,000 of this money is used to pay the residual value of that asset.

74. The $2,000 profit on the transaction is assessable to the lessee.

Example 4: ***equity transfer or replacement lease***

75. An asset is leased. Its market value is $20,000 and its residual value is $10,000. A replacement asset worth $100,000 will be leased.

76. The lessee does not pay the residual value to the lessor to acquire the leased asset, or receive directly the difference between the market value and the residual value of the asset. Instead the cost of the replacement asset is adjusted to take into account these amounts.

77. This type of transaction has been variously described as an equity transfer or as a replacement lease:

cost of replacement asset	$100,000
add residual	$10,000
	$110,000
deduct market value of original asset	$20,000
value of replacement asset for lease purposes	$90,000

78. The lessee will be treated as if they had received consideration of $10,000 on the original asset. This amount will be assessable in full unless section 26AAB reduces the amount which will be assessable.

79. The lease will not be accepted for taxation purposes. The lessee will be treated as if the replacement asset had been purchased. Depreciation will be allowed on the asset costing $100,000. Interest and other charges, if any, under the lease will also be deductible.

Example 5: ***trade-in profit used to reduce lease rental payments***

80. A previously leased motor vehicle is traded-in on 1 January 1993 contemporaneously with the payment of the residual prescribed in the lease agreement.

81. The profit (trade-in credit) resulting from the transaction is $10,000.

82. Another vehicle is leased for 4 years. This vehicle will be used 100% for business purposes as was the original vehicle.

83. The $10,000 profit is used to make a lump sum prepaid rental payment which reduces the 48 monthly lease rental payments from $364.33 ($4372 per annum) to $156 ($1872 per annum). The reduced lease rental payments are calculated on the basis of total cost of the leased asset, not the cost of the asset minus the balloon payment.

84. The profit of $10,000 is to be included in assessable income of the year ended 30 June 1993 by virtue of section 26AAB.

85. Also, the $10,000 prepaid rental payment is deductible over the term of the lease in accordance with section 82KZM. This deduction is additional to the monthly rental payment incurred.

86. The total deduction available each year is made up of the sum of the following amounts:

Year	Annual payment	Proportion of Prepayment	
30 June 1993	$936	$1239	($10,000 x 181/1461)
30 June 1994	$1872	$2498	($10,000 x 365/1461)
30 June 1995	$1872	$2498	($10,000 x 365/1461)
30 June 1996	$1872	$2505	($10,000 x 366/1461)
30 June 1997	$936	$1260	($10,000 x 184/1461)
	$7488	$10,000	

Example 6: ***use of trade-in profit to prepay less than 13 months lease instalments***

87. Mr Lee Sea entered into a 5 year lease on 1 July 1992, with monthly lease instalments of $1,000. From July 1992, Mr Sea pays $1,000 each month under the lease agreement, however in June 1993 he decides to make a prepayment of lease instalments. Accordingly, he pays $13,000 being $1,000 for the June 1993 instalment and $12,000 being a prepayment for the next 12 months. In July 1993 and subsequent months, Mr Sea continues to pay instalments of $1,000 12 months in advance. During the 1996/97 financial year, the year before the lease is due to expire, Mr Sea does not make any lease payments (referred to as a 'holiday period').

88. Under these circumstances, section 82KZM will not apply to the prepayment.

89. The $12,000 represents a prepayment of lease instalments up to June 1994. As Mr Sea has incurred the expenditure in relation to services that are to be provided within 13 months (that is, use of the leased asset), section 82KZM has no application. The same principle applies to subsequent monthly instalments. For example, the monthly payment made in July 1993 is in effect a prepayment for the July 1994 lease instalment. This payment is also for services to be provided within the 13 month time limit specified in section 82KZM, and therefore the section will not apply.

Your comments

90. If you wish to comment on this Draft Ruling, please send your comments by: 25 January 1996

to:

Contact Officer: Grant Murphy

Telephone: (077) 53 7405

Facsimile: (077) 53 7275

Address: Australian Taxation Office
P O Box 9990
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Attention: Mr Grant Murphy.

Commissioner of Taxation

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