IT 2519 - Income tax : ownership of plant or fixtures purchased under hire-purchase agreements as part of a financing arrangement

TAXATION RULING NO. IT 2519

INCOME TAX : OWNERSHIP OF PLANT OR FIXTURES PURCHASED UNDER HIRE-PURCHASE AGREEMENTS AS PART OF A FINANCING ARRANGEMENT

F.O.I. EMBARGO: May be released

REF N.O. REF: 10.88/6810-7 DATE OF EFFECT: Immediate

B.O. REF: DATE ORIG. MEMO ISSUED:

F.O.I. INDEX DETAIL

REFERENCE NO:	SUBJECT REFS:	LEGISLAT. REFS:
I 1011045	FINANCING ARRANGEMENT	
	DEPRECIATION	54
	FIXTURES	DIVISION 10D
	HIRE-PURCHASE	PART IVA

OTHER RULINGS ON TOPIC IT 175, IT 196, IT 2236

PREAMBLE Advice was sought from this office as to the income tax consequences of a proposed "tax effective" financing arrangement for the construction and establishment of a processing plant. This Ruling sets out the views of this office on the income tax consequences of the proposal.

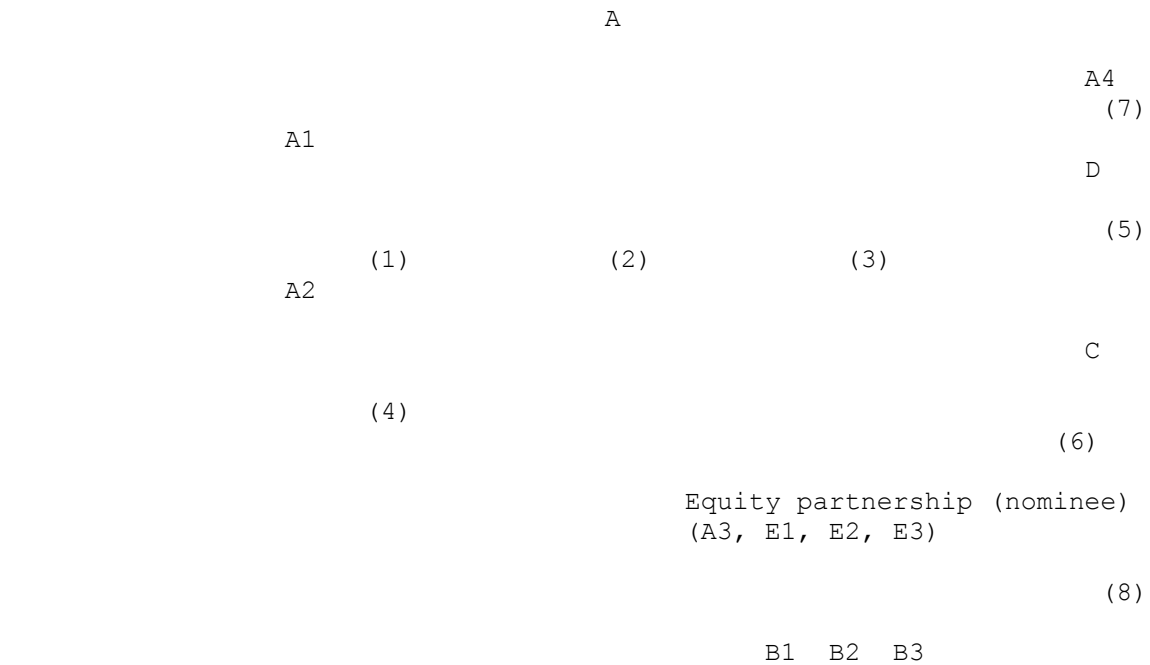
2. The financing arrangements concerned certain Australian financiers who through an equity partnership were to provide the finance for a substantial part of the total cost of the construction of the plant. Instead of providing the finance by way of a direct loan, the arrangements were to be structured in such a way as, if accepted, would allow the financiers the tax benefits of depreciation on equipment, deductions allowable in relation to buildings in accordance with Division 10D, and deductions for other finance charges, project development costs, other costs, fees and expenses incurred by the equity partnership. These tax benefits would have effectively allowed the financiers to charge a lower than market rate of interest without reducing the return on the funds provided. Details of the proposed arrangements are set out below.

3. The proposed arrangement involved the following entities :

A - a non-resident parent company
A1, A2, A3 - Australian subsidiaries of A
A4 - a non-resident subsidiary of A
B1, B2, B3 - Australian financiers
C - an Australian finance partnership
D - a non-resident finance company in which A4 had a less than 15% interest
E1, E2, E3 - Australian companies owned respectively by B1, B2 and B3.
Equity partnership - comprising A3, E1, E2 and E3, which appointed another company to act as nominee and agent for

the project.

4. The arrangement, as illustrated, was to proceed in the following manner :



(1) The equity partnership acquires shares to sufficiently fund 26% of the total cost of construction of the processing plant. The balance of the costs are met by finance obtained by A1 from independent banking sources and on-lent to the equity partnership and by funds made available through a hire-purchase facility applicable to the plant and equipment by D, a non-resident finance company, in which A has a minority share holding interest. (see steps (3), (5) and (6)).

(2) The equity partnership pays A1 to construct the plant and buildings on land owned by A1. A1 leases the land to the equity partnership which, under the site lease, is given a right to remove the plant. A1 is also paid by the equity partnership to manage and operate the plant. The equity partnership repays the loan from A1 referred to in (1) above (see step (4)).

(3) D purchases from the equity partnership the plant progressively during the course of construction of the plant by A1.

(4) A2 pays the equity partnership to process materials at the plant. The charges for this are calculated to cover any loan repayments to be made by the equity partnership to A1 under (2) and hire purchase payments under (5) plus a predetermined guaranteed annual return. Payment is to commence before the plant is completed and is to be made whether or not materials are processed.

(5) C acquires the plant from D by way of a hire-purchase agreement under which C will have a right to purchase the plant for a purely nominal amount after the hiring is terminated. (Alternatively, C may purchase the plant from D instead of entering into a hire-purchase agreement).

(6) The equity partnership acquires the plant from C under a hire-purchase agreement with similar terms to (5) (or by direct purchase).

(7) If the agreement in (5) is a hire-purchase agreement, the benefits are assigned to A4.

(8) The financiers own the shares in E1, E2 and E3. At the end of the arrangement, or upon the happening of certain events, the financiers have the right to require A3 to purchase their interests for certain preset amounts which ensure a determined rate of return on the funds provided. The equity partnership is to dissolve at the end of the arrangement.

5. Inter alia, the arrangements required consideration of the application of Taxation Rulings No. IT 175 and No. IT 196. Taxation Ruling No.IT 175 concerns the circumstances in which a site lessee will be treated as the owner of plant or articles for the purposes of depreciation under section 54 of the Income Tax Assessment Act where the plant or articles are structural improvements or fixtures situated on the leasehold property. Taxation Ruling No.IT 196 accepts that, under a hire-purchase agreement, the hirer may claim a deduction for depreciation based on the total cost of the plant to the hirer, subject to Taxation Ruling No. IT 2236 which precludes acceptance of this basis of claiming deductions where the period of write off of the plant is substantially less than the term of the hire-purchase agreement. It was necessary to decide whether Taxation Rulings No. IT 175 and No. IT 196 were applicable in the circumstances under consideration so as to allow a party a deduction for depreciation where it was both the lessee of the land to which the plant was affixed and the hirer of the plant under a hire-purchase agreement.

RULING

6. The predetermined and guaranteed payments under the contract for processing of the materials were to be made whether or not processing of the raw materials was undertaken. Those payments would also begin before the plant complex was completed. These circumstances gave cause to question the commerciality of the arrangement as presented.

7. There was also a question whether the equity partnership of financiers could be accepted as being the owner of the subject plant for depreciation purposes. It was considered that the partnership would not, in terms of Taxation Ruling No.IT 175, be the owner of the plant. As indicated in that Ruling, in ascertaining whether the necessary degree of "ownership" is present, the precise nature of the tenant rights and the nature of the plant itself and the circumstances of its annexation are material factors that need to be taken into account. Items of

plant will generally be the property of the freeholder either because they form part of the original building itself, or because the object and purpose of their annexation to the building is such as to make them a permanent part of the realty.

8. Under the proposed arrangement, although the documentation would on its face vest in the equity partnership the right to remove the plant, the financing arrangement taken as a whole indicated that the intention of the parties was that the partnership would not remove, or receive any compensation for, the plant. The partnership was not seen to have a real and effective control or interest in the plant. In fact, the partnership would not, in a physical or practical sense, be in a position to remove the various items of plant.

9. Further, in a situation where the equity partnership was to terminate within a fixed period that could be at the time of or before the termination of the hire-purchase facility referred to in step (6) in paragraph 5 above, any passing of the property in the plant to the partnership was likely to be of a transitory nature only - with the ultimate ownership continuing effectively to reside in A1. This is not a situation to which Taxation Ruling No.IT 196 would apply.

10. Further, having regard to all relevant matters in terms of section 177D of the Income Tax Assessment Act, it could not be concluded that the arrangements would not have been entered into for the sole or dominant purpose of obtaining a tax benefit. Accordingly, no assurance that Part IVA would not apply could be given. Notwithstanding the form of the arrangements, the equity partnership of financiers would under the arrangements effectively be making available a loan towards the cost of the construction of the plant. The predetermined and guaranteed net rate of return that the partnership would be entitled to under the processing contract in substance would constitute interest payments to the financiers. It was considered that the payments would fall to be assessed on that basis.

COMMISSIONER OF TAXATION
27 February 1989