IT 28 - Leasing arrangements of plant and machinery

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TAXATION RULING NO. IT 28

LEASING ARRANGEMENTS OF PLANT & MACHINERY

F.O.I. EMBARGO: May be released

REF

*** NOTE: THIS RULING HAS BEEN MODIFIED BY IT 2287

H.O. REF: J146/569 P2 F192 DATE OF EFFECT:

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F.O.I. INDEX DETAIL

REFERENCE NO:	SUBJECT REFS:	LEGISLAT. REFS:
I 1101973	LEASED PROPERTY RESIDUAL VALUES DEPRECIATION PLANT	260

OTHER RULINGS ON TOPIC IT 174

PREAMBLE A former Commissioner of Taxation issued a statement in reply to a request for advice on the likely taxation implications arising from the practice of finance companies leasing plant on a rental basis as opposed to the normal hire purchase arrangements

2. The statement is reproduced below.

RULING "INCOME TAX : LEASING ARRANGEMENTS OF PLANT AND MACHINERY
STATEMENT BY THE COMMISSIONER OF TAXATION
SIR PATRICK McGOVERN, C.B.E."

APPENDIX 3. Some twelve months ago a copy of an agreement providing for the leasing of plant and machinery was submitted to the Taxation Office for a ruling whether or not payments under the agreement were allowable deductions for income tax purposes. As the document was a lease agreement simpliciter, the enquirer was advised that the rentals payable would be deductible so long as the leased goods were used by the lessee in the production of his assessable income.

4. Subsequent investigation disclosed that, in most transactions of this nature, there were auxiliary arrangements under which, on the expiration of the lease, the lessee would gain ownership, or retain the use, of the goods previously leased by him. In some cases it was found that a three-party arrangement was effected whereby the lessor agreed, either in subsidiary documents or in correspondence, to sell the goods, on the expiration of the lease, to an intermediary who in turn agreed to sell them to the lessee. In other cases the circumstances surrounding the transaction were such as to establish the existence of oral commitments.

5. Some publicity material promoting leasing arrangements of plant and machinery made a feature of the opportunity given to the lessee of acquiring the goods at a low written-down value. It was stated further that the new lease procedure had

the effect of reducing the amount of tax payable by the person acquiring the goods and thus had advantages over conventional hire-purchase.

6. In view of such statements, I considered it expedient last February to issue a warning to persons concerned in this type of transaction that it might be necessary to ascertain the substance of the transaction between the parties from all the covenants entered into, whether expressed in the lease agreement or otherwise.

7. In short, it was made clear that, in determining the application of income tax legislation to this class of transaction, it was necessary to decide whether the payments were lease rentals or whether they were, in substance, consideration for the sale of the goods purported to be leased. In the latter case, of course, the payments would be outgoings of a capital nature which would not be deductible for income tax purposes.

8. Among the relevant factors which would determine this question are the following:-

(1) the existence of any agreement, express or implied, and whether in the lease agreement or in subsidiary documents or correspondence, under which the property in the goods would pass from the lessor to the lessee; and

(2) the degree of relativity between the "appraisal value" or "residual value" - by reference to which the amount of lease rentals was frequently determined - and the reasonable commercial value of the goods at the expiry date of the lease.

9. Further, where an arrangement had as one of its objects the purpose or effect of altering the incidence of income tax, a prima facie case for the application of section 260 of the Income Tax and Social Services Contribution Assessment Act existed. For this reason it would be necessary to examine each transaction in the light of its facts before any decision could be given.

10. This is the traditional approach of administrations not only in Australia but throughout the world. It arises from the difficulty of formulating general rules for application to particular facts.

11. Nevertheless, I have been pressed on all sides to delineate an area in which traders who wish to follow the procedure of leasing plant and machinery for reasons not connected with income tax saving may operate without fear of long drawn out legal argument after the event.

12. People making these representations maintain that it is not too much to expect from an administration that it should indicate the boundaries within which traders may operate without risk of subsequent challenge, entailing great disruption of business and possible monetary loss.

13. This is persuasive argument and, with pre-knowledge of

the difficulties of formulating general principles for application to particular cases and without in any sense attempting to define the limits of construction that may be placed upon the relevant provisions of the income tax legislation, I have attempted in this instance to promulgate minimum conditions that would ensure to a person complying with them freedom from challenge from my administration.

14. As I have already indicated, the basic question for decision is whether the transaction is, in practical effect, an ordinary commercial lease entered into in the normal course of trade. Obviously, not all payments under agreements purporting to be lease agreements can properly be regarded as rentals to be allowed as deductions for income tax purposes.

15. If, for instance, the arrangement were such as to confer on the lessee, if he chose to avail himself of the option, a right whereby the property in the goods would pass to him from the lessor at any point of time, the arrangement would, in my opinion, constitute for all practical purposes a contract for the sale of the goods. Similarly, I should not regard as a normal commercial lease an arrangement under which, on the termination of the lease or any extension thereof, the lessee was permitted or enabled to retain the use of the goods - as, for example, through the property in the goods passing to his nominee or agent. In these contexts, it is considered to be immaterial whether the lessee's right to secure the property in (or the use of) the goods was conferred in the head agreement or in some collateral agreement or agreements.

16. The inclusion in the agreement or agreements of a provision that the leased goods be disposed of, at the termination of the lease, otherwise than by way of public auction raises a presumption that the lessee has rights of purchase. Such agreements do not satisfy the minimum conditions herein being defined.

17. This is not intended, of course, as restricting or confining an owner's rights to dispose of his goods in any way he may choose after the leasing is completed. The objection is against provisions under which, prior to the termination of the leasing period, arrangements are entered into for the disposal of the goods other than by public auction.

18. Another factor that would be regarded as inconsistent with a finding that the transaction was a normal commercial lease would be the inclusion in the leasing agreement of a provision under which, in the event of the sale price of the goods falling short of an agreed residual value, the shortage should be paid by way of adjustment by the lessee to the lessor.

19. An unreal or nominal residual value in leases of relatively short term e.g. up to 5 years, would, I consider, raise a strong presumption that the transaction was something more than an ordinary commercial lease. By this it is not intended to convey that the residual value must necessarily correspond with the depreciated value of the goods for income tax purposes but it should, in my view, be in conforming with some generally accepted basis of commercial or industrial valuation.

20. The following table has been prepared as indicating what I would regard, in this context, as minimum residual values for various categories of plant and machinery (classified according to depreciation rates on a prime cost basis for income tax purposes) at the end of leases ranging from one to five years:-

MINIMUM RESIDUAL VALUES - PERCENTAGE OF COST

Term of Lease	Plant and Machinery Classified According to Income Tax Prime Cost Depreciation Rates				
	20%	15%	10%	7 1/2%	5%
1st year	60%	63.75%	67.5%	68.5%	70%
2nd year	45%	52.5%	60.0%	62.5%	65%
3rd year	30%	41.25%	52.5%	55.0%	60%
4th year	15%	30.0%	45.0%	50.0%	55%
5th year	nil	18.75%	37.5%	45.0%	50%

21. Subject to what I have already said concerning express or implied arrangements for the transfer of the property to or the use of the property by the lessee, I would not seek to impugn a lease agreement for reasons specifically relating to appraisal or residual values if those values equalled or exceeded the minimum limits indicated in the foregoing table.

COMMISSIONER OF TAXATION