Taxation Determination

Income tax: is a lease acceptable if it is based on a $1 residual value or if the lease is for the useful life of the asset?

1. If a lease is for the whole or a substantial part of the useful life of the asset, the lease is not acceptable. If a lease is for less than a substantial part of the useful life of the asset, and the residual value conforms with the table of values set out in IT 28 and TD 93/142, a lease may be acceptable even if the residual value is only $1.

2. The residual value of a leased item should either conform with the table of minimum residual values set out in IT 28 and TD 93/142 or a well considered estimate of the market value of the leased item at the end of the lease.

3. If the residual value did not conform with the IT 28 table, a $1 residual value would only conform to this test if the expected market value of the asset was $1, indicating that the term of the lease was for the whole or a substantial part of the useful life of the asset.

4. If a lease is for the whole or a substantial part of the useful life of the asset, the lease payments will not be wholly deductible for taxation purposes. Only the interest components of the lease payments will be deductible.

5. In the case of *Federal Commissioner of Taxation v. Ballarat & Western Victoria T.V. Limited* 78 ATC 4630; 9 ATR 274, the taxpayer had a shared right to use a TV aerial for the whole of its useful life. The masts had an expected life of 40 years. The sums payable for the right to use the mast were due at half-yearly intervals over eight years. These payments were equal to half the cost of the structure with interest thereon at a specified rate over the period of eight years.

6. Jenkinson J. held that the payments for the use of the mast were instalments of the price of a capital asset acquired by the taxpayer and of interest on that price; and that those instalments were to an extent outgoings of a capital nature. He confirmed that the non-interest components of the payments were not deductible under subsection 51(1). This was so even though the rights of the user were not "of a proprietary kind".

7. It has been argued that the decision in this case will be relevant to payments under a lease only where the lease is for the useful life of an asset and the lease payments are accelerated. This argument is not accepted. Jenkinson J. indicated that the acceleration factor was suggestive, but there is no indication that it was an essential factor of the case. To quote from ATC page 4639; ATR page 285:

> "In my opinion comparison between the period within which the payments are to be made, with the period during which, it is to be inferred, the parties expected the right to use the mast to endure suggests what the stated bases of calculation of the payments confirm: that the payments are instalments of a price, and interest thereon, for the right to use the mast for the whole of its life, not hire or rent for use during the first eight years or during a longer indeterminate period."

Accordingly, at the very least, this case is considered to be authority for the proposition that if a lease is for the useful life of an asset and the lease payments are for the cost of the asset plus interest calculated thereon, the capital component of the lease payments is not deductible.

8. Useful life is not necessarily the same as "effective life", as defined in section 54A for depreciation purposes. For example, although the Commissioner of Taxation has determined that the effective life of an aeroplane is 8 years, it is clear that the useful life of an aeroplane is longer than 8 years.

9. If a lease is not accepted, the lease payments will include outgoings of a capital nature which will not be deductible for income tax purposes. The lessee will be entitled to claim depreciation on the leased asset and any interest components of the lease payments. The lessor will not be entitled to claim depreciation, but will be required to treat the transaction as either a financed purchase of the leased asset by the lessee, or, if a sale and leaseback was involved, as a loan to the lessee. The reference to sale and leasebacks in the last sentence is not to be taken as an acceptance of sale and leaseback transactions.

10. This determination will apply prospectively from the date of release of the final determination.

Commissioner of Taxation
17/3/94

FOI INDEX DETAIL: Reference No. I 1217119 Previously issued as Draft TD 93/D157
Related Determinations: TD 93/142
Related Rulings: IT 28; IT 2594
Subject Ref: leasing; residual values
Legislative Ref: ITAA 51(1); ITAA 54; ITAA 54A
Case Ref: F.C. of T. v. Ballarat & Western Victoria T.V. Ltd 78 ATC 4630, 9 ATR 274
ATO Ref: NAT 93/195-1
ISSN 1038 - 8982