OPERATING AND FINANCE LEASES IN AN INCOME TAX CONTEXT

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In the past few years there have been several important taxation cases involving financing by means of leasing and the deduction of rental payments rather than financing by borrowing secured by mortgages. There have also been a number of rulings addressing the issue of tax avoidance in a leasing context[1]. These cases have involved lease financing of luxury cars[2], sale of leased property by lessees above residual values[3], and sale and leaseback of fixtures[4]. In these cases there have been considerable tax advantages to the lessee who might otherwise have chosen to finance by borrowing. If the taxpayer were to borrow in order to acquire depreciable assets, the repayments would be split up into principal and interest, and the debtor would depreciate the assets. If the taxpayer leases the depreciable asset from a financier, then the financier as holder depreciates and the lessee deducts the rental payments which are entirely on revenue account. At first blush there would appear to be no great tax advantage since the assets are depreciated by one party and what is entirely deductible as revenue outgoings to the lessee is fully assessable to the lessor. The problem from the revenue's point of view is that the financier/holder of the asset depreciates it, and at the same time the lessee's payments are entirely deductible. Yet the lease documents generally provide that the asset is to be sold at the end of the lease for a residual value which is invariably below its market value. An example of this occurred in *Granby Pty Ltd v FCT*[5] where the lessee purchased depreciating assets at the end of the lease and shortly thereafter sold them for a net gain of $123,558. This was an assessable capital gain. The standard lease does not give the lessee any right or obligation to acquire the depreciated asset, so taxation law must regard the payments as being entirely on revenue account. There is a capital allowance for the financier/lessor under Division 40 of ITAA 1997 and there is in commercial effect a capital allowance to the lessee who has purchased the asset below its market value at the expiry or termination of the lease using fully deductible payments.

In spite of these tax advantages there are sound commercial reasons[6] for using leases in a business context and these are not necessarily tax related, and even when there is a tax advantage, the dominant purpose of their use is not to gain a tax benefit in breach of Part IVA of ITAA 1936. In the commercial world business people have drawn distinctions between various types of leases, namely finance leases and operating leases. These distinctions are not reflected in the legal form of the underlying contracts, and taxation law generally regards all leases as operating leases[7]. Although there are some tax advantages in leasing, these advantages would be entirely eliminated if taxation law adopted the accounting approach of treating finance leases as equivalent to a conditional sale and allowing the lessee to be the

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[1] Taxation Ruling TR 2006/13 replacing Taxation Ruling TR 95/30 Income Tax: sale and leasebacks; Taxation Ruling TR 2005/20 Income Tax: the interaction of deemed ownership under division 240 of the Income Tax Assessment Act 1997 with "holding" rules and Division 40; T D 94/20; TD 93/142; I T 2594; IT 2395; IT2354; IT2287; IT2051; IT196; IT28.

[2] *FCT v Citibank Ltd* (1993) 26 ATR 423-luxury car leases;

[3] *Granby Pty Ltd v FCT* (1985) 30 ATR 400.

[4] *Eastern Nitrogen Ltd v FCT* (2001) 46 ATR 474 and *FCT v Metal Manufacturers Ltd* (2001) 46 ATR 497-both cases involving sale and leaseback of a fixture rather than borrowing against the security of assets.

[5] See footnote 3

[6] See generally Professor Roy Goode *Commercial Law* Third Edition Penguin 2004 chapter 28

[7] *FCT v Citibank Ltd* (1993) 26 ATR 423 per Justice Hill.

holder who depreciates. The rental payments would be split up into principal and interest and there would be no double use of capital allowances.

I ACCOUNTING POSITION UP UNTIL 2005

AASB[8] Standards 1008 defined operating and finance leases.

Paragraph 20.1 defined a finance lease as 'A lease under which the lessor effectively transfers to the lessee substantially all the risks and benefits incident to ownership of the leased asset and where legal ownership may or may not eventually be transferred.'

Paragraph 5.3 .4 describes a finance lease as one which is non-cancellable; and either the lease term is at least 75% of the economic life of the asset or the present value at the beginning of the lease of the payments exceeds 90% of the fair value of the asset at the start of the lease. In paragraph 5.3.1 we are told that the classification depends on its economic substance. The kinds of risks envisaged are obsolescence, idle capacity, fall in value and uninsured damage. Although there was a reference to the economic substance, in practice the 75% rule and that 90% rule were applied somewhat mechanically.

An operating lease was defined as 'A lease under which the lessor effectively retains substantially all the risks and benefits incident to the ownership of the leased asset.'

This is a definition that accorded with legal concepts. It recognized that ownership remained vested in the lessor and is likely to remain so given the absence of an option to purchase in the lease. The presence of an option would make it a hire purchase agreement thus necessitating the apportionment of the payments between principal and interest. According to the accounting standards, in the operating lease the lessee must recognise the rental expense in the financial year. The lessee has no asset and this is entirely in accordance with the legal form of the transaction.

II POSITION FROM ANNUAL REPORTING PERIODS BEGINNING ON OR AFTER 1 JANUARY 2005

A new approach was adopted in the 2005 standards which were made on 15 July 2004 though they applied to annual reporting periods beginning on or after 1 January 2005. These standards were adopted to give application to international standards. Under this approach there is a more clear emphasis on substance.

This is now contained in AASB 117. The definition of a finance lease is now more firmly based on economic substance and is found in definitions section 4:

"A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred."

"A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time".

"An operating lease is a lease other than a finance lease".

Paragraph 10 provides a number of criteria for deciding whether a lease is a finance lease. These include: whether the lease transfers ownership of the asset to the lessee at the end of the lease term, the presence of an option to purchase the assets at lower than a fair value at the end of the lease, the lease period is for a major part of the economic life of the asset, at the start of the lease the present value of the minimum lease payments represents substantially the value of the asset, and the assets are such of a specialised nature that only

[8] Australian Accounting Standards Board. The Board's functions and powers are set out in the *Australian Securities and Investments Commission Act 2001.* Under s 296 of the *Corporations Act* 2001 a company's financial report for the financial year must comply with accounting standards

the lessee could be expected to use them without major modifications. An example of assets being of a specialised nature would include sale and leaseback of a fixture where a third-party would not purchase the asset. Paragraph 10 provides that a finance lease is indicated where if the lease is cancelled the lessee will bear the gains or losses to the residual value at the end of the lease. Finance leases are also indicated where the lessee can at the end of the lease continue to use the asset for a rent that is substantially below the market value.

III LEGAL CHARACTERISATION OF THE LEASE

As far as legal characterisation[9] is concerned, the lease of a chattel is a hire contract involving the bailment of a chattel from one person to another. It is not strictly speaking[10] a lease. Although there is a distinction between a finance lease and an operating lease for the purpose of reporting accounts[11], at general law both types of leases are indistinguishable. If any question of insolvency arises the leased asset will belong to the lessor for the purposes of liquidation. Goode notes that although there is no significant legal distinction between an operating and a finance lease, operating leases tend to be used where the lessee does not require the use of the chattel for its effective life and the lessor will enter into a series of leases in respect of the chattel. The rental is fixed by reference to the asset's use value. In the finance lease the period of the lease tends to reflect the effective life of the asset .The rental instalments plus the residual value reflect the purchase price of the asset plus a reasonable return for the lessor. This payment is not unlike that which would be charged for a conditional sale of the asset. The assumption behind fixing of the rental payments is that the residual value of the chattel will be negligible at the end of the lease. In practice the Commissioner will not allow leases that do not have a residual value[12] for the asset at the end of the lease. Business persons look to the form of the agreement which in substance gives the lessee effective "ownership" though this would not be recognized by the general law. What is important is that the lessee has exclusive use and eventually will be the owner of the asset even though this is not provided for in the lease. Professor Roy Goode[13] examines the commercial reasons why a lessee may prefer a finance lease to a conditional sale. In a finance lease the lessor is the owner[14] and is therefore able to claim depreciation which enables it to pass on lower rental costs to the lessee. A second and less compelling reason according to Goode is that in a finance lease the lessee is not required to make a down payment as is usually standard in a conditional sale -- but there is no reason why this should be so in principle. Another historical reason was that liability under a finance lease did not have to be recorded on the balance sheet whereas a conditional sale would have to be capitalised as a liability on the balance sheet. This would enable the lessee's financial position to appear more liquid than it might otherwise be. Today the finance lease has to be recorded on the balance sheet[15]. AASB 117 paragraph 20 provides "At the commencement of the lease term, lessee shall recognize finance leases as assets and liabilities in their balance sheets at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments, each determined at the inception of the lease".

[9] Professor Roy Goode *Commercial Law* Third Edition Penguin 2004 chapter 28.

[10] Hill J in *FCT v Citibank Ltd* (1993) 26 ATR 423 noted this distinction, though nothing turned on the difference in that case.

[11] These are given the force of law by *Corporations Act* 2001 (Cth) Part 2M.3

[12] TR 2006/13.

[13] Goode op. cit. at 722 -- 723

[14] In Australia Division 40 of ITAA 1997 provides that the owner (lessor) in the circumstances is the holder and thus entitled to the depreciation.

[15] AASB 117.

Hence it is also recognized as an asset of the lessee which gives it a more favourable appearance than a loan secured against corporate assets. Such a loan would only be a liability. In *Metal Manufactures Ltd v FCT* [16]Emmett J at first instance said that using finance leases had the advantages of reducing after-tax financing costs, increasing reporting profits, improving cash flow and improving the balance sheet. An operating lease is not reported as a liability, but must be recognized as a "commitment". Paragraph 33 of AASB 117 provides "Lease payments under an operating lease shall be recognized as an expense on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit".

Paragraph 35 provides that other liabilities for the next year, next five years less one, later than five years also be recognized in the balance sheet. There is no corresponding asset in the lessee as there is in a finance lease. There may be some temptation to report a finance lease as an operating lease because of this favourable impact on the balance sheet. But the reporting of a lease as either finance[17] or operating will have a more favourable appearance for reporting purposes than the simple recording of the transaction as a loan which is the alternative method of finance. Thus at the outset there are sound non-tax reasons for lease financing as opposed to borrowing against the security of assets. This reason does not seem to have been recognized by the ATO in former ruling TR 95/35 and current ruling TR 2006/13. Those reasons for preferring lease financing might be stated simply as: the impact on the balance sheet, the immediate cash flow given by sale and leaseback, the fact that the lessor is getting deductions for depreciation which may result in lower "interest/rent" payments by the lessee, and the lessee's purchase of the asset at residual value[18]. Such value is generally lower than market value and this means that although some of the recurrent lease payments result in the acquisition of a capital asset, this is not the sole or dominant reason from the lessor's perspective. The fixing of the residual value gives the lessee a real incentive to look after the asset during the currency[19] of the lease, and a real incentive to purchase the asset at the end of the lease when the lessor/financier has no interest, reason or expertise to acquire the underlying asset.

IV PARTIES TO THE FINANCE LEASE

Generally there are three parties, namely the supplier, the end user (the lessee) and the financier (the lessor). Compared with the lessor, the lessee will have greater expertise as to its needs, the quality of the product, its cost and other characteristics. Once having chosen the particular plant the lessee may approach the financier who may purchase the asset from the supplier and then lease it to the lessee. More commonly the lessee may purchase the asset from the supplier and subsequently the contract will be discharged by novation so that the purchase contract will be between the supplier and the financier who will then lease the asset

[16] (1999) 43 ATR 375 at 386.

[17] Emmett J in *Metal Manufacturers Ltd* at 386 said " The State Bank provided a very comprehensive submission using a 37.5% residual value demonstrating that, assuming that the sale of the plant yielded $55 million with a $5 million up front fee to the State Bank, the company would save $7.8 million over five years compared to a conventional loan of $50 million. This represents an after tax interest rate of 5.68% per annum for the lease compared with 8.38% per annum after tax for a conventional loan". And see further at 388 where His Honour noted the favourable impact on the balance sheet of a sale and leaseback as compared to a loan.

[18] In *Metal Manufacturers Ltd* the parties considered that a residual value of 10% would not be acceptable to the Commissioner, and a 37.5% residual value was used.

[19] Per Lee J in *Granby Pty Ltd v FCT* (1985) 30 ATR 400 at 404.

to the lessee. Novation is necessary because it is only possible to assign benefits[20] and not burdens in contract law, though in some cases it may be possible to sever the benefits from the burdens[21]. In some cases the lessee may purchase an asset as agent on behalf of the financier who is an undisclosed principal. The recent capital gains tax case of *FCT v Sara Lee Household & Body Care (Australia) Pty Ltd*[22] showed that it is possible to ratify a contract by a subsequent contract which varies the first contract but does not discharge it. Ratification will only be possible where the contracting party has contracted on behalf of a third-party though it will not be necessary to disclose that fact where the purchaser (lessee) contracts on behalf of the undisclosed principal. This will be unusual but not unheard of, so normally novation will be necessary, or alternatively the lessee might sell the asset to the financier and lease it back which procedure is also recognized in the rulings[23] and which in this case is not tax driven. Sale and leaseback in this context is perfectly legitimate, though sale and leaseback might take place many years after the taxpayer has acquired the relevant asset[24].

The standard finance lease in a taxation context does not give the lessee the right to purchase the asset nor does it oblige the lessee the purchase the asset because it is envisaged that the asset will have no value at the end of its effective life. As Goode[25] notes this expectation was not realised in the 1970s in a time of high inflation. Often the residual values could be quite significant even though they were below market, and the result was that a lessee who purchased the asset at the end of the lease at residual value could make a gain by its sale, though in Australia this would be in the case of a company an assessable capital gain with no discount[26] and there would be no discount for other taxpayers if the sale took place within a year. Alternatively the lessee may continue to use the asset for productive purposes after the lease period has expired or after having purchased it at residual value, and depreciating it from that cost. Where the lessee has sold the asset after acquisition at residual value, Division 40 of ITAA 1997 should not apply. Even though Division 40 now applies to depreciating assets, the lessee would not be the holder at the time of acquisition and provided the lessee does not use the asset for the gaining of assessable income after acquisition, there is no room for Division 40 to apply. Even though the gain was assessable in *Granby*, the taxpayer has still had the advantage of purchasing a capital asset with entirely deductible payments and has not been assessed until the end of the lease, and has still enjoyed the cheaper finance made available because the lessor has been able to depreciate the asset.

The taxation effect is that the financier/lessor is entitled to claim depreciation, while the lessee is making payments towards the acquisition of an asset which will eventually be purchased below its market value. This will result in an assessable capital gain on disposal of that asset, the gain being the difference between the residual value and the market value. In effect, though not in legal form, the lessee will have incurred revenue deductions in acquiring a capital asset, but the lessee will eventually be assessed on that gain. The only advantage in this form of structure seems to be the time value of money. The deductions are made during

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[20] *Pacific Brands Sport & Leisure Pty Ltd and others v Underworks Pty Ltd* (2006) 149 FCR 395 at 404 paragraph 32 ; Meagher, Gummow & Lehane Equity Doctrines & Remedies Butterworth's Lexis Nexis 4th edition paragraph 6 -- 460; Greg Tolhurst *The Assignment of Contractual Rights* Hart Publishing 2006.

[21] *Don King Productions Inc v Warren* [1999] 3 WLR 276 at 300-301, [2000] Ch 291.

[22] (2000) 201 CLR 520 following *Tallerman Pty Ltd v Nathan's Merchandise (Vic) Pty Ltd* (1957) 98 CLR 93 at 114 per Taylor J.

[23] TR to 3 Income Tax: sale and leasebacks.

[24] For Example, *Eastern Nitrogen Ltd v FCT* (2001) 43 ATR 474; *FCT v Metal Manufacturers Ltd* (2001) 43 ATR 497

[25] op. cit. chapter 28

[26] *Granby Pty Ltd v FCT* (1995) 30 ATR 400.

the currency of the lease whereas the assessment on the capital gain will only be made at the end of the lease. In economic but not legal effect there has been capital allowance on both sides of the transaction.

V BREACH OF CONTRACT BEFORE THE LEASE IS COMPLETED

Leases usually contain agreed damages clauses[27] in respect of executory obligations. The accounting standards[28] refer to the situation where the lessee cancels the lease and the lessor's losses associated with the cancellation are borne by the lessee. The advantage of such clauses is not merely that they simplify the work of the court, but that they permit summary judgement in the absence of a triable issue. In *O'Dea v All States Leasing System (WA) Pty Ltd* [29] such a clause was held to be invalid where the damages following default by the lessee were the entire outstanding rental undiscounted, the lessor being also entitled to retain the proceeds of sale even where they exceeded the residual value. In such a situation a court has to estimate the loss of bargain damages. The plaintiff is entitled to the damages which flowed naturally from the breach which were in contemplation of the parties at the time of contract under the first limb of *Hadley v Baxendale*[30]. However, if the lessor chooses to terminate a lease under a provision in the lease for the lessee's conduct which does not constitute repudiation or breach of condition, the lessor's damages are confined to rental up to the date of breach[31]. Simply providing that a term is a condition[32] or that its breach entitles the innocent party to terminate does not ensure that that term is a condition. Although the approach in Shevill's case has been doubted it rests on the logic that the plaintiff who terminates for minor breach has itself caused the loss of expectation damages and therefore the defendant should not be liable in the circumstances. The same rule applies in the UK[33] . This means there will be problems in recognising the value of the lease.

VI COMMISSIONER'S ATTITUDE TOWARDS LEASE FINANCING

The ATO originally accepted the finance method of taxing leases but eventually came around to the operating method. It would be fair to say that the ATO has always been suspicious of lease financing, in particular in the context of sale and leaseback.

There are undoubtedly taxation advantages in lease financing but this does not mean that the taxation benefits are the dominant purpose of lease financing. The main advantage from the lessee's perspective is that the payments are entirely on revenue account and fully deductible. The Commissioner has sought to characterise certain lease financing as being in substance a

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[27] Otherwise known as liquidated damages clauses where they are a genuine pre-estimate of the likely damage at the time of contract and thus do not constitute a penalty: *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1915] AC 79 at 86. This is recognized in AASB 117 paragraph 11 (a) which provides "if the lessee can cancel the lease, the lessor's losses associated with the cancellation borne by the lessee".

[28] AASB 117 at paragraph 11.

[29] (1983) 152 CLR 359; *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170; *Esanda Finance Corp v Plessnig* (1989) 166 CLR 131; *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1915] AC 79 at 86

[30] (1854) 156 E R 145

[31] *Shevill v Builders Licensing Board* (1982) 149 CLR 620; *AMEV --UDC Finance Ltd v Austin* (1986) 162 CLR 170.

[32] *Schuler (L) AG v Wickman Machine Tool Sales Ltd* [1974] AC 235, *Commonwealth of Australia v Amann Aviation Pty Ltd* (1991) 174 CLR 64

[33] *Lombard plc v Butterworth*[1987] QB 527 where the terms of the agreement made the breach repudiatory -- but had it not been so the liquidated damages clause would have been a penalty. Financings Ltd v Baldock [1963] 2 QB 104 at 110 gives a clearer example of the principle.

loan and therefore the payments should be split up into principal and revenue, and accordingly only part of the payment should be deductible. The first manifestation of this approach is to be found in former taxation ruling TR 95/30 which dealt with sale and leasebacks. As noted above there is generally nothing sinister about a sale and leaseback where the purchaser in effect has selected the chattels from the supplier and has then chosen to finance by means of sale and leaseback rather than novation of the contract. The position may well be different where the asset has been owned for a long time by the taxpayer who chooses to sell and lease back a fixture to a financier instead of borrowing against the security of the asset. Part of the advantage used to be that although there was a balancing charge on recouped depreciation, sale above original cost did not involve tax liability, or attracted the CGT regime. Accordingly the cost of the asset could be refreshed for the purposes of depreciation. Today any sale above adjusted value will result in the excess being assessable: section 40-285 of ITAA a 1997.

VII COMMISSIONER'S RULINGS

It is proposed now to analyse the Commissioner's ruling on sale and leaseback in 1995[34]. The Commissioner made no distinction between the situation where the purchaser has acquired an asset and shortly thereafter has entered into a sale and leaseback with a financier, as opposed to the situation where the taxpayer has had the asset for several years and then decides to use sale and leaseback finance. In the typical leasing arrangement the purchaser has no right or obligation to acquire the asset at the end of the lease, though in practice this invariably happens and it is difficult to see the alternative purchaser where the asset is a fixture. Paragraph 3 of the ruling recognized the financing advantages of the sale and leaseback arrangement whereby the present value of the lease payments and the residual value is equal to the cost of the asset to the lessor (financier) and this provides an implicit rate of interest which is more favourable to the lessee (user) than ordinary interest rates. The Commissioner speculates that this may be partially attributable to the tax deductions available to the financier. Paragraph 8 of the ruling recognized that the payments will be deductible and these would generally be the same in an ordinary lease that did not exhibit the features of sale and leaseback.

In paragraph 10 the Commissioner refers to the sale values that are acceptable. One of these is market value under which the price must be "the price at which an asset can be bought and sold between a willing, arm's-length purchaser and vendor, both acting knowledgeably, prudently and without compulsion".

If no such market exists, the tax depreciated value is acceptable. Market value must be ascertained by independent valuation and the asset must be valued separately from its use in the business since this is the value it would realise should there be default by the lessee. All this sounds very convincing until one hears from practitioners[35] that market value can fluctuate wildly even on the stock market[36] on a given day, and as for arm's-length value this is a very difficult matter to pin down in practice. Most leases envisage the sale of assets at the end of the lease and in paragraph 12 the Commissioner accepts that although the residual value may be below market at the end of the lease, he will accept a genuine pre-estimate at the time of inception of the lease of the residual value as being market, provided there was independent evidence as to the value which was made bona fides.

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[34] TR 95/30 Income Tax: sale and leasebacks. Now withdrawn and replaced by TR 2006/13.

[35] Eg . Michael Brown "*Modelling Tax Compliant Tasks for Large Businesses*" Australian Tax Research Foundation Executing Australia's Income Tax 19 October 2006 Sydney.

[36] E.g. in the crash of 1987 NewsCorp Ltd shares fell from $24 to $14 on one day.

In paragraph 14 the Commissioner said that he would not accept sham[37] transactions where the documents do not reflect the true intention of the parties. He seems to have in mind that sale and leaseback might in reality reflect a loan transaction. In paragraphs 16 and 17 he dealt with sale and leaseback of a fixture which he denied was legally possible. The issue still remains unresolved at law though Professor Butt[38] sees no reason in principle as to why a legal holder could not dispose of a part legal interest in the land such as a fixture whilst retaining underlying ownership of the land. The Commissioner states that where the purchaser (financier) gains only a contractual interest in the asset whilst the user retains possession of the fixture, there will not be a valid sale and leaseback. However, the full Federal Court in *FCT v Metal Manufacturers Ltd*[39] has left open the question whether such arrangements will vest sufficient equitable title in a financier to enable the financier to gain depreciation, but concluded that the user can claim deductions for use of the asset. The sale and leaseback will provide for an equitable title in the financier that will empower the financier in the event of default to enter the land and take possession of the fixture. This is clearly more than a contractual right and was accepted as such by the Commissioner[40] before the full Federal Court in the *Metal Manufacturers case*. Indeed the matter was not contested in the application for special leave[41] to the High Court.

In paragraph 18 of the ruling it was stated that the presence of an option or other legal right in the lease would mean that part of the lease payments were on capital account. It is of course standard procedure to state in the lease that there is no option or obligation to purchase -- see for example *Eastern Nitrogen Ltd v FCT*[42]. Since the asset is invariably purchased by the lessee at the end of the lease the Commissioner submitted in a special leave application before the High court in *Metal Manufacturers Ltd* that the substance[43] of the agreement was that the lessee would purchase the asset at the end of the lease. The full Federal Court

[37] *Snook v London and West Riding Investments* [1967] 2 QB 786. See more recently *Equuscorp Pty Ltd v Glengallan Investments Pty Ltd* (2004) 218 CLR 471, *Sharrment Pty Ltd v Official Trustee in Bankruptcy* (1988) 82 ALR 530, *Scott v Commissioner of Taxation (no 2)* 40 ALJR 265, *Ascot Investments Pty Ltd v Harper and Harper* (1981) 148 CLR 377, *Gould and Gould; Swire Investments Ltd* (1993) FLC 92-434.

[38] Butt (2000) 74ALJ 130. In *Eastern Nitrogen Ltd v FCT* 46 ATR at 484 Carr J left open the possibility that the financier would gain a legal title in the fixture saying " It may well be that the Instalment Purchase Agreement was effective at common law to pass property in the ammonia plant to the financiers, even though it was a fixture and part of the land owned by the appellant……….. The subject is discussed by Mr Peter Butt in a note "Conveyancing and Property" (2000) 74 ALJ 130. I do not see anything in the authorities discussed in that note which would prevent ownership of the ammonia plant passing at common law to the financiers under the Instalment Purchase Agreement. What the appellant contracted to sell, and may well have sold, to the financiers was no mere "bundle of rights" [*Melluish v MBI (No 3) Ltd* [1996] 1 AC 454 at 475], it was full legal and beneficial ownership".

[39] (2001) 46 ATR 497 considering *Kay's Leasing Corporation Pty Ltd v CSR Provident Fund Nominees Pty Ltd* [1962] VR 429. The full court adopted the approach of Emmett J at first instance *Metal Manufacturers Ltd v FCT* (1999) 43 ATR 375. Emmett J also relied on *re Samuel Allen & Sons Ltd* [1907] 1 Ch 575, and *Melluish v BMI (no 3) Ltd* [1996] 1 AC 454 at 475 -- 476. See also *Re Morrison, Jones & Taylor Ltd* [1914] 1 Ch 50 at 54 -- 55, 58 and 60 -- 61 cited with approval by Carr J in the full Federal Court in *Eastern Nitrogen Ltd v FCT* (2001) 46 ATR 474 at 484.

[40] See Sundberg J in *Metal Manufacturers Ltd* at 510 paragraph 57 "Before the primary judge the Commissioner argued that because the plant and equipment were fixtures the instruments were ineffective to achieve their stated objects. The contention was not repeated on the appeal, and it was not suggested that his Honour's conclusion that while the Bank acquired no legal interest, it did obtain an equitable interest, was erroneous". His honour left open the question raised by Professor Butt as to whether the financier could acquire a legal title.

[41] Special leave was refused by the High Court in the *Metal Manufacturers case* and in *Eastern Nitrogen Ltd* which matters were heard together on 15th February 2002. Transcript of argument at Austlii.

[42] (2001) 46 ATR 474 at 483 paragraph 41.

[43] Section 177D (b) (ii) requires the court to have regard to "the form and substance of the scheme".

rejected this argument and the High Court would not allow special leave on the basis of it. In paragraph 19 the Commissioner sought to extend this proposition by saying that part of the payments would be capital where the residual value of the asset was less than market value or the lease was for the whole of the useful life of the asset. Needless to say neither proposition has been accepted by the case law and in paragraph 42 the Commissioner relied on *Mills v Stokman*[44] as authority for the proposition that a fixture cannot be sold separately from the land. Yet that case only decided that there was no sale of goods where there is no agreement to sever the relevant asset and therefore a contract for the removal of slate was a profit a prendre which was unenforceable because the requirement for writing or registration[45] which created an interest in land was not satisfied. The case is certainly not authority for the proposition that a fixture cannot be sold separately from the land. Indeed the Commissioner concedes in paragraph 45 that it may be possible to create an equitable interest in the financier in such circumstances.

In paragraph 20 the Commissioner discusses leveraged leases, but there is nothing exceptional about these where the end user is a taxpayer. The financier/lessor has simply borrowed money to enable more business to be done which is common enough in commerce. This does have the effect of increasing the cost base for the lessor's depreciation, but there has never been a requirement that the lessor must have 100% equity in the cost of an asset before being able to depreciate it using its acquisition cost.

In paragraphs 21 to 27 the Commissioner considers the application of Part IVA but this has subsequently been dealt with extensively in case law[46]. The Commissioner does not seem satisfied with the case law with respect to the sale and leaseback of fixtures. He has sought to characterise these as disguised loans where repayments should be broken up into principal and interest. So far he has not been successful.

VIII TAXATION RULING TR 2006/13

The Commissioner has revisited the issue in 2006. Although the ATO accepts the lease arrangement where the precedents of the full Federal Court in *Eastern Nitrogen Ltd* and *Metal Manufacturers Ltd* have been followed, any variation from that approach will likely be treated as a loan arrangement and apportionment will be made between principal and interest. It seems a rather futile distinction given the Commissioner's[47] unequivocal acceptance of these two cases. It is proposed to analyse the propositions in the ruling.

In paragraph 2 of the ruling it is stated that an agreement which purports to be a sale and leaseback may not be so having regard to the legal rights and obligations conferred on the parties. In paragraph 5 the Commissioner concedes that the requirements of sale and leaseback will be satisfied where there is an equitable interest vested in the lessor (financier). In paragraph 7 it is said that the presence of an option or obligation which will vest the asset in the lessee at the end of the lease will take the transaction outside the ordinary operation of leases. This is an obvious proposition but the taxpayer is always at pains to ensure that there is no obligation or option in the contractual documents. In paragraph 9 it is asserted that the transaction is similar to a loan, but however this may be, there is no room for economic equivalence in the field of taxation law. A transaction must be characterised by the legal

[44] (1967) 116 CLR 61; same approach maintained in TR 2006/13 paragraph 57.

[45] There was a contract for the sale of slate which was lying on land part of which was old system and another part was Torrens system. It is even questionable whether slate laying on land can be described as a fixture.

[46] *Eastern Nitrogen Ltd v FCT* (2001) 46 ATR 474; *FCT v Metal Manufacturers Ltd* (2001) 46 ATR 497.

[47] TR 2006/13 paragraphs 25 and 33. The Commissioner sets out criteria for tax avoidance in paragraph 37.

form in which it is clothed. This is a proposition which the Commissioner[48] recognizes later in the ruling.

The Commissioner then addresses the issue[49] of who is the holder of the asset for the purposes of Division 40 of ITAA 1997. In a sale and leaseback the sequence is as follows: the lessee sells the depreciating asset to the lessor who becomes the holder under item 6 of section 40-40. The parties then enter into a leaseback arrangement, the lessor losing the right to possess and therefore ceasing to be the holder under item 6. The lessor now holds the asset under item 4 because it is the lessor of a fixture with the right to enter and recover the asset in certain circumstances. The lessee also is a holder with a nil cost base and therefore its interest can be ignored for depreciation purposes. The Commissioner will accept a residual value[50] where there is a genuine pre-estimate of market value made at the time of entry into the lease. The valuation must be bona fide and based on independent evidence and be no lower than that set in Taxation Ruling IT 28 and taxation determination TD 93/142 and termination value will be determined in accordance with sections 40-300 or 40-305 of ITAA 1997.

In paragraphs 25 to 36 the Commissioner deals with assets that are fixtures. It is asserted that the owner of land cannot generally sell a fixture without its being removed from the land. No authority is cited for this proposition and it has been contested [51]by Professor Butt. Such a possibility was not ruled out by the full Federal Court in *Eastern Nitrogen Ltd* and in *Metal Manufacturers Ltd*, but the decisions were actually based on the lessor/financier having sufficient equitable title to justify the lessees' paying of rent. There is no clear authority[52] as to whether such equitable title would be sufficient to justify the claiming of depreciation as a holder under section 40-40. At paragraph 62, after conceding that the full Federal Court decision in *Eastern Nitrogen* was correct, the Commissioner concluded that the court did not consider whether the lessor's (equitable) proprietary right was sufficient to constitute "ownership" under s 54 of the 1936 Act which was then applicable. The Commissioner envisages that there may be dual ownership under the current provisions. This is because the lessor/financier has an equitable interest in the fixture together with a right to remove in certain circumstances,which is sufficient to constitute a holding under section 40-40 item 4. The lessee may also be a holder as legal owner under section 40-40 item 10 though in this context the lessee has sold the asset and has either been assessable on a balancing charge, or gained a deduction under a balancing deduction, and would have a cost of zero. It seems the only sensible outcome is that the equitable owner/lessor/financier should claim the depreciation as the holder.

The Commissioner has sought throughout the ruling to characterise sale and leaseback as a disguised loan. In economic substance it may well be a loan and this is the approach under the accounting standards AASB 117 when a finance lease is said to be in economic substance similar to a loan, though accounting standards for reporting purposes cannot govern the substantial legal issues in this context.

AASB 117 Paragraph 10 provides:

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[48] *ANZ Savings Bank Ltd v FCT* (1993) 25 ATR 369 at 391 -- 392 per Hill J at paragraph 79 and 81 of the ruling.

[49] Paragraphs 27, 28 and 29.

[50] Paragraphs 80 (C), 87 and 95 (a).

[51] Butt (2000) 74 ALJ 130 where he said there was no reason in principle why an owner could not at common law dispose of fixtures separately, since an owner was entitled dispose of part of an interest at law. See further the comments in footnote 37, and the comments of Carr J in *Eastern Nitrogen* supra.

[52] Paragraph 72 of the ruling referring to *Bellinz Pty Ltd v FCT* and see also *Melluish (Inspector of Taxes) v BMI (no 3)* [1996] 1 AC 454.

"Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract."
Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:

(a) the lease transfers ownership of the asset to the lessee by the end of the lease term;
(b) the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;
(c) the lease term is for the major part of the economic life of the asset even if title is not transferred;
(d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
(e) the leased assets are of such a specialised nature that only the lessee can use them without major modifications.

IX LEASES IN TAXATION LAW - FEDERAL COURT

Up until 1 July 1990 the ATO allowed taxpayers to derive their income in accordance with the finance method under rulings IT 2162 and IT 2166. These rulings were withdrawn from 1 July 1990 under ruling IT 2594. Subsequently the courts indicated that in taxation law they will only accept the operating lease as giving a substantially true reflex of the lessor's income[53]. In *FCT v Citibank Ltd*[54] the taxpayer was a banker who also leased motor vehicles in return for rental. Hill J described this as chattel leasing though it could be more correctly described as a bailment[55] for a series of payments. Nothing turned on the distinction in that case. Section 57 AF[56] of ITAA 1936 (Cth) placed a limit on the cost price of luxury cars for the purposes of depreciation. Before this limit it would make no difference to the income of the taxpayer whether the assessable income was calculated by treating the transactions as operating leases or financing leases.

If the transaction was treated as a finance lease the lessee is regarded as effectively having substantially all of the risks and benefits of ownership. The lessor is regarded as having an asset equal to its investment at the commencement of the transaction and then apportions the

[53] The right to claim capital allowance (depreciation) in Div 40 of ITAA now belongs to the "holder" who is generally the legal owner but more generally the person who suffers economic loss from the decline in value of the asset. In the case of a luxury car the holder is the lessee, which seems to follow the pattern of the finance lease. In the event of liquidation the asset would be the property of the lessor.

[54] (1993) 26 ATR 423

[55] A similar issue of characterisation of a fixture in sale and leaseback arose in *Eastern Nitrogen Ltd v FCT* (2001) 46 ATR 474 where there was sale and leaseback of a fixture which the parties sought to characterise as goods and which probably remained an interest in land. If it were an interest in goods and the law bailment would apply, if it were an interest in land than the law of leasing would apply. Carr J said at pp 484 --5 paragraph 50 "in my opinion the Instalment Purchase Agreement and the Agreement for Lease were effective to create an equitable interest in the ammonia plant, in the nature of property, in the financiers, which was sufficient to support the "leasing" by the financiers of the ammonia plant to the appellant and the "taking on lease" of the ammonia plant by the appellant. I shall, as a matter of convenience, use in these reasons the language of real property leasing (which seems appropriate given that it is common ground that the ammonia plant was a fixture) although the parties thought that they were dealing with personalty to which bailment principles were more appropriate".

[56] Now section 40 -- 230 of ITAA 1997 which for the year ended 2008 is $57,123. Under section 40-40 item 1 it is now the lessee of a luxury car who is regarded as the holder and therefore the person entitled to depreciation and the Div 40 of ITAA 1997. Depreciation is now referred to as capital allowance under Div 40.

rental payments between principal and interest. [57] This may be the correct method for reporting company accounts[58], but in the taxation context the approach is different. Under income tax law gross amounts are assessable income and from these are deducted amounts allowed under the statute to give a net figure described as taxable income[59]. Income tax law will characterise a net amount as assessable income in exceptional circumstances, but only where the gross amount is not income. Examples where this has occurred include switching by insurance companies[60], where Australian courts adopted English precedent which was based on a system that taxed profit.

Under the leases in the *Citibank* case, the lessor retained title to the plant and received a series of payments in respect of that plant. Those gross amounts could be described as rental and could not be distinguished from the situation of landlord and tenant where the gross rental is assessable income and the landlord has deductions for depreciation and repairs. Under a standard chattel lease the lessor leases the asset for several years, and the lease provides that the asset will be sold at the end of the lease for a residual value. If at the end of the lease the asset is sold below residual value, the lessee must pay the difference to the lessor, though this payment will be deductible as part of the lease[61]. Typically the residual value is in fact below the market value at the end of the lease. In *Granby Pty Ltd v FCT*[62] Lee J said that residual values were below estimated market values at the end of the lease so that lessor corporations could safeguard the capital they, as financiers, invested in their chattel purchase and lease transactions. The setting of residual values at below market at the end of the lease was as an inducement to the lessee to care for the property. In *Austin v United Dominions Corp*, Priestley AJ said[63]

> The commercial practice of lessors of chattels whereby their rental charges and residual values are so calculated that if a leasing agreement runs its full course and on its conclusion the lessee buys the chattel from the lessor (there having been no pre-existing obligation upon the lessor to sell if requested) the lessor will have been reimbursed by the receipt of the rental instalments and the residual value for the capital laid out on the

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[57] Under Citibank's standard lease the lessee promised to pay the instalments of rent notwithstanding any damage or defects in the goods, the lessee had no right of purchase being only a bailee. The goods were to be maintained by the bailee and were at the risk of the bailee who also had to take out insurance. At the end of the lease the goods were to be sold, and if below residual value the lessee had to pay the difference. The effect of this was that the lessor derived a calculable return. This meant that in terms of company accounting there was finance lease.

[58] *FCT v Citibank* (supra) at 433 adopting the expert evidence of Professor R Walker, then a Professor of Accounting of University New South Wales: at 429. Certainly on liquidation the courts will not look to 'the economic substance of the matter.' Formal legal ownership of assets is important here, and in terms of legal principles it difficult to understand why a finance lease should be treated as an asset of the lessee when it will not be available to the lessee's creditors in the event of liquidation .Where an entity has made a loan the principal is an asset but the loan contract is not a separate asset though it is a chose in action: *FCT v Myer Emporium Ltd* (1987) 163 CLR 199 at 217 – 218. Since this property right is not recognised as a separate asset, it is difficult to see why the lease should be.

[59] ITAA 1997 sections 4-15, 6-(5), 6 -(10),8-1.

[60] *Colonial Mutual Life Assurance Society Ltd v FCT* (1946) 73 CLR 604; *Australasian Catholic* Assurance *Company Ltd v FCT* (1959) 100 CLR 502; *Chamber of Manufactures Insurance Ltd v FCT* (1984) 15 ATR 599; *FCT V Employers Mutual Indemnity Association Ltd* (1990); *FCT v Employers Mutual Indemnity Association Ltd* (1990) 21 ATR 741. Investment companies where their holding of shares are not trading stock: *London Australia Investment Company Ltd v FCT* (1977) 138 CLR 106. Exchange gains and losses where the moneys advanced are capital : *Avco Financial Services Pty Ltd v FCT* (1982) 150 CLR 510. Profit-making schemes: e.g. *FCT v Whitfords Beach Pty Ltd* (1982) 150 CLR 355.

[61] TR 2006/13.

[62] (1985) 30 ATR 400 and 404.

[63] In *Austin v United Dominions Corp Ltd* (1984) 2 NSW LR 612 at 623 -- 624 Priestley AJ

> chattel and commercial rates of interest on that sum for the period of the lease, in a way analogous to that in which it is finally reimbursed at the conclusion of a hire purchase agreement. Thus, in a leasing transaction of this kind the residual value will be a balancing figure which, when added to the rental instalments, will produce a figure equal to a return of the lessor's capital plus the desired return of interest over the period for the outlay of its capital. It will thus bear no necessary relation to the market value of the chattel at the end of the lease, although presumably the lessor would tend to calculate it at a lower figure than market value (difficult though this might be to predict in regard to some types of chattel) to ensure that if the lessee did not indicate any wish to buy it at the end of the term it could then be sold without detriment to the lessor's original calculations. In some cases this approach would require the rental payments to be at a higher rate than what would be the market rate for the rental of goods which was to be expected to be returned to the owner at the end of the lease. In a lease arrangement this kind, a lessor needs some provision in the lease agreement to bring about the result, when the agreement is terminated mid-term, that the lessor will be in the position of recovering its capital together with the calculated rate of interest for the shortened term.

In other words the lessor sets the lease payments and the residual value in such a way as to guarantee a particular return. If the leases terminated before its agreed term there will be a liquidated damages clause to compensate the lessor. If at the end of the lease the lessee was able[64] to purchase the asset at below market value this was no concern of the lessor who had received its expected return. Although the arrangement has tax advantages there are substantial commercial reasons for using leases instead of loans, and the pitching of residual value is allegedly not tax driven.

From the lessee's perspective, the lease payments were entirely on revenue account since the lease itself gave the lessee no right to purchase the asset at the end of the lease. It is invariably the practice[65] for the lessee to purchase the assets at the residual value, thus in commercial effect giving the lessee the ability to deduct part of the purchase price. But such payments cannot be characterised as capital when viewed from a legal perspective because the leases themselves contain no option to purchase, and the law does not look at 'the economic substance of the matter[66] but is more concerned with form i.e. who owns the asset. As stated by Hill J in distinguishing between a loan and an annuity in *ANZ Savings Bank Ltd v FCT*,[67]

> What must be determined in the present case is whether the transaction into which the parties have entered is a loan involving the repayment of a principal sum with interest, or whether it is a contract for an annuity, or a contract for insurance. In the absence of a submission that the transaction entered into by the parties is a sham, a disguise for some other and different transaction, and in the absence of the application of the anti-avoidance provisions of Part IVA of the Act, the court must look to see what the transaction entered into by the parties by its terms effects. That is to say, regard must be had to the legal rights which the transaction actually entered into confers. Invocation of the doctrine of substance is of no assistance in this task.

[64] The lessee had no right under the lease to purchase the asset though this is what invariably happens. In effect the lessee is able to purchase an asset considerably below its market value of the end of the lease. In commercial effect it is getting a deduction for what is the purchase price of an asset and therefore analogous to capital. Since the lessee has no right to purchase the asset under the lease, the entire lease payments are regarded as revenue and hence deductible at the time of payment: *South Australian Battery Makers Pty Ltd v FCT* (1978) 8 ATR 879.

[65] The practice would seem to be inevitable with the relevant asset is a fixture subject to sale and leaseback.

[66] *Europa Oil (NZ) Ltd v IRC (NZ) (No 1)* (1970) 1 ATR 737 at 744 'Taxation by end result, or by economic equivalence, is not what the section achieves.' *Europa Oil (NZ) Ltd v IRC (No 2)* (1976) 5 ATR 744 at 750 'it is not the economic results sought to be obtained by making the expenditure that is determinative of whether the expenditure is deductible or not; it is the legal rights enforceable by the taxpayer that he acquires in return for making it.' Courts do not look to economic benefits and 'the reference to "reality" was directed only to the legal character of the payment and not to its economic consequences.'

[67] (1993) 25 ATR 369 at 391 -- 392.

The current position with luxury cars is that the rental is fully deductible at the time of payment, and the lessee will depreciate but will not be able to use the cost above that set by ITAA 1997. Had option 2 under the Ralph Report been adopted so that tax accounting would follow ordinary accounting, the finance lease may have found its way into tax jurisprudence. A similar attempt to bring finance leases within TOFA was abandoned in the May budget of 2007.

The Commissioner's ruling indicates that the ATO is not entirely happy with the sale and leaseback of fixtures and would like the opportunity characterise such transactions as disguised loans. However, a loan involves the advance of a sum of money from a creditor to a debtor and the debtor undertakes to repay the principal sum together with interest if applicable. The courts though must look to the legal rights conferred by the contracts. Sale and leaseback could not fall within this characterisation. In rejecting such an approach Carr J[68] said

> I accept the appellant's submissions that although the overall arrangement was a financing arrangement, it did not involve a loan. There was no obligation to repay a sum advanced. The authorities recognise that arrangements can be made for financial accommodation without a loan being involved: *Chow Yoong Hong v Choong Fah Rubber Manufactory* [69]; *Prime Wheat Association Ltd v Chief Comr of Stamp Duties* [70]; *ANZ v FCT* [71]; *N M Superannuation Pty Ltd v Young* [72].

X CONCLUSION

The only distinction between an operating and a finance lease is in respect of the reporting requirements which have the sanction of law under the *Corporations Act* (2001). The Commissioner does not seem to be satisfied with the outcome of leasing cases involving the sale and leaseback of a fixture[73]. He has sought in the past to characterise such arrangements as being disguised loans, but this is simply not possible given the nature of a loan. If finance leases are to be treated as loans for taxation purposes, legislation will be necessary to achieve this result. In the absence of such legislation Part IVA will not prevent standard leasing arrangements because there are sound reasons why commercial persons would choose to finance their business by means of leasing rather than borrowing against secured assets. These reasons are mainly concerned with the reporting requirements whereby the finance lease leaves a far better impression in the balance sheet than a simple loan. It involves the recognition of a liability, but the leased property is regarded as being an asset of the lessee and no such concession is possible where there is a simple loan. This factor was referred to by Emmett J in *Metal Manufacturers Ltd v FCT*[74] but has not been recognized by the Commissioner in the ruling TR 2006/13. There is a tax advantage in lease financing. This occurs because the lessor/financier being the holder depreciates the asset whilst the lessee is in commercial effect purchasing the asset through the lease payments which are entirely on revenue account. It is an invariable practice that the lessee purchases the asset at the end of the lease for a residual value below market. In economic effect the asset is being depreciated on both sides of the transaction, but this is not the legal effect of the documents. Arguments

[68] *Eastern Nitrogen Ltd v FCT* (2001) 46 ATR at 485 Paragraph 54.
[69] [1962] AC 209 at 216 -- 217.
[70] (1997) 42 NSWLR 505 at 511 -- 12; 37 ATR 479 at 483 -- 84; 97 ATC 5015 at 5019.
[71] (1993) 42 FCR 535 at 360; 25 ATR 369 at 391 -- 92; 93 ATC 4370 at 4389.
[72] (1993) 41 FCR 182 at 199 -- 201.
[73] TR 2006/13 at paragraph 37
[74] (1999) 43 ATR 375 at 386 -- 387.

as to substance had been rejected by the full Federal Court[75] and by the High Court[76] in rejecting an application for special leave in those cases.

Leasing is commonly and widely used, and though it cannot be denied that there are tax advantages, lease financing is not undertaken with the dominant purpose of gaining a tax benefit, and if the Commissioner wishes to address the problem of lease financing then it must be done by specific legislation. In this regard lease financing shares a common characteristic with the discretionary trust.

[75] *Metal Manufacturers Ltd*, *Eastern Nitrogen Ltd* (supra).
[76] McHugh and Gaudron JJ.