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Submission on *Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2006*

TAXATION OF FINANCIAL ARRANGEMENTS – APPLICATION TO EQUIPMENT FINANCE

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1. Introduction

The Australian Equipment Lessors Association (AELA) and Australian Fleet Lessors Association (AFLA) appreciate the opportunity to comment on proposals for the final stages of reforms of the taxation of financial arrangements (TOFA stages 3 and 4). AELA is the national association for the equipment leasing and finance industry, and AELA's 100 members encompass more than 90% of equipment finance activity in Australia. AFLA is the association of the major fleet leasing companies (membership lists attached). Our submission focuses on the impact of the TOFA proposals on the income tax treatment of equipment leases (i.e. as distinct from the treatment of hire purchase under Division 240 of the ITAA).

2. Policy Framework for Taxation of Equipment Leases

Under the income tax treatment applying to equipment leasing in Australia, the lessor is generally tax-assessed on the basis that the capital item is being used to produce assessable income: taxable income is lease rentals received less depreciation and any investment incentives operating through the tax system, and taking into account any balancing amounts (profit or loss on sale of the asset) at the end of the lease agreement. The legislation contains specific exceptions to this treatment, applying a 'notional loan' treatment to leases of luxury cars and certain leases to tax exempts (Division 16D), and Division 240 applies to hire purchase arrangements.

These taxation arrangements enable the lessor, as owner of the equipment, to concentrate the various taxation attributes of the ownership into the amount of the lease rental. This taxation regime for equipment leasing has been long accepted. For example, in 1988 the Government considered its policy response to the issue of 'tax effective financing', and on 20 December 1988 announced the result of its review as follows:

> 'This review has confirmed the need to act against tax effective financing. Tax effective financing relies upon the ability to transfer or share tax benefits. The Government considers that the broad scheme of the tax law requires that tax losses be carried forward by the taxpayer who in substance incurs them and that in general, such losses should not be available for transfer to other parties, including financiers. An exception, long accepted by revenue authorities, has been in respect of genuine leasing transactions for plant and equipment but the Government believes that other forms of tax benefit transfer should not be accepted.'

Research conducted by the Bureau of Industry Economics in 1990 noted the long-standing exception of equipment leasing from restrictions on tax benefit transfer and, in relation to the current taxation regime, found that *'leasing has the desirable effect of making the investment feasible for entities either in tax loss or anticipating some tax losses, without encouraging them to any greater extent than for fully taxed entities'*.

From the outset it has been the understanding of the leasing industry that the TOFA outcome would not alter the status quo of the 'rentals less depreciation' tax treatment of equipment leasing, i.e. that 'genuine leasing transactions for plant and equipment' would be excluded from the TOFA regime.

3. Finance and Operating Leases

Under a lease, the owner of the asset (lessor) confers the right to use the asset to another party (lessee) in exchange for rental payments, usually of a periodic nature. The lessee does not have ownership of the asset nor the right to acquire ownership. For income tax purposes, there has been no relevant purpose in distinguishing between finance and operating leases (except in relation to Division 16D). However, it is necessary to consider this distinction in the context of the TOFA proposals; in addition to the above elements of an operating lease, under a finance lease the lessee will indemnify the lessor for any residual value shortfall at the conclusion of the lease. It is important to stress that this is a contingent obligation which is very rarely triggered in practice. This is because residual values are realistically set to reflect market values, so as to avoid the additional credit exposure if the lessor needs to rely on the indemnity; but as residual values must be set at the outset of the lease, the indemnity is a mechanism to protect the lessor in the event that the market value at the end of the lease is not in line with the original valuation, and hence it allows the lessor to remove this risk aspect from the pricing. Furthermore, it is a shortfall indemnity, i.e. it relates only to the deficiency of realised value and the residual value. For example, in those rare cases where the indemnity is triggered it would be most unlikely for the deficiency to exceed 10 percent of the original capital cost of the equipment.

4. The TOFA Proposals and Equipment Leases

The TOFA proposals apply to a ‘financial arrangement’, and the definition of financial arrangement is so broad that both financing and non-financing contractual arrangements are caught, and the definition is sufficiently wide to capture equipment leases.

Sub-section 230-135(8) specifically excludes certain leases (eg leases of luxury cars) from the TOFA regime, and this exclusion in isolation can create the inference that all other equipment leases come within TOFA.

Therefore for equipment leasing generally to continue to embody the current income tax approach of ‘rentals less depreciation’ under the TOFA regime, it must be able to take advantage of the carve-out in section 230-125 dealing with short-term arrangements involving a non-monetary component.

Broadly, an arrangement must satisfy the following in order to be carved-out under section 230-125:

- it must be a financial arrangement and cannot be a derivative financial arrangement (which would seem to be satisfied for equipment leases);
- there must be an obligation to provide (or right to receive) ‘something of economic value in the future’;
- the things of economic value to be provided under the arrangement or the consideration to be received (or both) must not be money or a money equivalent;
- the time between the provision of (or a substantial proportion of) the consideration and the things of economic value must be no longer than twelve months;
- the arrangement must not be subject to a fair value election.

Accordingly the carve-out from the TOFA regime is not based on a generic description given to the lease, but is dependent on comparing the timing of all the things of value being provided by the lessor as against the timing of all consideration to be received from the lessee.

i) Operating Lease

An operating lease would seem to generally satisfy the requirements of section 230-125 for the following reasons:

- it involves the obligation to provide something of economic value, being the use of the equipment, and the consideration to be received in return is the rental payment;
- the use of the equipment by the lessee should satisfy the non-monetary equivalent requirement;
- clearly, the use of the equipment may extend past twelve months and thus the question for consideration is the interpretation of subsection 230-125(b). It would seem that where regular (ie. referable to periods of less than twelve months) rental payments are to be made by the lessee to the lessor as consideration for use of the equipment, then subsection 230-125(b) should be satisfied notwithstanding the entire lease term might exceed twelve months;
- assuming a standard operating lease will not be subject to the fair value election in TOFA then, prima facie, the operating lease should fall outside the operation of the TOFA regime.

However, it should be noted that where substantial rentals are pre-paid or deferred past twelve months duration then an operating lease may not come within the section 230-125 carve-out, in which case it would then come within the TOFA regime. Where lease arrangements did come within the regime, the absence of interaction rules within the Exposure Draft with other parts of the ITAA make it difficult for us to assess the tax consequences of such leases, eg. do they still nevertheless continue to be treated as rentals less depreciation, or is there now some type of interest and principal calculation; we would welcome further guidance in this regard.

ii) Finance Lease

As noted, a finance lease is distinguished from an operating lease by the existence of a residual value shortfall (RVS) indemnity. Therefore, in addition to the above reasoning, consideration of the RVS indemnity is necessary in determining whether a finance lease falls within the section 230-125 carve-out. Prima facie, part of the consideration received from the lessee (i.e. a promise to pay any residual value shortfall at the end of the lease) is not occurring regularly over the period that the use of the equipment is being provided by the lessor. In this regard, our analysis is as follows:

- under a typical finance lease (eg. a 5 year lease with a 40% residual) there is only one contractual arrangement, with the rental payments and the RVS indemnity comprising the consideration to be received under that contractual arrangement;
- provided that both the rentals and the RVS indemnity are regarded as being the consideration of the whole arrangement, then it should follow that a 'substantial proportion' of the consideration for the use of the asset is being received within the appropriate twelve month time frame. Thus, notwithstanding that a smaller proportion of the consideration to be received (i.e. any shortfall payment) may be received outside the 12-month time period, this in itself should not cause a failure of section 230-125. Accordingly, a finance lease can also fall outside the TOFA regime.

Again, as noted above for operating leases, we see the carve-out from the TOFA regime being dependent on comparing the timing of things being provided and the consideration being received. Our analysis attempts to interpret section 230-125 in the context of contracts which extend beyond twelve month, as well as interpreting the phrase 'or a substantial proportion' in situations where the consideration to be received (or indeed the things of economic value) have both a regular (i.e. less than 12 months) and an irregular component.

However, our view is dependent on a number of important assumptions, as noted above. Furthermore, uncertainty also arises in relation to the application of the section 230-125 carve-out to particular situations. For example, our analysis suggests that the existence of a RVS indemnity should not of itself be fatal to a finance lease falling within section 230-125 under the substantial proportion provisions of subsection 230-125(b), and the example above considered a 5-year lease with a 40% residual. But in the case of a 2-year lease with an 80% residual, even though the nominal residual value could greatly exceed the rental payments (i.e. subsection 230-125(b) is, prima facie, at risk of being breached), the actual exposure to a shortfall at the end of year 2 may not cause a failure of this subsection because the actual exposure is only the difference between the expected market value and the residual value. This in turn raises the concern that the appropriate tax treatment of this transaction would not in fact be known until the transaction was completed, hardly a situation conducive to tax certainty and compliance;

5. The TOFA Policy Approach to Equipment Leasing

Our understanding of the ‘principle’ of section 230-125 is that where a contractual arrangement involving goods or services has a substantial portion of the consideration aligned (at least on an annual basis) with a substantial portion of the value to be provided, then the arrangement should be excluded from the TOFA regime because the financing component should not be significant.

On this basis, our analysis leads us to the view that both operating and finance leases fall outside the operation of the proposed TOFA regime (subject to certain exceptions, principally those involving significantly deferred consideration, and those leases already subject to notional loan treatment).

6. Recommendations

From our involvement in the TOFA project from inception it has been our firm understanding that TOFA would not disturb the established policy framework applying to leases, i.e. that equipment leases would continue to be subject to the 'rentals less depreciation' regime, and any exceptions to this rule would be specifically and clearly defined (i.e. luxury cars and tax exempts together with Division 240) so as to provide taxpayer certainty.

Our analysis suggests that in fact most leases are excluded under the section 230-125 carve-out. We appreciate that section 230-125 has to cater for a wide variety of contractual arrangements under one 'generic' principle, but our concern is that this exclusion and the Explanatory Memorandum as presently worded do not provide sufficient certainty to enable lessors to confidently reach the view that all leases (apart from those currently subject to notional loan treatment) fall outside the TOFA regime. Also, as noted above, the specific exclusion for certain leases under sub-section 230-135 (8) can create the inference that all other equipment leases are included.

To overcome this uncertainty, we suggest that the Explanatory Memorandum note that the TOFA regime is not intended to apply to genuine leasing transactions for plant and equipment. If deemed necessary, certain leasing arrangements could be specified as coming within this regime. For example, it might be thought desirable to include within TOFA those leasing arrangements involving significantly deferred consideration; however, even in this instance we note that arrangements involving the prepayment of goods and services should be caught by the existing prepayments regime, i.e. there is already an integrity measure in place to deal with such arrangements.

Depending on the final structure of these provisions, it may also be preferable for the legislation to contain a specific exclusion for equipment leasing arrangements, by expanding section 230-135 to include the exceptions from a financing arrangement contained in section 974-130(4) of the ITAA. This would also serve to overcome any impression that only those leases presently excluded under sub-section 230-135(8) do not come within the TOFA regime.

7. Conclusion

In conclusion, we submit that the Explanatory Memorandum should provide a clear statement that genuine leasing transactions for plant and equipment do not come within the TOFA regime, and to specify any exceptions to this rule. We have also suggested that a legislative carve-out may be appropriate, and would appreciate the opportunity to further discuss this approach in the light of the development of these provisions.

We believe that it would be far better for taxpayer certainty for the regime to explicitly define which arrangements are intended to be captured, rather than bringing all arrangements within the regime and then trying to interpret the generic carve-out principle.

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AELA MEMBER COMPANIES

ABN AMRO Australia	IBM Global Financing
Adelaide Bank	Integrated Asset Management
Allens Arthur Robinson	International Decision Systems
Alliance e-finance	IT Insurance Services
Alleasing Group	John Deere Credit
ANZ Investment Bank	Key Equipment Finance
Australasian Asset Residual Management	Komatsu Corporate Finance
Australian Asset Finance Association	KPMG
Australian Equipment Finance Association (ALBA)	Lanier (Australia)
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Australian Structured Finance	LXM
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Baker & McKenzie	Mallesons Stephen Jaques
BOQ Equipment Finance	Medfin Australia
Bendigo Bank Leasing Division	Members Equity Bank
Blake Dawson Waldron	Mercer Finance & Risk Consulting
BMW Australia	Meridian International Capital
Bynx Australia	Minter Ellison Lawyers
Canon Finance Australia	Musgrave Peach
Capital Finance Australia	National Australia Bank
Caterpillar Financial Australia	Northern Arch
CBFC	NLC
CHP Consulting	Oracle
CIT Financial	ORIX Australia
Citibank	PACCAR Financial
Clayton Utz	Pitney Bowes Australia
CNH Australia	Print Solutions Finance
Colin Biggers & Paisley	Queensland Treasury Corporation
Commonwealth Bank of Australia	Realtime Computing
Computer Fleet	RentSmart
Corrs Chambers Westgarth	Ricoh Finance
DaimlerChrysler Financial Services	Rhodium Asset Solutions
Deacons	Service Finance Corporation
Deloitte Touche Tohmatsu	Sharp Finance
De Lage Landen	SG Equipment Finance
Dibbs Abbott Stillman	Sofico Services
Elderslie Finance	Solutions Asset Management
Esanda Finance	Southpac Finance Systems
Experien	Spectra Financial Services
Flexirent Capital	SurePan Fleet Risk Management
Focus Capital Group	Suncorp Finance
Freehills	St. George Bank
Fuji Xerox (Finance) Australia	Technology Leasing
GE Commercial Finance	Toyota Finance Australia
Gilbert & Tobin	Volvo Finance
GMAC Australia	Westlawn Investment
Henry Davis York	Westpac Institutional Banking
HP Financial Services	Yamaha Motor Finance

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Australian Fleet Lessors Association

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AFLA MEMBER COMPANIES

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DaimlerChrysler Services Australia

Esanda Fleet Partners

FleetAustralia

GE Fleet Services

Interleasing (Australia)

Lease Plan Australia

Macquarie Fleet Leasing

NLC

ORIX Australia

Summit Auto Lease Australia

Toyota Finance Australia

01.03.06