Tax Attack

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The Australian lease industry has had to deal with a series of confirmed and proposed changes to the tax and accounting environment over the last 15 months. Although government announcements have already had a profound impact on the volume of leasing done, particularly domestic lease volumes, there is still no end in sight to the tax reform process. Lease arrangers are nevertheless responding with typical resilience to an uncertain environment and several new niche markets look set to emerge over the next 12 months.

Because the reforms to Australia's tax and accounting regulations amount to no less than a complete overhaul of the business tax environment, they are being introduced piecemeal, in a process which will continue at least until 2003.

Tony Stolarek, a tax partner at Arthur Andersen in Melbourne, explains that the tax and accounting treatment of leasing is bound up with the issue of tax on infrastructure projects and the debate over the option to adopt a tax accounting or tax value method. Stolarek says that the implementation of tax value methodology is one of the victims of the slow pace of change and will be deferred until 2003. The lease market should be prepared, however, for a more rapid deployment of a new tax regime for infrastructure projects. ?This issue is currently getting a lot of attention from the Australian Tax Office (ATO). I think the new rules will appear in 2002,? says the tax partner.

The content of the tax regime for infrastructure projects is still a matter for conjecture, but market players believe that when the tax authorities do finally turn their attention to lease accounting methodology, the ATO will abandon its early notion of recharacterizing leases in line with the so-called Option 2 and instead recharacterize lease transactions as purchases.

Under the existing law, payments and receipts are characterized as either capital or revenue depending upon the circumstances. For example, lease premiums are generally characterized as capital receipts, but they may be assessable as income where the taxpayer's business includes the receipt of lease premiums or where such premiums are included by a specific provision. Transactions that are economically similar are treated differently depending upon whether the receipts and payments are characterized as capital or revenue. Some expenditures on rights are deductible or given a write-off under the tax law while others receive a capital loss on disposal or extinguishment of the right.

More explicit tax reform proposals, which also have implications for leasing, emerged on 21 February when the Australian Treasurer released its draft New Business Tax System (Thin Capitalization and other measures) Bill 2001, the fifth Business Tax Reform Exposure Draft to be released since October 2000.

Tax specialists say the changes are broadly consistent with prior announcements, and are intended to apply from 1 July 2001. The proposed law deals with corporate debt and equity mixes and new definitions of what should be deemed debt and what should be recorded as equity. At the same time, the Commissioner of Taxation has released two draft tax rulings dealing with related debt and equity issues in the context of the existing law. Hire purchase transactions were specifically covered by the draft document, say observers, but not leases.

How leasing fits into the revised definitions is a key question for the leasing industry. ?Its not entirely clear where the government is leaning on this,? says Rob Upfold, a partner at Sydney law firm, Blakes, ?although there are indications that they don't want it to be classed as equity,? he adds. Unless leases can be characterized as debt, deductions for leases won't be available in future. The debt and equity distinction is also relevant for interest and dividend withholding tax.

The proposed thin cap regulations are to be made effective from 1 July, says Stolarek, following a period of consultation with industry. Significantly, there is no grandfathering in relation to the main changes, which means that existing financial structures will be affected by the new rules from 1 July 2001. ?The leasing industry has made submissions about grandfathering transactions with respect to the thin cap proposals but the submission are pretty weak,? says a Sydney-based arranger.

Since the original announcement about changes to the thin capitalization regime were made back in September 1999 and since the Ralph recommendations set a clear precedent by not permitting grandfathering, the arranger explains that the tax authorities are likely to decide that the leasing business has had plenty of forewarning about thin cap and therefore that grandfathering is again not warranted.

A particular threat to the cross-border lease market, says Paul King, a director at tax firm Greenwoods & Freehills is Division 240, a draft segment of tax law that has been in the legislative pipeline for about three years, and which has just been reintroduced into parliament. Division 240 contains specific rules about where tax ownership rests under hire purchase (many cross-border leases are treated as hire-purchases). ?It will be a further complication for cross-border leasing. Technically the content of the Division makes it a little more difficult for lease deals in general to satisfy the rules,? says King.

Like tax value accounting, the process of turning the findings of the Ralph report (made public in September 1999) into law has also become a victim of the reform overload in the Australian civil service. The Ralph Report, for those unfamiliar with regulatory proposals in Australia over the last few years, was a general review of the Australian corporate tax system whose proposals will have a far reaching impact on leasing in Australia.

Some of the Ralph Report proposals have already been adopted by the government, including the recommendation to remove certain accelerated depreciation allowances. Just as deleterious for cross-border sale-and-lease-back financing, balancing charge roll-over relief will no longer be available if the Ralph recommendations are taken up by the Australian parliament. Under the present regime, when an asset is sold and the appraised value is in excess of the written down value, exemptions are available on the tax to be applied on the gains. The Ralph report recommends doing away with these exemptions altogether, says David Temby, a partner at law firm, Mallesons Stephen Jaques in Sydney.

Further recommendations include tighter anti-avoidance provisions for so-called ?lease-tail? transactions and new lease classifications that threaten to kill a major portion of the domestic lease market. With respect to domestic leasing, the Ralph Report advocates a distinction be made between routine and non-routine domestic leases. A routine lease is defined as a lease in which rentals are more or less the same throughout the term of the lease. In a non-routine lease where rentals are markedly different at the beginning and end of the lease, the Ralph Report recommends that the lease should in fact be classified as a sale, thus destroying all the tax benefits of the transaction.

According to Arthur Andersen's current analysis, all big-ticket, infrastructure, plant or equipment leases should be interpreted as non-routine if the Ralph Report recommendations are upheld in their present form. Arranging any big-ticket lease, including synthetic leases would be very challenging as a result.

In the current, uncertain environment, arrangers believe there is a clear need for reassurance from the government about the viability of particular lease deals. Unfortunately, Stolarek says that it has become more difficult to get a non-binding ruling from the ATO regarding specific lease transactions. That's because the tax office has imposed a more rigorous quality assurance requirement on itself. When it comes to seeking a non binding ruling from the tax office about a proposed lease deal, more approvals are needed for the ruling from senior tax office advisors than was previously the case, to ensure that the ruling is likely to be the right one. For that reason, Stolarek says, the process will be more lengthy and rulings more difficult to attain.

Market activity

The proposed and actual changes to the tax and accounting system, largely aimed at taking the tax effects out of leasing, combined with Australia's low interest rate, low corporate tax environment have brought the domestic lease market to a stand still. Cross-border leasing, on the other hand, is still viable for new assets, but for second hand equipment cross-border leasing is more difficult. The government ensured that was the case when it got rid of like-kind exchange back in September 1999.

Nevertheless, Paul King believes that deferral of the major reforms contained in the Ralph Report have created a window of opportunity for leasing companies and arrangers. Financiers agree: ?The ATO has a lot on its plate and that, for once, is good news for the lease business,? says a banker in Sydney. The potentially devastating reforms to the tax and accounting system may have been enunciated, but they will not be applied in short term, giving players some short term confidence about brokering deals.

One promising corner of the market in Australia is cross-border property leasing, says Upfold. Arrangers are now looking at doing leases similar to the water treatment plant deals done into Europe. The fixtures and chattels issue (chattels are property items not deemed to be fixed to the land) remains the key hurdle. If an asset is classed as a fixture rather than a chattel it will receive very different tax and stamp duty treatment. Classification as a fixture also raises troublesome legal issues about rights to the asset. Upfold is optimistic that the key issues can be resolved. ?I think we'll see a deal here within a year,? he says.

Packagers may have to target new water plants rather than old: according to one legal source, a cross-border lease on a water treatment plant in Australia was attempted in the last six months but lawyers found it difficult to unwind the existing financing and the deal fell apart.

On a less positive note, the Australian synthetic lease business, which has benefited in recent times because tax driven leases are the prime target of current Australian tax revisions, may soon also be the subject of increased regulatory scrutiny. In September last year the Australian Securities and Investments Commission (ASIC) highlighted its concern about what it termed as ?inappropriate accounting for complex lease agreements.? The ASIC, says a banking source, singled out a Broken Hill Proprietary lease for special mention at the time. However, in the six months since, market participants have not detected any further steps by the authorities to further examine or clamp down on synthetic lease transactions.

The leasing business is meanwhile awaiting the outcome of two appealed cases in the courts which have implications for the attractiveness of sale-and-leaseback structures. Eastern Nitrogen Ltd was the lessee in one case and Metal Manufactures Ltd the lessee in the other. The two cases saw contradictory rulings regarding deductions for rental payments on fixtures.

According to King, the decision in the Eastern Nitrogen appeal (the taxpayer's appeal to the Full Federal Court in the was heard on 21 and 22 August 2000) was that a sale-and-lease-back arrangement was ineffective to create a lease as the ammonia plant in question was a fixture. Consequently, the taxpayer was not entitled to a deduction for rental payments made under the arrangement.

In the Metal Manufacturers case, which was heard on 23 August 2000, the tax commissioner had appealed against a decision that rent paid under a sale-and-lease-back arrangement for plant and equipment was deductible, despite the court's finding that these were fixtures. Despite the fact that it is now over six months since the appeals were heard the verdicts have not yet been handed down.